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***Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.***

## The EBF welcomes the opportunity to express the views of the EU banking industry[[1]](#footnote-1) on the EBA consultation paper on Draft Guidelines for Common Procedures and Methodologies for the Supervisory Review and Evaluation Process (SREP) under article 107(3) of Directive 2013/36/EU (CRD IV).

## The EBF considers that the SREP Guidelines paper are a central part of the supervisory framework which will be instrumental in establishing a common procedure for the supervisory review and assessment of firm specific capital and liquidity requirements. These guidelines also inherit the valuable work initiated by the former Committee of European Banking Supervisors (CEBS) materialised in the CEBS guidelines No. 39 (GL39)[[2]](#footnote-2). We note that the draft guidelines currently proposed are intended to update and enhance the scope of the former GL39.

## The EBF appreciates the significant work undertaken by the EBA in the preparation of these Guidelines. Nevertheless, it is important to ensure that the finalised SREP Guidelines are robust and practical and can be applied across the EU. The EBF observes that for some EU jurisdictions this will represent a step change, whilst for others it appears to be close to current practice.

Although the EBF supports the introduction of EU wide practices, there are various aspects in the Guidance for which the EBF and the EU Banking Industry would welcome further clarification.

We thank you for extending the deadline and for the willingness to carefully discuss relevant issues in the meeting with the EBF of 13 October 2014. We would appreciate your consideration of the points raised in this letter.

## **Key Points**

1. The SREP framework
2. Scope of the SREP
3. Dialogue between supervisor and bank
4. Sheer pillar 2 and not just pillar-1-plus
5. Recognition of diversification
6. Evaluation of Business Model Analysis and Strategy
7. The meaning and interpretation of supervisory scores
8. Transparency of evaluations?
9. Peer Analysis Review and Use of Benchmarks
10. Level of Consolidation
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13. Interest rate risk in the banking book (IRRBB)
14. SREP liquidity assessment
15. Evaluating the complexity of IT
16. Consistency of Operational Risk definitions
17. Assessment of risk concentration
18. Order of the Pillar 2 capital requirement

## **Rationale of EBF key points**

1. **The SREP framework**

The EBF and the EU banking sector support the aim of the Guidelines to converge supervisory practices across the EU and introduce a common approach. We consider that this is particularly important as there are a wide variety of practices in particular to assessing Pillar 2. Our view is that a harmonised approach will help promote a level playing field within the EU. In addition we consider that it is particularly important to ensure an appropriate degree of harmonisation in disclosure requirements otherwise the comparative data will be misleading and may result in unintended consequences i.e. one bank being judged at having more weaknesses than another when the differences are actually framework differences rather than actual differences.

The EBF agrees with the EBA’s approach which it set out in our meeting on Monday 13 October 2014 which we understand has involved taking all the practices from across the EU, selecting the best practices and amalgamating into Guidance.

Whilst we fully support the aim we consider that as the EBA requirements are Guidance not Rules, the EBA will need to work with national regulators and conduct follow up work to ensure that the Guidelines are being implemented equally and in the same manner across the EU. In addition, we are keen that this does not result in a standard ‘tick box’ approach and the highly interactive and qualitative approach operated in some jurisdictions is maintained. Given the diverse nature of Europe’s banking and financial industry, we consider that proportionate judgment-based SREP practices are essential to ensure that risk is effectively addressed under the SREP framework.

1. **Scope of the SREP**

We note that the proposed guidelines widens the scope of the SREP to cover relevant matters related to the supervision of banks. The EBF would like to express its opinion about the main areas newly covered in the SREP:

* Incorporation of Liquidity and Funding Risks: We consider that the methodical assessment of risks to liquidity and funding is an important enhancement that should bring further consistency across supervisors supported by a common framework for evaluation. However, we believe that the EBA should consider that the Internal Liquidity Adequacy Assessment Process (ILAAP) is still a nascent area compared to the longer established Internal Capital Adequacy Assessment Process (ICAAP). There should be a call for caution to ensure consistency of approach and outreach across the EU.
* Business Model and Strategy Evaluation: Whilst the EBF and the banking industry considers that the supervisory evaluation a bank’s business model and strategy is an important safeguard to guard against business models developing in a direction whereby they are vulnerable to collapse and pose ramifications for financial stability, we are concerned about the direction taken in the draft guidelines. The EBF and the banking sector considers that Business Model Review and Strategy should not be evolved into a process whereby supervisors effectively make decisions regarding the likelihood of success of a business strategy or unnecessarily veto business decisions resulting in a loss of competitive opportunity. The EBF is of the opinion that this area should be only informational, just an input on the background against which the prudential compliance of the bank should be assessed. It should aim at putting the other SREP elements in context and at identifying risks and vulnerabilities that should be subject to the supervisory dialogue. The proposed assessment including evaluation of the business model and strategy of banks being expressed in a score seems to go beyond the remit of supervisory compliance. In short, the EBF advocates the removal of the score to business model and strategy. Supervisors can assess this factor without scoring it. Such analysis informs the supervisory score of other factors wherein the business model and strategy are useful.
* Stress Testing: We understand that the introduction of regular supervisory stress testing in the SREP incorporates the use of a forward-looking approach in the supervisory evaluation. Our concern is about the role of the bank’s internal stress testing in the new setup. A bespoke stress testing like the internal one can contemplate future events of particular relevance for the bank and tone down others that would have less of an incidence. Standardisation may undermine the individual significance for different banks.
* Reflecting Macro-Prudential Requirements: As required by CRR[[3]](#footnote-3) and CRD IV[[4]](#footnote-4), the scope of Pillar 2 is intended to incorporate provisioning for macro-prudential concerns. The EBF agrees with the approach for national supervisors to undertake a reconciliation of the additional own funds requirements with the CRR and CRD IV buffers and any macro-prudential requirements. In order to avoid double counting of risks and provisions, the EBF would welcome clear direction in the Guidelines that national supervisors must not set additional Pillar 2 own funds requirements where the risk is already covered by a required capital buffer or has been offset by additional macro-prudential requirements. This clarification should allow for proper delimitation of risks and policy tools in the realm of macro-prudential oversight.
* The link to the Bank Recovery and Resolution Directive (BRRD): There appears to be changes to the meaning and significance of the SREP evaluation. The SREP evaluation was initially intended to be an assessment of the capital required on a going concern basis, both under normal conditions and under stressed conditions. Care needs to be taken that the SREP assessment does not become an assessment of the likelihood to fail. Providing an institution with a score that it is likely to fail could probably have implications. The significance of the score becomes critical as it could trigger debt conversion into capital and eventually write-off via the comprehensive bail-in tool. As a result, the intrinsic value of debt instruments could be affected. These facts require careful attention to the implications on banks and the market.
* Any comments or guidelines in respect of recovery planning should mirror those referred to in the Commission delegated act contained in EBA final draft regulatory technical standards (RTS) on the assessment of recovery plans[[5]](#footnote-5). Equally all EBA RTS associated with the BRRD should be consistent with the SREP guidelines. Otherwise there is a risk of divergent developments.

1. **Dialogue between supervisor and bank**

It is not clear from the draft text that the interaction between bank and supervisor has been preserved in the new Guidelines. Our understanding is that the SREP was conceived to promote understanding and dialogue between the parties involved. The proposed guidelines barely mention a dialogue and challenge session with it looking more like a one-way process in which there is little recognition of the role of banks. We note from our meeting with the EBA on Monday 13 October 2014, that this is not intended to be the case and would be most grateful if the EBA should make it clear in the Guidelines that the SREP is intended to be a highly interactive and inquisitive process between the supervisor and the bank. Such interaction was apparent in the former CEBS guidelines No. 39 (GL39)[[6]](#footnote-6) which also recognised the need for a final exchange with the senior management of the bank before arriving at conclusions[[7]](#footnote-7).

In addition, the Guidelines contain considerable detail of the considerations that supervisors should take into account when assessing each risk. However there appears to be little assessment of the use of risk mitigants which are an important and key part of the risk management framework. Effective risk mitigants can considerably reduce risk and the likelihood of a risk crystallising. The guidelines should in our opinion give appropriate weight to taking this into account and recognising the effectiveness of any tools and techniques employed. The EBF has long maintained that a 5-step process should be followed in pillar 2 supervision whereby the supervisor would be expected to:

1. Gain a thorough understanding of the bank’s ICAAP;
2. Open the dialogue with the bank;
3. Challenge the points that deserve more attention or further qualification;
4. Agree conclusions between supervisor and bank thus enhancing communication and understanding;
5. Make recommendations, impose corrective measures if need be and, ultimately, evaluate the situation of the bank using the scorecard.

The document describes how supervisors should conduct a SREP, but not how institutions should organise their ICAAP, nor how and when should they provide their supervisors with which information on their ICAAP. No reference is made to any new ICAAP guidelines which clearly are necessary to achieve the primary objective of the SREP guidelines of establishing a consistent way for reviewing and assessing institutions with similar risk profiles and business models subject to broadly consistent supervisory expectations, and, thus, providing a level playing field for banks in the context of SREP. The guidelines could be enriched with clear indications on the information that will be requested from banks during the SREP.

The bank should be able to put forward its self-assessment and have it understood by the supervisor before proceeding with the scoring phase. In the absence of supervisory founded objections the self-portrayal of the bank, which is in part enshrined in its ICAAP, should prevail. This principle should be included in the guidelines.

If the competent authority decides to take a supervisory measure as a result of the SREP, the authority shall state its reasons. The statement of reasons is to contain all material facts and legal provisions on which the authority's decision is based, including a reaction to any objection that the institution may have brought forward in the dialogue preceding the final SREP decision.

Finally, it is important to weigh the changes that the start of operations of the Single Supervisory Mechanism (SSM) will bring in a significant part of the European supervisory community. Reportedly, the SSM has allocated supervisory duties to officials of different backgrounds and nationalities in pursuit of a common supervisory culture. The EBF considers essential to achieving success that an environment of dialogue between the new supervisors and their banks is created. Such a climate of common understanding could benefit from further recognition to the interaction between supervisor and bank in the SREP guidelines under way.

The above observations could be extended to the Internal Liquidity Adequacy Assessment Process (ILAAP) when a harmonised framework is implemented throughout the EU.

1. **Sheer pillar 2 and not just pillar-1-plus**

On the evidence of the draft guidelines, we also foresee a blurring of the current distinction between pillar 1 and pillar 2. We find it a good practice in some countries that economic capital is currently calculated under Pillar 2 on the strict condition that overall Pillar 1 requirements should not be undercut. The purpose of this calculation is to have a basis for risk management processes. As we understand it, the new approach will require a comparison to be made per risk between the Pillar 1 capital charge, the capital requirement calculated using the bank’s internal risk model and an amount calculated using a prudential benchmark model. In practice, we presume the highest of these three amounts will be taken as a (worst-case) yardstick. If it is above the Pillar 1 capital charge, an add-on for the difference will be imposed. These additional capital requirements for credit risk, market risk and operational risk will be added together and then supplemented further with a capital requirement for interest rate risk, model risk and reputational risk. No diversification effects will be taken into account. The objective of this exercise is to calculate the worst possible overall risk scenario facing the bank. We do not believe this is a viable approach suitable for the management of a bank. Pillar 2 would be diverted from its intended purpose and downgraded to a “Pillar 1 plus”.

We would instead suggest the following approach which is already in place in a couple of EU countries:

1. The first step is for the bank to calculate its overall need for economic capital and to discuss the outcome with supervisors.
2. This amount is then compared with the overall capital requirements determined under pillar 1.

In this context it must be mentioned that it should be permitted to take account of diversification effects in the first step as long as they make good economic sense. To arrive at figures that can be realistically used for risk management purposes, it is particularly important to consider diversification effects when it comes to risks determined by the same risk factors, such as general market risk and interest rate risk in the banking book, or credit default and credit spread risk.

1. **Recognition of diversification**

The EBF has noted that the guidelines do not recognise the benefits of diversification. However Article 98 CRD IV clearly provides that the review and evaluation performed by competent authorities shall include the impact of diversification effects and how such effects are factored into the risk measurement system.

The incentive to build well-diversified portfolios should remain. Diversification cannot be neglected in the supervisory evaluation as it is an essential element of bank business in all of its forms:

* Inter-risk (credit risk, market risk and operational risk);
* Intra-risk in different geographies and portfolio types;

Otherwise this assessment framework would be incomplete and a proper assessment of the banks is hampered.

Furthermore, we note that Commission Implementing Regulation (EU) No. 710/2014 provides that SREP reports shall be supplemented with a summary of capital adequacy assessment that includes inter-risk diversification effects[[8]](#footnote-8).

A simple example can illustrate the consequence of the current proposal which does not recognise inter-risk diversification:

|  |  |  |  |
| --- | --- | --- | --- |
| Required capital | Pillar 1 | Pillar 2 | SREP approach |
| for risk 1 | 300 | 400 | 400 |
| for risk 2 | 300 | 200 | 300 |
| total | 600 | 600 | 700 |

Although in this example the regulator and the institution would agree on the same appropriate capital requirement of 600, the SREP approach would, by taking the highest requirement on a risk-by-risk basis, impose a higher capital of 700. The greater number of risks are subject to this treatment the more overly conservative the result.

The guidelines should recognise the cross-border business model based on subsidiaries which are fully independent from a capital and liquidity point of view. This business model implies that the subsidiaries are financially independent from the parent company, they have their own ratings and tap the market without recurring to the parent company and without its support, hence with no risk of contagion within the banking group. In addition to the geographical diversification, the variety of sources of funding adds another type of diversification that should be taken into account. This fact should be recognised in the section of SREP capital assessment and taken into account in the business model analysis.

1. **Evaluation of Business Model Analysis and Strategy**

The EBF recognizes and understands that supervisors must consider and understand the business model and the strategy of the bank that they supervise if supervision is to be effective. However, the mandatory expression of the business model appraisal in the form of a score poses serious issues:

* We think that setting a score to the business model is out of scope because the remit of supervision should be confined to the evaluation of compliance within the regulatory framework rather than assessing and grading the viability of the business model and business strategies. Appending a score may result in unintended consequences and effects on the share price of the firm.
* Setting a score risks driving banks to all have the same business model. There are as many business models as banks and all of them are, in principle, legitimate and serve a need in the financial market and the broader economy. The diversity of business models contributes to the stability of the financial system. The use of scores to discriminate between business models would lead, inevitably, to the presumption that certain segments, products, geographies, credit grades or financing purposes are worse than others. Inputting this factor into the SREP scorecard could mar the credibility of the scoring system.

Finally, we support that the business model is implicitly valued in other factors like the funding profile of the bank, as the EBA proposes, but we cannot support to score the business model itself as a separate factor.

For these reasons, we would urge the EBA to consider the following recommendations:

* To maintain the content of the chapter on business model analysis (title 4) as it is but without assigning a score.
* To articulate the conclusion of the supervisory opinion about the business model and strategy in a qualitative complementary note attached to the SREP evaluation. For this purpose, the statements that EBA puts forward in the column of “Considerations” (table 2 – pages 38 to 40) can perfectly serve as a uniform guide for supervisors to ascertain their opinion on the entity. In addition, supervisors would be free to add comments, nuances and explanations in their complementary notes.

In conclusion, we think that the removal of the mandatory score is a better solution:

* Supervisors are not mandatorily required to express in a single number the results of such a subjective evaluation.
* It does not impede supervisory judgment from influencing the SREP overall score.
* In the recurrent SREP exercises supervisors can check the entity reaction to previous comments on their business models and strategies and adjust their qualitative assessment accordingly without the symbolism entailed in a numeric grade evaluation.

1. **The meaning and interpretation of supervisory scores**

The EBF supports the use of a scorecard as a means to identify areas where supervisory efforts should be focussed and to evaluate the findings of supervisors using a common scale, in particular for cross-border banks. From a practical point of view the following circumstances should be carefully considered for a successful implementation.

* Although a similar scoring system has been used by the EU supervisory community since the issuance of the GL39 in 2010, the experience accumulated is still limited and practices are still quite diverse among different EU supervisors.
* The implications of the proposed guidelines on SREP are considerably greater than in the current SREP. Whereas the mechanics remain similar the proposed guidelines introduce an element that has critical consequences on banks and the market. The score is meant to represent the distance to failure of a bank according to the supervisor’s perspective and it could trigger the conversion of contingent debt instruments into capital. In the same token, a downgrade (or an upgrade) implies a change in the perceived distance to failure of the institution therefore in the value (not necessarily in the price) of convertible instruments.
* It seems highly unrealistic that the supervisors can come to the conclusion, after performing the SREP, that the institution (especially category 1 or 2) is “Failing or likely to fail” on SREP assessment alone. The institution will need to have depleted the combined buffer requirements, requiring enhanced supervisory actions, including being submitted to a capital conservation plan and early intervention measures by the supervisor, before becoming “Failing or likely to fail”. In that case, the status of the institution is well known to the supervisors and the supervisory interaction with the institution is well beyond the SREP process.

Therefore, EBF recommends that:

* The scores should not aim at representing the distance to failure;
* The grade “Failing or likely to fail” is removed; and
* The scores should be used to identify areas where supervisory efforts should be focused.

Regarding the link with the resolution framework, as the SREP is a somewhat burdensome process that runs periodically, its outcomes will inevitably become a lagging indicator. As acknowledged in the draft guidelines, there is an overlap between CRD IV and BRRD that requires clear delimitation of the remit and coordination points between competent authorities and resolution authorities. We assume that the EBA will address the framing of such relationship in due course.

The semantics are also important, in our opinion. The draft guidelines introduce a scoring methodology which is expressly linked with the determination whether an institution is “failing or likely to fail” and with its viability. At the same time the scores are all defined as “pose an X risk to the viability of the institution” wherein X is “no discernable risk” (score 1) to “high risk” (score 4). The draft guidelines label all these scores as “positive grades”. However, it may easily be the case that public and market perception will be negative for each of the scores other than 1. If this were the case then the methodology would be unnecessarily stigmatizing and counterproductive. This is compounded by the fact that an institution cannot get a real positive score like for instance sufficient, more than sufficient, excellent or best-in-class. Somehow ‘no discernable risk’ sounds as ‘just adequate’.

The problem of the semantic is compounded by the fact that there is no quantitative information to anchor the qualitative assessment of scores. For example, when a credit rating agency assesses the creditworthiness of an institution the score is automatically associated to a probability of default in a certain period of time (e.g. one year). That probability of default confers meaning to the assessment and makes it sound, comparable and reliable (or not). But a supervisory estimation of the viability of a bank with no expression of the probability of occurrence leads to a wide range of interpretations. In the face of such uncertainty interpretations tend to conservatism.

It can be argued that the scores, the assessment and their interpretation will be retained solely within the domain of the supervisory community and that there will be no external access to such information. If that is the case throughout all supervised entities and during the indefinite time period that these guidelines are meant to be applied, the abovementioned concerns will not be relevant. Just in case, we prefer to err on the side of caution. A discussion on the question of transparency follows in the next point.

1. **Transparency of evaluations?**

In our opinion, this dilemma is a critical aspect of the new SREP. We think that the use of a scorecard, which is supported by the EBF, inevitably entails implications that should be carefully addressed. There are at least three options with different advantages and drawbacks:

1. No reference to the disclosure of scores in the guidelines.
2. Indication in the guidelines (or elsewhere including orally) that the scores should only be known by supervisors.
3. Indication in the guidelines of the terms for disclosure of scores to banks and, potentially, to other stakeholders.

The first option is tantamount to leaving the decision to supervisors. Ambiguity and divergent approaches could appear among supervisors.

The second option could work theoretically but there are grounds for thinking that the risk of leaks and public disclosure will be high due to the mounting pressure that can be expected from the effects that the scores will have on the value of debt instruments and the sheer number of institutions and supervisors involved.

The third option would overcome the problems of potential divergences and partial leaks of the two other options however it would put much pressure on the accuracy of a scoring system that has short history and is central to the credibility of the European framework of supervision.

We note that SREP scores are currently known by banks in many countries and there does not appear to be unintended consequences so far.

Every option would require certain reconsiderations to the content, language and meaning of the SREP methodology proposed in these guidelines.

It can be strongly argued that the scores should not be publicly disclosed but confined to the supervisory and banking community. As long as this privacy is maintained, the market price should remain unchanged irrespective of variations in supervisory scores. But the intrinsic value of debt instruments would be in fact altered even if not known outside the supervisory community. This grouping includes all the members of the college of supervisors in cross-border banking groups thus involving in many cases non-European supervisors whose supervisory practices on this question may differ.

In conclusion, it all leads to think that considerable tension will mount up around the scores due to the direct link with the triggers for resolution envisaged in the bank recovery and resolution directive (BRRD) that comes into force on 1 January 2015 and the bail-in element a year later.

1. **Peer Review Analysis and Use of Benchmarks**

The draft guidelines generally encourage supervisors to conduct peer analysis as part of evaluating individual institutions. Benchmarks potentially provide a valuable tool in ensuring consistency of application of supervisory measures between institutions and in ensuring that supervisory objectives can be assessed and met. However, caution must be taken in their application. Benchmarks should be risk sensitive and take account of the different risk appetites and market segments taken by different firms whose portfolios are used to construct the benchmarks.

The use of peer analysis may not be appropriate if the peer group does not reflect the institution's operating environment in terms of geography, product offerings, segments, etc. If peer groups do not match an individual institution, the latter could incorrectly appear to be an outlier. Benchmarks applied should be free of embedded supervisory floors/caps and should not be used to increase conservatism within bank estimations in a non-transparent manner. It should also be indicated that data is drawn from the same time period to avoid the effect of differences due to changes in the underlying economic environment.

The guidelines should specify in further detail the process for determining additional own funds requirements, particularly in relation to unexpected losses where supervisory benchmark calculations are used to support this determination, thereby ensuring a consistent and transparent approach is applied.

We find it important that the guidelines include cautions regarding the risks associated with an inappropriate use of peer group analysis. Peer group analysis always bears the danger of fostering herd behavior which clearly should not be the outcome of a supervisory review and evaluation process.

The guidelines should also address the consideration of national discretions because, as long as some of them persist, comparisons could be distorted and the level playing field dismissed.

The enhanced dialogue between supervisor and bank should address the benchmarks. Institutions should understand how the benchmarks are calculated and how the results can be interpreted; on this basis only, the comparison between internal quantifications produced by institutions for ICAAP purposes and supervisory benchmarks can lead to a satisfactory and relevant outcome.

1. **Level of Consolidation**

It is a longstanding claim of the EBF that the SREP be performed in cross border groups only at consolidated level. EU cross-border banks should not be subject to solo level evaluations of subsidiaries performed by host authorities without considering that the subsidiaries are part of a group strategy. In our experience, local evaluations on a standalone basis produce misleading SREP results, countermeasures and requirements at subsidiary level that negatively affect group strategies and risk management frameworks.

Within the scope of the Single Supervisory Mechanism (SSM), cross-border banking groups should be subject to a single ICAAP and ILAAP assessment.

In case of a central body with credit institutions affiliated to it that are wholly or partially exempted from prudential requirements in national law in accordance with Article 10 of Regulation (EU) No 575/2013, the requirements of these Guidelines shall only apply to the central body and the affiliated credit institutions as a whole on a consolidated basis. For that purpose, any reference to an institution shall include a central body and all credit institutions permanently affiliated to the central body as referred to in Article 10 of Regulation (EU) No 575/2013 as a whole on the basis of the consolidated situation on a consolidated basis. Any reference to a group shall include a central body and all credit institutions permanently affiliated to the central body as referred to in Article 10 of Regulation (EU) No 575/2013 and their subsidiaries.

1. **Categorisation of institutions**

The categorisation of the institution is fundamental to the operation of the individual and overall SREP on a proportional basis. While category 1 institutions may potentially be easily identified, more clarification would be helpful on how the Competent Authorities would categorise institutions that fall into category 2 or 3, especially if borderline. We assume that the intention is that banks of similar size and complexity that do not impose a systemic risk qualifying as Other Systemically Important Institutions (O-SII) should be categorised similarly across the European Union, independently of the size of the market in which they operate. In that case, this purpose should be clearly reflected in the text.

1. **Composition of own funds to cover Pillar 2 capital requirements**

The draft guidelines specify that competent authorities shall set a composition requirement for the additional own fund requirement under Pillar 2 of at least 56 % CET1 and 75 % Tier 1. Though the proposed ratios are in line with the Basel III requirements (4.5% CET1; 6% T1 and 8% total capital), the EBA proposal poses a potential problem of global uneven playing field.

Further, these proposed quantitative restrictions on Additional Tier 1 instruments (44 %) and Tier 2 instruments (25%) follow a different approach than the current one in some member states, where competent authorities have recognised Additional Tier 1 instruments and Tier 2 instruments with additional trigger features for write downs or conversion to equity as eligible to cover Pillar 2 capital requirements. The EBF urges the EBA to consider this same approach in the guidelines.

Otherwise, additional tier 1 and tier 2 instruments with additional trigger features that are recognised by competent authorities to cover Pillar 2 capital requirements shall, at least, be protected by a grandfathering clause. The deferred implementation date until 1 January 2019 would not be sufficient because of the long effective maturity of many such issued instruments.

1. **Interest rate risk in the banking book (IRRBB)**

The industry is not in a position to deliver final views on the IRRBB part of the draft Guidelines on SREP before the Guidelines on IRRBB are finalised and issued. Pending the publication of the final guidelines on IRRBB, we would like the EBA to take into account the following considerations:

* In the current interest rate environment, a 200 basis points shock is not necessarily adapted to all circumstances and rate environment. This is currently illustrated with very low interest rates in Europe, Japan and the US, whereas rates are higher in other economies. Additionally, the EBA Guidelines on IRRBB refer to a shock equivalent to 1st and 99th percentile which, in 2006, was broadly equivalent to a 200 basis points shock. We recommend to change the wording of +/-200 basis points for a ‘standard shock’.
* The number of shock scenarios should be limited.
* Whether an institution pursues an earnings or economic value approach should be left at the choice of the institution. The choice of limits should be consistent with the risk management strategy and risk appetite of the institution. Whether an institution pursues an earnings or value proposition will tilt the focus on what metric is deemed more appropriate.
* As the interest rate risk is symmetric, there is no prudence-bias that should be referred to IRRBB prudential framework. We recommend replacing ‘sound’ with ‘prudent’.
* The standardised outlier test should be calculated in line with banks IRRBB management and assumptions. Removing equity from the standard test for banks that are modelling their equity creates a significant discrepancy between the actual management (for which equity capital is invested in fixed rate assets to stabilise earnings over time) and the prudential standard test. We recommend that the standard test is calculated so as to be consistent with the IRRBB assumption framework of the bank. Such assumption framework is decided at the highest level of the organisation and subject to strong governance including independent review and validation of main assumptions by senior management.

Credit spread risk in the banking book is also included in the work undertaken by the Basel TFIR but the scope has not yet been defined. We suggest waiting for the results of the TFIR discussions.

1. **SREP liquidity assessment**

We are concerned that so detailed and comprehensive liquidity requirements could prove too onerous in aggregate. There will be a significant amount of subjectivity required as the responses to the requirements by institutions will be individually interpreted and assessed by the regulator.

The Competent Authorities should clarify, at an early stage, the data requirements for supervised institutions necessary to meet the SREP liquidity requirements. This is vital to allow institutions to implement any resulting information technology changes, which typically may have significant lead times.

Supervision of the Liquidity Coverage Ratio (LCR) should be consistent with the LCR assumption set. For example, in the definition of the LCR’s High Quality Liquid Assets (HQLA) reverse repos are supposed not to have to be returned since the reverse repo is assumed to roll over. It is important not to be penalised twice, once by considering that the inflow of the reverse repo is assumed not to be received (due to the roll-over) and to assume that the borrowed security has to be returned.

Supervision should not further stress the already extremely highly stressed LCR. It seems extreme to add additional stress factors on top of the LCR which by itself combines two extreme idiosyncratic and systemic stress scenarios. Quantitative requirements are suggested that would impose even more severe liquidity requirements than the already extremely severe LCR and NSFR. Though those regulatory requirements could in theory be adapted to an evolving environment, any potential issue should be addressed globally for the entire industry, and not discretionary applied, without clarified governance, to a specific bank. This would risk creating an uneven playing field. We seek clarity on the governance of discretionary quantitative measures suggested by the competent authority.

1. **Evaluating the complexity of IT**

The management of the complexity of IT architectures and systems is of increasing relevance. Hence we understand the general requirement to introduce the assessment of IT complexity in regulatory considerations. However, we consider it is problematic that complexity is usually an intuitive and subjective metric which is based on difficulty and incomprehensibleness. The assessment of complexity of IT architectures and systems is regardless of long lasting research activities still lacking a common market standard. Existing models use a combination of different indicators. However, absolute values of these indicators are not seen to have any explanatory power. Instead the combination and development of the indicators need to be evaluated. Hence cross-industry comparability is missing. Given that we consider it inevitable to introduce common and comprehensible metrics to regulatory assessments of IT complexity.

1. **Consistency of Operational Risk definitions**

Operational risk and conduct risk are standalone risk types and should be treated separately. The assessment of these risk types should be clearly structured and reflected in the organisation of the guidelines (e.g. with a dedicated subsection). Furthermore rather than include reputation risk within the operational risk assessment then this should be viewed as an impact of negative events in other risk types and thereby excluded from this section of the guidelines.

The definition of model risk[[9]](#footnote-9) as part of the operational risk should be regarded consistently with the definitions stated in other regulations. As per CRR IV model risk is defined as “the potential loss an institution may incur, as a consequence of decisions that could be principally based on the output of internal models, due to errors in the development, implementation or use of such models”. In addition the EBA consultation to RTS “Assessment methodologies for the Advanced Measurement Approaches for operational risk“ Article 5 (5) gives the precisely definition: As a specification of the paragraph 5(4), the following events, and the related losses, shall be excluded from the scope of operational risk: (a) events due to wrong selection of a model, made through a formalized corporate process; and (b) losses caused by a pricing model where the potential exposure to the model risk had been previously assessed. To reach overall consistent regulations corresponding specifications should be adopted in the SREP guideline. With regard to para 225(b)(ii). It should be specified that only operational risks are, in this issue, part of the operational risk assessment and not eventually occurring credit risks.

1. **Assessment of risk concentration**

This issue concerns the assessment of the level of credit risk concentration where the draft guidelines point to the need to consider the effect of potential high correlation between exposures when considering concentration risk. Although Herfindahl Hirschmann Index (HHI) and Gini coefficient were listed as example of quantitative measures and indicators, there are other, typically more sophisticated, measures of correlation and concentration risk measurement that can also be used to measure such effect (e.g. Economic Capital models). These are based on empirically derived measures of loss volatility and correlations. We believe the measurement approach for credit concentration risk should not be prescriptive and should be proportionate to the bank size and business model. Inappropriate use of simple quantitative measures and indicators can produce very misleading results. Therefore, we suggest that the reference to HHI and Gini coefficient is removed from the guidelines.

In the case of IRB institutions, credit risk concentration is already factored in the calculation of Pillar 1 risk-weighted assets. As a general principle, pillar 1 should be respected. Additional charges via pillar 2 should only be imposed if there is clear evidence of extreme concentration.

In the case of standardised approach, there are good practices for the estimation of concentration risk for small banks in the current supervisory landscape that could help overcome the problem of proportionality.

1. **Order of the Pillar 2 capital requirement**

We observe that the pecking order of the different layers of capital requirements matter. However, it is ill-defined in CRR and CRD IV. In particular, article 141 CRD IV sets the rules for restrictions on distributions. There is no clarity as to whether the Maximum Distributable Amount (MDA) will be calculated for institutions that fail to meet the combined buffer before consuming the Pillar 2 additional requirement or only after depleting it.

In practical terms, it can be argued that Pillar 2 is an uncertain and volatile requirement for institutions. This affects the capital planning of the bank. The Pillar 1 requirement is known in advance. So is the combined buffer. But the Pillar 2 requirement is unpredictable for the bank until the end of the SREP process. The thresholds of restriction to distributions could be hit as a result of the SREP with no time for the bank to set out a plan.

Against this background, we think the question of whether to place Pillar 2 on top of all requirements or between Pillar 1 and the combined buffer deserves careful consideration. The EBF stands ready to discuss about it and to provide with practical views to regulators and supervisors involved.

1. Contact person at the EBF Secretariat: Gonzalo Gasos ([g.gasos@ebf-fbe.eu](mailto:g.gasos@ebf-fbe.eu)). [↑](#footnote-ref-1)
2. Guidelines for the joint assessment of the elements covered by the supervisory review and evaluation process (SREP) and the joint decision regarding the capital adequacy of cross-border groups (GL39). [↑](#footnote-ref-2)
3. Regulation (EU) No 575/2013 (“Capital Requirements Regulation”). [↑](#footnote-ref-3)
4. Directive 2013/36/EU (“Capital Requirements Directive IV”). [↑](#footnote-ref-4)
5. EBA/RTS/2014/12 where Article 5(3) (a) (iii) refers to CRD IV. [↑](#footnote-ref-5)
6. Point 14: “In the spirit of ICAAP-SREP dialogue discussed in the GL 03, the process of the joint assessment should involve a close interaction with the banking group in question”. [↑](#footnote-ref-6)
7. Point 14: “Dialogue between the group, its entities, and relevant supervisors to discuss the results of the assessment”. [↑](#footnote-ref-7)
8. [Link to Implementing Regulation 710/2014 (see Annex II; Table 2; Line F)](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0710&from=EN). [↑](#footnote-ref-8)
9. Paragraph 225(b)(ii). [↑](#footnote-ref-9)