ASOCIACIÓN ESPAÑOLA DE BANCA

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# AEB RESPONSE TO EBA CONSULTATION ON THE REVISED COMMON PROCEDURES AND METHODOLOGIES FOR THE SUPERVISORY REVIEW AND EVALUATION PROCESS (SREP) AND SUPERVISORY STRESS TESTING

The Spanish Banking Association (from now on, "AEB") welcomes the consultation paper (EBA/CP/2017/18) on "*Draft Guidelines for the revised common procedures and methodologies for the supervisory review and evaluation process (SREP)*". We consider that the proposal will enhance the current framework by adding more clarity on certain aspects and by ensuring greater harmonization.

We provide detailed comments on the draft Guidelines in the second section of this response after highlighting our main concerns regarding the general EBA framework on SREP which are:

- The insufficient recognition of the benefits of diversification, both between risks and across geographies. We consider the approach to Pillar II should not be just a Pillar I plus some add-ons, but a comprehensive overview of the risk profile of an institution. This could only be achieved by assessing the risk holistically using models or approaches which reflect the benefits of no correlation between the different elements. Any assessment that does not take fully into account the benefits of diversification would be limited for the purposes of the SREP. We understand that the framework should incentivize the development of comprehensive models by accepting its use in Pillar II when they meet the supervisory expectations in terms of quality and reliability.

  Another option could be a simple and comparable methodology that captures the main features of diversification. Even being a second option, in our opinion this would offer a better trade-off between an accurate risk assessment and ensuring harmonization that the current framework.

- The Guidelines should clarify that P2R can only be applied when material risks are not covered by Pillar 1, and that these additional requirements cannot be used to reverse policy choices adopted in the level 1 text.

- There are still some parts that require an additional effort such as the business model analysis. In fact, we believe that this version loses a good momentum to reinforce this part.

- It must be said that it is a good approach to include the recovery plan assessment in the SREP evaluation. However:

  - Not all the elements detailed in the Guidelines would be covered in the recovery governance as the recovery plan is elaborated for a different purpose.

  - Regarding to recovery options, there are some recovery measures that can only be executed for recovery purposes.

  - Recovery stress scenarios should have a greater degree of severity than ICAAP and ILAAP stress tests.

  - Some items mentioned in the Guidelines such as the process for creating new products or the remuneration policy are not included in the scope of a recovery plan, so they should not be considered for the recovery SREP evaluation part.

- International standards regarding internal governance should not be imposed on institutions as if they were binding legal instruments, nor should they be equated to EU or national laws and other regulations.

- It is questionable whether the SREP Guidelines require the incorporation of certain – selected – paragraphs/sections of the Guidelines on internal governance or if it would be more convenient to state their general application by direct reference to them.

- The draft SREP Guidelines should thus not only envisage whether "group-wide policies and procedures are implemented consistently at subsidiary level" but also note that the assessment to be done by competent authorities will duly account for national differences and the principle of proportionality.

- Supervisors should assess the benefits of not disclosing the P2G to financial institutions and therefore negotiate the level of the P2G and the corresponding management buffer as part of the supervisory dialogue with banks.

- AEB is of the opinion that recovery scenarios are based on specific risks and vulnerabilities of the entity, so it makes sense to compare them with other internal stress test scenarios such as ICAAP or ILAAP.

- We welcome the EBA proposal that Stress tests which feed the P2G is carried out only every two years instead of annually.

1. **What are the respondents' views on the overall amendments and clarifications added to the revised guidelines?**

AEB welcomes the general review of the Guidelines. In this regard, the new parts/chapters included in them fill a gap of the previous version. As such, some explanations of the Pillar 2G and the link of other supervisory activities with the SREP decision are also welcome.

However, there are still some parts that require an additional effort such as the business model analysis. In fact, we believe that this version loses a good momentum to reinforce this part.

We also consider this revision is pursue at a proper timing. With two years of functioning of the SREP framework, it is a good time to take stock of how the framework working and propose changes (see comments on the part related to the Recovery Plan).

Moreover, within the wider revision of the CRD IV package this consultation can help to settle down the new requirements that are being introduced.

Additionally, we acknowledge the insufficient recognition of the benefits of diversification, both between risks and across geographies. We consider the approach to Pillar II should not be just a Pillar I plus some add-ons, but a comprehensive overview of the risk profile of an institution. This could only be achieved by assessing the risk holistically using models or approaches which reflect the benefits of no correlation between the different elements. Any assessment that does not take fully into account the benefits of diversification would be limited for the purposes of the SREP. We understand that the framework should incentivize the development of comprehensive models by accepting its use in Pillar II when they meet the supervisory expectations in terms of quality and reliability. Another option could be a simple and comparable methodology that captures the main features of diversification. Even being a second option, in our opinion this would offer a better trade-off between an accurate risk assessment and ensuring harmonization that the current framework.

Specifically, paragraph 352 represents a clear limitation of these benefits when determining additional own funds to cover unexpected losses. We agree that Pillar I requirement should be a floor for the overall capital requirements, but it does not mean, however, that Pillar I requirement for credit risk set a floor for credit risk internal economic capital. Otherwise, the EBA Guidance would not be aligned with the incentive of institutions to develop sound, effective and comprehensive internal capital processes that is clearly defined in article 73 of Directive 2013/36/EU.

We also note that these Guidelines introduce two types of scores: (i) risk scores to be applied to individual risks to capital, liquidity and funding that indicate likelihood that the risk will have a significant prudential impact on the institution (e.g. potential loss), and (ii) viability scores to be applied to the four SREP elements and overall SREP score that indicate the magnitude to risk to the institution's viability stemming from a SREP element assessed. With this new distinction, we consider that the diversification and business model should be given much more weight in assessing the viability score as a clear mitigating factor which could make an institution more resilience to absorb unexpected losses.

With regard to Pillar 2 Requirements (P2R), the Guidelines should clarify that P2R can only be applied when material risks are not covered by Pillar 1, and that these additional requirements cannot be used to reverse policy choices adopted in the level 1 text. This would include for instance not using P2R to override transitional or grandfathering arrangements, but also Pillar 1 exemptions and exposures subject to a 0% risk weight under the Pillar 1 framework.

Finally, we have also noted that the Table 8. "*Supervisory considerations for assigning a score to capital adequacy*" introduces as a new input for capital score and, therefore, for Pillar 2R whether the institution is able to comfortably meet its P2G.

According to this, we understand that the same risks that justified a determined Pillar 2G could also impact Pillar 2R in case the institution is breaching, or close to breach, the Pillar 2G. We see this as a source of double counting since the same risk in considered twice in Pillar 2 decisions.

2. **What are the respondents' views regarding 'the interaction between SREP and other supervisory processes, in particular assessment of recovery plans' provided in the 'Background and rationale' section?**

The recovery plan is part of the entity governance and supervisory report documents, so it is fair to include its assessment in the SREP methodology Guidelines as an additional tool for a complete evaluation.

- Governance: the recovery plan governance should be consistent with the rest of supervisory reports, such as ICAAP and ILAAP, and additionally it should be aligned with the risk appetite framework. However, not all the elements detailed in the Guidelines would be covered in the recovery governance as the recovery plan is elaborated for a different purpose.

- Indicators: recovery indicators are closely related to risk appetite framework indicators and the process to monitor them; its internal control and reporting channels should be embedded in the business as usual management of the entity. The decision-making process for recovery indicators should be included in the recovery plan and should be very similar to the one described in other supervisory documents.

- Recovery options: many of the capital and liquidity measures are closely related with capital and liquidity leverages included in other supervisory documents. Even if they have different timings, size and impacts, its execution plan and decision-making process usually remains the same.

  However, there are other recovery measures that can only be executed for recovery purposes.

- Stress scenarios: even if recovery stress scenarios have a different objective from ICAAP and ILAAP scenarios, they are closely related. The elaboration process, risks

and vulnerabilities included in the scenarios are very similar, however, in the case of recovery there is a greater degree of severity.

It must be said that it is a good approach to include the recovery plan assessment in the SREP evaluation.

However, some items mentioned in the Guidelines, such as the process for creating new products or the remuneration policy, are not included in the scope of a recovery plan, so they should not be taken into account for the recovery SREP evaluation part. The SREP assessment for each supervisory document should be only focused on relevant items for its subject.

From AEB point of view the following elements from the recovery plan should be analyzed in the SREP:

- Business model analysis:
  - Analysis of critical functions and core business lines.
  - Analysis of internal and external interconnectedness.

- Assessment of internal governance and institutions-wide controls:
  - Assessment of governance arrangements.
  - Assessment of recovery plan indicators.
  - Assessment of scenarios.

- Assessment of risk to capital and capital adequacy:
  - Assessment of recovery plan indicators.
  - Assessment of recovery options.
  - Assessment of viability analysis.

- Assessment of risks to liquidity and funding and liquidity adequacy:
  - Assessment of recovery plan indicators.
  - Assessment of recovery options.
  - Assessment of viability analysis.

It is necessary to remark that only those elements expected to be part of the recovery plan would be evaluated for the corresponding SREP evaluation.

**3. What are the respondents' views on how the assessment of internal governance and institution-wide controls has been aligned with the revised EBA Guidelines on internal governance (Section 5)?**

**A. International standards in the assessment of internal governance**

Before examining the way in which the draft SREP Guidelines have accommodated the new Guidelines on internal governance, it should be noted that the consultation process and approval of revised Guidelines provide an ideal opportunity to address the issue of SREP

assessments obliging institutions to comply with "international standards" (para. 88 of the draft Guidelines).

**International standards should not be imposed on institutions as if they were binding legal instruments, nor should they be equated to EU or national laws and other regulations**, especially if the latter allow institutions a degree of discretion in their application which international standards do not.

Taking an institution supervised by the ECB as example, it has to be borne in mind that the outcome of competent authorities' SREP will, in most instances, be a legally binding decision taken by the ECB, which has to be based on EU law (including the national transposition of directives) as stipulated in the SSM regulation (Article 4). Accordingly, the EBA should take into account that, **by introducing international standards within the Guidelines' scope, it is doubtful whether the Guidelines will achieve their objective of establishing consistent, efficient and effective supervisory practices or, quite the opposite, it will make supervisory tasks more difficult and cumbersome and lead to less degree of harmonization in the field of supervision of institutions across Europe.**

Including international standards as part of competent authorities' assessment tools poses much uncertainty for institutions, given that the Guidelines do not specify the framework of application of said international standards, which, de facto, means **that institutions will not know what to expect from their SREP** (in this sense, the draft Guidelines are not clear regarding what is to be considered an "international standard" and whether any international standards in the field of corporate governance are potentially applicable for the purposes of the SREP). Likewise, **the Guidelines may create an uneven playing field where different competent authority make use of different standards, once again at the expense of achieving a common and uniform application of Union law, which remains the objective of the Guidelines (Article 16 of the EBA Regulation).**

## B. Integration of the new EBA Guidelines on internal governance (EBA/GL/2017/11)

As a general comment, it is questionable whether the SREP Guidelines require the incorporation of certain – selected – paragraphs/sections of the Guidelines on internal governance or if **it would be more convenient to state their general application by direct reference to them**. This would avoid institutions and competent authorities a double process of interpretation, seeing as the SREP Guidelines only include certain extracts of the Guidelines on internal governance (without expressly excluding all the rest from the scope of the SREP assessment) and not always with the exact same wording. The following paragraphs of the SREP Guidelines serve as example of the inconsistencies between both texts:

- Paragraph 91 j) *"the internal governance framework is set, overseen and regularly assessed by the management body" where the Guidelines on internal governance provide that "the internal governance framework and its implementation should be*

*reviewed and updated on a periodic basis taking into account the proportionality principle, as further explained in Title I"* (para. 27).

- Paragraph 91 k): *"the internal governance framework is transparent to stakeholders, including shareholders" where the Guidelines on internal governance state that "the structure of an institution and, where applicable, the structures within a group, taking into account the criteria specified in Section 7, are clear, efficient and transparent to the institution's staff, shareholders and other stakeholders and to the competent authority"* (para. 71).

- Paragraph 92 h) - *"appropriate internal governance practices and procedures are in place for the management body and its committees, where established"* which has no clear direct reference to the Guidelines on internal governance.

- Paragraph 94 e) - *"institutions have implemented independent whistle-blowing processes and procedures" where the Guidelines on internal governance are much more flexible in this sense ("it should be possible for staff to report breaches outside regular reporting (e.g. through the compliance function, the internal audit function or an independent internal whistleblowing procedure)"*, (para. 118); *"institutions may also provide for a whistleblowing process"*, (para. 120).

- Paragraph 96 h) – *"the institution has the capacity to produce risk reports and uses them for management purposes and whether such risk reports are: i. accurate, comprehensive, clear and useful; and ii. produced and communicated to the relevant parties with the appropriate frequency"* which has no clear direct reference to the Guidelines on internal governance.

- Paragraph 97 b) – *"[the internal audit function] has its purpose, authority and responsibility defined in a mandate that recognizes the professional standards and that is approved by the management body"* where the Guidelines on internal governance do not envisage the obligation of the management body to approve said mandate.

- Paragraph 97 h) – *"[the internal audit function] adequately covers all areas in a risk-based audit plan, including ICAAP, ILAAP and new product approval process (NPAP)"* which has no clear direct reference to the Guidelines on internal governance.

- Paragraph 97 i) – *"[the internal audit function] determines if the institution adheres to internal policies and relevant EU and national implementing legislation and addresses any deviations from either"* which has no clear direct reference to the Guidelines on internal governance.

- Paragraph 100 a) – *"the responsibility of the management body in respect of risk strategy, risk appetite and risk management framework is exercised in practice by providing appropriate direction and oversight"* which has no clear direct reference to the Guidelines on internal governance.

Throughout the document, some **risk-related terms are used not always consistently** creating confusion (e.g. "risk strategy", "risk appetite", "risk appetite statemen", "risk management framework", "risk policy"). Thus, there is no definition of the "risk policy" (please see para. 100 f)) neither in the SREP Guidelines nor in EBA Guidelines on internal Governance. Additionally, the risk strategy seems to encompass the risk appetite and the risk management framework under the EBA Guidelines (para. 23.b *"the overall risk strategy, including the institution's risk appetite and its risk management framework and measures…"*), but the SREP Guidelines frequently treats risk appetite and risk management as separate elements from the risk strategy (e.g. para. *99*[1]*)*

As regards section 5.10 of the draft Guidelines ("Application at the consolidated level and implications for the group entities"), we would suggest reviewing the section's wording, in order to more comprehensively accommodate the new Guidelines on internal governance. In this sense, it is important that the SREP assessments are conducted taking into account the wide-array of national differences that may exist within subsidiaries of CRD institutions, and which the Guidelines on internal governance duly take into account, inter alia, in the following paragraphs:

> *"83. The management body of a subsidiary that is subject to Directive 2013/36/EU should adopt and implement on the individual level the group-wide governance policies established at the consolidated or sub-consolidated level, in a manner that complies with all specific requirements under EU and national law.*
>
> *[…]*
>
> *87. The consolidating institution should ensure that subsidiaries established in third countries, and which are included in the scope of prudential consolidation, have governance arrangements, processes and mechanisms in place that are consistent with group-wide governance policies and comply with the requirements of Articles 74 to 96 of Directive 2013/36/EU and these guidelines, as long as this is not unlawful under the laws of the third country*
>
> *[…]*
>
> *196. Institutions should ensure that their subsidiaries and branches take steps to ensure that their operations are compliant with local laws and regulations. If local laws and regulations hamper the application of stricter procedures and compliance systems implemented by the group, especially if they prevent the disclosure and exchange of necessary information between entities within the group, subsidiaries and branches should inform the compliance officer or the head of compliance of the consolidating institution".*

As regards **section 5.10** of the draft Guidelines ("**Application at the consolidated level and implications for the group entities**"), **the draft SREP Guidelines should** not only

[1] Paragraph 99 states "Competent authorities should, in particular, assess if there is an appropriate and consistent link between the business strategy, risk strategy, risk appetite and risk management framework, capital and liquidity management frameworks."

envisage whether "*group-wide policies and procedures are implemented consistently at subsidiary level"* but also **note that the assessment to be done by competent authorities will duly account for national differences and the principle of proportionality.** The way in which group-wide arrangements, processes and mechanisms are implemented in a Group's subsidiaries will depend on whether the subsidiaries are themselves subject to CRD on an individual level and, importantly as regards subsidiaries not themselves subject to CRD, on whether these arrangements, processes and mechanisms can be accommodated to their national laws and regulations.

Lastly, concerning section 5.11 ("**Summary of findings and scoring**"), specifically as regards **diversity targets set by institutions**, it should be noted that these will only be measurable once the deadline by the institution, if applicable, has been met, and thus **in no case should diversity targets be measured before said deadlines and have the effect of downgrading SREP scores for the institution.**

**4. What are the respondents' views on the provisions of the newly introduced Pillar 2 Capital Guidance?**

AEB welcomes the transparency included in the draft Guidelines related to the methodology of computation of the Pilar 2 Guidance and its link to relevant supervisory stress tests (including those performed by the EBA). In the same vein, it is also welcome the possibility to update the computation of a P2G using a simplified version of a stress test. However, for both cases AEB would recommend maintaining a certain stability of the methodology in order to avoid unnecessary fluctuations in the capital ratios (including P2G).

**Calibration:**

When determining the size of Pillar 2 Guidance, the EBA draft Guidelines set (para. 395) that competent authorities should consider the year when maximum stress impact occurs in relation to the starting point and time horizon of the scenario of stress tests.

AEB considers that a more holistic view on how losses are distributed over the forward-looking time horizon would be needed. In this sense, the EBA proposal to focus on the year when maximum stress impact could, in some cases, distort the results.

A good example of this would be the market risk shocks, which according to paragraph 208 of the stress test methodology should be fully recognized in the first year of the stress test horizon.

Another example is how IFRS 9 impacts would be treated under the stress test exercises, concentrating losses on the first year of stress as a consequence of the perfect foresight and other assumptions. In our view, the necessary level of loss absorbing capacity for the banking system is invariant to accounting standards. The change in accounting standard will not, by itself, change the cumulative losses banks incur during any given stress episode, and neither should the capital requirements associated to these losses.

According to paragraph 127[2], we consider that further clarification is required on how competent authorities will decide, and the grounds on which it is based, whether or not future regulatory changes should be considered. In our view, to avoid different interpretations among jurisdictions, objective criteria should be defined in the final Guideline.

**Consequences of breaching P2G:**

The draft Guidelines, even if they do an extraordinary effort in trying to explain the methodology to compute the P2G, lack a proper description of what are the implications of breaching the P2G vis-à-vis other requirements. In this regard, it would be welcome that the Guidelines establishes the proper framework to understand the "binding degree" of this Guidance/recommendation and in the same vein to include a menu of options available to supervisors in case banks breach the P2G.

AEB considers that if the P2G is some sort of "soft" requirement then it is very similar to a management capital buffer. If this is the case, there is a certain overlapping between the risks the P2G is covering and the risks covered by the management buffer defined by the institution increasing "de facto" the capital requirements.

**Periodicity:**

We welcome the EBA proposal that Stress tests which feed the P2G is carried out only every two years instead of annually. According to paragraph 392, in the other year, competent authorities should assess based on all relevant information, including outcomes of past supervisory stress tests together with additional sensitivity analysis, i.e. simplified forms of supervisory stress testing, whether P2G is still relevant or needs to be updated.

**5. What are the respondents' views regarding disclosure of P2G (paragraph 403), having in mind the criteria for insider information?**

Bearing in mind all the above, supervisors should assess the benefits of not disclosing the P2G to financial institutions and therefore negotiate the level of the P2G and the corresponding management buffer as part of the supervisory dialogue with banks. To be more precise, this supervisory dialogue will have as main outcome the determination of the capital target of banks. And this capital target will include not only the minimum capital requirements but also the management buffer being the P2G embedded in this capital buffer.

We consider that Pillar 2 disclosures should limit to P2R, which can be relevant for investors for MDA purposes. Nevertheless, we are concerned that local authorities (e.g. market

[2] Paragraph 127 states: "In the assessment of stress testing results, competent authorities should also consider all known future regulatory changes affecting institutions within the scope and time horizon of the stress test exercise".

authorities) may require the disclosure of the P2G, which is likely to create disclosure pressure across the market and possibly lead to unsettled markets.

That is why we consider that a legal obligation not to disclose P2G would be necessary and even if this must be introduced within the level 1 text, we consider that the EBA could be more specific when regulating this issue. Thus, we consider that generalities should be avoided and that it should be stated that P2G is not to be disclosed under any circumstance, not only "generally".

**6. What are the respondents' views on the introduction of supervisory stress testing in the revised guidelines (Section 12)?**

The consultation document proposes in point 574 the use of supervisory stress test outcomes and scenarios as additional source in the assessment of institutions' recovery plans, particularly, when assessing the severity of scenarios. In that respect, AEB believes that recovery scenarios are based on specific risks and vulnerabilities of the entity, so it makes sense to compare them with other internal stress test scenarios such as ICAAP or ILAAP.

However, recovery scenarios are not comparable with the supervisory stress test outcomes, as they have different processes, purposes and methodologies (recovery scenarios are focused on the entity's risks while supervisory stress is common for all entities).

AEB is of the opinion that supervisory stress test outcomes may serve as a relevant input for determining P2R/P2G. In that sense and concerning point 580, AEB does not see the relevance of establishing a predefined target capital ratio by CA that defines a pass or fail. It should be noted that such approach was last applied in 2014's EBA wide stress test exercise where no SREP programme was in place.

For the purposes of supervisory dialogue with institutions regarding the outcomes (point 584.c), more transparency would be appreciated in terms of the identified sources or deficiencies which leads to supervisory measures.

Nevertheless, regarding paragraphs 385[3] and 580[4] in AEB's opinion, the criteria that justify the following circumstances; (i) Banks participating in the same wide-stress test exercise may have different target-levels depending on the jurisdiction; and (ii) Banks participating

[3] Paragraph 385 states: "*In cases where a pre-defined target ratio is set for a system-wide stress test (including country level stress tests) as referred to in paragraph 580, the competent authorities should assess the adequacy and quality of the institution's own funds also considering such target ratio*" and;

[4] Paragraph 580 states: "*Competent authorities may also consider setting pre-defined target capital ratios, especially in the context of system-wide stress tests (including country level stress tests) or setting general or idiosyncratic thresholds. In such cases, those must be suitable by taking into account the supervisory objectives….*"

in the same wide-stress test exercise, even in the same jurisdiction, may have different target-levels justified by idiosyncratic reasons, should be more objectified and harmonized. Otherwise, the EBA Guidelines would leave supervisors with wide leeway to size the pillar 2G without the due transparency between the supervisor and the specific institution.

In our view, supervisors already have a wide range of tools to address country-specific risks or idiosyncratic risks. To set different pre-defined target capital ratios for banks and jurisdictions would undermine the main essence and usefulness of a system-wide exercise.

AEB welcomes the initiatives to encourage the dialogue with colleges of supervisors overseas when applying supervisory stress testing to cross-border groups (point 585). In particular, paying attention on scenarios definitions and the range of risk factors provided.

Regarding the publication of results of supervisory stress test, although is always done by Competent Authorities, banks should consent the publication after checking that the final version is consistent with the final submission. In this regard, in point 586 which covers the publication process should be complemented with comments on that respect.

AEB is supportive on the recommendation addressed to Competent authorities according to consider appropriate timelines for conducting supervisory stress tests.