Piers Haben, Director of Oversight,
European Banking Authority (EBA)

04/05/2015

2nd Round Table "Frankfurt 120", International Bankers Forum, Maleki Group

Keynote speech of Piers Haben, Director of Oversight at The European Banking Authority (EBA)

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Common European SREP framework and EBA Guidelines

Ladies and gentlemen

It is my great pleasure to be here to discuss the common European framework for the supervisory review and evaluation process (SREP). Our aim is to ensure rigorous supervisory assessments of risks. Assessments which are designed to work with, not against, banks risk management frameworks and to ensure this is done in a way which promotes supervisory judgement at the same time as ensuring convergence and consistency of supervision across the Union. Building a common supervisory culture is one of the cornerstones of the EBA work and vital for the efficient functioning of the banking system across the single market.

I appreciate that many of you in the audience are familiar with our work on SREP, and in fact contributed to the **fruitful dialogue we had with the industry when developing our Guidelines on common procedures and methodologies for the SREP**. This dialogue and responses to the consultation has helped us immensely with clarifying many technical aspects and policy choices our Board of Supervisors had to make. I also appreciate your understanding of the EBA mandate, in particular developing Single Rulebook and increasing convergence of supervisory practices across all 28 member states of the European Union. We aim at achieving this based on our legislation capitalising on the expertise of all European competent authorities, including the SSM. I am particularly glad to confirm that, despite the challenges of the comprehensive assessment and setting up its organisation, the SSM did contribute to the development of the EBA Guidelines on SREP and we have very good cooperation in this regard.

I would like to structure my intervention as follows: first, I will briefly outline the role of SREP, its evolution over time and highlight the need for convergence. Then, I will introduce to you some key issues identified by the banking sector on the SREP guidelines. I will then briefly highlight some specifics of the guidelines that I would like to bring to your attention. Lastly, I wish to share with you a broader understanding of the work the EBA is undertaking on supervisory convergence, with particular focus on the need to ensure consistency and comparability across the Union.

I. SREP as a comprehensive supervisory view on institution

Supervisory approaches are focused on risk-based supervision – proportionate engagement based on the assessment of materiality of risks and control deficiencies. This approach was also supported by the introduction of Basel II, especially its advanced approaches to credit, market and operational risk, which allowed greater specialisation of supervision and a focus more on risk-specific technicalities. I understand some have raised concerns that this has led to creation of a silo based approach, but that is where Pillar 2 comes in. Under Pillar 2, the SREP (supervisory review and evaluation process) is meant to capture all risks, governance and risk management and controls aspects. There has in the past been a tension between the focus on ICAAP and internal capital models on one side and supervisory review of risks on the other and how the two work to challenge each other. Some argue that in the past this balance was too focused on internal capital models but we must also resist the risk of ignoring banks risk management frameworks.

The recent financial crisis has anyway taught us to have a comprehensive view on the institution and consider not only the risks it is exposed to in isolation but, look at them in the context of its business model, risks posed by an institution to the financial system, and to assess the overall viability of an institution. This calls for the SREP to move towards an ongoing supervisory assessment bringing together outcomes of all supervisory activities into an up-to-date view on an institution and its overall viability. The view, which may necessitate application of supervisory or early intervention measures to address any shortcomings. **The expansion of the scope and depth of SREP and moving to an ongoing engagement with an institution is a fundamental premise in the EU-wide common SREP framework.**

It is by means of the SREP that supervisors will ensure that risk models employed by institutions to calculate their minimum capital requirements produce adequate results, and apply a range of supervisory measures to address model deficiencies or underestimation of risk. In the SREP supervisors take into account the quality of assets, including their classifications and valuations, ensuring that we have right foundations for further analysis. **By means of the SREP supervisors will break silos of risk assessment, by putting the outcomes of assessments of individual risks into the context of business model analysis and assessment of internal governance and institution-wide controls.** It is also by means of the SREP that supervisors will be able to fulfil new tasks entrusted to them by new Bank Recovery and Resolution Directive. In particular, by using SREP outcomes as a basis for the decisions on the application of early intervention measures, and to help decide to engage with resolution authorities with a view to trigger resolution proceedings for failing institutions.

Another fundamental premise for the EBA work on SREP is the need to ensure a level playing field and convergence of supervisory practices and comparability of supervisory outcomes across the whole Union. The creation of the SSM will, de facto, harmonise supervisory practices within the SSM, which is welcome. But we will need to work together to ensure that changes in one area do not lead to divergences with other, non-participating jurisdictions, in a way which damages the integrity of the single market. To this end the EBA's mandate on ensuring supervisory convergence across the Union becomes even more important. Under this mandate we have several tools:

- Developing aspects of the Single Rulebook, including the Handbook, addressed to supervisors and dealing with supervisory processes;
- Training of supervisors across the EU to ensure a common foundation and culture for supervision;
- Direct participation in colleges of supervisors and feedback to ensure cooperation and effective joint risk assessments and joint decisions;
- Ensuring effective application of the Single Rulebook and effective assessment thereof;
- Mediation in the event of misunderstandings or disagreements.

It is under its convergence mandate that the EBA issued last year its Guidelines on common procedures and methodologies for SREP.

II. Challenges raised by banks on the EBA Guidelines on SREP

The EBA Guidelines cover all aspects of on-going supervision of an institution bringing together outcomes of all activities supervisors would perform (including off-site and on-site analysis) **into a comprehensive supervisory view considering the overall viability of an institution** given its risk profile, business model and capital and liquidity. The common European SREP framework is built around the assessment of four major building blocks: (1) business model analysis; (2) assessment of internal governance and institution-wide controls; (3) assessment of risks to capital and capital adequacy; and, (4) assessment of risks to liquidity and funding and adequacy of liquidity resources. During the consultation period we received numerous comments and I would like to take the opportunity to address some of these here.

The first is Proportionality and the careful line the Guidelines tread between consistency and flexibility. We take proportionality very seriously. We understand our guidelines have to work in multiple differing cases, different institutions in terms of size, business models and complexity, and differing markets and systems. That is why the common framework and processes stipulated in the guidelines, and the way that they are applied, are subject to the principle of proportionality. To operationalise this principle, we ask competent authorities to allocate all institutions into 4 categories reflecting their size, complexity, systemic importance. These categories will drive the frequency and intensity of the assessment and supervisory engagement with the institutions at various levels. In particular, although some elements will be performed with the same frequency, e.g. quarterly monitoring of key indicators, the in-depth assessment of SREP elements will be required annually (for Category 1 institutions) or on a 3-year cycle for Category 4 institutions.

This categorisation of institutions will also help to set supervisory expectations with respect to the degree of sophistication of risk management and control arrangements expected form the institution.

Other related aspects are relevance and materiality. First, only aspects relevant to an institution will need to be assessed, if a bank is not engaged in securitisation, then there is no need to assess securitisation risk. Second, materiality of risk is paramount, as supervisor should focus more on what is material to an institution in terms of exposure and potential prudential impact. This principle is enshrined into the approach to risk assessment elements, where supervisors can assess and score sub-categories of risk on an individual basis, if those are deemed material. For example, if conduct risk is considered to be material, then it will be assessed individually, otherwise under the operational risk. The decision on materiality is subject to the supervisory judgement, although for some risk (e.g. FX lending risk) guidelines provide criteria.

The second issue raised was the use of scoring. The Guidelines set out common approaches to scoring and, for the sake of illustration, introduce two types of scores – traditional risk scores for the assessment of individual risks to capital and liquidity, and viability scores for the SREP elements and overall SREP score. The EBA provides definitions and some constraints by means of basic 'consideration' for each scores, but the decision to assign each scores is based on **supervisory judgement** – I wish to be clear - there are no indicators, thresholds, or scoring matrices prescribed in the Guidelines.

Thirdly we received comments about the Guidelines' provision of a common approach to the **determination and articulation of additional capital requirements**. This is a hugely important aspect if we want to achieve comparability of supervisory outcomes and a level playing field across the single market. It also provides a solid foundation for the work of supervisory colleges in their annual joint risk assessments and in reaching the joint decision on institution-specific prudential requirements. For the first time we have clarified that additional capital requirements (Pillar 2 requirements) that we call Total SREP Capital Requirement (TSCR) should be seen as a binding requirement below the combined buffer requirements, and that should be met by the same quality of capital instruments as the minimum capital requirements. The EBA also has chosen an approach where minimum requirements on risk-by-risk basis act as a floor also for the SREP purposes and no diversification between risk types is recognised – an approach that is known as "Pillar 1+".

Getting this common approach to the articulation of additional capital requirements was a crucial step for the EBA as until recently we witnessed lack of consistency in how supervisors were setting additional capital requirements, in particular whether such requirements were seen as binding, or breachable buffers, what is the basis for their calculation (ICAAP or other), what instruments are allowed to meet such requirements, approach to the incorporation of stress testing results).

Fourthly, comments identified a risk that the **ICAAP** and dialogue with the institution was being side-lined in our guidelines. We are clear that **ICAAP continues to play an important role as a risk management tool and provided its outcomes are assessed as reliable, is a starting point for quantifying capital requirements**. Supervisory benchmarks and other additional inputs serve mainly to challenge internal estimates or as alternative starting points when ICAAP estimates are unreliable. In this regard I would also like to note the challenges we all facing in quantifying many emerging risk types, both as bank in their ICAAPs and supervisors, in particular growing importance and prudential impact form conduct risk events, information and computer technology risk, interest rate risk in the banking book in the current low (and even negative) interest rates environment. This all deserves your attention in your ICAAP submissions and capital quantifications, and also is the focus of our immediate follow-up work on the development of supervisory benchmarks, which we are currently launching.

III. Specific issues of attention in the guidelines

Some of the elements in the guidelines are relatively new to many supervisors. For example **business model analysis**, where the EBA in addition to the guidelines developed also comprehensive supervisory handbook to help supervisors grasp the range of approaches to assessing the sustainability of business models. Whilst, other elements like assessment of risks to capital have been practiced by all supervisors for some time and the EBA capitalised on reflecting best practices to date. Another example is the introduction of **conduct risk** in prudential terms where the guidelines provide definitions and examples of how conduct risks can have prudential implications – a fact being brought to light only too harshly with billions in redress costs for some banks in recent years. The guidelines also provide ideas for how to assess conduct risk and provide indicators for supervisors to consider. We will be working closely with supervisors this year to identify how this is working in practice.

The **multiple use of stress testing** in the supervisory toolkit is another area of great interest. The guidelines envisage the following role for stress testing: (1) a valuable source of information into the assessment of SREP element potentially highlighting business model vulnerabilities in risk management and controls, or problems with certain risk exposures, (2) a means for testing a banks' ability to meet its capital requirements over the economic cycle (3) an important risk management tool for banks and (4) a broader tool by public authorities to understand issues in the financial system more broadly. The EBA is currently revisiting its guidelines on stress testing, which will include also information on supervisory stress testing, and the interaction between SREP and supervisory stress testing. But for now let me just say that stress tests are key in the SREP, both the idiosyncratic stress test provided by the bank and any information from stress tests run by supervisors. Should the outcomes of stress test reveal problems in a banks' ability to meet its capital requirements, supervisors will have a range of measures to choose from, ranging from requesting capital plans and other mitigating actions from the institution, to revisiting capital requirements, or applying additional requirements for systemic risk purposes in case of system-wide supervisory stress tests.

Supervisory outcomes is another area which is new in the guidelines and we dedicate a specific focus to the determination of additional capital and liquidity requirements, as these are subject to the joint decision process in colleges of supervisors. However, direct capital measures are not the only solution, and we recognise there is room for the application of other measures. The general stance is, that additional requirements as these need to be set for the risk of unexpected losses will be there at all times, as long as risk not covered by Pillar 1 requirements are present – concentration risk, IRRBB, pension risk. There are no other mitigants in place. However, for other deficiencies identified supervisors will have a choice of capital or non-capital measure to apply, and in the guidelines we provide some common ground for making such choice. This is the first time that the EBA goes into the detail of application of supervisory measures, as we see this being of extreme importance in our work on convergence. However, this is a small step, and we will be paying more attention to the way supervisors are taking measures in our future work on convergence.

IV. Supervisory convergence across the Union

I have mentioned supervisory convergence many times in my intervention so far. This is intentional. **In the EBA we pay significant attention to promoting good quality supervision based on the compliance with the Single Rulebook requirements leading to consistent and comparable supervisory outcomes** – our fundamental objective is that institutions with similar risk profiles, business models and geographic exposures are reviewed and assessed by competent authorities consistently and are subject to broadly comparable supervisory expectations, actions and measures. This lies at the heart of our convergence mandate, which we aim at fulfilling through the development, and monitoring, of the application of Union standards and guidelines, a heightened emphasis on training activities, and regular assessment of actual convergence in the supervisory processes through our active involvement in the work of colleges of supervisors, peer reviews, and various monitoring activities. We will use this work to continue to reports on the progress made by colleges, and to produce our annual convergence report, where we just recently published the first one. However, I wish to emphasise again that we see this as key for all 28 member states. As I said at the start, the welcome formation of the SSM means harmonisation in practice for 19 countries. But we should acknowledge the risk, however remote, of an inadvertent ‘two-speed’ process within the concentric circles of the Union, and the potential for fragmentation of the single market in the shadows of more harmonisation of supervisory practices within the SSM.

Before starting the work on the SREP Guidelines, we undertook a comprehensive analysis of SREP approaches in Europe, and drew on best identified practices to come up with a solution that could work for the whole of the European Union. This solution is rather ambitious and we are not simply looking for the lowest common denominator. **Absolutely all authorities will need to make adjustments to their past approaches whilst leaving ample scope for proportionality, supervisory judgement and working with banks own and varied risk management frameworks.** However, if we do not adapt to find this vital common ground, divergence in supervisory practices may create the risk of an un-level playing field, fragmentation and costly inefficiencies in the functioning of Single Market, which benefits we all like to enjoy.

I thank you for your attention and stand ready to answer your questions.