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Comments regarding the multi-year plan on SSM Guides on ICAAP/ILAAP

Dear Ms Nouy,

Reflecting the particular importance of this topic, and in addition to the comments made by the institutions you have addressed directly, the German Banking Industry Committee (GBIC) would like to take this opportunity to submit some key comments regarding the planned SSM Guides on ICAAP/ILAAP, together with some urgent concerns put forward by the institutions we represent.

Fundamentally, we take a positive view of the SSM Guides' structure, and of the underlying regulatory approach. GBIC has been supporting a principles-based approach for Pillar 2 for several years, which we believe to have been adequately implemented for the selected aspects, in the draft presented. This set of regulations should not evolve into a higher density – or deeper detail – of regulation during the course of the subsequent consultation process. We nevertheless welcome clarification and further details concerning various elements, which we would like to outline in the following letter. For this purpose, we have appended a reference to the Excel template for comments (and hence, to the original document) under each item. GBIC would very much welcome being able to contribute to the ongoing development of SSM Guidelines, within the framework of a close, regular dialogue.

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Moreover, we kindly ask to clarify how institutions should deal with national provisions governing ICAAP and ILAAP (in Germany, this concerns especially the Minimum Requirements for Risk Management - MaRisk and the ICAAP guideline issued by national competent authorities). Specifically, we request that a clearly-defined hierarchy and approach be established for any conflicting national and European requirements. We assume that these Guides are set to replace preceding documents, whilst also representing the full and final set of requirements institutions are expected to comply with.

ICAAP

Introduction

The provision that institutions are expected to take into account all ICAAP-relevant publications from the EBA and from international fora (even including draft regulations as indicated in footnote 2), is in contradiction to standard legislative procedures and should be entirely removed. From our perspective, documents/regulations may only be taken into account after their transposition into EU law, or applicable national law. Regulations from the Basel Committee on Banking Supervision (BCBS), such as standards, guidelines or consultation papers, or individual statements from institutions with no legislative rights, are – in our opinion – not legally binding.

Other	1	Deletion
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ICAAP principle 1

We support the approach that the management body is responsible for the sound governance of the ICAAP. However, we emphasise the fact that the planned close involvement of the management body will have considerable process-related consequences at institutional level. Sound capital planning is – in particular at larger financial institutions – the result of collecting data from various entities or parties; the aggregated data must be finalised and considered reliable before the management body's approval. As we have learned from our conversations with DGMS IV, the deadline to report ICAAP/ILAAP information is currently planned to be moved to an earlier date, i.e. 31 March of every calendar year. Given the fact that ECB's SREP notification is a central part of capital planning, the final notification must be received by financial institutions no later than November of the previous year in order to enable them to provide the Capital Adequacy Statement by 31 March of the respective year.

Capital Adequacy Statement	2	Clarification
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ICAAP principle 2

From our perspective, the requirement of using ICAAP projections as key performance benchmarks and target figures, used to measure all financial and other results at divisional level, is exaggerated. ICAAP projections and results could become important elements in the determination of qualitative and quantitative targets, or variable remuneration, regarding internal organisational structures, should be limited exclusively to risk-bearing entities. However, the Guide itself should not make any detailed remuneration requirements, which are provided in other regulations.

The ICAAP as an integral part of an institution's risk management and decision-making	3	Clarification
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ICAAP principle 3

In order to ensure a consistent risk and capital approach, and to appropriately reflect the best practice currently employed, we believe it is necessary to specify the text of ICAAP principle 3 as follows:

“Institutions are expected to implement a proportionate ICAAP that incorporates two complementary perspectives focused on the viability of the institution. The normative internal perspective (based on regulatory/supervisory/accounting views) is aimed at the fulfilment of all capital-related legal requirements, supervisory demands and internal objectives, on an ongoing basis. In addition, institutions are expected to take into account a sound economic internal perspective for their internal view.

In case of risks that are not apparent when focusing solely on the normative perspective (e.g. migration risk, credit spread risk in the banking book for positions not accounted at fair value, value-based measurement of interest rate risk in the banking book (IRRBB)), such risks shall be taken into account, based on a consistent risk and capital approach.

Both perspectives, normative and economic, should be assessed over a short-term horizon, complemented for the normative perspective by baseline and adverse scenario projections for the medium term, as set out under principle 2. ”

Principle 3	4	Amendment
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We believe it generally makes sense to establish the normative and economic perspectives as part of the ICAAP concept. However, ECB’s current practices prevent the comprehensive implementation of this concept. If all capital components were to be considered in relation to the individual risks and the different risk measurement approaches, the institution would have to be informed of its exact P2R share amount attributable to the total risk exposure. Given the “Pillar 1 plus” approach, P2R is also determined by the institutions’ internal risk measurement. Therefore, we recommend explicitly indicating the amount of the P2R requirements attributable to particular risk categories in the SREP notification. If this is not possible, institutions should be allowed to decide at their own discretion whether to reflect in the normative perspective risks identified under the economic perspective in order to avoid double inclusion (e.g. IRRBB, spread risks, etc.).

Normative internal perspective	5	Clarification
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The internal provision of additional management buffers may be reasonable, depending on the institution’s risk appetite. However, no binding requirements should be established in this regard outside the CRD framework. This applies in particular in view of the various own funds requirements and buffers already in place, which have to be observed under different adverse scenarios, or may partly be violated in case of certain adverse developments. Implementation of Basel III and the SREP Guidelines led to a marked increase in capital requirements – above and beyond pillar 1 requirements; therefore, institutions’ capital adequacy has been already safeguarded. Hence, the introduction of a virtually binding additional component, based on ECB guidelines, is not appropriate. We therefore request deletion of these provisions.

Normative internal perspective	5	Deletion
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Under footnote 1 of figure 1, reference is made to reverse stress testing requirements. Given the fact that reverse stress tests are expressly addressed in principle 7, we found this footnote misleading and suggest deleting it.

Normative internal perspective	5	Deletion
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We believe that a consideration of baseline projections and adverse developments within the normative perspective is comprehensible. Furthermore, we agree to the idea that adverse developments reflect bank-specific vulnerabilities. However, we reject a mandatory link between adverse developments and stress test results. Stress test simulations are carried out at the level of individual institutions as part of the ICAAP. Stress test implications are appropriately reflected in management activities. However, the draft Guide does not specify whether the required analysis of the adverse scenarios within mid-term projections under the normative internal perspective shall be carried out as part of capital planning, or as part of the instruments and processes of the stress test approach according to principle 7. Therefore, we kindly ask the ECB to specify its expectations regarding the characteristics of the adverse development under the normative perspective, particularly with respect to consistent interaction with the stress test approach.

Normative internal perspective	6	Clarification
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The wording “to account for (...) any other known changes in the legal/regulatory/accounting framework” could be interpreted to mean that supervisory consultation papers have to be considered in mid-term capital planning. Based on our experience, it is impossible to reliably predict the further development of regulatory requirements – both in terms of time and content. Furthermore, the evolving regulations currently under discussion at the Basel Committee may deviate from, or be in contradiction to, the European regulations already in place. Therefore, we consider ECB’s expectations to include future developments – which are not quantifiable to the required extent – by building capital buffers, or by any other means, as inappropriate, and suggest either clarification (or deletion) of the respective requirements.

Normative internal perspective	6	Clarification
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The draft Guide specifies that under the economic perspective, risks are taken into account “that are not apparent when focusing solely on the normative perspective (e.g. migration risk, credit spread risk in the banking book for positions not accounted at fair value, value-based measurement of interest rate risk in the banking book (IRRBB) or hidden losses)”.

ICAAP is supposed to be focused on the viability of the institution by consistently applying all relevant elements. Nonetheless, this should not prevent institutions from placing their individual ICAAP focus on creditor protection, by applying a consistent definition of internal capital, and risk measurement.

Economic internal perspective	6	Clarification
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Under the economic perspective, the Guide expects institutions to manage their risks and also adequately integrate them into stress testing, the monitoring of capital adequacy and normative perspective capital plans. From our view, it was probably not intended to require consideration of all risks taken into account under the economic perspective in the normative perspective as well, but rather to focus on those risks which may lead to an actual impact on the normative perspective that is mainly based on the applicable accounting standards. Otherwise, this would result in a confusion of the two perspectives, which we consider inappropriate and virtually impossible to manage. From the experience of current market practice, two different management perspectives are generally required. The integration of the two

perspectives suggested by the ECB aims to introduce a combined management circle, which has proven not feasible from our experience. Therefore, we kindly request amending the text as follows:
 “Institutions are expected to manage those risks and also adequately integrate them in their adverse development as well as into stress testing, the monitoring of capital adequacy and normative perspective capital plans, to the extent that such risks could have an impact on the normative perspective”.

Economic internal perspective	6	Amendment
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On various occasions, the Guide states that the normative and economic perspectives are considered internal processes at institutional level. However, the Guide also includes a series of requirements considerably restricting internal risk measurement approaches. Given the numerous requirements, there is a risk that the supervisor simply prescribes the ICAAP, and therefore prevents institutions from improving their own, internal methods. Furthermore, the comprehensive implementation of the planned requirements may result in risk management systems not reflecting the internal view of institutions, i.e. banks will hardly be able to draw any meaningful management decisions from such systems. If the supervisory requirements contain too many details, institutions may be forced to implement additional own approaches, which would make use tests even more difficult. Therefore, we kindly ask that the level of details provided with the planned requirements be kept within reasonable limits.

Capital adequacy assessment follows complementary approaches.	6	Amendment
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In their assessments under the economic perspective, institutions are expected to “account for the full set of even very rare unexpected economic losses”. However, consideration of the “full set” of economic losses is simply not feasible. Therefore, we kindly ask that the expression “full set” be removed, particularly in view of the fact that the focus on very rare unexpected economic losses would still apply.

Capital adequacy assessment follows complementary approaches.	6	Deletion
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The ECB expects institutions to determine – under the economic perspective – very rare unexpected economic losses for a large variety of risks at high levels of confidence, and to adequately reflect such risks under the normative perspective. Obviously, the authors of the Guide refer to sensitivity analysis for specific types of risk instead of adverse scenarios for mid-term projections under the normative perspective. We therefore kindly request that a clear distinction is made between the following items: adverse development under the normative perspective, risk measurement under the economic perspective, and stress test simulations used for both perspectives.

Capital adequacy assessment follows complementary approaches.	6	Clarification
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We believe it would be inappropriate to fully include all results produced under one perspective in the other perspective. From our view, this was not intended, since it would imply total parallelism/synchronisation of both perspectives – ignoring the fact that the two perspectives have a different focus. Hence, we recommend the following addition:

“Therefore, the results of the economic perspective shall be taken into account under the normative perspective, and vice versa, always considering a consistent risk and capital approach.”

Capital adequacy assessment follows complementary approaches.	7	Amendment
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We would like to raise the question as to how interest rate risks are to be reflected under the normative perspective, if such risks – following the applicable normative accounting standards – are recognised through profit or loss and may have a negative impact on equity positions or on the institution’s viability. Depending on the accounting standards to be applied, such risks would mainly affect net interest income, or valuation results, we believe. Economic value effects were to be reflected under the normative perspective only to the extent that they have an impact on the annual financial statements, we assume. Given that reference is made to the value-based measurement of interest rate risk in the banking book (IRRBB) under the economic perspective, we suggest to include the following specification under the normative perspective in principle 3: “... as well as internal targets (such as measurement of interest rate risk based on net interest income (IRRBB))”.

Capital adequacy assessment follows complementary approaches.	7	Amendment
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ICAAP principle 4

We expressly welcome the approach of institutions being responsible for their own risk identification process. In this connection, we would like to point out a key definition adopted by institutions: for the purposes of internal management, numerous institutions do not separate interest rate risk in the banking book ("IRRBB") from market risk. Instead, they consider IRRBB as a form of market risk, which is integrated into the measurement and management of market price risk, also considering intra-risk diversification effects. The individual listing of risks under principle 4 suggests that the ECB requires IRRBB to be treated separately from market risk. We believe that this would be incompatible with the principle of own responsibility; besides, it would be methodically inappropriate.

Risk identification process	8	Clarification
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ICAAP principle 5

We can understand the requirement that in the economic perspective, the definition of internal capital must be consistent with the risk measurement. Each institution is responsible for ensuring this consistency. Given the free choice of methods to be applied, the wording: "As a matter of principle, it is expected that a large part of internal capital components will be expressed in terms of CET1 own funds" is too restrictive. We therefore request that this expectation be amended, due to the fact that a quality assessment of available internal capital solely on the basis of CRR criteria would be incomplete, and might in fact contradict the requirement of a consistent view on risk and capital.

Principle 5	9	Amendment
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We reject the asymmetric treatment of hidden losses and hidden reserves, since this would create false regulatory incentives and prevent a level playing field. The different treatment of hidden reserves and hidden losses would create regulatory incentives for early realisation of hidden reserves, to permit these to be eligible as equity – which might in fact oppose the internal economic objectives. Hence, hidden losses and hidden reserves should be consistently taken into account within the measurement of institution-specific risk and the definition of the internal capital under the internal economic perspective. Any diverging treatment is also opposed by the economic perspective presented under principle 3: figure no. 2 explicitly refers to a "net present value method", also mentioning a definition of internal capital that is consistent with risk management.

Treatment of hidden losses and hidden reserves	9	Clarification
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We request clarification that the respective accounting standards (e.g. fair value accounting) apply with respect to hidden losses within the normative perspective. These accounting standards determine to what extent hidden losses are to be recognised in income, or directly in equity. According to the Guide, additional hidden losses (e.g. items not accounted at fair value) "that may not be captured in the normative framework, or that may only materialize over time", and should thus be deducted from capital in the economic perspective. We therefore propose consistent consideration of hidden losses and hidden reserves in line with the measurement of institution-specific risk and the definition of internal capital within the internal economic perspective. However, this must be consistent with the internal capital definition, especially concerning the eligibility of subordinated capital.

Treatment of hidden losses and hidden reserves	9	Clarification
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Furthermore, we request clarification that hidden losses and hidden reserves are to be viewed on a net basis for each bank. Especially in the banking book, hedged transactions and related hedges are linked within the scope of micro or macro hedges; for example, hidden reserves from loans may be offset by hidden losses (or negative fair value effects) from derivatives (depending on applicable accounting standards). Accordingly, the required consistency definitely requires a net view.

Treatment of hidden losses and hidden reserves	9	Clarification
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ICAAP principle 6

From our point of view, principle 6 constitutes a key aspect of the draft regulation – yet in its current wording it is contradictory. If risk quantification methodologies are supposed to be in line with institutional risk appetites, market expectations, business models, and risk profiles, the regulatory expectation cannot forcibly impose a conservative approach that is at least in line with internal models under Pillar 1. We continue to believe that the purpose of Pillar 2 is to measure risk in accordance with the institution's own assumptions. Risk measurement does not need to be conservative per se, but needs to be 'right' – in the sense of being adequate for the institution. Pillar 2 cannot reflect the institution's own view on risks if it needs to be increasingly oriented upon Pillar 1. Clearly, the current regulatory approach concerning Pillar 1 is shaped by the objective of comparable risk measurement. Footnote 12 explicitly notes that the requirement for orientation upon Pillar 1 need not refer to a specific parameter within the Pillar 1 risk measure. Still, an institution may have good reasons for divergence from each and every single parameter, in which case its assumptions would not be oriented upon Pillar 1 in its entirety. The aim of 'correctly' measuring risks should be focused. We therefore demand that the reference to Pillar 1 be deleted.

Comprehensive and conservative risk quantification	9	Deletion
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Irrespective of this, financial conglomerates generally face the issue of what is the 'right' orientation parameter. Given that the requirements set by banking supervisors (on the one hand) and by insurance supervisors (on the other) differ fundamentally, "Pillar 1" – as referred to in the Guide – is not well-defined. At the same time, this raises the issue as to what extent a requirement to apply a uniform confidence level across all types of risk is in fact justified where financial conglomerate are concerned. Regulatory requirements clearly specify a difference: 99.9% for banks, 99.5% for insurance companies. Against this background, it would appear appropriate to delete the requirement for a uniform confidence level applicable for all types of risk. We believe this might be replaced by wording similar to footnote 12, i.e. setting a requirement to ascertain a functioning, closely integrated risk management system throughout a financial conglomerate, in the event that confidence intervals differ within that conglomerate.

Comprehensive and conservative risk quantification	10	Clarification
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Requiring institutions to hold capital to cover diversification effects in a stress scenario, whilst also requiring them to account for such stressed diversification effects both for stress testing and capital planning purposes is a contradiction. Firstly, it is fair to expect stressed diversification effects not to exacerbate any further in stress tests or adverse scenarios. Secondly, principle 3 in particular emphasises that the economic perspective is based on a one-year horizon, which is why multi-year capital planning (according to principle 3) should focus on the normative perspective. Hence, the sentence "Institutions should also take this into account in their stress testing and capital planning" should be deleted.

Inter-risk diversification effects	10	Deletion
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The requirement that the validation process for ICAAP risk quantification methodologies should respect the principles underlying the respective standards established for Pillar 1 internal models should be further specified by pointing out that material aspects of Pillar 1 validation should be applied. The principle of proportionality should be observed in this respect. For example, in cases where only a very simple and conservative model is being used (because a specific type of risk only has minor importance for an institution), having to comply with all requirements under Pillar 1 would be disproportionate. In our opinion, a blanket application of all requirements to Pillar 2 models would not be appropriate.

Independent validation	11	Amendment
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ICAAP principle 7

Within the framework of capital planning, institutions supplement their baseline projection by an adverse scenario, in order to be able to assess potential negative deviations from planned developments. The underlying question is how the institution would develop if its future would not turn out quite so positively. In contrast, the purpose of a stress test is to assess the institution's situation in a truly extreme negative economic environment. As a rule, stress testing thus constitutes a supplementary assessment within the ICAAP framework, with the underlying question as to how the institution would develop in an extremely negative scenario. The way principle 7 is formulated suggests that the same assumptions should be used for defining negative scenarios (or the adverse scenario being determined by stress test parameters), both for capital planning in the normative perspective and for risk measurement in the economic perspective. We believe that mixing both assessments is inadequate. We therefore request a clear distinction be made between stress tests required under the economic perspective (i.e. stress tests for specific risk types and providing for strong deviations) from those adverse scenarios

required under the normative perspective (i.e. multi-year scenarios across risk types which reflect plausible economic crises). Moreover, it is still unclear whether one single adverse scenario is required under the normative perspective, or if banks are required to determine multiple scenarios. A more detailed description of the precise interaction between scenarios and methodology in the context of planning, adverse developments and stress testing would also be helpful.

Principle 7	11	Clarification
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The requirement for applying scenarios "e.g. quarterly" should be deleted. Whilst scenarios should be applied on a regular basis, institutions should be free to determine the frequency. Experience shows that even examples provided automatically evolve into actual requirements in auditing practice.

Principle 7	11	Deletion
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ILAAP

ILAAP principle 1

We request clarification how the principles interact with the version published in the previous year (e.g. as regards liquidity costs and intraday liquidity). We assume that the draft Guide represents a revision, replacing previous documents by providing a conclusive presentation of regulatory expectations.

Key elements of ILAAP	2	Clarification
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The requirement that "The institution should on at least an annual basis self-assess its ILAAP against the relevant regulations, EBA guidelines, and BCBS best practices and expectations" appears to be ranking BCBS best practices and expectations on a same level as the law. In this way, ILAAP requirements would clearly exceed existing requirements. At the same time, an obligation to comply with final BCBS frameworks at an early stage would counteract both sense and purpose of European implementation adjustments: these would – at least temporarily – be rendered meaningless, or might even contradict the regulations of the Basel regime. In addition, we believe the reference to industry best practices to be inappropriate, given a lack of generally-accepted definitions of such "best practices".

Management body	2	Deletion
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ILAAP principle 2

The wording: "In order to assess and maintain adequate liquidity to cover the risk, the internal processes and arrangements shall ensure that risks do not exceed internal limits set, based on the current and expected future available liquidity" should be amended regarding the permissibility of limit transgressions, since the current wording gives the impression that such transgressions are generally not permitted. However, the purpose of the risk management process is to prevent any permanent breaches of limits, whilst temporary transgressions are not fully excluded. In fact, the required effectiveness of the limit system is demonstrated through the latter, with corresponding escalation processes being defined as part of the risk management process. Hence, limits are set in a manner that a temporary transgression will not threaten the institution's existence *per se*, and thus does not constitute a threat to the institution's viability.

The ILAAP as an integral part of an institution's risk management and decision-making	4	Amendment
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ILAAP principle 3

The explanations provided to ILAAP principle 3 suggest that institutions are called upon to cover the liquidity needs resulting from institution-specific stress scenarios over a horizon of up to one year with a liquidity buffer. At this point, the one-year horizon is deemed to be a "short-term" view. This contradicts the explanations on a 30-day period, as provided under principle 4, as well as the terms defined in EBA/GL/2014/13 (SREP). We therefore request a clear definition and application of timeframes within the scope of ILAAP, observing existing normative rules.

Combinations of perspectives	5	Clarification
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A multi-year LCR planning was already considered inadequate during the consultation process for EBA/GL/2014/04 (Funding Plans). We ask that the consensus reached at the time – according to which a maximum planning horizon of one year is appropriate for this short-term liquidity indicator – be duly taken into account.

Combinations of perspectives	5	Amendment
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ILAAP principle 4

We request clarification that the target survival period refers to the aggregate effect of all liquidity risks identified, and not to each individual risk driver.

Sources of risk	6	Clarification
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ILAAP principle 5

We request that terms be used consistently with other legal rules. The term "liquidity buffer" is defined in Delegated Regulation 2015/61, using a legal definition that is inconsistent with the one used in this Guide. We advocate the uniform application of the term of "counterbalancing capacity" (which is also used in EBA/GL/2014/13 (SREP)), which allows for a differentiation between economic (counterbalancing capacity) and regulatory liquidity (liquidity buffer).

Liquidity buffer	7	Amendment
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ILAAP principle 6

The Guide demands that models be developed exclusively by the risk control function. We request clarification of this requirement, since independence of model development and validation is ascertained by Controlling/Risk Control as a department or unit. Exclusively restricting this to a risk control function would not be in line with established market practice.

Independent validation	9	Clarification
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ILAAP principle 7

We request that the terms "reverse" stress test be used consistently. The German translation of the document uses the concept of "reverse" for ICAAP, but "inverse" for ILAAP.

Stress scenario definition	9	Amendment
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We would be pleased to discuss these Guides with you in more detail.

Yours sincerely,
on behalf of the German Banking Industry Committee,



Gerhard Hofmann

Bernhard Krob