
Consultation response

EBA consultation on guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)

20 October 2014

Introductory remarks

We welcome the opportunity to respond to this EBA consultation on the SREP guidelines. We believe that the creation of the SSM and the preparation of the EBA Single Supervisory Handbook represent an important opportunity to significantly enhance the consistency of the Supervisory Review and Evaluation Process (SREP) across Europe.

We have very recently created within AFME a new Special Committee on European Supervision (SCES) which will over the coming period lead AFME's work on supervisory matters. The SCES is a senior committee gathering AFME member firms' heads of supervisory relations.

We take the view that both within and outside of the SSM, EU countries should standardise their views for Pillar 2 purposes. We support improved convergence of supervisory practices across Europe.

Interviewed firms in the framework of an AFME report on cross-border supervision published last year noted that the SREP has not been applied in a common manner by supervisors across the EU¹. It was noted that supervisors might capture the same set of risks as part of their SREP assessment of an institutions, but their approaches to assessing these risks are often very different.

As the SCES has just been created, there has not been sufficient time for AFME to develop a full industry view and thus a detailed response on the SREP guidelines. Below are some initial high level comments on a number of key aspects of the SREP guidelines. However, given the importance of the SREP, we are committed to work further on this issue and would welcome the opportunity for further engagement and comments.

Key aspects

Ensuring a level playing field

We take the view that many of the provisions in the guidelines on the incremental capital and liquidity requirements arising from the SREP tolerate a wide range of different outcomes across member states. A lot of discretion seems to be left to supervisors.

¹ AFME report on 'Supervising cross-border banks in Europe', July 2013

Given the role of the EBA in ensuring a level playing field across the EU, additional work should be undertaken by the EBA to avoid differential approaches and competitive distortions across the EU.

While these provisions are, by their legal nature, guidelines, we do not believe that they should be conceived and developed as 'minimum' standards. These should be seen as guidelines as to the appropriate harmonised approach to be adopted by authorities. Accordingly we do not support the approach articulated at page 12 that NCAs are able to 'apply stricter requirements to cover risks if they believe that appropriate' that do not seem to be fit for the purpose of enhancing supervisory convergence and harmonising supervisory approaches.

Translating SREP into additional capital and liquidity requirements

The translation of the SREP assessment into setting capital and liquidity requirements for individual firms represents the central element of the exercise. In our experience, quantification of additional Pillar 2 requirements can be a rather opaque and subjective process, leading to diverse outcomes.

In this context we consider that the draft guidelines are too general when it comes to the key decisions of setting of capital and liquidity add-ons in excess of the CRDIV minima. We do not consider that they will achieve the objective of establishing a level playing field across the EU. The proposal leaves scope for ongoing major divergence of practice among national supervisors, and therefore for outcomes that will continue to be divergent and non-comparable.

We thus believe it necessary to further and better develop in the guidelines a comprehensive framework that specifies the reasoning and details of how SREP scores are translated into capital and liquidity requirements.

In this framework, we believe that overall the SREP guidelines' approach to liquidity and funding should be set keeping clearly in mind recent regulatory changes related to these issues in Pillar 1 and to increased mandatory reporting.

Supervisory benchmarks

The guidelines refer to the use of supervisory benchmarks as a tool to support the determination of risk-by-risk additional own fund requirements (Chapter 7.1) as well as specific quantitative liquidity requirements of institutions (Chapter 9.4).

We take the view that more clarity should be provided as regards how these benchmarks will be designed and calibrated. The industry considers that those benchmarks should incorporate transparency on the part of supervisors on their development and full, open dialogue with the industry on outcomes. This also to avoid a one-size-fits-all approach that would lead to an automatic alternative 'standardised approach' calculation and that could have significant consequences on quantitative capital and liquidity additional requirements.

Business model analysis

It is essential that supervisors interrogate closely and understand well a bank's risk profile and business model. High quality and effective supervision needs to be intensive in nature. The key challenge is to

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achieve the appropriate level of intensity. In particular it is essential to ensure that intensive supervision does not stray across the boundary into becoming the shadow management of a bank. AFME members are concerned that the approach to business model analysis set out in the draft requirement runs a significant risk of contributing to such an outcome which would be both detrimental and replete with potential unintended consequences.

We would suggest that an appropriate solution to this problem would be that the business model analysis should not in itself lead to a distinct score that contributes directly to the overall SREP scoring. Rather this analysis should inform a key component of the other areas of analysis and should be reflected in the scores to be determined in respect of those areas.

Risks to capital

We believe that the elements on risks to capital included in the guidelines are generally appropriate. However we believe that the language used as regards some areas could be clarified. We refer for example to the definitions of conduct risk, counterbalancing capacity, and model risk.

The guidelines seem to introduce an alternative approach to regulatory treatments of assets and risks (para 111). We believe this might give rise to subjective assessments, and to potential double-counting of risks.

Moreover, the guidelines' approach to reputational risk seems to ignore the role of internal committees charged with responsibility for reputational risk issues and we would suggest amending the text in order to recognise the role they play.

Application to Cross-border groups

Overall, we would caution on the approach implementing SREP at solo level for consolidated groups and believe that the guidelines should pay particular attention to the SREP application in relation to specific issues on legal entities within cross-border groups. The guidelines should better reflect key elements of the home-host dynamics. Here are some examples:

- Business model - legal entities can appear very different when looked at individually rather than as part of a group given booking practices that are largely driven by regulatory constraints, and a single business may be spread across multiple entities. Factors like accounting policies, ring fencing of capital locally and absence of netting benefit across entities, may also mean legal entities may not generate an adequate RoE when viewed in isolation, but do when considered as part of the whole line of business/group. A single (viable) business may be spread across multiple legal entities. While the individual entities may appear less viable and less diversified than the group as a whole, the critical determinant of their long-term performance is likely to be how the group as a whole performs. We believe the SREP guidelines should reflect this;
- Strategy - the strategy of an institution is unlikely to be set at a legal entity level. Commonly it is determined on a group-wide, global basis, with the board of local legal entities ensuring that the strategy can be executed in a prudent and safe manner, i.e. that the entity has appropriate levels of capital and liquidity to support the proposed strategy, and that risk management and controls are

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in place to execute it safely. The proposed framework does not seem to appropriately reflect these nuances;

- Governance - legal entity governance tends to be different to group-wide, with less regulatory/legal driven requirements applicable at the legal entity level (and less need for this);
- Risk appetite - commonly this is less well defined at legal entity level, and given factors described above may not be tied to a desired economic return in the same way as group-wide.

Business model diversification

It is important that business model diversification should be considered by the competent authorities.

In some countries, diversification benefits are accepted while in others they are not. Moreover, even if they are accepted, the basis for acceptance can differ across jurisdictions both in terms of details and methodologies. Also, where countries accept the same methodologies they may require them to be applied differently.²

We believe that diversification is an important factor in determining the risk profile of an institution. It is therefore important in our view that the benefits of conducting business across diversified activities be reflected in the SREP guidelines, both in the Business Model Analysis and in the total SREP Capital Requirements quantification. Instead, diversification does not seem to be recognised in the guidelines, which do not allow for the recognition of the diversification between and within risks.

For example, paragraph 139 in the draft guidelines states that 'diversification between risks...should not be considered as part of the determination of additional own funds requirements'. This provision does not seem to be in line with the CRD IV text, where art. 98 clearly stipulates at paragraph (f) that 'in addition to credit, market and operational risks, the review and evaluation performed by competent authorities pursuant to Article 97 shall include...the impact of diversification effects and how such effects are factored into the risk measurement system'.

Interaction with BRRD

We fully agree with the idea that the work performed by competent authorities in the context of the SREP must inform competent authorities with respect to potential threats on the viability of institutions. In this respect, such work may for example contribute to analysis of circumstances where early intervention measures should be considered. However, for the sake of clarity and consistency, we think that a clear separation must be established between matters relating to the SREP as described by Directive 2013/36/EU, and matters relating to the implementation of the BRRD and, more generally, to decisions pertaining to recovery and resolution.

For example, as regards scores of the SREP assessment, the introduction of an 'F' score as currently proposed (defined as 'the institution is considered as failing or likely to fail'), seems to exceed the remit of the SREP analysis and it orientates the SREP analysis towards the question of the 'viability' of an

² AFME report on 'Supervising cross-border banks in Europe', July 2013

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institution, departing from a going-concern approach. The determination of whether an institution is failing or likely to fail should be done pursuant to the terms of article 32 of the BRRD and the guidelines under that article.

We are thus not sure whether the current definition of the 'F' score is appropriate and we would suggest re-defining it in line with what the SREP approach allows to determine. We therefore suggest that the description of an 'F' score is recast as indicating that 'the institution infringes or there are objective elements to support a determination that the institution will, in the near future, infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority'. This would align the outcome of the SREP assessment with the proposed guidelines on failing or likely to fail under Article 32 of the BRRD.

Leverage ratio

We note that the SREP guidelines include in Part 7 the reference to the risk of excessive leverage. This risk is not clearly defined, and can only be understood at this stage with reference to a minimum percentage level of leverage ratio. However, the calibration of the leverage ratio's minimum levels, its binding or non-binding nature, and its implementation conditions are all subject to an EBA report expected by October 2016, and to a further report of the Commission.

A very high degree of uncertainty and imprecision currently surrounds the concept of leverage in the current prudential framework. We are thus unsure about the inclusion of such considerations in the SREP guidelines.

Communication with the industry

The industry takes the view that communication related to the SREP is of paramount importance. The draft guidelines are rather silent on the dialogue between supervisors and financial institutions and on the procedures to support it, with the exception of a brief reminder at paragraph 35: 'when planning SREP activities, competent authorities should adhere to a minimum level of supervisory engagement (e.g. in the form of a dialogue...)'. We believe the draft guidelines could be further developed as regards this important aspect.

National competent authorities should always offer the possibility to have a constructive dialogue with banks to discuss SREP results before deciding any potential actions.

More specifically, we would welcome clarifications on the feedback to be given to banks (at which level of granularity for example), and whether some information will be made public (either by NCAs or by banks which may consequently have to abide by some communication requirements when they are publicly listed). Moreover, it is also unclear the nature of the feedback which would be provided to banks after the proposed peer reviews.³

³ Draft SREP guidelines, paragraph 329

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