



## European Banking Industry Committee

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European Banking Federation (EBF) • European Savings Banks Group (ESBG) • European Association of Cooperative Banks (EACB) European Mortgage Federation (EMF) • European Federation of Building Societies (EFBS)  
European Federation of Finance House Associations (Eurofinas)/European Federation of Leasing Company Associations (Leaseurope)  
European Association of Public Banks (EAPB)

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

Brussels, 1 September 2004

### **EBIC Response to CEBS' consultation paper on the application of the Supervisory Review Process under Pillar 2.**

Dear Mr. Roldán,

The European Banking Industry Committee (EBIC) is an alliance between the main European banking industry federations: the European Banking Federation (FBE), the European Savings Banks Group (ESBG), the European Association of Cooperative banks (EACB), the European Mortgage Federation (EMF), the European Federation of Building Societies (EFBS), the European Federation of Finance House Associations (Eurofinas) / the European Federation of Leasing Company Associations (Leaseurope), and the European Association of Public Banks (EAPB).

EBIC welcomes the opportunity to comment on CEBS' High Level Principles (HLPs) on the Supervisory Review Process (SRP). We feel that CEBS has taken an important step in sharing its views with the industry on Pillar 2 at this early stage.

### *Introductory comments*

Pillar 2 goes beyond the prescriptive measurements of Pillar 1 by addressing directly the individual risk profile of each institution. Its overarching objective is to enhance understanding on the part of the group, and its supervisor, of a groups whole risk profile thereby reducing the probability of prudential failure in a cost efficient manner.

EBiC believes that to facilitate this process, the framework for both banks and supervisors must be clear and practicable, and should be in line with the objectives of the Single Market. The Supervisory Review and Evaluation Process (SREP) High Level Principle 1 makes reference to the importance of consistency of application. EBiC feels that this point should be strengthened in the paper. In the context of convergence and a level playing field within the EU, EBiC is supportive of the supervisory disclosure regime which has been included in the Commission's proposal for a Directive and which will help banks to compare the approaches of supervisors.

A number of the EBiC member associations firmly believe that the SRP will only work in practice if it is applied at the level of the consolidated group. If it is not, financial institutions will be subject to inconsistent supervisory treatment across subsidiaries and the objective of enhancing the understanding of firms' overall risk profiles will be jeopardised. These members feel that application of the Supervisory Review Process at sub-consolidated or solo-level would lead to double counting of risks and would, therefore, distort analysis of the risk profile of the group. Moreover and in many cases, such an analysis at subsidiary level will not be possible or, at least, will be truncated as many essential components like strategic considerations, capital planning, or risk management take place only at group level.

Furthermore, the same member associations feel strongly that in order for both the Internal Capital Adequacy Assessment Process (ICAAP) and SREP to work in practice, it is essential that the consolidating supervisor leads the SRP. Only in emergency situations should the host state supervisors exercise Pillar 2 powers, for example in case of liquidity issue or a clearly inadequate allocation of capital to the subsidiary.

However, some EBIC member associations are concerned that extending the role of the consolidated supervisor to the SRP could lead to level playing field issues within EU national markets as local banks and subsidiaries of international groups would be submitted to different supervisory authorities though competing in the same market.

Furthermore, in order to ensure consistency, and avoid the limitation of activities on a cross-border basis, financial institutions with subsidiaries abroad should not be subject to different, inconsistent or even contrary requirements arising from the SRP. Given that the consultation paper does not include any statement on this subject, CEBS should publish a separate paper on the issue in the coming months.

EBIC agrees that the ICAAP and SREP must be closely intertwined. We believe that it is essential that the two processes function as a dialogue between the supervisor and the institution. The process should flow from the institution to the supervisor: the institution must first design an ICAAP which fits with its particular risk profile and which is fully integrated into the management of the firm, and then work with the supervisor to approve and implement that system taking into account the complexity of the institution.

### ***The Supervisory Review Process – Key considerations***

1. Pillar 1 sets out the minimum capital requirements for banks covering both quantitative and qualitative risks requiring banks to meet high standards and to take the most conservative view. EBIC strongly believes, therefore, that additional capital requirements under Pillar 2 should be the exception and not the rule. Additional capital should only be required where there is a clear case that it will provide effective and efficient mitigation of risk. This concept is acknowledged in Principle VIII of the SREP and it is therefore inconsistent to emphasise additional capital add-ons above other tools in this paragraph.
2. We feel that the explicit reference to setting additional regulatory capital in paragraph 17 should be deleted. Pillar 2 is about the strength of banks and is delivered not just through additional capital but through the quality of thinking, management and reputation. It follows that threats to the financial soundness of an institution are not always best addressed with greater financial resources, but systems, controls, management and mitigation strategies.

3. We strongly believe that the positive impact of diversification of risk should be recognised. Diversification gives grounds for a negative adjustment within Pillar 2, offsetting unmeasured risks and the results of stress testing. Pillar 2 should not simply sum the areas of capital deficiency and disregard the areas of capital surplus.

### ***The Internal Capital Adequacy Assessment Process***

4. EBIC welcomes the explicit recognition of the proportionality principle in Principle II. It is not desirable that supervisory requirements should lay a burden on firms to manage risks to which they may not be exposed. We believe that the criteria of size, risk profile and complexity should be used throughout the paper as a guideline to ensure that the proportionality is clearly respected.
5. Principle IV of the HLPs refers to the outsourcing of parts of the ICAAP or its review. While EBIC agrees that the CEBS recommendations on outsourcing will serve as a guideline in this regard once they are fully developed, we feel that CEBS should be careful to avoid restricting institutions from outsourcing on the basis of prescriptive principles. The decision to outsource parts of the ICAAP should be reviewed by the supervisors on a case by case basis.
6. CEBS recognises in Principle VIII that the ICAAP must be comprehensive but that “there is no standard categorisation of risk types”. It is, therefore, unclear why a new risk taxonomy is presented in Annex B. A list of this nature neither reflects the diversity in supervisory practice nor the diversity in institutions’ own risk practices. For example:
  - reputational risk may already be captured as a combination of operational and business risks in many institutions;
  - strategic and earnings risk can be combined in a business risk definition as both risks relate primarily to earnings risk or risk to net operating profit;
  - the additional risk to earnings and capital through capital risk is entirely unclear as the composition of capital is defined within the elements eligible for Tier 1, 2 and 3 capital.

This new taxonomy presented in the HLPs risks placing more burdensome requirements on EU banks than banks only subject to the revised Basel Framework.

7. Furthermore Annex B reintroduces concerns for the industry that Pillar 2 will become a box-ticking exercise. This outcome would be directly contrary to the objectives set out by CEBS in this paper and should be prevented at all costs. This kind of categorisation of risks could also lead to overlap between Pillars 1 and 2.
8. EBIC is concerned with the proposal in Principal XI that firms should make disclosures on their ICAAP model for comparison amongst their peer group. There are dangers inherent in supervisors encouraging too great a degree of uniformity of practice. Pillar 2 should have a systemic value in allowing institutions to exercise a diverse range of measures and management techniques. The SRP should be, in its entirety, a confidential process between banks and supervisory authorities.

### ***The Supervisory Review and Evaluation Process***

9. EBIC recognises that the HLPs set out in this consultation paper were developed before the proposal for a Directive was published. We feel that, for the sake of clarity, in future iterations of these principles, reference should be made by CEBS to the minimum requirements for supervisors as required under Article 124 of Act 1.
10. As previously mentioned EBIC agrees with the statement in Principle VIII that additional capital requirements represent only one of several regulatory tools to be used by the supervisor. We would urge CEBS to go further. Principle I of the SREP should explicitly state that Pillar 2 should not automatically require a higher capital standard than Pillar 1.
11. Furthermore, Principle VIII states that the SREP could lead to prudential measures and other supervisory actions being taken to address deficiencies identified under Principle VII. VIII(b) indicates that a supervisory authority can require credit institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements. In the event that a provisioning policy is imposed, we assume that this will be aligned with the relevant

accounting standards so that inappropriate disparities between regulatory and accounting standards will not arise.

12. EBIC welcomes the acknowledgement in Principle X that the nature of the annual review “will depend on the nature and scale of the institution.” However, we would invite CEBS to specify in this context, that the annual review does not necessarily imply on-site inspections.

We look forward to working with CEBS in developing these principles as the Capital Requirements Directive evolves.

Yours sincerely,



Ian Mullen  
EBIC Chairman



Simon Wills  
Chairman of EBIC Capital Adequacy  
Working Group