afme/ Finance for Europe

Consultation response

ECB Draft Guides on ICAAP and ILAAP

4 May 2018

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the **ECB's consultation on the Draft ECB Guides to the ICAAP and ILAAP.**

AFME represents a broad array of European and global participants in the wholesale financial markets. We are contributing to this consultation on behalf of our Special Committee on European Supervision (SCES) which, in its SSM configuration, provides a platform for the most systemically relevant banks who are lead-supervised by the SSM to engage the most systemically relevant banks who are lead-supervised by the SSM to engage with the ECB's supervisory function, and in its full configuration, is a vehicle for engagement on the future development of supervision within the EU more generally.

Many of our members have previously contributed detailed feedback bilaterally to the ECB in the context of the first stage of the ICAAP/ILAAP multi year plan which commenced last year. As a result of this feedback, the ECB has made welcome updates to the previous draft versions of the ICAAP and ILAAP guides. In general, our members welcome the ECB's approach to these guides which describe its supervisory expectations in a principled manner that is generally in line with institutions' management approaches

Our comments below therefore focus on the few remaining or outstanding issues of relevance to our members.

ICAAP and ILAAP governance

Paragraphs 15[1] of both the ICAAP and ILAAP guides require the management body to produce and sign the CAS and LAS respectively, and to approve the respective key elements of the ICAAP and ILAAP. We agree broadly with the intention of these paragraphs but have two comments. Firstly, the formal signature of the CAS and LAS is in our view an unnecessary formality that would add operational complexity without adding value or changing the need for compliance with its content. We recommend that this be changed in both guides to refer to the management body having to "produce and <u>approve</u>" the CAS and LAS respectively. Secondly, according the EBA Guidelines on Internal Governance, the management body defines and oversees the implementation of the strategy, key policies and governance arrangements to ensure effective and prudent management of the institution whereas the operational implementation of these strategies on a day-to-day basis is the responsibility of senior management. Some of the elements listed in paragraphs 15 as examples of those element of the ICAAP and ILAAP requiring approval of the management body, such as "internal documentation requirements" or "the risk identification process and the internal risk inventory and taxonomy" are not key or strategic elements of the ICAAP or ILAAP. Instead, they are related to daily capital and liquidity management and as such should fall under the remit of senior management. We recommend that the examples in paragraphs 15 be adapted accordingly.

[1] Concept repeated in paras 21 of both guides

Normative vs economic perspectives of ICAAP and ILAAP

While we generally agree with the high-level statement in the introductory section to the ICAAP guide that "a sound, effective and comprehensive ICAAP is based on two pillars: the economic and the normative perspectives", we find that these perspectives become confused in the guidance provided to illustrate Principle 3. In our view, the normative perspective should clearly be based on regulatory minima in Pillar 1, whereas the economic perspective complements this by going further and capturing all material risks identified by the institution from its own internal perspective. As currently drafted, Principle 3 does not provide a sufficiently clearly distinction between these two approaches. Indeed, the concept of "normative internal" perspective is somewhat confusing and appears to be a contradiction in terms.

By way of illustration of some areas that reinforce the confusion, statements such as those in paragraph 38 of the ICAAP guide which says "*the normative perspective is not limited to the Pillar 1 risks recognised by the regulatory capital requirements. When assessing its capital adequacy under the normative perspective, the institution is expected to take into account all relevant risks it has quantified under the economic perspective*" do not convey the difference between the two approaches or the concept of complementarity between the two perspectives. Elsewhere there are references to "hidden losses" – distinctions between accounting values and fair values (supposedly economic values?) are very difficult to understand for institutions that are operating within standardised valuation frameworks.

Moreover, although simple on the surface, the refence to taking future changes in legal, regulatory and accounting frameworks into account in the ICAAP is likely to subject to various interpretations. 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 planning horizon, etc.?

We would welcome further discussion with the ECB to better understand how its sees the normative and economic perspectives being different and informing each other so that we can assist in articulating these expectations more clearly. In particular, it may help institutions' understanding if the ECB could articulate how in practice it views the normative and economic perspectives of ICAAP being used to generate Pillar 2 capital requirements.

Finally, while the above comments are made in relation to the ICAAP guide, the same type of clarifications would also be welcome in the ILAAP guide where the normative and economic perspectives are also used.

Risk identification

We fully support Principle 4 of the ICAAP and appreciate the approach the ECB has used to develop this guidance in a principled manner, using examples as illustrations. In this context, we question however why one specific risk category, i.e. risks from exposures to shadow banking entities has been singled out in the risk identification process (paragraph 56). It may be more appropriate to reference this in example 4.1 (other risks). Otherwise, we suggest that the ECB provide more specific information on its expectations with respect to the relevant EBA Guidelines.

Quality of internal capital

Example 5.1 in Principle 5 on the quality of internal capital also seems to confuse normative and economic perspectives in our view. For instance, goodwill might well not have a value of zero from an economic perspective. For example, internationally diversified banks with businesses in many geographies have the option of selling one or more of their subsidiaries and thus obtaining value from the goodwill of that subsidiary without putting at risk the continuity of the banking group as a whole. This represents economic value that can be tapped in to in case of need and should be included in an economic capital model. As the ICAAP is a going concern concept, we also think it is legitimate that DTAs which are likely to have a positive economic value can be reflected in economic capital. We recommend therefore that this example be clarified accordingly and more generally recommend that internal or economic capital concepts be left to the institution to define.

Inter risk diversification

We understand that the ECB, in line with the relevant EBA Guidelines, will not take inter-risk diversification into account in the SREP and that the Guide urges institutions to be cautious when applying this in their ICAAPs. In particular, paragraph 78 of the ICAAP guide indicates that "The institution is expected to be fully transparent about assumed risk diversification effects and, at least in the case of inter-risk diversification, report gross figures in addition to net figures". We support the need for transparency and conservatism in ICAAPs but wish to recall that the non-recognition of inter-risk diversification in the SREP may discourage the geographic and business diversification of European banks.

Liquidity transferability in stressed conditions

While we fully appreciate that liquidity transferability in stressed times can be very different to business as usual scenarios and that this has to be taken into account, from the point of banks operating cross-borders, we would welcome a greater emphasis being placed in paragraph 62 of the ILAAP guide on the benefits of cross-border intra-bank funding, particularly within the Banking Union and progress that has been made in terms of regulatory reform and international supervisory cooperation over the past decade.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.