

**British Bankers Association (BBA)  
London Investment Banking Association (LIBA)  
International Swaps and Derivative Association (ISDA)**

**Response to**

**CEBS CP03  
The Application Of The Supervisory Review Process Under Pillar 2**

**31 August 2004**

## 1 Introduction

The Associations (BBA/LIBA/ISDA) welcome the consultation paper released by CEBS on the Application of the Supervisory Review Process under Pillar 2. We recognise the significance of a paper that seeks to establish a high level framework for a common EU approach to supervision and we commend CEBS for its open and constructive approach. The CEBS consultation marks a significant advance in thinking and we hope that the paper provides a firm basis for dialogue between supervisors and the industry with a view to promoting a level playing field for the implementation of the Pillar 2 requirements across the EU's different jurisdictions. We believe that the paper reflects a largely positive reaction by supervisors to the joint submission of the Associations to the European Commission on Pillar 2 in October 2003. This is most encouraging as it re-enforces our mutual desire to work constructively together moving forwards.

We are glad to see that CEBS has set out a high level framework. We believe that this delivers great clarity of intention without distracting minutiae and should help to form a solid foundation for the consistency of approach that industry and regulators both seek. We hope that the work by CEBS can be influential outside of a purely EU sphere and will inform the international dialogue and approach.

Inevitably, there will be areas of particular sensitivity both for regulators and for firms, and not all of these issues are within the scope of influence of CEBS itself. Crucial areas for our firms are the topics of home/host responsibilities and the scope of application and the overall impact on capital. Naturally we must take as our starting point for debate the proposals set out by the Commission in the re-cast directives. Our objective, therefore, in setting out our response to CEBS in this paper, is to make clear our key concerns about the supervisory review process in the hope that this understanding will inform the application of discretion that the directive allows to supervisors.

**Next stage:** We would welcome the opportunity to discuss this paper with CEBS and to understand the way in which the supervisors intend to develop this stream of work.

## 2 Reaction to Key Considerations raised by CEBS (Section 3 of CEBS paper)

Overall we welcome very warmly the paper issued by CEBS. We see in this paper an appreciation and articulation of many points that we have ourselves raised in dialogue with regulators (most notably in our paper of October 2003 submitted to the European Commission) and would like to emphasise our particular support for the following principles embedded in the CEBS document:

- Proportionality concept both for ICAAP and SREP
- Responsibility of firm to define and develop its ICAAP
- Risk based framework
- Importance of capital planning.

There are areas which we particularly wish to draw to the supervisors' attention and where we wish to be very careful in ensuring that the supervisors understand our concerns:

- **Scope of Application.**

The CEBS paper notes that, prior to the directive being released it is not clear what the scope of application will be. The directive proposal has now been issued and, according to our reading, applies to credit institutions and investment firms, and to groups at the level of each Member State. In certain situations (where a firm is not part of a consolidated group) the Pillar 2 requirements apply at individual entity level.

We have argued previously and continue to stress that it is important that Pillar 2 processes should take place at the level of the firm/group that is most appropriate in the given circumstances and we welcome ICAAP High Level Principles III and V in this context. No firm should have to replicate pillar 2 processes and practices in multiple legal entities unless this delivers meaningful cost/benefit. We are sceptical whether it would achieve this, particularly in the light of the implied increased resource requirements for regulators and firms alike. Some Pillar 2 functions and processes take place at group level, and over the years firms have actively been encouraged to develop these procedures. In such circumstances we would argue that it is at the group level that the assessment best takes place. The application of Pillar 2 should be able to recognise the group dimension.

For example recognition of diversification and correlation benefits in firms' internal capital models is typically determined and managed at group holding level - the lower level organisations within the group are not truly independent units. Hence the home supervisor will be the most appropriate regulator to oversee this process, rather than host supervisors who might have more partial information available and hold views that conflict with that of the home supervisor. Ascribing a leading/ coordinating role to the home supervisor is therefore a natural and practical consequence of the recognition of correlation and diversification benefits. Whilst liquidity and solvency issues will remain a legitimate focus for any supervisor of a regulated entity incorporated in its jurisdiction, there must be a meaningful dialogue between home regulator, parent and subsidiary institutions, but which does not imply a full scale supervisory review process by the host regulator.

- **Home/Host relationships**

In the light of our concerns regarding scope of application, it will be clear that we place as much premium as supervisors do themselves on the importance of effective relationships between supervisors. National discretion, particularly under Pillar 2, has the capacity to lead to severe competitive distortions, and for firms operating in more than one Member State, to additional costs for the implementation and running of the new capital framework. Supervisors need an effective mode of cooperation so that firms are not subject to duplicative or conflicting requirements. Much of our concern can, we believe, be resolved by rigorous planning, coordination and communication. The more complex the group, the more important this becomes.

Of course we understand that the directive allocates responsibilities to supervisors and we do not wish to comment here specifically on merits or demerits of consolidation supervision/lead supervision structures. We wish to emphasise only that to the greatest extent possible, supervisors should be able to work with and place reliance upon each other when satisfying themselves on whether the Pillar 2 assessment of an individual entity or sub-group is adequate. This concern is crucial to firms with cross border activities.

We recommend that the mechanisms for such home/host cooperation be formally recognised through publicly available bilateral agreements or memoranda of understanding, describing the process by which responsibilities are shared. It is to be expected that, with appropriate trust and mutual understanding in a steady state supervisory cooperation will work well. However we recognise that in times of stress either of an individual firm or the market more generally individual regulators' jurisdictional responsibilities could tend to over-ride the pre-agreed modus operandii. Whilst we are sure that CEBS has already recognised this potential for dissonance we do encourage it to create robust workable solutions to this problem.

We note that the CEBS paper does not specifically address in detail the co-operation of member states' supervisory authorities as regards the implementation of Pillar 2 of individual cross-border institutions. This is a major topic and we would ask CEBS to publish its thinking on the treatment and possible alignment of Pillar 2 supervisory practices including scope for streamlining of Pillar 2 rules for firms operating in more than one country. We believe that the wording of recitals 48 and 49 of the recast directive 2000/12/EC could act as a fruitful starting point for CEBS' consideration.

- **Capital Adequacy**

The late introduction of the scaling factor into both the Accord and the EU Directive proposals and the implications this may have on the new Pillar 2 regime has been a major cause of concern for the industry. The whole validity of a firms' Pillar 2 programme could be undermined by a potential blanket increase in its Pillar 1 charge. Moreover, the absence of any Pillar 2 dimension in former Quantitative Impact Studies means that the potential "capital impact" of Pillar 2 cannot yet be assessed by firms. This is a significant area where there is little reliable information yet available.

In our paper of October 2003, we iterated a number of principles, a key one of which was that **Supervisory action should be the exception**: Supervisory action requires the substitution of the judgement of the supervisor for the judgement of the firm, although the firm retains full responsibility for the consequences. Therefore action should be the exception and needs to be explicitly justified by the supervisor, especially as Pillar 1 will on average deliver an adequate capital charge and require firms to meet high qualitative and quantitative standards. Supervisory action – notably capital add ons - under Pillar 2 should therefore be the exception not the rule. In other words it is important that capital add ons should be the exception rather than the norm. While accepting that supervisors have a wide discretion permitted to them, it is important to realise that the debate on capital adequacy to date has not at any time suggested that Pillar 2 would yield systematic or material charges under pillar 2. Even if material intervention may be appropriate for temporary or outlier situations, many firms based on the fact that none of the former Quantitative Impact Studies contained pillar-2 segments, will expect that capital add-ons would be rather the exception than the norm and that capital charges based on pillar-2 would be non-material. If the regulators are of a different view, we would urge them to incorporate this element in the future study of the capital impact on firms during the period of "parallel running".

The question of "capital add-on" is of course one aspect of the assessment the supervisor must take in considering whether a firm has demonstrated that its management and capital are "adequate" relative to its risk profile. However, there is no definition of "adequate" (and nor will there be a definition in the directive). As in past comments, we think it worth re-iterating that the capital standard under Pillar 2 is the same as under Pillar 1, it is merely that the form of the test is different. Pillar 2

should not be used simply as a way for supervisors to restore or exceed historic capital levels.

Furthermore, we wish to re-iterate that the requirement to hold extra capital under the Pillar 2 SREP process is not the only answer, as capital is not a substitute for appropriate risk assessment practices or adequate internal controls. If further capital is required supervisors should give their reasons and specify what remedial action should be taken to reduce it.

- **Interaction of ICAAP and SREP and Reliance on Firms' Management.**

We fully endorse the targets of Pillar-2 in general, the ICCAP and the bilateral relationship between firm and regulator concerned arising from SREP. The SREP demands that the supervisor comes to a view on whether a firm's ICAAP addresses the institution's risk profile appropriately. We do not wish to argue for a formulaic outcome of the interaction of ICAAP and SREP, but it is important to note that it is here that (a) the reliance upon/intervention in a firm's management is critical and (b) that the scope for national divergence could be at its most severe.

We believe that it is fundamental that Supervisory Review remains a firm driven process and responsibility. The Pillar 2 process is first and foremost the responsibility of the firm management and shall be integral to the management of the firm. The onus is and will always remain upon the firm to assess and manage its risks. Hence, for their part, while having to be comprehensive in their scope of observation, supervisors' activities in the context of the supervisory review process should not extend into the responsibilities of a firm's management. The firm-supervisor relationship arising from SREP is rightly and repeatedly characterised as being a "dialogue". We would not wish to see the balance of this dialogue moving into areas which are and should remain at the firm's business decision discretion.

We support the iteration of supervisors' and management's responsibilities spelled out in the final Basel Framework Document (para 746) and we would like to see a similar wording supported by CEBS. We have serious concerns on this issue and would like therefore to have it addressed in a highly visible manner, such as via an additional SREP-principle or at the SREP-summary.

We argue, in our comments on Home-Host relationships for the value of greater cooperation between supervisors and closer alignment of practices. We see this as fully compatible with another core concern which is that the interaction of the ICAAP and SREP needs to be a tailored approach to the firm. Ideally there would be case-by-case decision making available to all firms in all jurisdictions, but we appreciate that it may not be possible for supervisors to attempt deliver this in all instances, but given our overwhelming preference for a case-by-case assessment, we would advocate further discussion in order to identify exceptions where it would not reasonably be expected.

### **3 Reaction to ICAAP Principles:**

In general we support the ICAAP principles as outlined in the CEBS paper. Further commentary may be appropriate.

- Principle V – "for the more sophisticated institutions, a complete integration of the ICAAP into day to day management." The implication of this principle may be open to interpretation. We do not, however, agree with the concept

whereby a firm should manage its economic capital on a day-to-day basis. This may not be the intention of CEBS, but greater clarity on this point is needed.

Principle VIII c “There is no standard categorisation of risk types, although supervisors will usually expect that the institution has considered all material risks – see annex B. The institution should be free to use its own terminology, but should be able to explain to the supervisor the details, methods used, the coverage of all risks and how this relates to its obligations under Pillar 1.” In view of the statement that there is no standard categorisation of risk types, it is unclear why a new risk taxonomy is presented in Annex B. Such a list B reintroduces concerns for the industry that Pillar 2 will or could 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.

Furthermore, a list of this nature neither reflects the diversity in supervisory practice nor 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.
- Principle VIII d – we stress that the external factors that are to be taken into account should be left to the firm to define. The regulator may query further if it is a peer outlier. It is important to ensure that any detailed list remains a guideline, not a requirement.
  - Principle VIII g – We welcome very strongly the statement: “In the aggregating of all risks in a comprehensive manner the institution may take into account risk correlations.” (Note. correlation is also referenced in principle X c iii )
  - Principle VIII f and IX c – stress testing. CEBS advocates stress testing but may intend to refer to both stress and scenario testing. Greater clarity on CEBS’ expectations in relation to these principles – bearing in mind that firms’ views differ on what constitutes stress and scenario testing would be welcome.
  - Principle IX b - whilst we agree that firms should have a forward looking capital plan, some of the explicit requirements here may be onerous for some firms – this principle provokes important questions of interpretation. For example how far in the future should the capital plan be extended? Meeting the requirements of part (a) should provide enough of this detail without becoming overly prescriptive.
  - Principle X – we support the concept that there is no one “correct” process for developing the ICAAP (Xc); the fact that CEBS does not suggest that a formal economic capital model be mandatory (Xb); acknowledgement that some

risks can only be assessed, but are not measurable (Xg); and advocacy of use of management judgement, rather than sole reliance upon pure quantitative methods (Xf).

- Principle XI a states that the ICAAP should produce a reasonable overall capital number which the firm should be able to compare with its regulatory requirements. Firms acknowledge that they could produce such a number, but are concerned that such a figure could be very misleading to those without access to the ICAAP detail of the respective firm and in particular how much “spare” regulatory capital a firm usually has at its disposal. We seek clarification that the ICAAP number cannot be “translated” into a regulatory number (e.g. in the manner of an exchange rate), but we accept that a firm should be able to discuss why it believes its ICAAP responds appropriately to the risks that the firm is exposed to an about which the supervisor will have concerns. This would appear to fall naturally within a well structured dialogue.
- Principle XI b – we do not believe that firms should be required to make greater disclosures of their ICAAP routinely. Greater disclosure to the supervisor should take place only when the firm is comfortable, and when supervisor would use the information on a confidential/aggregated basis. Further, we are not clear on what basis the regulators might seek to establish peer groups – which we imagine could easily be misleading. If peer analysis is intended, however, then the need for greater depth of examination than comparison of the single ICAAP number (as noted above) is a pre-requisite.

#### **4 Reaction to SREP Principles:**

We very much appreciate that CEBS has provided an opportunity to comment on the supervisors practices and objectives. This is an important and highly welcome development as it provides an invaluable insight into the supervisors needs and concerns which is indispensable if we are to build an effective regulatory dialogue which we believe is essential. We therefore welcome the opportunity to respond to this section of the paper, believing that it will foster a necessary climate of greater openness and understanding between the regulator and the industry.

We would like to draw attention to two areas of the section on SREP in particular as well in addition to some remarks on the principles as articulated in the paper.

- **Supervisors should not attempt to recalculate a firm’s internal assessment.** We have stressed to supervisors consistently over the recent years that it is essential that supervisors should not seek in some way to “second guess” or “recalculate” an institution’s internal capital processes. Instead it is important to understand the institution’s practice and comment on clear omissions or risks that have not been addressed or appropriately captured. We believe that broadly this concept is embedded in the SREP principles, but we feel it necessary to articulate our concern again.
- **Home host cooperation and coordination.** As noted above, we encourage the strongest degree of organisation and planning by the supervisors. It appears not to be necessary to seek a reallocation of home and host responsibilities on a formal legal basis, but an emphasis on planning and control of process by the supervisors will avoid much unnecessary effort and expense in applying the Pillar 2 regime. The home/host relation is omitted in this CEBS consultation paper on Pillar-2. As we understand, a working group

of the Groupe de Contact was asked to prepare a document on this subject, which we are awaiting with great interest.

Commentary on some individual principles:

- Principle 1 d – we support wholeheartedly the need for consistency and a level playing field across the EU (and beyond!)
- Principle II – scope of application. We acknowledge that the directive will set certain parameters that the supervisors must observe, but we wish to encourage supervisors to think as holistically in terms of a group as possible and not to introduce additional burdens needlessly on individual entities.
- Principle IV e – we are concerned by the suggestion that there should be “stress tests” used by supervisors. As we are not wholly certain what might be in the Committee’s mind, we seek greater clarification on what is intended.
- Principle IX a – we support in the strongest terms the fact that the supervisor should provide sufficient detail in its feedback to a firm, including the reasons for any adjustment to the capital requirements. We think that this is an indispensable foundation to the Pillar 2 relationship and we were disappointed to see that the final framework issued by Basel excluded this commitment though earlier iterations of the framework had supported the principle.

## **5 Reactions to Annex A – Minimum Content of Risk Assessment Systems**

We welcome the Committee’s willingness to share its thoughts on how supervisors’ internal processes and responsibilities might be managed. We are encouraged by the creation of a template to promote consistency of practice among supervisors. Two themes could be emphasised more than at present however:

- **Cross border dimension.** Again we can only stress the importance of coordination and effective cooperation in dealing with cross border groups (not only within the EU, but those groups that are global also).
- **Cross sectoral groups.** The CEBS consultation paper refers to credit institutions. Nevertheless, of course, the directive and the Supervisory Review and Evaluation Process will not apply exclusively to credit institutions, but to groups with both credit institutions and investment firms. In this context it will be essential for CEBS and its regulatory partners in other sectors to bear this aspect fully in mind in articulating their practices further.

## **6 Reactions to Annex B – SREP: Business Risk and Control Factors**

CEBS recognises in principle VIII that ICCAP must be comprehensive but “there is no standard categorisation of risk types”. It is, therefore, unclear why (as noted above) a new risk taxonomy appears as Annex b for “SREP: business risk and control functions”.