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EBF COMMENTS TO THE BCBS CONSULTATION ON THE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The European Banking Federation (EBF) welcomes the opportunity to put forward our comments on the update of the Core Principles for effective supervision by the Basel Committee on Banking Supervision (BCBS).

The EBF response to the BCBS consultation represents the consolidated view from all EBF members i.e., 33 national banking associations from across Europe representing in total about 3,500 banks.

The Core Principles are the foundation for the supervisory architecture of Member jurisdictions and also rule in a large extent part of the content of the regulatory framework for which it is vital to have these regularly updated. Accordingly, we consider the current update is timely and support such decennial updates to take into account all relevant developments.

In the context of the most recent update, it is our understanding that most of the changes are either already embedded in Basel Standards or already form part of the supervisory architecture. Nevertheless, there are certain aspects in regards to the principles that we are pleased to explain below. It is our sincerely hope that you will review and take into account our comments and recommendations as part of your assessment

We hope our comments are useful in the further development of the Core Principles and remain at your disposal to clarify and/or provide further details on any comment.

COMMENTS ON SPECIFIC ASPECTS AND CORE PRINCIPLES

Proportionality

In our view, the concept of proportionality in supervision must not conceal another key aspect against which it should be tested. Indeed, we consider that proportionality cannot be adequately exercised without a proper reflection on materiality. We consider it is important that supervisors can concentrate on material risks, whether within a given institution or across the banking system. In the same way that we believe that the prudential framework should be fundamentally risk-based and that non-risk based measures, such as the leverage ratio should merely be used as a backstop, supervision should aim at targeting the most material risks, beyond standard indicators of size or complexity that are typically used to inform proportionality. It is our view that the recent episodes of banking crisis i.e., SVB and Californian banks, Credit Suisse, are illustrative of ill-targeted supervision and poor supervisory action in front of the most material risk areas.

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While paragraph 02.11 correctly states that "The Core Principles recognise that the appropriate intensity of supervision for banks varies, with more time and resources devoted to larger, more complex or riskier banks.", we consider it fails to clarify that this holds also true within a given institution where the intensity of supervision should concentrate on the riskier areas.

Furthermore, we consider the statement in paragraph 02.12 "In the context of the Core Principles, this is reflected in the expectation that requirements imposed by supervisors on banks will be commensurate with the risk profile and systemic importance (including size and complexity) of banks." should be revised to state "commensurate with the risk profile and or systemic importance (including, but not limited to, size and complexity)."

We are also wary of the use made in these Core Principles of the notion of systemic importance. There might be here an undesirable confusion between the regulatory definition of a systemic institution (as per G-SIBs or D-SIBs frameworks) and the supervisory analysis that should be carried on to identify potentially systemic risks that an institution could pose to the system, irrespective of it being designated as G-SIB or D-SIB.

Core Principle 1: Responsibilities, objectives and powers

The updated principles reinforce supervisory powers, to ensure that competent authorities have access and can act in relation to any concern they have on any individual bank or the banking system. Nevertheless, we find that it would be useful that the process, when an issue is identified, is better defined in all its different phases.

Under the EU supervisory model, the communication process is very clear when an issue is identified, but not so much when the finding should be closed. When the supervisor finds anything concerning in the entity, an ad-hoc supervisory review is initiated, with data requests and a constant dialogue between the entity and the supervisor. This implies a heavy workload for entities, often involving many people to obtain the data requested, especially in decentralized banking groups where the consolidated supervisor might request data from any entity in the group. Once all the information is handed to the supervisor and potential and corrective actions are taken it is not clear when the finding is closed by the supervisor. We find that it should be part of the supervisor's duties to make clear when the supervisory review is finalized in a timely manner, so that the entity can free the resources allocated to it.

We also consider that it is important that proportionality is taken into account. However, improving the supervisory process for smaller banks should not automatically lead to a heavier supervisory load for all banks.

Regarding point 5, we would like to point out that the reference to supervisors having full access to the board, including individual members (cf. footnote 3), may be inconsistent with the principle of collegiality set under corporate laws of certain jurisdictions.

With regard to point 5a (essential criteria), while we understand the need for the supervisor to have access to information that is in the hands of key/strategic third-party service providers, we consider this activity should be channelled through the supervised bank. Given that the supervised bank is in permanent contact with the supervisor, this solution seems more efficient to us than requesting it directly from the third-party service provider. Our feedback also applies for point 7 since we believe the supervisor should access this information through the supervised bank, even when the records are held by a third party.

Core Principle 2: Independence, accountability, resourcing and legal protection for supervisors

The changes introduced in this principle are in line with a higher degree of transparency from the supervisor. We particularly welcome the specific mentions to:

- the supervisor regularly having to communicate its supervisory priorities publicly, and
- the supervisor defining clearly its allocation of responsibilities within the organisation as well as the delegation of authority for particular tasks or decisions.

We however believe that it should be clarified that the full discretion of the supervisor referred to in point #1 (essential criteria) should be within the limits of supervisor's powers, as defined in the legal framework of the jurisdiction considered.

In footnote #5, the immunity of the supervisor's staff is extended to *"external providers"* without any restriction, which seems to be excessive and may lead to abuses. The Core Principle should clarify that such extension of immunity can only apply if external providers are subject to the same obligations and duty of confidentiality as the supervisor's staff.

Core Principle 3: Cooperation and collaboration

With regard to point #2 (essential criteria), we believe inter-supervisory cooperation is essential and is already reflected in the Core Principles to some extent. However, putting this cooperation into practice is equally important for which we consider that there is room for improvement. Information sharing (both between authorities and between authorities and banks) should be enhanced. This is particularly important in cross-border groups, where there is a need to align local regulations and supervisory expectations (host supervisors) with supervisory expectations at Group level (home supervisors). Supervisory colleges play a key role in this regard.

More specifically, focusing on the collaboration between macroprudential authorities and prudential supervisors, we consider that there is a certain overlap between macroprudential and prudential requirements, for example with regards to countercyclical & systemically buffers and Pillar 2.

Core Principle 8: Supervisory approach

With regards to point #2 (essential criteria), it is our view that the decision on whether an entity is systemic or not should remain at the local supervisor, as it has a better knowledge about the local cycle and the local banking system.

With regards to point #5b (essential criteria), we support this idea and understand that non-bank financial institutions (NBFI) would be addressed under this point. Specifically for those entities, we believe not only should the supervisor control bank's exposures to such counterparties, but ideally they should be regulated and supervised themselves.

With regards to point #15 (footnote), we see different references are made to climate-related financial risks (CRFR) throughout the document. It may seem that this is being treated as a new risk category. We however consider that climate-related risks are risk drivers to be considered under other risk types that banks manage (credit, market, operational, etc.), but they are not a risk type themselves. This is also the ECB's position, as it can be seen in its Guide on climate-related and environmental risks (2020): *"Consequently, physical and transition risks are drivers of existing risk, in particular credit risk, operational risk, market risk and liquidity risk, as well as non-Pillar 1 risks such as migration risk, credit spread risk in the banking book, real estate risk and strategic risk (see Table 1). Climate-related and environmental risks may, in fact, be drivers of several different risk categories and sub-categories of existing risk categories simultaneously"*.

Core Principle 9: Supervisory techniques and tools

In general terms, we would find it useful that the BCBS clarifies that any benchmarking analysis should not result in supervisors influencing the business models of their supervised banks towards an ideal conceptual target. We are indeed concerned of the tendency of some supervisors to develop standard top down models and transversal benchmarking analysis to assess individual institutions and derive supervisory expectations. There could be a risk that excessive reliance on such tools could foster a lack of diversification in the banking landscape, with unintended concentration features that could enhance systemic risk. For example, the BCBS mentions *"horizontal peer reviews"* as a tool available to supervisors to perform their assessment duties in point #4 (essential criteria) of this Core Principle. We would find it appropriate that the BCBS also specifies that benchmarking approaches should not be used to define the desirable outcomes of supervisory actions, and that the idiosyncratic characteristics of the business model of each bank should be respected when delivering supervisory expectations.

Still in reference to point #4, it is a concern that the following sentence is deleted in the revised version of the principles: *"The supervisor communicates its findings to the bank as appropriate and requires the bank to take action to mitigate any particular vulnerabilities that have the potential to affect its safety and soundness"*. The supervisor does normally communicate its findings and it is essential for banks to receive this information. Therefore, the mentioned sentence should be reincorporated to the text.

Regarding point #11 (essential criteria), a series of criteria are mentioned that supervisors must consider when third parties are used. We do not see, under that criteria, a specific mention to the duty of confidentiality. We consider it should be included as a mandatory requisite to be taken into account when hiring third parties that will most likely be exposed to delicate information.

Core Principle 13: Home-host relationship

Cooperation amongst supervisors is one of the key principles and is implicit in many others to ensure an effective consolidated supervision, especially for global decentralized banks. We welcome that these ideas are reinforced in the Core Principles. Nevertheless, we find that these concepts are often more related to macroprudential supervision. We also consider that coordination could be enhanced, especially from a micro perspective, regarding an individual bank or group.

The establishment and good functioning of supervisory colleges is of course of utmost importance, but there it would be very positive to have a more fluent relationship between relevant supervisors, possibly outside the supervisory college structure. For international decentralized banking groups it is especially relevant as the double layer of regulation and supervision ultimately confers the consolidated supervisor to some extent powers regarding subsidiaries in third countries.

Supervision and regulation of decentralized banking groups is especially complex for which not only a fluent cooperation but also coordination between relevant authorities is necessary to ensure adequate supervision and to avoid an excessive operational burden on entities. While all these ideas are reflected in the Core Principles, it is our understanding that this is not always put into practice. Certain issues such as the authorization of capital instrument emissions in third countries are not always handled in an efficient manner between the consolidated supervisor and other competent authorities. Another example can be found in the exemption of central banks reserves from the leverage ratio measure. In this case, we consider that there was a lack of communication between competent authorities that negatively affected the concession of the exemption.

Therefore, we call to emphasize that coordination and cooperation between authorities is key for consolidated supervision of decentralized banking groups and that these relations should be based on fluent day-to-day communication and not only rely on supervisory colleges structures.

Core Principle 14: Corporate governance

With regard to point #7, we do not see the added value of inserting *"and effective in addressing conduct that potentially results in losses"* which we consider that, in the context of this provision, is redundant with *"prudent risk-taking"*. Moreover, it is not clear as it may be interpreted as implicating any unsuccessful business decisions. Risks are inherent to the conduct of banking activity which may generate losses. We therefore propose that *"and effective in addressing conduct that potentially results in losses"* should be removed.

Core Principle 15: Risk management process

Since we consider climate is a driver of risk, but not a risk as such, and for which we cannot pre-empt that it is material, we consider that the text *"but not limited to, climate-related financial risks and"* should be removed from the introductory text of this Core Principle.

Furthermore, with regards to point #14, where supervisors are empowered to require banks to submit their materiality assessments *"The supervisor requires banks to have forward-looking stress-testing programmes[…]Where relevant, stress testing should reflect and incorporate climate-related financial risks and emerging risks assessed as material over relevant time horizons)".* It is our understanding that the expression *"where relevant"* is linked to the materiality exercise. We however consider that it could also be open to other interpretations. Accordingly, we suggest clarifying this since we consider it is a relevant point because the results of materiality assessments may lead to other obligations, for example stress testing exercises. Moreover, we wonder how can homogeneity be achieved amongst different supervisors when establishing the threshold for what is considered *"relevant"*.

Also with regards to point #14, it is important to note that the EBA Stress Tests currently do not cover liquidity. While point #15 refers to liquidity by stating that "*The supervisor assesses whether banks appropriately account for risks (including liquidity impacts) in their internal pricing, performance measurement and new product approval process for all significant business activities"*, the following sentence which has been added in the consultation shall be removed from point #14 since the principles should remain principle-based *"At a minimum, banks' stress-testing programmes cover credit risk, market risk, interest rate risk in the banking book, liquidity risk, country and transfer risk, operational risk and significant risk concentrations.".*

Core Principle 18: Problem exposures, provisions and reserves

We would highlight the great supervisory focus that emerges from the document in relation to the provisions. Core Principle 18 includes some new details that imply a more demanding control environment of the IFRS 9 Framework (regulations, processes, methodologies, resources, control, governance, Board involvement and additional control layer by an independent function), as well as an increase in the scrutiny and powers of the supervisor over them. This is aligned with the expectations conveyed in the follow up letter of IFRS 9 Framework, which are more demanding with regards to the issuance of corporate guidelines and criteria and control and oversight of countries' compliance with them. In this context, it is worth highlighting two new aspects which are the (i) focus on resources and (ii) the need for an additional control layer for an independent function that, from our perspective, may put additional pressures on those that already exist.

Core Principle 23: Interest rate risk in the banking book

We propose the following amendments for points #2 and #3(b) (essential criteria) as we consider, for the latter, it is too detailed for such a guidance.

(2) The supervisor determines that a bank's strategy, policies and processes for the management of interest rate risk have been approved, and are regularly reviewed, ~~by the bank's board~~. The supervisor ~~also~~ determines that the board oversees management in a way that ensures that these, policies and processes are implemented effectively and fully integrated into the bank's overall risk management process.

(3) The supervisor determines that banks' policies and processes establish an appropriate and properly controlled interest rate risk environment including:
(a) comprehensive and appropriate interest rate risk measurement systems;
(b) a regular review, and independent (internal or external) validation, of any models used by the functions tasked with managing interest rate risk (including a review of key model assumptions ~~, eg regarding optional elements embedded in a bank's assets, liabilities and/or off-balance sheet items, in which the bank or its customer can alter the level and timing of their cash flows.~~

Core Principle 24: Liquidity risk

Recent experience evidenced that non-level playing field requirements, such as so call proportionality, is a source of fragility for the system. We accordingly recommend adopting the same requirements on all banks for which we suggest removing the text *'at least for internationally active banks'* from the introductory text. Furthermore, we suggest also removing from the same text the added reference *to 'including funding'* since funding is not defined and there is the need to be consistent with the other BCBS standards.

With regard to point #3, we suggest removing the text "~~*that which have been approved by the banks' Boards*~~", since we consider the text to be removed is already covered in point #2.

ADDITIONAL COMMENTS

Non-bank financial sector

There is a lot of literature recommending strengthening the regulation of the non-bank financial sector. The FSB published its policy recommendations to enhance its resilience ten years ago. Recent stress episodes have shown that non-bank financial institutions (NBFI) can amplify stress in the wider financial system, especially due to the liquidity mismatches they can face and the high level of leverage they maintain.

Certainly, banks are exposed to NBFI liquidity, market and credit risks via loans, securities and derivatives exposures, as well as funding dependencies. Funding from NBFI entities is a very relevant spillover channel, as some NBFIs maintain their liquidity buffers primarily as deposits and very short-term repo transactions with banks.

Banks put a lot of effort into managing their risks, including counterparty credit risk; banks are the first ones interested in mitigating the risks. However, putting the responsibility for mitigating systemic risks from shadow banking on the bank's counterparty credit risk management, while policy discussions on adjustments to the regulatory framework for NBFIs continue, does not seem to be appropriate.

If it is important to enhance vulnerabilities in the non-bank financial sector, the macroprudential policy framework should focus not only on the banking sector, but also on the policy framework for non-bank financial institutions.

Recovery and Resolution

In the last version of the Core Principles, recovery and resolution frameworks were not developed yet. For example, the European Bank Recovery and Resolution Directive was approved in 2014. We find positive that recovery and resolution is more embedded in these updated Core Principles, since this is a key part of a bank’s structure. Nevertheless, we consider that there could and should be a better differentiation between resolution models since it is not the same to follow a Single Point of Entry (SPE) or a Multiple Point of Entry (MPE) resolution strategy.

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