

ZENTRALER KREDITAUSSCHUSS

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Comments of the
Zentraler Kreditausschuss¹
on the CEBS Call for Comments on the 3rd Consultation Paper Concerning the Application of the
Supervisory Review Process under Pillar 2

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¹ The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekbanken (VdH)*, for the mortgage banks. Collectively, they represent more than 2,500 banks.

Dear Sirs,

We would like to thank you for the publication of CEBS's 3rd Consultation Paper Concerning the Application of the Supervisory Review Process (Pillar 2). We gladly follow this call for evidence and would like to herewith provide our comments.

Now that the key decision on adoption of Basel II has been made, the debate on its implementation will gain a higher profile. In this process, the main challenge will be shaping Pillar 2 in a way that creates a reliable framework for banks and supervisory authorities on the one hand thus allowing them to establish a European level playing field, whilst on the other hand ensuring a sufficient degree of flexibility for necessary action.

More specifically, we have the following general comments to make:

1. Consideration of all material risks

Concerning the first fundamental principle, i.e. banks' in-house capital allocation process, under item 732 to 742, the Basel Paper states that "all material risks ..." need to be included. There is explicit mention of credit risks, operational risks, market risks, interest rate risks in the banking book as well as of liquidity risks. Furthermore, as far as "other risks" are concerned, item 742 explains that, particularly for the reputational risks and strategic risks thereunder, there is still a lack of qualitative methods of assessments and that the Basel Committee rather expects banks to develop such methods for various risk management aspects.

Contrary to this, the CEBS's 3rd Consultation Paper emphasises several times quite correctly that there is the need to capture "all material" Risks (e.g. indent 22, 2nd bullet), yet, it explicitly includes

other risks such as reputation risks and strategic risks (same indent, ICAAP VIII a) as well as Annex B) and at other points it even includes further risks that are not mentioned in the Basel Paper as risks that have to be taken into account by banks. In this regard we would like to mention e.g. further risks of the consolidated group and here notably during outsourcing, e.g. information and communication technology risks (SREP III b)).

Firstly, this clear expansion of risks that need to be captured leads to a situation where banks generally have to adequately take account of any potential risk during their internal capital allocation process. Secondly, it results in a mandatory supervisory audit and assessment for **all** credit institutions in order to verify that their consideration of such risks is suitable; and this will be mandatory regardless whether this is a meaningful move for the individual bank or not. Whilst the requested consideration of all risks at the level of banks already requires an unjustified input of resources for the establishment of respective systems, the outcome of such risk assessment by supervisors may consequently trigger additional regulatory measures such as, for instance, the obligation to provide additional equity capital in order to cover these risks.

In order to prevent over-interpretations and deviations, we therefore strongly propose that the principle of material risks shall be applied consistently across the entire document. This applies both to the question whether a risk has to be considered as material *per se* as well as to the question whether the potential consequences from the manifestation of this risk would be material in relation to scope and type of a bank's transactions.

Additionally, we would like to point out that under indent 19 of the material recitals, the Consultation Paper states the objective of minimising the burden on institutions. The implementation should take account of this objective.

2. Individual, additional capital adequacy requirements only as a means of the last resort (*ultima ratio*) on the list of potential supervisory

It is furthermore our understanding that the material risks in the lending business are largely adequately reflected and covered through the capital adequacy requirements under Pillar I. Against this background we feel that indent 16 should be premised on the working assumption that the capital adequacy regime is sufficient and risk appropriate. In this context there could also be a clarification under indent 18 line 1 to the effect that capital adequacy requirements under Pillar I will continue to be deemed as generally sufficient minimum standards which meet regulatory capital adequacy requirements.

The current language of the CEBS Consultation Paper suggests that, as far as risk aspects are concerned, compliance with the capital adequacy requirements under Pillar I shall only be deemed as appropriate for a small number of banks. ICAAP X c) i) states, for instance, "the pillar 1 approach may, in fact, be appropriate for some less sophisticated institutions, although they would have to take an active role in justifying this, including consideration of forward-looking elements." In our view, this language implies a conversion of the rule-exception relation pursuant to which capital under Pillar I shall generally be deemed as sufficient and individual, additional capital requirements under Pillar 2 shall only be regarded as a means of the last resort (*ultima ratio*) amongst the various options available to the prudential supervisor. Such a policy would relegate compliance with Pillar I requirements to the status of a paltry indicator for compliance with the requirements under Pillar 2. We feel that the Consultation Paper should clearly emphasize the Rule-Exception relation between Pillar 1 and Pillar 2 and that the quality of the individual, additional capital requirements should be explicitly labelled as a means of last resort (*ultima ratio*) on the list of possible Pillar 2 sanctions. Also indent 759 of the Basel Paper, for instance, mentions the obligation to take out additional capital as a last option among a range of several intervention options. We see individual, additional capital adequacy requirements as one instrument at the bottom of a hierarchical ladder of various other prudential supervision instruments. If and when banks comply correctly with the Pillar I obligations, we furthermore feel that measures by supervisors aimed at minimising risks and higher requirements with regard to capital adequacy under Pillar 2 may only be legitimate for those risks that are not covered by Pillar 1.

3. Balance between supervisory review process (SREP) and decisions by the bank

On various occasions, relations between the supervisor and the bank under the SREP have been, quite rightly, referred to as a 'dialogue'. Yet, contrary to this, the CEBS Consultation Paper repeatedly creates the impression that decisions which are the prerogative of banks' senior management may fall under supervisory discretion. Indent 746 of the Basel Paper, however, quite rightly points out that any assessment should focus on assessing the quality of the institution's risk management system and on the bank's controls and that it should not lead to a scenario where the supervisor takes over the role of the bank's management. We therefore invite CEBS to adopt this aspect in its SREP principles and/or in the SREP summary.

4. On SRP for internationally active groups

The paper does not contain any presentations concerning the approach for conducting an SRP in multinational groups with subsidiaries in other EU Member States and/or non-EU Member States and it gives no information on the powers that shall be vested in the respective supervisors. In

order to avoid competitive distortions and unnecessary costs for internationally active banks, there need to be safeguards ensuring that banks with subsidiary companies based abroad will not be faced with different, conflicting or even incompatible obligations. We take it that CEBS plans to publish a separate Consultation Paper on this matter.

5. Outsourcing

Under "ICAAP High Level Principles", the Consultation Paper also contains provisions on outsourcing. Here it says, *inter alia*, that whilst giving particular emphasis to less well developed banks, conditions with regard to such outsourcing could be established nationally or at a European level, that it must be clear that each institution is considered according to its individual risk profile and that this shall not prejudice management's responsibility in the event of outsourcing. In our view, this merely reiterates outsourcing conditions that already exist at a national level and which are also already contained in the CEBS Consultation Paper on outsourcing. Secondly, we feel that the intended differential treatment for banks during the outsourcing of parts of ICAAP is inconsistent with the overall philosophy. Generally, the decision on the admissibility of an outsourcing measure cannot rest exclusively on size or performance of a bank. Particularly for smaller banks or for networked groups, outsourcing can indeed be a meaningful measure. We therefore propose that the provisions on outsourcing contained in the Consultation Paper should be deleted and that the focus should rather be exclusively on the existing national and/or forthcoming European provisions on the part of CEBS.

6. Distinction between "management body" and "senior management"

On various occasions, the Consultation Paper refers to "management body and senior management" (cf. for instance the entire chapter "4th The Internal Capital Adequacy Assessment Process"). Given the structures of German banks which generally have an Executive Board on the one hand and an Administrative Board or, moreover, Supervisory Board on the other hand, the question arises whether "senior management" relates to the Executive Board and "management body" to the Supervisory Board or, moreover, the Administrative Board. Should this be the case, then we would like to point out that under German national law, the Supervisory Board/Administrative Board does not have any executive decision-making powers and that, at most, it may set the general course for corporate policy and thus a bank's risk appetite. We therefore propose a clarification that is modelled on footnote 61 of the Basel Consultation Paper.

7. Comments on the individual provisions

7.1 Consultation Paper

- a) Indent 11, 3rd sentence "... to determine appropriate prudential measures" should be complemented by "when necessary" in order to clarify that prudential measures may only be adopted on an optional basis whenever there is a need for this.
- b) For larger and more complex banks, indent 16 stipulates the need to develop stress tests and scenarios with the help of which the sensitivity of capital adequacy requirements *vis à vis* external factors have to be assessed. We take it that the stress tests defined by Basel (e.g. indent 434ff, 764, 775) comprehensively meet the Pillar 2 requirements and that this therefore dispenses with the need for further stress tests.
- c) Indent 18, 1st sentence emphasizes the categorisation of the capital adequacy requirements under Pillar 1 as minimum standards for supervisory capital adequacy requirements. It should be made clear that compliance with these minimum standards will generally be deemed as sufficient in order to meet the criteria with regard to a risk sensitive coverage. Furthermore, the emphasis on risk management processes in the last sentence on meeting the Pillar 2 requirements should be made clearer especially when compared to the option of individual, additional capital adequacy requirements. We would like to refer to the foregoing presentations under item 2.

7.2 High Level Principles of the ICAAP

- a) We should like to point out that the review of the ICAAP which is requested from banks on an annual basis is frequently already performed during the audits of the annual accounts. In ICAAP VI a) it should therefore be made clear that an annual review under an annual account audit will be deemed to meet the requirements concerning a regular review by banks.
- b) ICAAP VIII a) calls for consideration of all risks. We feel that ICAAP should be limited to consideration of all material risks. The risks considered under ICAAP VIII a) ii. are in our view already sufficiently reflected by ICAAP VIII a) i. What is more, we oppose the requirement for capturing a banks' external risk factors that is implied under ICAAP VIII a) iv. Both indents should be deleted without any replacement. Please also confer our foregoing presentations under item 1 and 2.

- c) Indent VIII g) implicitly calls for a comprehensive aggregation of all risks by banks. Firstly, we would like to point out that an aggregation of only those risks may be envisaged that are material and quantifiable. Furthermore, we would like to point out that the overwhelming majority of banks is currently not in a position to carry out a meaningful aggregation of risks. Hence we are of the opinion that the objective of aggregating all material risks should be reserved for future bank control provisions.
- d) ICAAP VIII f) stipulates that residual risks shall be taken into account for the purposes of credit risk mitigation approaches. In our view, the risks mentioned are already reflected through corresponding hair cuts and a fairly conservative recognition of securities under Pillar I CRM techniques. We therefore propose deleting the corresponding language.
- e) Concerning the obligation to carry out stress tests, which is *inter alia* laid down in ICAAP IX c), please cf. our foregoing presentation under 7.1 b. Furthermore, we feel that an obligation for banks to perform e.g. an analysis of the impact of new legal provisions as well as of competitors' action is too far-reaching and should therefore be deleted.
- f) Concerning the language under ICAAP X c), i) please cf. our foregoing presentations.
- g) Pursuant to ICAAP XI a) 2nd sentence, the bank should be in a position to explain to the supervisor's satisfaction e.g. similarities between its ICAAP and the regulatory requirements. We feel that in the case presented where ICAAP meets prudential supervision requirements, there is no need for explanation on the part of banks. Also SREP, under V c), consequently only calls for a mandatory explanation whenever there are differences. We therefore propose deleting the obligation to explain similarities contained under ICAAP XI a) 2nd sentence without any replacement.
- h) ICAAP XI b) invites the supervisor to encourage banks to make greater disclosures and to carry out peer benchmarks between their own ICAAP and the ICAAP of competitors. Given the fact that banks are faced with strong competition by their peers and that the specific ICAAP structure touches upon a highly sensitive area in terms of competition, we strongly oppose this indent. Large areas of the ICAAP should remain limited to a bilateral exchange between the bank and the supervisor.

7.3 High Level Principles of the SREP

- a) Concerning the call for capturing further risks that is being made under SREP III b), please confer our foregoing presentations.
- (b) Concerning possible stress tests under SREP IV e), please confer our presentations under 7.1 b).
- (c) The list of measures presented under indent VIII b) contains measures which would constitute a considerable interference with a bank's corporate policy (cf. (iv) and particularly (v)). We feel that interference with business areas where decisions are the prerogative of senior management would no longer be warranted by the basic rationale behind the supervisory review process. We hence propose deleting (iv) and (v). Concerning measures (i) to (iii) we would like to refer to our aforementioned presentations under item 2 and we would like to propose changing the sequence of the presented measures modelled on the sequence under indent 759 of the Basel Paper; in other words, in order to clearly reflect the hierarchical order of such measures, the possibility of the individual, additional capital adequacy requirements should be put at the bottom of the list of possible options.
- d) For the same reason, under SREP VIII d), in the context of individual capital adequacy requirements, the wording "at least" should be replaced by "only".
- e) The wording of SREP VIII e) should clearly highlight that individual capital adequacy requirements shall only be regarded as a supervisory means of the last resort (*ultima ratio*). Please cf. also the foregoing presentations.
- f) SREP X calls for a formal supervisory review on an at least annual basis. We feel that the frequency of supervisory reviews should similarly be based on the systemic risk level as well as on the nature and size of the bank. From our point of view, making the frequency of reviews subject to the generally correct reservation of double proportionality would be a consistent move.

8. Annex B

For the reasons explained above, seeking to capture all risks set out in Annex B during the supervisory as well as during banks' internal capital allocation process would be too far-reaching.

Yours sincerely,

For and on behalf of the

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Deutscher Sparkassen- und Giroverband