EBA report on convergence of supervisory practices

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Contents

1. Executive summary

This report provides a summary of current observations regarding the convergence of supervisory practices and EBA activity under Article 107 of Directive 2013/36/EU, in particular with regard to the supervisory review and evaluation process and assessment of risks (SREP), supervisory stress testing, ongoing review of permissions to use internal approaches, and supervisory measures and powers.

Risks for the Single Market

The smooth operation of the Single Market requires enhanced convergence of regulatory and supervisory practices between the competent authorities of the Member States. Despite the existence of common rules, divergent supervisory practices and outcomes pose a potential risk to the effective oversight of cross-border groups and the development of a level playing field in financial services. This is particularly so in the context of the SREP, where competent authorities may also adopt supervisory measures in the form of additional binding capital requirements to address risks not covered by minimum own funds. Conversely, convergent practices and methodologies can significantly contribute to achieving a balance between necessary supervisory judgment and the consistency of outcomes in SREP assessments.

The EBA's mandate on supervisory practices convergence

The EBA is entrusted with developing a Single Rulebook and recommendations, along with a European supervisory handbook, to ensure there is supervisory convergence and consistency of supervisory outcomes within the Union. Its founding regulation requires the EBA to promote supervisory convergence. Under Article 81, the first issue assessed in the review of the EBA is an evaluation of the convergence in supervisory practices reached by competent authorities.

Article 107 of Directive 2013/36/EU includes a specific mandate for the EBA on consistency of supervisory reviews, evaluations and supervisory measures in Member States. Based on this mandate, the EBA has collected information and analysed relevant supervisory practices and has engaged in a considerable development of regulatory products (guidelines and technical standards), and promotion of convergence in supervision (participating in colleges of supervisors of cross-border institutions, developing a European supervisory handbook, providing dedicated training, conducting analytical and benchmarking activities).

Outcome of the assessment on supervisory practices convergence

The EBA's observations and analyses demonstrate that, since 2011, there has been significant progress in strengthening supervisory colleges and that supervisory convergence has occurred. However, further steps will be needed to neutralise the risks to the Single Market.

The EBA has observed a satisfactory degree of convergence in the overall supervisory frameworks, and the fact that the great majority of colleges of cross-border groups have reached smooth joint decisions is a demonstration of this convergence. Nonetheless, differences have still been identified in some aspects of:

- supervisory methodologies;
- supervisory practices; and
- supervisory outcomes.

In this context, whilst colleges of supervisors for cross-border colleges have clearly demonstrated their strengths as an important platform capable of effectively bringing together responsible supervising authorities of cross-border groups in a single market, experience in a meaningful minority of cases demonstrates that lack of cooperation, often caused by misunderstandings based on divergent supervisory methodologies, continues to pose challenges in, for example, reaching joint decisions on capital. While improvements have been made over the years, also thanks to the EBA mediation, some differences in supervisory assessment and supervisory measures persist, with the associated potential risks for the development of the Single Market.

Expectations and next challenges

At this junction in 2015 it is not surprising that further work is necessary. Indeed, a significant step forward in supervisory convergence across Member States is expected following the delivery of the EBA's main policy products around supervision, as they are implemented by competent authorities. In the case of significant institutions that are subject to direct supervision by the European Central Bank (ECB), the implementation of these policy products will be done centrally by the ECB, which will ensure more unified supervisory practices in Single Supervisory Mechanism Member States. The EBA's role is particularly important in ensuring that relevant standards and guidelines are consistently implemented across the Single Market. For this purpose, the EBA will provide training for competent authorities across the Single Market providing the foundations for a common approach, and will conduct peer reviews and benchmarking to assess the level of convergence.

Nevertheless, other challenges in supervisory practices convergence are looming and further EBA efforts are necessary, particularly with respect to the interaction between capital buffers and additional capital requirements, as well as the use of stress testing in SREP. Looking forward, the EBA will gradually add to the assessment of convergence of methodologies and practices, focusing on the consistency of outcomes and measures across and within competent authorities' jurisdictions.

2. Background

The main tasks of the EBA include contributing to the establishment of high-quality common regulatory and supervisory standards and practices, contributing to a common supervisory culture, and conducting peer review analyses of competent authorities in order to strengthen consistency in supervisory outcomes. In particular, the EBA aims to foster and promote:

- a common supervisory culture;
- convergence of supervisory practices;
- consistent application of the Single Rulebook and of the outcome of supervisory assessments; and
- coordination of supervisory activities, particularly in the context of colleges of supervisors of cross-border institutions.

Article 107 of Directive 2013/36/EU includes a specific mandate for the EBA to contribute to the development of consistency in supervisory practices by performing the following activities:

- to collect and assess the information provided by national authorities regarding the functioning of their supervisory review and evaluation process and assessment of risks (Article 97 and 98) (SREP), methodologies for supervisory stress testing (Article 100), ongoing review of internal models approaches (Article 101) and supervisory measures (Articles 102, 104 and 105);
- to develop guidelines addressed to competent authorities for common procedures and methodologies for SREP and for the assessment of the organisation and treatment of the risks;
- to conduct peer reviews in order to increase the degree of supervisory convergence; and
- to report annually to the EU Parliament and the Council on the degree of convergence of supervisory practices between Member States.

This is the first report prepared in accordance with this mandate. It covers the main activities undertaken by the EBA to enhance supervisory convergence within the scope of Article 107 as well as noting the remaining challenges and the way forward.

The assessments of supervisory practices are based on information collected over the last three years from national competent authorities and institutions, as well as from the EBA's participation in colleges of supervisors established for cross-border banking groups.

For this report, supervisory convergence is understood as a process for achieving comparable supervisory practices in Member States which leads to a consistent application of Union rules and consistent supervisory outcomes. In a broader sense, supervisory convergence should be understood as building a common supervisory culture across the Single Market. In the case of cross-border institutions, supervisory convergence also covers supervisory cooperation in colleges, an aspect under the EBA's oversight responsibility which is not covered by this report.

3. Convergence of supervisory practices in SREP and stress-testing

SREP represents the core instrument of the ongoing prudential supervision and the basis for the supervisory determination of the level and quality of own funds and liquidity held by institutions to cover all the risks they are exposed to. Stress testing is an important tool employed by supervisors to assess the resilience of an individual institution or, to some extent and with limitations, of the financial system, conditionally to determined shocks. In the EU framework (Articles 97 and 100 of Directive 2013/36/EU), the outcome of stress testing should be used to facilitate the SREP.

Significant differences in SREP methodologies across the Member States led to an inconsistent application of supervisory measures across the Union and, in the context of cross-border banking groups, also caused difficulties in supervisory cooperation. Recognising the impact of the level of divergence on the functioning of the Single Market, the main priority for the EBA was to prepare the guidelines under the mandate of Article 107.

To fulfil the mandate regarding convergence and consistency of SREP methodologies and processes, the EBA has undertaken two main steps:

- a detailed mapping of existing SREP practices and methodologies in all EEA competent authorities (completed in 2013 as part of the preparatory work for the development of guidelines); and
- drafting of the EBA 'Guidelines for common procedures and methodologies for the supervisory review and evaluation process' (completed in 2014).

These activities were supported by the monitoring and promotion of best practices in the colleges of supervisors established for cross-border banking groups.

In fact, the guidelines aim to address the main divergences identified in SREP practices and methodologies and in supervisory measures adopted in the context of capital adequacy assessment in order to build a minimum common framework, practices and methodologies, where supervisory judgement would apply without undermining the development of the Single Market.

Given the variance of supervisory practices and the significance of divergences, which required EBA mediation in some cases, the adoption of comprehensive SREP guidelines has been one of the EBA's primary objectives as the most effective tool in fostering supervisory convergence and identified best practices.

The EBA took great efforts to finalise these guidelines before the ECB took over responsibility for the banking supervision of significant banks in the euro area to accelerate the convergence of supervisory practices within the scope of the Banking Union while ensuring consistency across the Single Market.

3.1 Main findings of the review of SREP and stress test practices

The comprehensive review of SREP practices carried out between 2012 and 2013 across the European Economic Area (EEA) has provided the EBA with a broad and quite deep overview of supervisory approaches and methodologies.

In general, the analysis has shown a satisfactory degree of convergence of SREP general frameworks, which are based on broad common principles. However, the detailed approaches, tools and practices applied by national competent authorities differ in several aspects, which in some cases had material effects on the possibility of running comparisons of SREP outcomes and/or of reaching smooth joint decisions in the context of cross-border institutions. Hence, the EBA continues its work on convergence of SREP practices across the EEA

Differences have been found in particular in the scoring of the SREP elements, use of ICAAP, scope of risks assessed and risk categorisation. However, the most significant differences concerned the determination and the articulation of the capital requirements.

The EBA’s unceasing efforts in promoting coordination, consistency and convergence of supervisory practices in the context of supervisory colleges, including through the definition of common templates for risk assessment reports for the cross-border institutions (under the mandate of Article 113), has smoothed out some of those divergences, facilitating the joint decision process. However, as observed from supervisory colleges in 2013 and 2014, the main SREP concepts, in particular the determination of prudential requirements, have remained unchanged, along with the main findings identified in the stock-take.

In order to assess the level of convergence in supervisory practices in the area of stress testing and prepare the ground for a possible review of existing guidelines, over 2012 and 2013 the EBA conducted a peer review across EU aimed at the assessment of the implementation of CEBS/EBA ‘Guidelines on stress testing’ (GL32). Notwithstanding a general application of the guidelines, with some exceptions, the assessment identified new emerging practices which suggested reviewing the guidelines in order to respond to the methodological developments that occurred in the field. A review of the guidelines has been consequently undertaken in 2014 and is currently ongoing.

The following section includes the main outcomes of the analysis conducted on SREP methodologies and practices.

(i) Overall SREP framework

There is a relatively high convergence on the set of elements considered in the SREP, although the scope and the depth of analysis vary across Member States. SREP generally covers risk assessment and own funds requirements, governance and controls; it also covers the ICAAP, business model and strategy, institutions' stress testing and compliance with relevant laws.

There is a general understanding and main use of SREP as the supervisory process to review institutions' risk profiles and own funds adequacy as well as a tool for planning the intensity of supervision and necessary resources.

The proportionality element is largely taken into consideration by competent authorities to determine the level of supervisory engagement (intensity and frequency). The frequency of performing the SREP is at least annual in almost all Member States, in line with the provisions of the Capital Requirements Directive at that time.

(ii) Risk assessment

The risk categories assessed in the SREP are broadly the same for all competent authorities and include both risks subject to Pillar 1 minimum own funds requirements (credit, market and operational risk) and other risks generally named as 'Pillar 2 risks'.

However, there are differences in the sub-categories of risks subject to assessment. Under the credit risk, some competent authorities have included, for example, the sovereign risk, participation risk and counterparty risk while others have assessed these risks under different risk categories (i.e. counterparty and participation risk) or these sub-categories have not been considered at all (i.e. sovereign risk). With respect to other risks, there are different practices for how competent authorities treat the same risks (e.g. strategic risk has in some cases been assessed as an individual category which needed to be covered by capital, while in other cases has been used to as an input for the assessment of business and capital plans), affecting the dialogue within colleges of supervisors.

Risk assessments have generally been performed by considering both the level of risk (risk exposure) and the risk control perspective, which are scored separately and then reflected in a final score by applying a variety of approaches, some more quantitative and automated, others more judgment-based.

(iii) ICAAP assessment

In almost all Member States, competent authorities examine institutions' methodologies to quantify internal capital (Article 73 of Directive 2013/36/EU) and stress testing, with particular regard to the main assumptions and calibration for the most material risks. The assessments, however, are not supported by codified frameworks but generally rely on supervisory expertise and judgment, and vary with respect to the perimeter of entities and of risks covered.

Depending on the approach adopted, ICAAP is evaluated by giving more importance to its strategic role for risk and capital management purposes or it is used to support the determination of the institutions' capital adequacy.

(iv) Prudential requirements

The prevailing approach to capital quantification is based on a 'Pillar 1+' logic[1]. However, there is no convergence in the procedure to quantify the additional capital: a slight majority has adopted a risk-by-risk quantification while there are cases where the capital has been determined for the institution as a whole, through a holistic approach, with no separate quantification for individual risks. In a few cases, competent authorities do not perform any capital estimation. In general, quantitative estimates are corrected to factor in other SREP elements like internal controls, governance, business model or stress test results, although without any common methodology.

In terms of capital articulation, in most cases prudential requirements are expressed in the form of a ratio (i.e. Tier 1 ratio, Common Equity Tier 1 and/or Total Capital Ratio), therefore varying with the risk weighted assets (RWAs), as opposed to a determination in pure nominal terms which is stable over time. In between, there are few cases where capital requirements are determined in both relative and absolute terms, where the latter is often used as a floor.

The determination of the quality of capital to cover the estimated capital requirements is an area where two fundamentally different approaches exist: one envisages that these requirements should be fully covered by the eligible own funds (those admitted for Pillar 1 purposes) while the other one allows the use of other instruments, although only under specific circumstances (e.g. expected profits to cover prospective internal capital, elements deducted by own funds in case the corresponding risk is used to determine ICAAP internal capital).

Through its participation in colleges of supervisors of cross-border banking groups, the EBA has been monitoring their functioning and the consistent application of the SREP process and supervisory measures, in particular with regard to the decisions on capital adequacy. In this position, the EBA has had the opportunity to observe some cases of significant difficulties in reaching joint decisions on the required level of capital for entities in cross-border banking groups stemming from differences in supervisory methodologies for the assessment of the risk profile of supervised institutions.

(v) Stress testing

The conclusions of the EBA's peer review of stress testing practices showed that national competent authorities were largely compliant with the EBA 'Guidelines on stress testing'. The last two EU-wide stress tests coordinated by the EBA in 2011 and 2014, moreover, showed a good level of cooperation among competent authorities and helped increase the level of convergence of the national frameworks. However, differences were observed in the implementation e.g. resources and organisation, focus and coverage, incorporation into SREP, usage of top-down models or not. Additionally, some best practices were identified with respect to competent authorities' assessment

[1] The 'Pillar 1+' logic consists of determining the overall capital requirements as the sum of minimum requirements (Pillar 1) and of additional own funds requirements for other risks or elements of credit, market and operational risk not covered by minimum requirements (Pillar 2)

of institution's stress testing programmes, scope and results, institutions' procedures, involvement of senior management, on-going dialogue with institutions, use of supervisory stress tests, use of reverse stress testing, different types of stress tests and scenarios or assessment of management actions.

3.2 The EBA Guidelines for common procedures and methodologies for the supervisory review and evaluation process

In order to achieve more convergence of supervisory practices in SREP and to address fundamental divergences in past practices leading to a risk of inconsistent treatment of institutions with similar risk profiles and business models, in December 2014 the EBA issued the 'Guidelines for common procedures and methodologies for the supervisory review and evaluation process'. These guidelines represent a major step in the improvement of supervisory standards in the EU and convergence in methodologies to assess the risks, capital and liquidity of supervised institutions. The guidelines will also serve to enhance the implementation of the Banking Union in the euro area, since they already provide the common framework on which the ECB can build consistent detailed methodologies.

The guidelines aim to enhance consistency in supervision in the EU by providing a common framework and methodologies which national competent authorities, still applying necessary supervisory judgment, should adopt to assess the business model, internal governance, risks, and finally capital and liquidity adequacy.

Moreover, the supervisory standards pursued by the guidelines aim to increase the resilience of the EU financial system by increasing the quality of capital to be held to meet additional requirements and by limiting the recognition of diversification across risks for capital quantification, an area where practices diverge the most. The scope of the SREP guidelines covers the areas of supervisory practices in implementing the requirements set out in Articles 97, 98, 102, 104, 105 and partially Article 100 of Directive 2013/36/EU.

(i) General framework

The guidelines establish a minimum supervisory engagement model, proportional to the systemic relevance and complexity of institutions, and define the minimum elements of the assessment (i.e. business model, risks to capital and liquidity, capital and liquidity adequacy) as well as the factors and the principles to be considered in assessing these elements.

Institutions will be categorised in four main categories which should be subject to a regular assessment of all SREP elements, proportional to the relevance of the institutions for the financial system (both with respect to the frequency and to the scope/width of the analysis).

(ii) Scoring of SREP elements and overall score

Having a common scoring methodology is one of the objectives of the guidelines, and for this purpose the guidelines provide high-level qualitative criteria for each SREP element and each grade. Scoring harmonisation will assist competent authorities in their communication of SREP assessment within the college of supervisors and scores will be important indicators for deciding appropriate supervisory measures, in particular in the area of early intervention.

In anticipation of the entry into force of the resolution framework pursued by Directive 2014/59/EU (Bank Recovery and Resolution Directive, BRRD), the SREP guidelines establish a link between supervisory and resolution settings by focusing the scoring on the viability of institutions, which would allow competent authorities to use SREP outcomes to determine whether an institution could be also considered as 'failing or likely to fail' within the meaning of the BRRD, acting as a trigger for potential resolution proceedings. By pursuing this approach, competent authorities' assessments will serve as the major input for resolution authorities.

(iii) Risks assessment

Risk assessment distinguishes the analysis of risk exposures (inherent risk) from that of risk management arrangements and organisation. It also separates risks to capital and risks to liquidity and funding, in line with the SREP objective of determining the adequacy of own funds and liquidity. For the most material risks, the guidelines define principles, minimum elements of analysis and criteria to summarise the assessment in a score.

(iv) Capital quantification and role of ICAAP

For capital adequacy assessment, the guidelines aim to reach convergence in several aspects. First, they foster the application of a 'Pillar 1+' approach which allows a truly consistent application of Regulation (EU) No 575/2013 and Directive 2013/36/EU provisions. In this context, no diversification across risks is recognised, while additional capital is demanded for material risks not covered by minimum own funds requirements (e.g. concentration, interest rate risk on banking book exposures, etc.). Provided the 'Pillar 1+' approach constraint[2], institutions' ICAAP is the starting point for capital quantification and it is assigned fundamental importance for assessing the soundness of risk management and its link with business and capital plans.

The guidelines also define the framework for using stress testing for SREP and for capital adequacy.

(v) Capital quality and articulation

As a major step to increase convergence in the application of supervisory measures, the guidelines provide a common formulation to determine requirements in terms of a capital ratio, comprising both minimum and additional own funds requirements. Moreover, in terms of quality of capital resources, the guidelines make clear that no instruments and items other than those eligible with respect to the 'own funds' definition should be allowed to meet capital requirements. In addition,

[2] 'According to the Pillar 1+ approach', capital requirements for credit, market and operational risks are set at least equal to the own funds determined as per Regulation (EU) No 575/2013.

this provision is intended to clear the field from national practices altering the level of competition across institutions and Member States which was observed in the stock-taking.

(vi) Liquidity adequacy and articulation of liquidity requirements

The guidelines also introduce a common methodology and approach for the assessment of liquidity adequacy, which assist competent authorities in addressing the new requirements arising from Regulation (EU) No 575/2013 and Directive 2013/36/EU. *Mutatis mutandis*, the guidelines introduce the same framework provided for capital adequacy also for liquidity, with specific benchmarks and articulation of requirements.

As the scope of these guidelines is significant, covering all institutions across the EU, the time period for implementation is 12 months and the guidelines should be applied by competent authorities starting from 1 January 2016. A significant impact of consistent European supervision based on these guidelines can be therefore expected from 2016.

3.3 Revision of Guidelines on Stress Testing (GL32)

Building on the results of the peer review conducted over 2012 and 2013 and based on the experience gained in a recent EU-wide stress test, the EBA is currently in the process of revising GL32 on Stress Testing.

In reviewing the guidelines, the EBA will take into consideration the supervisory developments towards risk assessment and capital and liquidity adequacy as set out in the SREP guidelines and will address specific elements of the stress testing such as taxonomy, types of stress test exercises, data infrastructure and the use of a reverse stress testing process for both regular stress testing and recovery and resolution planning purposes.

4. Convergence of supervisory practices in the ongoing review of internal approaches

Regulation (EU) No 575/2013 and Directive 2013/36/EU entail a wide recognition of institutions' internal models approaches to determine minimum own funds requirements, covering all the main risk categories. While this allows a tighter link between requirements and risk, it brought new challenges for competent authorities responsible for assessing the adequacy of internal models approaches, due to their complexity and to the degree of flexibility and expert judgment involved.

Also in this area, common rules should therefore be coupled with harmonised supervisory practices for the assessment of internal models approaches as well as for the adoption and calibration of supervisory measures addressing possible issues.

Since 2013, the EBA has been conducting benchmarking analyses across EU on internal models approaches for credit risk and market risk to identify possible sources of divergent own funds requirements, including supervisory practices. The EBA also performed a stock-take of national supervisory frameworks concerning internal models approaches for credit risk which revealed several areas of divergences, then partly addressed with the entry into force of Regulation (EU) No 575/2013 and the many draft technical standards developed by the EBA.

4.1 Main findings[3]

Following the mandates arising from Directive 2013/36/EU (Article 78 and 101) and from Regulation (EU) No 575/2013 and (Article 502), over the last two years the EBA has been analysing the consistency of own funds requirements across EU for the main risky assets in the institutions' balance sheets, with a focus on internal models approaches recognised for the calculation of minimum own funds requirements. The analysis has been conducted by the EBA looking at both institutions and supervisory practices that are strongly interrelated and complementary.

On one hand, the EBA has assessed RWA consistency for credit risk and market risk on the basis of specific benchmarks, focusing on the most relevant exposures classes and particularly on credit risk[4].

[3] Detailed reports on the 'Review on the consistency of Risk Weighted Assets' are available on the EBA website http://www.eba.europa.eu/risk-analysis-and-data/review-of-consistency-of-risk-weighted-assets.

[4] No analysis has been carried out on operational risk since no specific mandate exists from Directive 2013/36/EU and Regulation (EU) No 575/2013.

On the other hand, the EBA has analysed the existence and convergence of national laws and supervisory rules and practices (or standards) with regard to fundamental elements of the internal models approaches for credit risk (Internal Ratings Based Approach or IRB Approach) which can influence institutions' (modelling) choices and own funds requirements.

4.1.1 Review of consistency of risk weighted assets

The analyses were conducted in 2013 (for both credit and market risk) and 2014 (only for credit risk) on the most significant exposure classes in the portfolios of those EU institutions permitted to use internal models approaches to determine minimum own funds requirements.

Outcome of the assessment on credit risk

Significant differences in own funds requirements have emerged, mainly ascribable to the existence of widespread definitions of key elements (i.e. default and downturn conditions) necessary for the estimation of credit risk parameters (i.e. PD, LGD, CCF[5]) and to some national practices (e.g. treatment of defaulted exposures, application of floors, etc.) which have contributed further to widening the variances.

Data limitations have also been a determinant for some asset classes (i.e. 'low default portfolios'), leading to material expert judgment in model development as well as in model validation by competent authorities.

Finally, the analysis conducted by the EBA has highlighted differences in internal validation practices (and tolerance levels) adopted by institutions to trigger the recalibration or re-estimation of models, contributing to differences in the level of credit risk parameters.

Outcome of the assessment on market risk

The outcome has shown a quite significant variability across institutions and across sub-categories of market risk capital requirements (VaR, SVaR, IRC, APR)[6].

The main factors have been primarily identified in the flexibility allowed by the regulatory framework (e.g. VaR methods, data weighting schemes, time series length, time scaling rule), modelling choices made by the institutions and, finally, supervisory actions (such as regulatory add-ons and/or restrictions to diversification), although the validity of the results were affected by the small number of institutions covered.

The conclusions obtained from the data available have clearly suggested a significance decrease in the variability of VaR when eliminating differences coming from methodological discretions contemplated in regulation.

[5] Respectively probability of default, loss given default and credit conversion factor.

[6] Respectively Value at Risk, Stressed Value at Risk, Incremental risk charge, All Price Risk.

4.1.2 Assessment of supervisory rules and practices on internal approaches for credit risk

Following the specific mandate set out in Article 502 of Regulation (EU) No 575/2013, in June 2013 the EBA sent a survey to competent authorities to find out more about different national supervisory rules and (unwritten) practices regarding the implementation of internal models approaches for credit risk across EU and to assess their possible impact on the comparability of own funds requirements.

Overall, substantial differences were found in the actual implementation of Directive 2013/36/EU framework by national competent authorities, likely leading to diverging practices in institutions and non-risk based differences in own funds requirements. However, it has to be stressed that no issues of compliance with the EU legislation were identified in light of the significant room for flexibility provided by the IRB regulatory framework.

The table below summarises the observed variability of supervisory rules[7].

Figure 1: Observed variability of supervisory rules

High	Medium	Low
Roll-out plan	Default and past due definition	Rating philosophy and general approach
Permanent partial use	IRB shortfall/excess	CCF calibration
PD calibration	Regulatory mapping	Maturity (M) calibration
LGD calibration		
Floors		

Source: EBA analysis

For the majority of the elements characterising the internal models approaches for credit risk, a minimum level of harmonisation across competent authorities was observed, mainly promoted by CEBS[8]. However, some material differences were found, confirming the same evidence revealed by the benchmarking analysis (credit risk parameters, floor, default definition, IRB shortfall).

[7] This variability is assessed as low mainly where most of the national competent authorities have not issued public rules or have not published the criteria they applied when assessing internal models. Divergences in supervisory practices may exist, but they are difficult to prove.

[8] See the 'Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches (CP10)'.

4.2 The EBA's work in the area of internal models approaches

Following the mandates contained in Directive 2013/36/EU and Regulation (EU) No 575/2013, the EBA developed a number of technical standards regarding the broad scope of internal models approaches, which set the requirements to be complied with mainly by those institutions seeking approval of their internal models approaches for own funds requirements calculations. In order to promote convergence of supervisory practices, the requirements in the technical standards also affect the processes and practices which supervisors apply for the assessment of internal models approaches. The main regulatory products, and other activities of the EBA regarding internal models approaches, are outlined below.

4.2.1 Materiality of model extensions and changes

Articles 143(5), 312(4)(b) and (c) and 363(4)(a) of Regulation (EU) No 575/2013 contain specific mandates for the EBA to develop draft regulatory technical standards (RTS) to specify the conditions for assessing the materiality of extensions and changes of internal models when calculating minimum own funds requirements for credit, market and operational risk. Material extensions and changes to approved internal models need to be subject to prior authorisation by competent authorities, all the rest only need to be notified.

The EBA developed three draft RTS, one for each risk category, following a similar structure which provide lists of the qualitative conditions for classification of extensions and changes to the internal models. Quantitative thresholds are also introduced as 'back-stop' measures, for those extensions and changes classified as less material may still alter the own funds requirements.

For the purposes of supervisory convergence, these RTS introduce a common minimum engagement for competent authorities supervising institutions with approved internal models.

The drafts on IRB and AMA were already submitted to the European Commission at the end of 2013 and came into force mid-2014, whereas the draft RTS on the internal model approach for market risk (IMA) were submitted to the Commission in the middle of 2014.

4.2.2 Assessment methodology

In the application of the mandates specified in Articles 144(2), 312(4)(a) and 363(4)(b) of Regulation (EU) No 575/2013, the EBA has been developing draft RTS to specify the methodology competent authorities must follow in assessing the compliance of institutions with the requirements to use internal models approaches.

These RTS provide, in particular, the assessment criteria and a description of the methods to be used by competent authorities in this context.

It is expected that these draft RTS will significantly increase harmonisation of the supervisory assessment methodology across all EU Member States, thereby rectifying the issues identified in the assessment of comparability of the IRB models.

The consultation papers for RTS on the IRB Approach and AMA were already drafted in 2014; the EBA is currently working on RTS on IMA. The final three draft RTS will be submitted to the Commission by the end of 2015.

4.2.3 Analysis of benchmarks

Enhancements in the convergence of supervisory practices in the ongoing review of internal models approaches are expected to be significantly boosted by the EBA work on benchmark portfolios.

Following the mandate set out in Article 78 of Directive 2013/36/EU, the EBA has developed RTS and implementing technical standards (ITS) to assist competent authorities in assessing the quality of internal models approaches on credit and market risk through the use of benchmark portfolios. In particular, the EBA has defined the standards for the assessments as well as the procedures for sharing the conclusions and the benchmarking portfolios used in the assessment.

As part of the mandate, the EBA has conducted regular analyses comparing RWAs, and more general capital requirements, on these benchmark portfolios for credit and market risk assets. Based on the outcomes, the EBA has engaged institutions and relevant competent authorities to identify institutions' modelling choices and, consequently, supervisory practices for model review, leading to divergences with peers. In performing these exercises, the EBA aims to find the right balance, ensuring greater consistency across institutions while at the same time avoiding imposing preferred methods or leading to a standardisation of the outcomes of internal models.

On 2 March 2015, the final draft RTS – ITS on benchmarking were submitted to the Commission and published by the EBA. The first full exercise based on the legal text will be conducted in 2016, based on 2015 data, and will comprise data from all institutions using internal models approaches for capital calculation purposes (except for operational risk) across the whole EU. Competent authorities are expected to use the results of these analyses for the ongoing review of internal models approaches.

4.2.4 Next steps

In the context of the IRB Approach, substantial work is still outstanding to achieve a higher degree of comparability across IRB models. The EBA has also recognised that an open discussion with institutions on the proposed measures will improve the robustness of internal models approaches and improve the comparability of capital requirements, and help determine how best to implement these changes.

For that purpose, the EBA has issued a discussion paper outlining the EBA mandates, priorities and a roll-out proposal for the implementation of the mandates on internal models approaches[9].

[9] https://www.eba.europa.eu/-/eba-puts-forward-preliminary-proposals-to-improve-the-irb-regulatory-framework

There are three parts to the EBA proposals: developing regulations – technical standards and guidelines – on key aspects of the IRB models; promoting supervisory convergence; and enhancing transparency of IRB models.

5. Supervisory measures

In accordance with the powers and mandates contained in Articles 8 and 21 of its founding regulation, the EBA has been monitoring and promoting the efficient, effective and consistent functioning of the colleges of supervisors set up for the most significant cross-border banking groups[10], fostering the consistent application of Union law across these supervisory settings. Particularly with the objective of converging supervisory best practices, the EBA has also been promoting joint supervisory plans and joint examinations, with the former ones quickly becoming a standard for the majority of colleges monitored.

The work in supervisory colleges is also a main source of information for the assessment of consistency of supervisory measures. Supervisory convergence in measures, particularly the capital and liquidity measures taken as part of joint decisions on institution-specific prudential requirements, is crucial for ensuring a level playing field for cross-border institutions. By participating in colleges of supervisors, the EBA has been able to monitor the degree of convergence of these supervisory measures and promote harmonisation in this area.

5.1 Main findings

Competent authorities have been shown to have similar broadly expectations of the institutions they supervise in terms of how these institutions address the supervisory findings and deficiencies identified, in particular relating to internal governance and risk management practices. However, the form and instruments used by competent authorities to translate these findings into supervisory measures vary significantly. Some competent authorities use ‘soft’ forms of measures, such as management meetings and recommendations, while others take formal administrative written measures.

More significant differences have been observed in terms of imposing institutions’ specific prudential requirements pursuant to Article 104 of Directive 2013/36/EU. All competent authorities assess the adequacy of own funds held by supervised institutions and in all almost cases require a specific minimum level of capital, taking into account the risk profile[11]. However, the way the minimum level of capital is actually communicated and effectively imposed on institutions is very different.

Some competent authorities preferred articulating it in the form of an expectation or recommendation, while other ones formulated the minimum level as clear legal requirements based

[10] Article 115 of Directive 2013/36/EU requires that, for cross-border banking groups with the parent undertaking established in one Member State and at least one subsidiary in another Member State, the consolidating supervisor establishes a college of supervisors to reach a joint decision on the capital and liquidity adequacy of supervised institution.

[11] Some practices have been observed where competent authorities did not set any specific capital requirements but limited their determination to a statement of adequacy of the level of own funds held by the institution.

on the application of Article 104 of Directive 2013/36/EU. In a few cases, competent authorities achieved the same prudential objective by recommending ICAAP improvements which generally translate into higher internal capital.

Likewise, supervisory practices differ in terms of the quality of additional capital required to meet the target levels, with some competent authorities referring to specific elements of own funds (i.e. Common Equity Tier 1 ratio) and others setting the requirements in terms of Total Capital ratio, which implies broader options for the institutions. In assessing capital adequacy and setting the requirements, a few competent authorities widened the range of instruments and items accepted beyond those eligible as own funds pursuant to Regulation (EU) No 575/2013.

These differences in imposing prudential requirements have posed further difficulties to the process of reaching joint decisions on capital for cross-border institutions in addition to those stemming from methodological aspects of SREP approaches (e.g. articulation of capital level).

In some cases, supervisory measures taken at national level led to disputes between competent authorities due to financial stability concerns in another Member State as a consequence of the measures. In these cases, the lack of prior communication and consultation between competent authorities was identified as the main cause.

The significant progress made in reaching effective joint decisions means that only in a limited number of cases was the EBA asked by the competent authorities involved to settle disagreements on joint decisions and other disputes between competent authorities. So far, the EBA has successfully conducted non-binding and binding mediations (Article 19 of its founding regulation) in eight cases (including two cases that occurred in the conciliation phase of a binding mediation request, five non-binding mediation cases, and one informal mediation case). Four cases were concluded by formal, albeit non-binding, agreements and four cases by consensual informal agreement. Where the subject of disagreements stemmed from divergent SREP methodologies (e.g. risks covered by SREP assessment, determination of additional capital, use of ICAAP), the EBA facilitated mutually agreeable solutions. While the mediation has worked well in these specific cases, underlying divergences in national methodologies have not been reconciled. In fact, mediation is not a tool designed for reaching convergence.

In this regard, the SREP guidelines are expected to clear the field of many of those contentious elements which were behind the requests for the EBA mediations and will set the reference for any future mediation cases.

Finally, because of the take-over of supervision on the most significant institutions in the euro area by the ECB at the end of 2014, during that year, the EBA observed substantial efforts to achieve more consistency in the joint decisions on capital of these institutions, particularly with regard to the articulation of measures, although SREP assessments were still based on existing national methodologies.

6. Other EBA activities and the way forward

In addition to the activities mentioned in the previous sections of this report, the EBA has undertaken several other initiatives promoting convergence in supervisory practices, and significant work is ongoing or planned for future.

Achieving convergence in supervision requires an iterative process (monitoring practices, setting standards, monitoring practices, etc.) which enables rules and practices to be adjusted in the face of a rapidly changing environment and to new best practices.

6.1 European supervisory handbook

In the amendment to the EBA's founding regulation, (Regulation (EU) No 1022/2013) following the establishment of the Single Supervisory Mechanism (SSM), the EBA was assigned the responsibility of drawing up a European supervisory handbook on the supervision of financial institutions. While the handbook does not take the form of legally binding acts and does not restrict judgment-led supervision, it identifies best practices across the Union as regards supervisory methodologies and processes that competent authorities should use in conducting supervisory activities.

In 2014, the EBA issued the first two chapters of the handbook covering (1) the supervisory assessment of institutions' business models, which is a new component of the common SREP framework, and (2) the assessment of recovery plans, including joint decisions on group plans, a new requirement only recently introduced by the BRRD.

Both chapters are designed as practical tools with multiple examples and case studies aiming to assist supervisors in performing their activities and support the practical application of the relevant EBA technical standards and guidelines.

The coverage of the supervisory handbook will be gradually expanded, prioritising new areas of supervision, considering the novelty, timeliness, level of potential conflicts, importance of the topics in the cross-border context, but also taking into account availability of resources and existence of developed practices. Handbook work can be supplemented by EBA recommendations and additional own initiative guidelines if necessary as decided by the Board of Supervisors.

6.2 Training for national competent authorities

An important element in building the common supervisory culture is the training provided by the EBA to the national competent authorities. In 2014, the training activities were particularly focused on the implementation of new parts of the Single Rulebook (i.e. technical standards for reaching joint decisions) and new areas for supervisors (i.e. assessment of recovery plans, business model analysis, mediation) to facilitate and accelerate their consistent application. These training activities were also supported by specific case studies. In 2015, further training is planned on colleges, recovery plan assessments and SREP guidelines. An overview of training[12] provided in 2014 and of training planned for 2015 is presented below.

Title	2014	2015
Supervisory colleges functioning and joint decisions on capital and liquidity	X	X
Assessment of recovery plans and joint decision on group recovery plans	X	X
Data Analysis Systems in Supervision		X
SREP process and methodology for the assessment of risks		X
Liquidity Risk	X	X
Functioning of resolution colleges and resolution planning		X
Business Model Analysis	X	X
Cross-border aspects in the implementation of the BRRD		X
Key Risk Indicators		X
Stress testing guidelines and potential changes	X	X
Market Risk		X
EBA Mediation		X
Product Oversight and Governance		X
IT Supervision in Financial systems		X
Asset Quality Review Workshop	X	
Analytical Solutions for Banking Supervision	X	

6.3 Monitoring of supervisory practices going forward

In the next few years, important contributions to the convergence of supervisory practices are expected to come from the implementation of the SREP guidelines in combination with a review of the ‘Guidelines on stress testing’, further development of the European supervisory handbook, and participation of the EBA in colleges of supervisors of cross-border banking groups (an overview of these projects and activities is provided in the following paragraphs) as well as from the benchmarking and the technical standards on the assessment methodology of internal models approaches.

The EBA will continue to monitor and promote supervisory convergence and report the results of its activity to the EBA Board of Supervisors, the EU Parliament and the EU Council. The main tools and sources of information to monitor development in convergence and the consistent implementation of the Single Rulebook will be based on review work, centred on the EBA’s peer review mandate and any supporting reviews as needed as well as mapping of supervisory practices related to the information submitted to the EBA by competent authorities pursuant to Article 107(1) of Directive 2013/36/EU.

[12] They also include joint initiatives with national competent authorities.

The monitoring of benchmarks will provide additional information on supervisory practices in the review of internal approaches, while the participation in colleges of supervisors will give the EBA the opportunity to observe SREP and other supervisory measures. With the entry into force of the BRRD and the new responsibilities assigned to competent authorities, the scope of analysis within colleges will be extended to include the assessment of institution's recovery plans.

Peer reviews (and similar activities), however, will allow the EBA to gather a broader and deeper overview of supervisory convergence than can be observed from colleges which, by definition, are limited to cross-border banking groups, and they will provide more transparency across EU about methodologies as well as assessment techniques underlying supervisory outcomes and measures. The outcome of these analyses will then be used either to require more adherence to the rules or to identify areas where further as well as new guidance is necessary.

Looking forward, the EBA will focus more on the consistency of practices and of outcomes, both across and within competent authorities' jurisdictions, possibly including domestic institutions in the scope to monitor level playing field issues across the Union.

Concerning the ongoing review of internal models approaches, the EBA will continue to analyse the comparability of RWAs and will gradually extend its assessment to supervisory practices, methodologies and measures adopted in the ongoing review of internal models approaches including, but not limited to, the use of benchmarks.

Other areas where convergence will need to be achieved and supervisory practices consequently be monitored mainly concern those aspects that are only partially addressed by the SREP guidelines, like the use of stress testing for joint decisions on capital and liquidity.

In fact, by monitoring the joint decision process on capital and liquidity adequacy in 2014, the EBA observed the existence of different ways of incorporating the results of stress testing into the SREP and of translating them into the supervisory measures (e.g. additional binding own funds or capital buffers). The gradual entry into force of the capital buffer requirements (particularly the capital conservation and the countercyclical buffers) in the next few years will raise the issue of how these interact with other requirements, particularly with those set to address stress test outcomes.

Based on the outcomes of its broad monitoring activity and analysis tools, including on risks and vulnerabilities, the EBA has also identified the supervisory assessment and measures for IT risk and conduct risk as additional new areas where steps need to be taken. In this regard, the EBA has started preparatory work to define the strategy and the tools which would best fit the purpose of fostering convergence of supervisory practices.