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The voice of banking

A response to the European Banking Authority's consultation on

Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)

by the British Bankers' Association

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Introduction

The BBA is pleased to respond to European Banking Authority's consultation on Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)[1].

The BBA is the leading association for banks active in the UK. It represents over 170 banking members, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management. As well as banks headquartered in the UK our members include third country banks which operate in the UK as a UK subsidiary some of which will have further branches and subsidiaries other EU countries. So this consultation paper is relevant to the activities of the vast majority of our members.

General comments

Need for harmonisation

The Guidelines are voluntary, lengthy and drafted widely which provides considerable room for different degrees of adoption and interpretations by national regulators. We believe it is important to limit the divergence between member states practices in order to achieve a harmonised approach and consider that the Guidelines are unlikely to achieve harmonisation or lead to a level playing field. This could be achieved through the EBA seeking to issue more concise guidelines, focusing on the key elements required to secure a degree of harmonisation across the EU, whilst preserving a sufficient degree of flexibility for the ICAAP and ILAA assessment to be firm specific.

In particular, the guidelines do not explore differences in methodologies for assessing and quantifying the identified risks to capital. It is likely that the outcomes of the SREP process will therefore continue to be inconsistent for firms with similar risk profile, depending on the approach/methodology used by different regulators. Disclosure of methodologies could be a solution to achieve greater harmonisation in the medium/long run.

[1] https://www.eba.europa.eu/documents/10180/748829/EBA-CP-2014-14+%28CP+on+draft+SREP+Guidelines%29.pdf

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Another area the guidelines should explore with a view to ensure commonality of approach is the disclosure of Pillar 2 – both in terms of transparency of methodologies used by regulators as well as principles around disclosure of Pillar 2 capital requirements by institutions.

On the other hand, the guidelines are too prescriptive and stretch outside the mandate conferred by CRD IV in certain aspects – namely, the determination of the composition of own funds required to meet Pillar 2 risks and the articulation of the requirements to be met over the economic cycle on a base case and stressed scenario.

Diversification Benefit

In addition to risk mitigants, diversification is an important factor when assessing risk as a good degree of diversification can reduce the levels of risk being run. However there does not appear to be a reference in the guidelines to ensuring that diversification is considered during the SREP. We recommend that the EBA considers including a requirement to assess diversification in the Guidelines.

SREP capital assessment and potential Double Counting of Risks

The guidelines essentially assume that a capital add-on is the likely response to any identified risks and issues as part of the exercise of supervisory review. Capital is not always the right and adequate tool – for example, governance and liquidity issues cannot necessarily be alleviated through more capital.

Additionally, during the SREP, it is essential that care is also taken to avoid double counting and double provisioning for the same risks. We would ask the EBA to consider this issue and include some principles in the guidelines.

Namely, particular attention is required around the interaction of Pillar 2 capital assessment with macro-prudential measures and the CRD IV capital buffers (e.g. interaction of concentration risk capital charge with countercyclical capital buffer, sectorial capital requirements or systemic risk capital buffers). CRD IV contemplates a wide range of measures/tools and it is not clear how the various measures will work alongside each other – it would be important to define some principles with a view to ensuring these would not overlap in a way that would result in double-counting the capital required for the same risks.

Please find below Annex 1, which provides answers to the questions specified in the paper, and Annex 2, which provides comments on the titles not addressed in the questions.

Annex 1: Responses to questions

1. Do the guidelines specify the SREP process sufficiently? Are there areas where the EBA should aim for greater harmonisation, or where more flexibility would be appropriate?

We fully support harmonisation of supervisory practices between regulators and convergence of the supervisory review process.

We believe that defining the guidelines for the supervisory review process will be a very helpful catalyst in ensuring the consistent application of Pillar 2 throughout the single market, an objective of which we are very supportive.

However, we do think that the guidelines ought to explore in more detail the methodologies used by regulators in assessing and quantifying the risks covered by the supervisory review process. As a first step, the guidelines could include some principles around transparency of the methodologies used by the regulators with a view to achieve some commonality of approach. Failure to go down to this level will frustrate the objective of ensuring consistency of supervisory outcomes for institutions with similar risk profiles across the Union, one of the key objectives set by the EBA in these guidelines.

Another area that is not sufficiently covered by these guidelines is the interaction of Pillar 2 with macro-prudential measures or the CRD IV capital buffers. This is an essential component under the revised Basel 3 and CRD IV framework. CRDIV contemplates a wide range of measures/tools and it is not clear how the various measures will work alongside each other so as not to overlap or in achieving best supervisory outcome. Guidelines could be set out around how Pillar 2/SREP could be used instead of certain macro-tools such as some of the buffers or Art. 458 of the CRR. This will likely be a new area of supervisory divergence.

Finally, the guidelines do not specify disclosure aspects in relation to the SREP and the resulting level of total capital requirements. Guidelines could be set so as to define a common supervisory approach to disclosure. However, consideration ought to be given as to how the SREP is formulated and how this can conflict with disclosure.

In terms of areas where the guidelines may be too prescriptive, we would point out that competent authorities should determine the composition of capital resources to meet the capital requirements emerging from the SREP. Also, the examples given in the guidelines seem to inevitably point to capital as a solution to any regulatory issue identified (including Pillar 1 model deficiencies, governance or even liquidity issues) however, not necessarily considered the most effective or appropriate tool. It is important to consider that more capital may not always be the more appropriate answer to an identified issue/risk and further, that the composition of capital required to meet Pillar 1 risks may not necessarily be the most proportionate and adequate response in relation to Pillar 2 risks identified as part of the supervisory work more generally.

2. Do you agree with the proportionate approach to the application of the SREP to different categories of institutions? (Title 2)

We agree proportionality is an important component of the regulatory architecture. Competent authorities should allocate their resources based on their assessment of the overall risk the failure of an institution could pose to the financial system. The categorisation of institutions into four categories is an appropriate expression of this proportionate approach.

However, it is important to consider the interdependencies between institutions and how this translates into the ultimate level of systemic risk within the financial system. For example, stress testing of the system may need to capture transmission mechanisms of the shocks through some of the institutions outside the defined level 1 category.

3. Are there other drivers of business model / strategy success and failure that you believe competent authorities should consider when conducting the BMA? (Title 4)

No, we are satisfied with what has been identified in the consultation paper.

4. Does the breakdown of risk categories and sub-categories proposed provide appropriate coverage and scope for conducting supervisory risk assessments? (Title 6)

Yes, we believe the breakdown is comprehensive. However, as per our response to question 1, the guidelines do not further elaborate on the methodologies to use to assess and quantify those risks.

5. Do you agree with the use of a standard approach for the articulation of additional own funds requirements to be used by competent authorities across the Union? (Title 7)

Yes, a common approach to the articulation of any additional own funds would be welcomed. However, capital is not the only answer; risk mitigation plans can often be more beneficial and this is an important component in introducing consistency to the Pillar 2 process.

6. Do you agree that competent authorities should be granted additional transition periods for meeting certain capital and liquidity provisions in the guidelines (Title 12)?

Yes.

Annex 2: Comments on individual titles not covered in questions

Title 1. Subject matter, definitions and scope of application

We have no comments to make on Title 1 but note and support the proportionate approach that the EBA encourages in relation to the assessment of capital and liquidity adequacy in relation to an institution's subsidiaries which are in the same member state.

We also encourage all supervisors of significant subsidiaries to work cooperatively through the college of supervisors to identify the scope of application in order to ensure the appropriate entities are subject to the SREP process so that duplication of effort is avoided.

Title 2. The common SREP

The draft guidelines establish the components of a common SREP framework. It is important that there is appropriate supervisory engagement with the institution and that this engagement is more than a one way process, starting with the ICAAP. As currently written the guidelines place less emphasis than we would like on the need for reviewing the firm's assessment and discussing the SREP findings with the institution based on a two way dialogue before the overall SREP assessment is made. The Guidelines should be more explicit in this regard.

The guidelines however do not go into the necessary level of granularity and this undermines the objective of ensuring consistency of outcome for institutions with similar risk profile.

Title 3. Monitoring of key indicators

We agree that there should be proper follow up by the competent authority where an institution displays a deterioration in financial and risk indicators when judged against its peers.

Of course it is possible, in a downturn that all members of the peer group could show downward trending indicators. To emphasise, only those deteriorations that are outliers to the average peer group performance should be investigated.

EBA is proposing that the competent authorities should base their judgement not only on COREP monitoring but also, very sensibly, market based indicators. We suggest that these should be supplemented by the independent research produced by equity analysts where this is available which can be a helpful source of alternative points of view. In any case, this component should not translate into imposing an additional reporting burden on banks.

Title 4. Business model analysis

It is not clear how competent authorities will apply SREP scoring of 1-4 to BMA given that there are no widely accepted indicators for evaluating what a viable business model and sustainable business strategy are.

Title 5. Internal governance and institution-wide controls assessment

We are concerned that there is a lack of detail concerning how supervisors will assess the adequacy of an institution's ICAAP and ILAAP. Whilst we acknowledge there is a limit to how prescriptive the EBA can be in these guidelines, there needs to be greater detail on what supervisors will base their decision on. This is also important as there needs to be a minimum level of granularity within the guidance to ensure there is a common approach by supervisors across Europe.

Title 6. Methodology for the assessment of risks to capital

Methodologies

The guidelines do not explore differences in methodologies for assessing and quantifying the identified risks. It is likely that the outcomes of the SREP process will therefore continue to be inconsistent for firms with similar risk profile, depending on the approach/methodology used by different regulators. Disclosure of methodologies could be a solution to achieve greater harmonisation in the medium/long run.

Ad hoc reporting

We note that paragraph 120 suggests that competent authorities should be able, subject to the bank's agreement, be able to call for ad hoc reporting to assist its risk assessment.

Ad hoc reporting is a resource intensive exercise and we request that competent authorities use this as a last resort. Although the Guidelines suggest that ad hoc reporting should be agreed with the bank we think it improbable that, faced with such a request, a bank would not agree. We suggest the relevant text be amended as follows:

> *120. When performing the risk assessment, competent authorities should rely on all available information sources including regulatory reporting, ~~ad-hoc reporting agreed with the institution,~~ the institution's internal metrics and reports (e.g. internal audit report, risk management reports, ICAAP), on-site inspection reports, and external reports (e.g. the institution's communication to investors, rating agencies). Before a competent authority requests ad hoc information from an institution it should only do so after assuring itself that the request will provide the required information in an effective and efficient manner, having regards to the likely costs to the institution of responding.*

Benchmarking portfolios

We would suggest it is not well defined in these guidelines what is meant by "supervisory benchmarks". That aside, benchmarking can be a useful tool as highlighted in para 158. But as we emphasised in our response[2] to the EBA's recent consultation on Article 78, we do not believe that looking at the outputs in isolation that any meaningful conclusions can be derived with respect to an underestimation, appropriate estimation or overestimation of the OFR or RWAs. The capital adequacy of an institution includes many other considerations that take into account actual and or perceived shortfalls or excesses in modelled losses derived from the IRB approach. Benchmarking should therefore be used with caution.

Non performing exposure – overlap with FINREP?

In assessing an institution's non-performing exposures the competent authority should solely rely on the very comprehensive information provided in accordance with the ITS on supervisory reporting on forbearance and non-performing exposure, annexe 2. No further information should be required or requested.

[2] https://www.bba.org.uk/policy/financial-and-risk-policy/prudential-capital-and-risk/credit-risk/bba-response-to-the-eba-cp-on-benchmarking/

Stress testing

We agree that the results of stress testing performed by the institution can help to identify previously unidentified sources of credit risk. However, the guidelines do not explore how the results of the stress testing feed into the SREP assessment and contribute to capital adequacy requirements.

Other than in exceptional circumstances, competent authorities should not require the institution to undertake further ad hoc stress testing and duplication of existing stress test exercises should be strongly avoided.

Internal control framework

We fully agree that the competent authority should assess the institution's internal control framework in order to ensure that in can manage and mitigate credit risk in line with its risk strategy and framework. However this assessment should, in the spirit of proportionality, take into account the risk profile, business model and size and complexity of the institution, as helpfully emphasised in Article 5.

Market risk

We note that there could be market risk arising from accounting positions creating asymmetry between the true economic risk where it is different from the accounting (for example FX risk on accounting fair value unwinds). Is this section also seeking to covering those exposures?

Credit spread risk in the banking book is also included in the work undertaken by the Basel TFIR but the scope has not yet been defined. Paragraph 190 seems to suggest that the scope for credit spread risk in the banking book is accounting driven under IFRS accounting rules? Or is this referring to risk from Credit Valuation Adjustment (CVA)?

In the same paragraph it would be useful to get further clarification of the definitions of "structural foreign exchange rate risk". At the moment it is not clear to us what structural means in this definition.

At paragraph 192 it would be useful to get further clarification of the definition of "inherent" market risk. At the moment it is not clear to us what this means.

Conduct risk

We agree that the impact of conduct risk exposures arising from an institution's business model is an important issue for the competent authority to assess. This should be on a forward looking basis, as emphasised in para249, and based on the rules, regulation and guidance applying at the time, for instance, product sales were made. Retrospection, which imputes today's regulatory requirements to product sales made in the past under a different regime, should not be applied.

Interest rate risk in the Banking Book

The internal control framework on page 108-109 references that "authorities should assess whether the institution has in place a strong and comprehensive control framework and sound safeguards to mitigate its exposures to IRRBB in line with its risk management strategy and risk appetite" but also goes on to say that they should assess whether the limit system addresses EVE and NII sensitivity (section 308b on page 109) – in line with our previous guidance in the TFIR correspondence. It could be made clearer that the choice of limit system should be consistent with the risk management strategy and risk appetite e.g. whether an institution pursues an earnings or value proposition will tilt

the focus on what metric is deemed to be more appropriate and should be the choice of the institution.

In the IRRBB scoring framework on page 110, there is no clear definition of what is deemed to the materiality threshold with respect to the sensitivity of economic value and earnings.
Is materially measured in absolute or relative terms?
If measured in relative terms? If so, what is the basis for it?

- For EVE is sensitivity measured relative to T1 / CET1 / Total Capital?
- For earnings is it relative to overall NIM or underlying profit?

Model risk

The assessment of model risk on page 85 identifies two different forms of model risk. In section 6.5, 225 b ii) there is reference to “risk relating to improper use of any other models by the institutions for decision-making”. Here clarification is needed on the use of the wording 'any other model' and what the scope of model risk is expected to be. Some guidance is provided in Section 6.5.2, 255, where the following model usage categories are listed: “financial instruments trading; risk measurement and management; and capital allocation (including lending policies and pricing).” But our view is that more detailed guidance possibly a clear definition of model risk that is used consistently across the industry may be required here.

Title 7. SREP capital assessment

We agree, as suggested in para 320 that, where not based on institution-specific considerations, additional capital requirements should be applied consistently. Where however there are institution specific considerations, before making a final determination the competent authority should firstly have an appropriate dialogue with the institution concerned to ensure there is a complete and mutual understanding of the issues the competent authority has identified.

Paragraph 331 contemplates the requirement for additional own funds to cover control/governance deficiencies. It is important to emphasise that capital is not the only answer. Often a Risk Mitigation Plan, with agreed timetables will be a more effective measure, which could be backed up with an ‘expectation’ of further capital if deadlines were not met.

We are unsure the extent to which, in para 322, capital acts as an appropriate mitigant to cover funding risk. Again a mitigation plan that explains how the institution plans to restore it stable funding ratio as opposed to the immediate application of an extra capital requirement may be more beneficial and relevant.

Title 8. Assessment of risks to liquidity and funding & Title 9. SREP liquidity assessment

General comments

It is difficult to comment on intraday assessment proposals until we receive the outstanding regulatory update. It would be useful if the EBA could provide guidance on how this is likely to be integrated into the SREP process. Is likely to be incorporated into the Pillar II approach, or will there be a further consultation? In any case we would stress the importance of a level playing field in SREP.

This lack of clarity regarding the final rules for in regards to intraday liquidity is a concern for firms. While all banks want to be able to monitor intraday liquidity for their own sake, they cannot implement final systems until they know they know the precise requirements.

With regards to the quarterly monitoring of key indicators, could the EBA confirm that these will be part of existing LCR/NSFR reporting, rather than being an additional requirement? We believe the detail contained in the LCR and NSFR should be more than sufficient, but it there is to be any incremental data required, firms need to know.

Specific comments:

Para 366: the current wording 'before 30 days and after 3 to 12 months' appears to omit the 1-3 month time bucket. Can the EBA clarify whether they expect institutions to look at the liquidity position at 30D, 3M and 12M or (as we recommend as preferable) 0-30D, 1-3M, 3-6/12M.

Para 367: it is very important that the revised templates contain the actual calculation, or failing that, detailed guidelines to help firms, which will ensure there is consistent application across the industry. We would also strongly recommend that the revised templates are accompanies by detailed reporting guidelines, to ensure firms understand the templates, and will reduce Q&A's at a later date.

Para 369: could the EBA confirm what happens when an institution receives an intraday add on with regards to how it is reported in the Annual Report i.e. should it be in Pillar 1 or Pillar II?

Para 371(a): further details are required on the time gap between 1 month and 1 year; for example, should there be 3M, 6M and 9M in between?

Para 371(f): we are concerned that the definition on liquid asset could be deviated from "where justified". For a potential decision of such significance there needs to be a great deal more detail on what circumstances would be regarded as "justified". Furthermore, if one of the key supervisory objectives is to allow investors to compare different institutions on a level playing field, deviating from the set definition of liquid assets will detract from this objective.

Para 384(g): the intention of this paragraph is unclear. Could the EBA confirm that the intention is purely to ensure that appropriate controls are in place to manage potential conflict of interests between employee incentives and the best interests of the institution? Specifying "remuneration" into the paragraph would suggest that Treasury/ALM functions could not act as a profit centre.

Para 391: could the EBA clarify whether intraday liquidity will be based on international stress testing standards, or will the EBA be suggesting further scenarios?

Para 391(a): could the EBA provide further clarification as to what "survival horizon" actually means in practice. We believe the LCR is a reasonably severe monthly stress test, which is based on a full scenario, rather than sensitivity, analysis. For example, does the EBA expect this to be related to the risk appetite of the board? Further clarification is needed.

Para 400(d): by definition, contingency plans come into force when an institution has reached a scenario beyond risk tolerance and appetite. As worded, the CP could be read as institutions are expected to implement a contingency funding plan at the first sign of stress, which we are assuming is not the EBA's intention.

Para 416: we recognise the desire for supervisors to compare institutions and to summarise their findings into a liquidity SREP score. However, we would like to highlight that by summarising an institution's overall liquidity governance and controls in to a single number, regulators would introduce a new piece of non-public market sensitive information in to the overall system. A leak of this information could have a material impact on an institution, particularly if they are already unable to maintain adequate liquidity buffers. Furthermore, it is unclear whether market participants would

also request disclosure of the liquidity SREP score alongside LCR and NSFR. The risk of some institutions willingly sharing their SREP score while others do not could send negative signals into the market. We would request that the EBA makes it very clear that the SREP score is to be treated as confidential between the institution and relevant supervisors, and that it should not be shared by either party with any market participants.

Tables 9&10: "there is no discernible risk of significant prudential impact" - we find the use of the word prudential unusual; we would have thought "idiosyncratic" would be more appropriate. Could the EBA explain its thinking behind this terminology?

Para 420: we are not sure why additional own funds requirement, a capital measure, is considered in the context of liquidity. We assume any liquidity shortage must be supported with additional funding, not additional capital.

Para 428: we are concerned that this could potentially introduce another metric with which to calculate liquidity. Providing firms meet the minimum standard, it is not a supervisory duty to instruct them how to do so.

Para 434: it is unclear on what theoretical basis the EBA has developed approach 1. Approach 1 appears to be macroprudential, but appears in Pillar 2. It is also unclear as to why as to why the denominator should be multiplied by 125%. Further clarity on the EBA's thought process, and what they are aiming to achieve, would be helpful.

We are also concerned that "counterbalancing" could be introducing another metric. HQLAs are the basis of the numerator, and should remain so, rather than considering "counterbalancing", introducing this concept will only lead to inconsistency in liquidity management.

Title 10. Overall SREP assessment and application of supervisory measures

The SREP guidelines state that supervisors may use supervisory measures, including requiring changes to business model and strategy "to address specific deficiencies identified in the assessment of SREP elements" without specifying what these 'specific deficiencies' would be. This requirement can be interpreted very broadly by competent authorities, and to avoid any doubt we would suggest that EBA clarifies this point further, ensuring that it is aligned with the Article 104 of Directive 2013/36/EU.

Title 11. Application of SREP to cross-border groups

The level at which the SREP assessments are conducted should be aligned with the approach taken by the competent authority for Pillar 1 requirements. Therefore the SREP would be done at the group level, or sub-consolidated or solo level depending on differing business models, organisational structure, risks facing individual banking groups, capital and liquidity fungibility across the group, and taking into account the preferred resolution strategy. Specifically, the competent authority should be able to carry out a SREP on a consolidated or sub-consolidated basis only rather than at each individual entity level, where capital and risks are adequately allocated and there are no impediments to the transfer of capital across the group or sub-group. This would allow for a proportionate and appropriate assessment of the risks, but would not necessarily mean that the individual entities are absolved of their obligation to comply with capital adequacy requirements. This approach would also accommodate for instances where competent authorities have waived the application of prudential requirements on a solo basis (e.g. in accordance with Article 7 of CRR).

It is unclear why for subsidiaries of cross-border groups, the focus should be primarily on a solo basis. Even where these are subsidiaries of banking groups which are headquartered overseas, the SREP assessment can still be carried out on EU consolidated/sub-consolidated basis rather than only on an individual basis. It is important that the SREP and Pillar 2 requirements are applied at the

same level as Pillar 1 requirements. Furthermore if SREPs are done on a solo basis, this does not take into account interdependencies and complexities of large banking groups.

Title 12. Final provisions and implementation

We have no comments on this title.

Other comments

Peer Review Analysis

The Guidelines emphasise the use of Peer Review Analysis during the SREP process. Although peer review analysis can be a useful tool in flagging differences between firms, there are a number of drawbacks with peer review analysis if the group of firms selected are not 'perfect peers'. For example, a difference may be due to justifiable differences in firm's business models, plans and risk appetites, differences may be due to the data being drawn from different time periods (e.g. due to differences in the economic environment rather than differences between firms). National regulators should also avoid drawing in the 'next best fit firm' just to have sufficient number of firms to conduct peer review analysis, which are not really peers, as this will skewer the outcome of the peer review analysis. We recommend that the EBA should provide guidance on the composition of the peer group and also declare to banks the composition of the peer group.

Unintended consequences - Confidentiality and loss of competitive advantage

A great deal of the SREP involves considerable assessment of banks business strategy and plans, including future plans not yet in train. This is particularly the case with the ICAAP. It is important to stress in the Guidelines that such details need to be treated with the highest degree of confidentiality otherwise commercial opportunity and competitive advantage can be lost.

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