



Fédération Bancaire Européenne
European Banking Federation
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Mr José María Roldán
Chairman
Committee of European Banking Supervisors
Banco de España
Alcalà 50
28014 Madrid

Brussels, 31 August 2004

Subject: Consultation paper on the application of the Supervisory Review Process under Pillar 2

Dear Mr. Roldán,

The European Banking Federation (FBE) welcomes the opportunity to comment on CEBS' consultation paper on the Supervisory Review Process (SRP). We congratulate CEBS for this initiative which we believe represents an important step forward in terms of delivering a common approach to EU supervision.

Pillar 2 goes beyond the prescriptive measurements of Pillar 1 by addressing directly the individual risk profile of each institution. However, in the FBE's response to the European Commission's CP3, we expressed our concern that the SRP had the potential to be the most significant source of inconsistent treatment in the Directive.

The FBE, therefore, believes that the SRP will only work in practice if it is applied at the level of the consolidated group. If it is not, financial institutions will be subject to inconsistent supervisory treatment across subsidiaries and the objective of enhancing the understanding of firms' overall risk profiles will be jeopardised.

In this regard the FBE is disappointed that the proposed recasting Directive leaves open the possibility for Member States to apply the SRP at the level of each individual entity. This would not be interests of depositors and borrowers. It would result in competent authorities having a view of the position in one part of the group, but no overall view, which is a critical problem as many issues, such as strategic and capital planning, but also risk management are tackled at a group level.

The FBE accepts that competent authorities must be in a position to fulfil their legal responsibility for supervision. We believe that this could be delivered by extending the role of the consolidating supervisor to applying the SRP, thus enhancing the quality of prudential supervision whilst respecting authorities' legal position.

The proposals in CEBS' consultation paper will significantly contribute to providing both financial institutions and supervisors with a SRP framework which is practicable and which will deliver the objectives originally outlined by the Basel Committee.

Please find enclosed our detailed comments on the consultation paper.

Yours sincerely,



Nikolaus BÖMCKE

Enclosure: 1



Fédération Bancaire Européenne
European Banking Federation

FBE Response to CEBS' consultation paper on the application of the Supervisory Review Process under Pillar 2

The FBE welcomes CEBS consultation paper which we feel represents significant progress in supervisors' thinking on the Supervisory Review Process. The FBE commends CEBS for producing this first important consultation paper so soon after its establishment. It allows both supervisors and industry to begin work on the implementation of Pillar 2 at an early stage in the process. The FBE firmly believes that the Level 3 implementing measures must flow from the Level 1 principles and the Level 2 technical measures. We, therefore, look forward to seeing these High Level Principles evolve to reflect the final Directive text.

We believe that the proposals set out in the paper should deliver a less mechanistic and more holistic approach to risk management both for supervisors and for financial institutions. Pillar 2 is different, and should be different from Pillar 1: It should be a challenge process and not a compliance exercise.

The FBE believes the overarching objective of a separate Supervisory Review Process is to enhance understanding on the part of the group, and its supervisor, of a groups whole risk profile, including its programme of mitigation or capital planning, thereby reducing the probability of prudential failure in a cost efficient manner.

The following are important base assumptions and high-level principles which reflect the key concerns of the banking industry regarding Pillar 2:

- **The Supervisory Review should be applied at the level of the group;**
- **Pillar 2 must be a firm driven process;**
- **Capital is not the only answer;**
- **Supervisory Review should be a dialogue between firm and supervisor;**
- **Scope of risk assessment should be responsibility of the firm;**
- **Supervisory action should be the exception;**
- **Supervisory action must be justified;**
- **Supervisory Review is a confidential process.**

Taking the above principles into account the FBE would make the following detailed comments on the consultation paper:

It is an absolute priority for the FBE that *the Supervisory Review Process be applied at the consolidated group level.*

It is unclear from the paper how the SRP would work in practice. **The FBE firmly believes that in order to align with the group risk structure operating within most firms Pillar 2 should only be applied at the consolidated group level.** Application of Pillar 2 at sub-consolidated or solo level would lead to double counting of risks and impede institution's ability to design and implement the ICAAP process as set out in the paper. This principle is also relevant to two factors which are not treated in the CEBS paper:

Home/Host provisions

There is no mention in the paper of the coordination between home and host supervisors. Again the FBE believes that Pillar 2 would be applied at the top European consolidated level and supervisory responsibilities would be exercised by the home state supervisor. Only in exceptional circumstances should Pillar 2 requirements be exercised by a host state supervisor. If there is a dispute between the home supervisor and host supervisor and no solution can be determined within a six month period, the home supervisor's requirements should take precedent.

Scope of application

The FBE agrees with the principal in key consideration 19 that supervisory authorities must be in a position to fulfil their legal responsibility for supervision. However, it must be clear what the scope of that responsibility is. The FBE believes that capital should not be separately addressed at the host level if the following criteria are met by an institution:

- there is adequate capital distribution within the group;
- exposures to members of the group are managed and controlled on an integrated basis;
- the parent undertaking has in place a policy to provide financial support to members of its group;

Introductory comments

The FBE welcomes the acknowledgement in SREP High Level Principle I of the need for consistency of application and a level playing field across Europe. This is a fundamental point and should be made more explicit in the introductory comments to the paper.

Supervisory Review Process

The FBE notes that Principle 1 of the Basel Committee's SRP states that banks should have "a strategy for maintaining their capital levels." We believe that this language should be clarified in the CEBS paper. Capital should be kept in line with the risk profile of the institution. Banks should not be compelled to maintain their capital levels in absolute terms, which may be inappropriate from an economic standpoint.

The draft high level principles provide clarification on many of the concerns expressed by industry during the consultation with the European Commission including clear separation of the ICAAP and the SRP processes. The FBE fully agrees that, despite the separation of the two processes, there should nonetheless be a close fit between them.

The SRP must be a firm-driven process

Pillar 2 should be an ongoing, dynamic and open dialogue between firms and their supervisors. **The responsibility rests with the firm to explain its processes, analysis and actions to the supervisor and to satisfy the supervisor that its ICAAP is appropriate for its business.** The supervisor's role is to challenge the firms risk assessment through the SREP.

Key considerations

The FBE welcomes the language in paragraph 16. We believe that the paper provides the necessary level of freedom to institutions to develop and implement tailored approaches to the measurement of Pillar 2 capital. The Pillar 2 process is first and foremost the responsibility of the firm's management and should be integral to the management of the firm.

However, it is important that there is clarity around stress and scenario testing procedures and we feel that CEBS should reflect the language in paragraphs 434-7 of the new Basel Revised Framework for International Convergence of Capital Measurement and Capital Standards. Stress and scenario testing should not require banks to take worst case scenarios into account but to assess the effects of mild recession scenarios such as consecutive periods of zero growth taking into account international diversification.

Additional capital requirements must not be automatic

Pillar 1 is calibrated to generally deliver an adequate regulatory capital charge and will require banks to meet high qualitative and quantitative standards. Additional capital requirements under Pillar 2 should therefore be the exception and not the rule.

We feel that the explicit reference to setting additional regulatory capital in paragraph 17 should be deleted. **Pillar 2 is about the strength of banks and is delivered not just through additional capital but through the quality of**

thinking, management and reputation. It follows that threats to the financial soundness of an institution are not always best addressed with greater financial resources, but systems, controls, management and mitigation strategies. This is explicitly mentioned in paragraph 723 of the Revised Basel.

Additional capital should only be required where there is a clear case that it will provide effective and efficient mitigation of risk. This concept is acknowledged in Principle VIII of the SREP and it is therefore inconsistent to emphasise additional capital add-ons above other tools in this paragraph.

We would stress that financial institutions can operate safely at, or slightly above, the minimum capital requirements. In our view, the consultation paper suggests that significant buffers are warranted and ignores the value of mitigants such as diversification.

Any additional capital requirement should be a net adjustment within Pillar 2. That is, whilst Pillar 2 rightly focuses upon model fit, there can be no presumption that this fit is always negative. We strongly believe that a net adjustment is required where the under and overstatements of required capital produced by poor model fit are netted off. For example, the positive impact of diversification of risk should be recognised. Diversification gives grounds for a negative adjustment within Pillar 2, offsetting unmeasured risks and the results of stress testing. Pillar 2 should not simply sum the areas of capital deficiency and disregard the areas of capital surplus.

Internal Capital Adequacy Assessment Process

The FBE welcomes the explicit recognition of the proportionality principle in Principle II. This addresses industry's concerns on the scope of risk assessment. It is not desirable that supervisory requirements should lay a burden on firms to manage risks to which they may not be exposed.

However this principle should explicitly recognise that proportionality is equally important for larger financial institutions as it is for smaller ones. It is important not only to take account of the risk to a supervisor's objectives that may be posed by the size of a bank but also the levels and complexity of managerial structures involved. Hence for larger institutions it should be recognised that senior management and the Board of Directors may distribute the responsibility for approving relevant risk policies, in particular the policies that have a high technical content, amongst the appropriate senior management levels within the bank.

The FBE agrees with the underlying objectives in the High Level Principles on the ICAAP. However, economic capital is only one dimension in the bank's management. Principles IV and V perhaps overemphasise the ICAAP as a risk management strategy and this could detract from other practices within a bank. This would neither be in the interests of the institution nor the supervisors.

Principle IV of the HLPs refers to the outsourcing of parts of the ICAAP or its review. While the FBE agrees that the CEBS recommendations on outsourcing will serve as a guideline in this regard once they are fully developed, we feel that

CEBS should be careful to avoid restricting institutions from outsourcing on the basis of prescriptive principles. The decision to outsource parts of the ICAAP should be reviewed by the supervisors on a case by case basis.

CEBS itself recognises in Principle VIII that the ICAAP must be comprehensive but that “there is no standard categorisation of risk types”. It is, therefore, unclear why a new risk taxonomy appears in Annex B. A list of this nature neither reflects the diversity in supervisory practice nor the diversity in institutions’ own risk practices. For example:

- reputational risk may already be captured as a combination of operational and business risks in many institutions;
- strategic and earnings risk can be combined in a business risk definition as both risks relate primarily to earnings risk or risk to net operating profit;
- the additional risk to earnings and capital through capital risk is entirely unclear as the composition of capital is defined within the elements eligible for Tier 1, 2 and 3 capital.

Furthermore Annex B reintroduces concerns for the industry that Pillar 2 will become a box-ticking exercise. This outcome would be directly contrary to the objectives set out by CEBS in this paper and should be prevented at all costs. This kind of categorisation of risks could also lead to overlap between Pillars 1 and 2.

Principle VIII states that the ICAAP should be comprehensive and in paragraph (f) makes specific reference to “stress-testing in IRB, residual risk in CRM, concentration risk, securitisation etc”. Firstly the FBE believes that residual risk in CRM should be considered as operational risk. Furthermore it is covered by the haircut in the IRB Foundation and is calculated in the LGD estimation against guaranteed exposures. We do not believe that supervisors should pay special attention to residual risk in CRM except for in exceptional cases.

Secondly on concentration risk and securitisation the FBE believes that the use of the active portfolio management’s techniques (traditional or synthetic techniques to reduce concentration and to optimise the portfolio) should be explicitly considered as a plus for institutions employing them.

Principle VIII(g) states that institutions may take into account risk correlations. The FBE urges CEBS to explicitly recognise that diversification may exist and should warrant capital reductions. In our view Principle X should also make reference to capital reductions for risk mitigation through diversification.

The FBE is highly concerned with the proposal in Principle XI that firms should make disclosures on their ICAAP model for comparison amongst their peer group. Much of the relevant information would be of competitive importance. There are dangers inherent in supervisors encouraging too great a degree of uniformity of practice. Pillar 2 should have a systemic value in allowing institutions to exercise a diverse range of measures and management techniques. The SRP must be, in its entirety, a confidential process.

The Supervisory Review and Evaluation Process

The FBE welcomes the tone of the SREP HLPs and in particular the recognition that both dialogue and quantitative feedback are important to the SRP. We also feel that it should be made explicitly clear that supervisors must respect the day-to-day management of the group while carrying out the review and evaluation.

It is unclear in paragraph 33 of the SREP summary what is meant by “broad disclosure on the RAS”. From the context we understand this to mean that disclosure would be restricted to the supervisors and the bank concerned, or only be related to the methodology which underpins the process. This should be clarified.

The FBE appreciates that CEBS had to wait until the Directive was published before elaborating on Principles II and III. However, it is unclear from the paper how the SREP would work in practice across jurisdictions. The FBE firmly believes that in order to align with the group risk structure operating within most firms Pillar 2 should only be applied at the consolidated group level and the dialogue should be with the consolidating supervisor. Application of Pillar 2 at sub-consolidated or solo level would lead to double counting of risks and impede institution’s ability to design and implement the ICAAP process as set out in the paper.

Furthermore, in jurisdictions which do not have a single supervisor there should be no overlapping between supervision of different sectors for financial conglomerates (for example securities and insurance supervisors). Banking supervisors must ensure that they communicate with, and take account of the work of, other supervisors where business units outside the banking supervisor’s reach are nonetheless regulated.

As mentioned above the FBE welcomes CEBS’ recognition in Principle VIII that additional capital requirements represent only one of several regulatory tools to be used by the supervisor. We would urge CEBS to go further. Principle I of the SREP should explicitly state that Pillar 2 should not automatically require a higher capital standard than Pillar 1.

Furthermore, Principle VIII states that the SREP could lead to prudential measures and other supervisory actions being taken to address deficiencies identified under Principle VII. VIII(b) indicates that a supervisory authority can require credit institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements. In the event that a provisioning policy is imposed, we assume that this will be aligned with the relevant accounting standards so that inappropriate disparities between regulatory and accounting standards will not arise.