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## Consultation response

### Draft EBA Guidelines on the Revised SREP and Supervisory Stress Testing

31 January 2018

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the EBA's consultation paper on its **Draft Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing**.

#### I. General comments

AFME welcomes the visibility provided by the EBA's Pillar 2 roadmap and the ensuing publication of the revised SREP Guidelines. The clarifications they provide with respect to the determination and setting of Pillar 2 Guidance (P2G) and the integration of the section on supervisory stress testing are particularly useful for ensuring harmonised supervisory practice in these important areas. We also welcome the useful articulation set out in the consultation on the interaction between the SREP and other supervisory processes relating to the ICAAP/ILAAP, and recovery plans.

Our comments below are therefore mainly focussed on the mechanism for setting P2G, including how this links with stress testing, and also point to areas where additional clarification could be useful prior to finalisation of the Guidelines.

#### *Consistency between the SREP Guidelines and the CRD5*

We appreciate that the EBA is developing these Guidelines while changes are simultaneously being made to the Pillar 2 framework in the CRD level 1 text. Given the need for further clarity and convergence in this area of the overall prudential framework, we wish to stress the importance of the EBA and co-legislators ensuring consistency between the final SREP Guidelines and the level 1 framework. The final Guidelines should not be published without ensuring this is the case. Timely coordination and precise drafting in both texts will be key to achieving the clarity and harmonisation objectives of all regulators involved in this process.

#### *P2R should only be used to address material risks not adequately covered by Pillar 1*

It is necessary to clarify in the Guidelines (and level 1 text) that policy choices established by the co-legislators through the level 1 process cannot be unduly reversed by the imposition of an associated P2R. P2R should only be imposed when material risks are not covered by Pillar 1. To clarify what we mean by this, in addition to transitional or grandfathering arrangements, we consider for instance that exposures currently receiving a specific risk weight treatment (such as a 0% risk weight for certain sovereign exposures), or that are explicitly exempted from Pillar 1 requirements (e.g. exemptions from capital charges for CVA for exposures to EU corporates) should not be reversed via P2R. While CAs must indeed have sufficient flexibility in their use of P2R requirements, the current approach taken in the Guidelines enables the complete override

of Pillar 1 requirements. Not only would this reverse policy decisions, it risks undoing the level playing field benefits provided by the single rule book and that these Guidelines are trying to foster.

## **II. Specific comments on the determination and setting of P2G**

*Duplications between the risks covered by P2G, macroprudential tools and the combined buffer requirement must be avoided*

Section 7.7.2, which articulates how P2G should be used to address the quantitative outcomes of supervisory stress tests is a very helpful addition to the Guidelines. In our view, this, along with other sections of the draft Guidelines (such as Section 7.3) clarifies that P2G is not to be used to address macroprudential risks or risks already covered in specific buffer requirements, something that we support.

In order to aid consistent interpretation of P2G going forward, we suggest the inclusion of the schematic representation of its calculation as illustrated in [slide 7 of the presentation given during the associated public hearing](#) in the body of the final Guidelines as this clearly indicates the different steps involved in setting P2G, i.e. the determination of the so-called “maximum stress impact” followed by supervisory adjustments (including credible mitigating management actions), off-setting with the capital conservation buffer, and where relevant, the counter cyclical buffer.

This being said, we find para 387 to contradict this approach to the determination of P2G: if the maximum stress impact does not lead to a breach in firm’s TSCR, we do not see the justification for the imposition of P2G. In the case of no breach, the setting of P2G would be akin to a “capital conservation buffer” requirement. Yet, the draft Guidelines precisely recognise that there should be an offset of the CCB from P2G to avoid double counting for the same risk. We therefore think it would be more accurate for paragraph 387 to say that, in such cases, competent authorities should not set a P2G, rather than leaving the possibility open (and risking diverging practice).

We would also welcome further explanations in the final Guidelines on the circumstances for when off-setting with the counter cyclical buffer would be considered appropriate.

Finally, while the current emphasis of Section 7.7.2 is on the use of supervisory stress testing in the determination of P2G, it would be helpful if the final version of the Guidelines could also include, where appropriate, references to internal stress testing in this section. This is to avoid any risk of misinterpretation and ensure alignment with the principle set out in paragraph 383 which refers to both internal and supervisory stress testing.

*Overlaps between P2R and P2G should also be avoided*

We agree with the general principle being described that there should be no overlap (duplication of capital requirements for the same risk) between P2R and P2G.

However, we suggest the EBA distinguish between two types of risks inherent in the determination of P2G. The first type are risks which are covered under P2R and which do not reflect a stressed component of risk (e.g. concentration risk or conduct risk). As a result, stressing these risks under a P2G scenario will not lead to duplication as the stressed and non-stressed components are (relatively) easy to distinguish. However, for those risks which

inherently contain a stressed component under P2R (e.g. IRRBB or pension risk) the distinction is not as straightforward. Further subjecting them to a stress scenario to determine P2G can potentially lead to duplication of capital requirements for the same risk.

We would therefore welcome redrafting of paragraph 393 and 396 to avoid this overlap. It would also be helpful to clarify what is meant by “certain aspects of the same risks” (and any relationship this has with concept of “elements of risks” used in the CRD5 text – see below). We think this refers to the “stressed vs unstressed” components of risk as we describe above, but more precision in the drafting will be helpful and avoid interpretation differences in the future.

Table 8 introduces the concept of whether an institution is able to comfortably meet its P2G as an input for determining its capital score, and therefore P2R. This would imply that the same risks used to determine P2G could also impact P2R if the institution breaches or is close to breaching P2G. This would be another source of double counting of the same risk in Pillar 2 decisions.

Finally, along the same lines of avoiding double counting, we would also welcome clarification from the EBA around the way firms should use reverse stress testing to inform internal models, especially as paragraph 92 of the *Internal Stress Testing* consultation has acknowledged that the two are not comparable as each addresses different points in a firm’s loss distribution (going vs gone concern).

#### *Focus on the year of maximum stress impact in the setting of P2G may create distortions*

While IFRS 9 is applicable from 1 January 2018, the change to this new accounting standard does not in itself impact the cumulative losses a bank may incur during an episode of stress. Similarly, the change to the lifetime expected loss model, should not impact the P2G component. We are concerned that the emphasis placed on the “year of maximum stress impact” in paragraph 395 of the draft Guidelines may lead to a distortion of P2G when losses are in fact distributed over a different, forward-looking horizon. If this emphasis remains, the distribution of losses should be recognised through supervisory adjustments in determining the size of P2G.

#### *Drafting of and consistency with the level 1 text is key for interpretation and harmonisation of the Pillar 2 framework*

Finally, while we think the EBA text is relatively clear (subject to the above suggestions) we struggle to reconcile the wording of the (evolving) CRD5 level 1 text with the draft Guidelines in these areas. In particular, more precision in the level 1 text would be helpful in the following areas: i) specification that Pillar 2 does not address macroprudential risks, ii) ensuring that there is no overlap (through the offsetting mechanism) with risks already covered by the combined buffer requirements, and iii) the concept of “risks or elements of risks” (vs the EBA language “risks or aspects of risks”)

Moreover, we stress that, as it is not MDA relevant, P2G should not be subject to the disclosure requirements of the Market Abuse Regulation. If this is confirmed in the level 1 text, the wording used in paragraph 403 of the EBA Guidelines referring to P2G disclosure must be amended accordingly.

### **III. Specific comments on supervisory stress testing**

*How future regulatory requirements affect stress test outcomes and their assessment should be better specified.*

We note the inclusion of the requirement for CAs “to consider all known future regulatory changes affecting institutions within the scope and time horizon of the stress test exercise”.

Although simple on the surface, this wording is likely to subject to various interpretations on what will be included in the assessment of the stress test results. Is a regulatory change considered to be an international standard, a level 1 EU Regulation under negotiation, a level 1 EU Regulation that is adopted but with an implementation date beyond the scope of the stress test, an RTS that is not yet applicable, etc.? There is the distinct possibility that different CAs will interpret this differently unless additional guidance, on the basis of objective criteria, is established in the final Guidelines. We would also welcome clarity on how this relates to the setting of thresholds used to assess the results of the stress test. These should be adjusted accordingly to reflect additional requirements that will be introduced during the stress test time horizon.

*Greater clarity with respect to the setting of thresholds is welcome*

Paras 385 and 580 raise a number of questions as to whether CAs will be able to introduce different thresholds for institutions that should be subject to the same standards, such as those supervised by the SSM. Country wide or idiosyncratic thresholds appear to undermine the usefulness of what should be a system-wide exercise. The wording referring to concepts of system-wide stress test may need to be revisited to better reflect the SSM situation.

#### **AFME contact**

Jacqueline Mills, [jacqueline.mills@afme.eu](mailto:jacqueline.mills@afme.eu)

+44 (0)20 3 828 2710

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