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21 October 2005

The Committee of European Banking Supervisors  
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Dear Sirs

The London Investment Banking Association (LIBA), the British Bankers' Association (BBA) and the International Swaps and Derivatives Association (ISDA) welcome the opportunity to comment on CEBS' revised paper on the Supervisory Review Process. As a joint response this represents the views of both trading firms and banks. Our key messages are discussed in the body of our response paper. However, we would like to draw particular attention to the following considerations:

**The global perspective** Industry urgently encourages the EU regulators to adopt the same pragmatic approach to coordination and cooperation in the global arena as they have undertaken within the EU. Home host relationships are of paramount importance both within the EU and reaching out to beyond the EU. Firms believe that considerable legal scope exists to enhance cooperative structures and that EU is capable of setting a leading example to other regulators. Not only will cross border groups be the beneficiary, but there will be an important strengthening of the global financial system.

**The overall approach** Industry welcomes all CEBS statements that reinforce the understanding that one size cannot fit all and that the most effective approach to Pillar 2 is founded in the quality of the dialogue between regulator and industry, respecting the group dimension to the greatest extent possible. It is essential for Pillar 2 to be principles based and to avoid prescription. We find that the regulators have moved away from principles and towards greater prescriptiveness. This will lead to a rigidity of approach, weaken the quality of the dialogue and intensify the scope for a generally additive approach to capital. Firms urge CEBS to revert to the language of its earlier paper.

Finally our Members look forward to working with CEBS in finalising the proposals and hope there will be scope for further discussion. Please contact Katharine Seal (Katharine.seal@liba.org.uk), Ed Duncan (eduncan@isda.org) and Simon Hills (simon.hills@bba.org.uk) if you would like to discuss any of the aspects of this letter or future proposals.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'K Seal'.

Katharine Seal  
Director, LIBA

A handwritten signature in blue ink, appearing to read 'Ed Duncan'.

Edward Duncan  
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A handwritten signature in black ink, appearing to read 'Simon Hills'.

Simon Hills  
Director, BBA

**British Bankers Association (BBA)  
London Investment Banking Association (LIBA)  
International Swaps and Derivative Association (ISDA)**

**Response to**

**CEBS CP03R  
The Application Of The Supervisory Review Process Under Pillar 2 Revised**

**21 October 2005**

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## EXECUTIVE SUMMARY

Industry welcomes the opportunity to comment on the revised version of the CEBS CP03 on the Supervisory Review Process. As the Committee will recall, firms were broadly positive in their reaction to the initial version of this paper, and we are glad to see that a number of our comments and suggestions have been accepted by the Committee.

On balance, however, firms regret that they are disappointed with the current CEBS paper. Taken together, firms believe that the changes proposed by CEBS are a retrograde step that will not promote an effective partnership between firms and regulators, which is central to the new Basel framework achieving its potential. Industry is concerned that the current iteration of the proposals are unduly complex and prescriptive. A fixed and quantitative application of Pillar 2, which the paper appears to encourage, risks losing many of the benefits of the revised and enhanced capital framework. Failure by CEBS to address these issues identified in our response, therefore, could undermine the original objectives of the Pillar 2 enterprise.

Our key messages are highlighted in the executive summary below and discussed in more detail in the body of the response.

### Principles Underpinning Pillar 2

- **ICAAP Principles and over prescriptiveness:** previously, firms were generally supportive of the ICAAP principles, but we are now disappointed to find greater levels of prescription and potential rigidity. The paper now appears to deliver a checklist approach and to encourage a more additive approach towards capital. Moreover there is less emphasis than before on the two way dialogue and we take this change to be an intentional, retrograde, step.
- **Status of the Guidelines:** Firms need to know whether, or to what extent, and from which date the guidelines in this paper will or may come into force in the relevant jurisdictions.
- **Costs:** the manner in which supervisors implement the Pillar 2 regime could increase the cost base of the regulated firms. Industry hopes that regulators will be mindful of this, so that costs can be constrained, not least as higher costs are passed on to end users and can lead to decreased efficiency in the system.

### Implementation

- **Scope of Application:** Although the directive text sets legal constraints, the Pillar 2 process needs to be applied, as far as possible, at the group level. The supervisory effort needs to be able to assemble information from all parts of the group and determine whether the individual legal entities are receiving the support that is required.
- **Home Host:** the Home-Host relationship, including delegation of tasks, is crucial to the effective operation of Pillar 2 to avoid duplication of time, effort and resource for industry and regulator. Firms remain unclear on the principles under which home-host supervisory structures will respond to cross border group structures and would welcome stronger statements by CEBS clarifying that for certain risks, such as strategic risk, home-host cooperation is essential.
- **Non EU dimension:** the relationship with non EU entities or regulators is under-developed. However, CEBS work is highly influential and firms would welcome a strong statement that third country regulators will be incorporated fully into the regulatory assessment of the group.
- **Proportionality and Materiality:** The principle of proportionality needs to be reinstated explicitly. The guidelines currently demand that firms carry out an assessment of ALL risks. This requirement is a practical impossibility. Clearly, firms need to identify material and quantifiable risks and the paper needs to reflect this understanding.

- **Level playing field, Convergence, Consistency:** Firms recommend that the regulators provide more information on how they will strive for convergence and consistency of approach, whilst ensuring that the individual needs of firms are respected.

### Capital Adequacy

- **Capital is not the only answer:** regulators should focus on risk management and mitigation processes, rather than setting ever higher capital levels
- **Building Block approach:** Firms do not support the “building block” analysis and believe that a prescriptive set of risk buckets within Pillar 2 is inappropriate and will not drive consistency. A more fluid concept is necessary to discourage any tendency towards a purely additive approach to capital.
- **Stress Testing:** Firms do not seek more guidance on stress testing. The results of Stress tests should not automatically lead to additional capital: the parameters in Pillar 1 are already stressed and to require firms to hold additional capital against stressed situations is overly conservative.
- **Relationship of own funds and internal capital:** Internal and regulatory capital are two different concepts and approaches to assessment of capital adequacy. The concept of economic capital has not been applied homogeneously between firms and such differences are beneficial and to encourage firms to use the same process would be to stifle innovation and increase systemic risk. The internal capital assessment should be a starting point for dialogue result rather than the basis for setting additional capital requirements.
- **Capital buffers:** Industry is concerned that regulators fail to appreciate fully the consequence of requiring a firm to hold additional capital. Many, if not most, firms will as a matter of course, and for varying reasons, sustain the cost of holding more capital than is required by the regulatory minima. Regulators must take account of this dimension when exercising their powers in this field – including the costs that must be borne by the firm in raising additional capital.
- **Quality of capital:** Should a firm be required to hold additional capital, there should be no automatic requirement that this capital should be in the form of Tier 1 only. The assessment of what form of capital is appropriate should be on a case by case basis.
- **Diversification/Capital in legal entity.** Capital at the group level is not the sum of the individual parts. In particular the effects of diversification, and correlation factors will all be taken into account, by the firm.

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## **i) Impact of the Guidelines.**

- *Status of Guidelines*

The status of the paper is unclear. While recognising that CEBS is a committee that works by consensus and cannot make these guidelines mandatory, it is important to individual firms to understand whether, or to what extent, and from which date the guidelines in this paper will or may come into force in the relevant jurisdictions. Firms support the drive towards convergence in EU prudential regulation but require a clear explanation of how and when such guidelines may come into operation. We ask that CEBS encourages its individual regulators to disclose publicly their intentions towards the CP03R guidelines as soon as possible. Otherwise the guidelines will lead to increased levels of uncertainty.

- *Over prescriptiveness.*

The principles and guidelines contained in the revised CEBS paper are too prescriptive. Disappointingly, the paper has moved away from high level principles and has the nature of a supervisory checklist which we believe will limit and constrain supervisory understanding of firms and the quality of the relationship with firms. We recommend that the paper revert to earlier drafting wherever possible.

- *Consequences of Pillar 2.*

Taken as a whole, it is to be hoped that the overall impact of the newly introduced Pillar 2 regime will enhance the safety and soundness of the financial system both within the EU and beyond. Nevertheless, the manner in which supervisors implement the Pillar 2 regime has the capacity to drive up the cost base of the regulated firms. Industry hope that these costs can be constrained to the greatest extent possible, not least as higher costs are passed on to end users and can lead to decreased efficiency in the system.

Industry welcomes the fact that CEBS aims to facilitate convergence, and we recognise that this drive represents a shift in cross border prudential regulation. The drive towards convergence, though, brings the public discussion closer than before to addressing the specific implementation choices made by regulators, because the impact on firms' costs and their competitive efficiency is more visible than before.

## **ii) Key themes and concerns**

- **Scope of Application.**

Industry fully understands that CEBS must work within the legal constraints of the CRD, which in its final form provides the legal basis, as opposed to the duty, to apply Pillar 2 at each incorporated entity, rather than at group level alone. However, industry continues to ask in the strongest possible terms that supervisors consider Pillar 2 as holistically as possible. The active use of colleges of regulators, using the CRD framework, and extending colleges beyond the EU will be essential. We refer CEBS to our earlier response.

To summarise our position, it is essential to firms that the practical implementation of Pillar 2 applies as much at group level as possible, using all means of cross border cooperation and collaboration. If the discussion is purely at entity level, complications will occur, for example how could strategic risk be adequately assessed, and how will regulators recognise features such as the fact that firms would buy insurance at group level and not at individual entity level? Firms therefore welcome the indication given by CEBS in its introductory chapter, that it wishes to streamline the supervisory process in a cross border context as much as possible. We provide more detailed comments on home-host relationships in our response to CP09, but offer greater consideration of the need for a group application of pillar 2 below.

### *Management processes*

The industry fully supports CEBS' objective that the ICAAP should not be "simply regarded as an add-on that permits management to 'tick the box' and indicate that supervisory expectations have been met". However, inevitably the ICAAP will be a box-ticking add-on if applied at the level of an individual subsidiary. This is because groups focus their internal capital efforts at the level of the consolidated group. Capital raising is performed at the level of the holding company, and is a sensitive, complex, costly and time-consuming process, which is undertaken at this level so that capital may be raised cost effectively and down-streamed efficiently to other group entities. Any subsidiary can then be readily recapitalised by simple injection from the parent. In addition, for a complex institution the internal capital process will be aligned to business lines rather than legal entities: an ICAAP for a subsidiary entity will likely therefore be a completely separate process designed primarily to meet local governance and regulatory requirements. We would further note that, often, at the level of an individual subsidiary capital is driven not by the risks inherent in the business conducted by the entity but rather by the need to hold capital at a particular level so as not to breach regulator-imposed exposure limits, particularly in respect of intra-group transactions.

### *Supervisors*

Given the directive requirements, firms realise that there will be significant demands placed on supervisors. Nevertheless, the Pillar 2 regime cannot be wholly delivered via statistical reporting or desk top review. Supervisors must take all opportunities to cooperate and where necessary delegate tasks to each other. Many functions within a firm are delivered centrally, so for supervisors to assess the extent to which these functions perform effectively and support the individual legal entities, the supervisory effort needs to be able to assemble information from all parts of the group and determine whether the individual legal entities are receiving the support that is required. In most cases this assessment will not be possible or relevant at the legal entity only.

### *Industry support for collective solutions*

Firms believe it would be appropriate for CEBS to provide guidance to supervisors to ensure that the ICAAP/SREP framework is applied in such a manner as to comprehend fully how the ICAAP works within and throughout the group. It is not reasonable to suppose that a process designed by a firm to operate on a group wide basis can be understood fairly and accurately through separate examination of its subsidiaries. There needs to be a collective enterprise between the relevant supervisors and with the competent home state regulator taking the appropriate lead in pulling the threads together. Informal groupings such as colleges or the lead supervisor concept can do this job well and industry would support such initiatives. The alternative will be a duplication of effort which is as expensive to regulators as to firms.

- **Home Host.**

As we stressed in our earlier response, it is essential for regulators to create constructive, non-duplicative cross border relationships in order to avoid replication of time, effort and resource at multiple levels within a cross border group. Despite CEBS release of CP09 on Home Host relationships, firms remain unclear on the principles under which home-host supervisory structures will respond to cross border group structures. Firms need reassurance that the applications made to local supervisors will be adequate and are directed to the correct authority. Equally, the operation of Home Host relationships is fundamental to the confidence firms can place in the international level playing field. We would welcome stronger statements by CEBS clarifying that for certain risks, such as strategic risk, home-host cooperation is essential.

- **Non EU dimension.**

The relationship with non EU entities or regulators remains an under-developed aspect of this paper. For level playing field reasons alone, the global perspective cannot be ignored. Already it is clear that the work of CEBS is highly influential with, and interesting to, regulators outside the EU. Firms

welcome this, as it will assist gradual international convergence. However, there is little sign that the EU regulators are actively reaching out to their wider peer group. Industry recognises that the CEBS remit is not yet fully developed with respect to third country relationships, but global perspective is essential. The strength of the single market lies not purely in the establishment of intra-EU activity, but in the ability of EU firms to expand their business globally and for third country firms to bring their business into the EU.

The CRD provides a framework for regulatory relationships within the EU, it provides less clarity for relationships with third countries. Nevertheless, there are gateways within the directives for exchange of information and the possibility of strong cooperation. Industry asks, in the strongest terms, that the EU regulators take the initiative and utilise all pragmatic opportunities to coordinate and cooperate with third country regulators when implementing the CRD and the Pillar 2 regime in particular. Otherwise a critical dimension of information concerning internationally active cross border groups could be missed. Greater clarity on this topic is needed therefore. Firms would welcome a strong statement from CEBS that third country regulators – who may be the regulators of the parent entity, or of significant sub-groups – will be incorporated fully into the regulatory assessment of the group as a whole.

- **Level playing field, Convergence, Consistency:**

We welcome the explicit reassurance that the regulators wish to ensure a level playing field. However, it is clear that it is difficult, in the context of confidential bilateral relationships between regulators and firms, for consistency of approach to be achieved even where regulators are striving for this outcome. Moreover, it is essential to instil confidence into the market that national regulators would not apply a more laissez-faire attitude to locally incorporated subsidiaries of one of their large domestic institutions, while deploying the full SREP to local subsidiaries of groups headquartered elsewhere. We recommend that the regulators provide more information on how they will strive for convergence and consistency of approach, whilst ensuring that the individual needs of firms are respected. What role do supervisors envisage supervisory disclosure as playing here in terms of supporting the level playing field and competitive equity? As discussed above, it is necessary for supervisors to consider the global/cross-border competitive impact of their work.

- **Proportionality and Materiality**

It is welcome that the CP places such emphasis on the importance of proportionality, but we believe that it is important that this point be re-inserted specifically in the ICAAP, SREP and RAS principles. Please note also discussion below.

Materiality is one aspect of proportionality and we note that the CEBS paper demands that firms carry out an assessment of ALL risks. On the face of it, this requirement is a practical impossibility (it would extend from the business and financial risks of the firm to environmental factors, to political factors, to the potential for the firm's head office to be hit by a comet etc). However, it is possible that the paper does not express the regulators' intention clearly. Firms need to be able to identify material risks and in the process of making this identification, will review a much wider set of risks, even though it is probably impossible to be sure that all risks can truly be identified much less assessed. Then the effective risk assessment can concentrate on assessing the impact of the material risks to its business.

### **iii) Capital Adequacy**

- **Capital is not the only answer**

In our earlier response to CEBS, industry's strong view was that "capital is not the only answer" to address risks and that CEBS should avoid an automatic capital add-on approach. We are very conscious, though, that the tenor of the revised CEBS paper emphasises the capital aspect more strongly than the previous version. We believe it is imperative that regulatory focus and scrutiny is on risk management and mitigation processes and is not solely focussed upon setting ever higher capital levels.

While CEBS continues to acknowledge that capital is not the only answer, this message is more muted than before and there is a corresponding weight put on the need to operate above minimum levels. In view of the shift in tone, we wish to reiterate strongly that capital is not always the best or most appropriate mitigant for risk. We are concerned that supervisors are less focused on ensuring that risks are dealt with appropriately, engaging with the firm to determine whether appropriate strategies and mitigants are in place than they are in establishing that a firm has surplus capital.

In particular we seek clarification that there shall be no additional capital charges for firms that are fully compliant with the SRP and that a supervisory decision that no additional capital should be levied will be seen as a valid and “normal” outcome. Additionally, we find it necessary to reiterate that the SRP should not be a granular bottom up process by supervisors (or firms) to recalculate and augment any perceived “deficiency” in the Pillar I charge.

- **Building Block approach**

In the context of discussing the potential for additional capital, one issue that is problematic for firms is the “Building Block” approach. This is a matter of considerable concern for firms and we would be disappointed if the supervisors dismissed the matter merely as one of terminology, as it is an issue on which we believe that form will drive substance. Industry understands that the concept of the “building block” approach was probably designed to ensure a stable process or structure and to ensure consistency across jurisdictions and clearly we support this objective. However the use of language drives a perception that the process will be prescriptive and additive.

Although supervisors will wish to take a structured approach in determining that capital is held where the risk is located within firms, the concern is that the “building block approach” encourages/ creates (a) hard risk categories; (b) an additive, cumulative, aggregation approach; (c) and an attendant inability on the part of the supervisor to understand how the “whole big picture” meshes - how different aspects interact with each other, and affect each other for better or worse, because there will be an interplay between risks which will not simply be cumulative – as the metaphoric building blocks imply. The more rigid these “building blocks” are, the greater the impact on the firm’s ICAAP. Moreover, it calls into question how tailored a firm’s own ICAAP can actually afford to be, given that the firm will have to explain its ICAAP to the supervisor under the challenge of the SREP. We strongly recommend that the supervisors modify the terms they use as a matter of urgency. In seeking to identify a more appropriate image, we suggest using phrases such as “streams” of risks – to imply the more fluid nature of the risks, the manner in which they act upon each other and the flexibility of approach that will be needed to assess the overall situation.

- **Stress Testing**

The industry does not believe that it would be helpful for CEBS to offer more guidance on stress testing. The connection between stress testing under Pillar 2 and capital requirements is particularly complex. We strongly believe that it is inappropriate for firms to have to hold capital to cover stressed situations. The parameters in Pillar 1 are already stressed and thus to require firms to hold additional capital against stressed situations is overly conservative. Industry assert that there is an important role for stress testing in areas such as limit setting and longer term capital planning however we reject any suggestion that increased capital be necessarily held to cover the stress situation. The interaction of stress testing and Pillar 2 and capital would be a very useful area for CEBS to clarify. However the industry does not believe that it would be helpful for CEBS to offer more guidance on the form which stress testing should take but rather allow flexibility to accommodate the diverse approaches firms could employ.

- **Specific Risks in Pillar 2**

The CEBS paper refers to the specific risks that a Pillar 2 approach is supposed to include. We expect a future paper from CEBS on this subject. As an early comment, however, we advise caution and lack of prescriptiveness. None of the risks, or “risk buckets” to be included in Pillar 2 are subject to a harmonised EU approach (were this the case, they would certainly be part of the pillar 1 minimum capital framework). Nor is it clear that all of these risks can in fact be quantified consistently across institutions, or benefit from capital being allocated to them. Moreover firms are strongly of the opinion

that capital does not function as a mitigant for certain risks, notably reputational risk and liquidity risk. Firms instead believe it is more appropriate to and indeed do spend considerable effort on assessing, managing and mitigating these risks. It is of major importance that the regulators understand this dimension.

- **Relationship of own funds and internal capital**

We support and understand the desire to align regulatory capital more closely with the underlying risks to remove obvious anomalies and distortions, but we must stress that internal capital and regulatory capital are two different concepts with different approaches to assessment of capital adequacy. We do not believe that a formulaic relationship should be enforced between internal capital assessments and Pillar2 regulatory capital requirements. Rather the regulator should use the internal capital assessment as a starting point for engaging in a meaningful dialogue with the firm and to identify key issues to discuss.

Guidance: Firms do not seek guidance from regulators on the relationship between own funds and internal capital. Industry perception is that this will lead to excessive complexity, prescription and rigidity which firms will find unhelpful and which will create adverse systemic effects. It is not appropriate to stifle innovation in the field of assessing internal capital and it is unwise to encourage, even indirectly, convergence in firm's approaches. Firms are not comfortable, as indicated elsewhere in this paper, with the "building block" approach that is advocated. Furthermore, it is not apparent to firms that "benchmarking" between firms in the field of their models for internal capital is realistic, feasible or appropriate.

Dialogue/challenge: Industry urges that there be an in-depth bilateral dialogue-challenge process at the heart of the ICAAP, in particular in examination of the outcome of ICAAP-SREP. This process should be two way, with the firm expecting to have to explain its rationale, and outcome of its own process to the regulator and the regulator to expect that the firm might challenge the regulatory interpretation and stand ready to justify the approach that has been taken.

Capital requirements: The angles that cause particular concern are as follows.

- Quality of capital required by regulators: Industry seeks unambiguous confirmation from CEBS that in the event that a regulator believes that it is imperative for a firm to hold additional capital, that there is no automatic requirement that this capital should be in the form of Tier 1 only. We accept that under certain circumstances this may well be appropriate, but this can only be determined in specific circumstances. We note that capital deductions under the new framework are made 50-50% from Tier 1 and Tier 2, therefore additional capital should not be Tier 1 only rather the assessment should be case by case and agreed in discussion with the firm in relation to its risk profile.
- Capital buffers: Industry is concerned that regulators fail to appreciate fully the consequence of requiring a firm to hold additional capital. Many, if not most, firms will as a matter of course hold more capital than is required by the regulatory minima. The reasons why firms will hold "surplus" capital will differ, but this capital is not held lightly as it represents a cost to the firm. Hence, where the regulatory minimum level increases – as it might under the Supervisory Review Process intervention – the firm will in all likelihood also look to increase its buffer. For example, if a firm opts (as some though not all firms will do) to hold a certain level of capital above the regulatory minimum in order to allow for a specified level of volatility in one or more factors, then the need for this capital headroom will remain and more capital must be raised in order for the firm to sustain the same level of protection. The buffer is not "free" capital that the regulator can allocate to its own regulatory needs. Regulators must take account of this dimension when exercising their powers in this field – including the costs that must be borne by the firm in raising additional capital. In each individual instance it will be important to understand why a firm holds the level of "excess" capital that it chooses to do. This is just one area where in depth dialogue between firm and supervisor will prove critical.

- **Diversification/ Capital in legal entity:** Capital at the group level is not the sum of the individual parts, not least due to inter-company transactions which are obviously excluded from the group calculation. In particular the effects of diversification, and correlation factors will all be taken into account, by the firm. It is not clear that the CEBS paper fully recognises this dimension as the main reference is found only in the diagram (page 35 of CP03R) and the final iteration of the paper should include this point.

#### **iv) Responses to CEBS' specific questions**

- **Is there agreement on the importance of internal governance and should it be a key focus of the evaluation of the ICAAP?**

Firms agree, naturally, that internal governance is an acutely important topic, however we do not welcome the inclusion of principles on this subject which we find to be duplicative of other regulations (particularly the Basel paper on sound governance) and overly prescriptive in outlook. While a single principle can be welcomed, there is clear and unhelpful duplication of material and confusion of international work streams. Please see below for further discussion.

- **How could the proposed "dialogue" between institutions and supervisors be made more effective?**

The primary guiding principle for the dialogue between institution and supervisor is that one size cannot fit all. Instead, the dialogue should encourage and reinforce ownership and senior management responsibility for capital. There can be a very fine line between a regulator probing a firm's decisions and actions and stepping into forms of shadow management. If regulators deem increased capital to be necessary, the industry expects that the regulator should justify the rationale for this decision.

It is important that regulators should state clearly their reasons for asking specific questions and must be ready to justify directly any demand made for increased capital.

To the greatest extent possible it would be helpful if the Pillar 2 dialogue were embedded within the normal regulatory relationship. For example, in the UK it makes sense to undertake the dialogue in the context of the existing processes set up to deliver risk based approach to supervision (known as "Arrow"). Although it may not be possible to align the timing of the programmes and meetings immediately, over time this is a practical goal, which would reinforce the principle that Pillar 2 processes are integral to the management and operation of the firm and not something merely added on to fulfil regulatory requirements.

Two areas in which industry would appreciate greater clarification from the regulators on the way in which the SRP will be approached are in the fields of dialogue/burden of proof and peer group review. Industry has long advocated a discursive, relationship-based approach to the SRP, as CEBS knows. This ought to be the approach regulators aim for to the extent that resource constraints allow. However, regardless of the style in which the relationship is conducted, when supervisory intervention is decided upon, the supervisor's judgement is substituted in place of the firm's. This substitution cannot take place lightly as ultimately the consequences of this substitution will rest upon the management and ownership of the firm and therefore the burden of proof must lie with the regulator who believes that the firm's own strategies and capitalisation is inadequate and who wishes to insist on increased capital or other non-capital mitigants.

One element of the overall SRP process in general and the supervisory dialogue in particular, which remains sketchy is the Peer Group Review. Industry supports the initiative, as we believe that it will be crucial in limiting/avoiding competitive distortions both within and between jurisdictions. However, the form of the reviews is uncertain and the degree of transparency following the reviews is unknown – what form of feedback would a firm expect to receive relative to the performance of its peer group? Greater information from the regulators would be appreciated.

Firms also note that the cross border and 3rd country dimension is central to the overall process. Where a firm has a third country parent, or where an EU firm has subsidiaries outside of the EU, the third country regulator (whether banking supervisor or securities regulator) is a critical participant in the ICAAP/SREP dialogue.

- **Would smaller, less complex institutions find additional optional guidance on the ICAAP helpful and what might such guidance cover?**

The more detailed and prescriptive any additional guidance is, the more firms have a concern that supervisors will be encouraged to apply a rigid/checklist/tick box approach to the larger more complex firms. Additionally, for smaller and less complex institutions (including small or less complex institutions which are part of a larger group) it should be made clear that much of the guidance will not be relevant to them. It may be of more use to firms to be aware of the potential that certain areas will be irrelevant to them, than to have significant amounts of additional guidance provided to them. Smaller firms cannot be deemed to be lacking in the capacity to understand the CEBS principles or guidance, and are likely only to be constrained in capacity of resource to absorb large volumes of guidance which is not highly targeted and efficient.

- **It would also be useful to have views on the concept of proportionality, both as it related (i) to the size and complexity of institutions and (ii) to the intensity of the dialogue between institutions and supervisors.**

Industry welcome the priority that the regulators wish to place on the issue of proportionality. Ironically, therefore, it is a significant concern that all references to the principle of proportionality have been removed from the guidelines text. We recommend that proportionality is re-inserted in the principles set out in the guidelines.

Furthermore, intensity of the dialogue/intervention process should be significantly scaled down in the following instances:

- Where an entity is a small firm within a larger group (we query the extent to which a one-to-one dialogue with such a firm could be fruitful for either party).
- Where an entity is on the standardised approach(es). In this context it is irrelevant if the parent entity is on an advanced approach, as the intensity of the dialogue should be directed towards the parent/group level.
- Where capital is readily available from a parent company.
- Where capital levels are maintained at significantly higher than the 8% minimum as a result of large exposures constraints.

## **v) Detailed comments on CEBS paper**

### **Internal Governance**

CEBS asks for feedback on the new material on Internal Governance. On balance this section is not welcomed by firms. We note the paper includes the section on Internal Governance which is apparently driven by Article 22 of the re-cast CRD, but the insertion fits poorly with the SRP structure. Firms do not support the need for guidance on Internal Governance. This is due to

- duplication of material with other regulations (eg MiFID, or IAS, Sarbox or even within the CRD i.e. the Operational Risk framework , or Pillar 3 in respect of IG20, or the extensive IG guidance included in CEBS CPI0);
- failure to explain the interaction of these guidelines with other regulations;
- overlap with coverage in operational risk arena;
- errors in supervisors' understanding of governance and organisational structures in firms; and

- prescriptiveness and rigidity in the guidelines (rather than high level principles).

As in all sections of the CEBS paper, industry seek high level principles and not detailed, prescriptive guidance which will increase supervisory burdens and creates the expectation that the dialogue between firm and regulator will be rigid, rather than tailored to reflect the firm's profile.

Structurally, within the CEBS paper, firms note that the IG Guidance does not align with ICAAP. Hence the link between IG and ICAAP is obscured and does not support firms looking to understand the supervisory approach. This contrasts with the Basel paper on Corporate Governance where there is greater clarity on accountability and transparency.

In conclusion, the locus of CEBS in the arena of Internal Governance is unclear, the quality of the content is poor, and the manner of delivery seen as unhelpful. Firms do not find the Internal Governance "principles" to be useful material to develop their practices or structures.

### **ICAAP Principles**

Previously, firms were generally supportive of the ICAAP principles. In common with other areas of the revised paper, we are disappointed to find greater levels of prescription and potential rigidity than before. The principles now appear to deliver a checklist approach as well as an additive approach towards capital. The dimension of the two way dialogue, although not formally missing from the paper, has less emphasis than before and we take this change to be an intentional signal. Industry retains its preference for high level principles and a contextual environment that made it clear that individual firms were to make their own decisions.

- We welcome the clarification that while ICAAP should be integrated into management processes, it is not necessary to review the entire ICAAP on a daily basis.
- We note and regret strongly the loss of references to correlation (previously in principle VIII, but not contained in principle 7).
- We do not support the regulatory concept of the "building block" – this issue is discussed in more detail below, under "SREP-ICAAP Interaction." For Pillar 2 to complement Pillar 1, it is important to allow a level of discretion to firms to determine whether to adopt a "bottom up" or "top down" approach. Firms should then stand ready to justify the appropriateness of their approach when challenged by the regulator. Indeed, the benefit of a top-down macro approach is that it offers a different perspective on risk levels to the Pillar 1 approach.
- We continue to support ICAAP principle 9 before but find sub-para "g" unhelpful, as we do not believe that it is feasible. (ie "non quantifiable risks should be included if they are material, even if they can only be estimated"). This discussion links to the wider topic of materiality discussed above.

### **Risk Assessment (RAS)**

Firms note that the revised principles are a longer elaboration of the previous paper. Formerly we had no comments to offer. Our revised view is that the new principles are too prescriptive - even though we recognise in this section that the principles are directed towards the supervisors themselves. Specifically, we note:

- RAS4a implies that supervisors must have a rating system to assess firms. Industry supports the concept that supervisors ought to have some systematic method in place to assess firms, but we believe it is inappropriate for all supervisors to be required to adopt one specific system, i.e. a rating system.
- RAS2 implies (2) that Treasury is a divisional, rather than a centralised function, but both Treasury and ALM functions can be central functions. It would be better if CEBS did not name departments that carry out specific functions as the terms do not always translate well across industries, firms or Member States.

- RAS seeks (2d) a breakdown of capital allocation by operating entities and states that operating entities should have capital to allow for “sufficient leeway for growth.” This is an intrusive and inappropriate proposal and infringes upon the business decisions that a firm must make. Firms may choose not to grow a particular entity for legitimate business and strategic reasons.

### **SREP-ICAAP Interaction**

As CEBS acknowledged, the earlier version of CP03 did not address how the SREP and ICAAP processes would interact and this section is the major new element of the revised paper. Firms find the guideline principles to be broadly satisfactory and there is a welcome recognition of the importance of dialogue, which is a dimension that we have emphasised throughout. For example, firms strongly support the statement "it would be inappropriate for the supervisor to enter into the ICAAP SREP dialogue with pre-conceived ideas as to how much capital may be necessary to cover Pillar 2 risks."

A key features of the SREP-ICAPP interaction is represented by the concept of the “Building Block Approach.” Firms are concerned by implicit mindset of the regulators (i.e. additive approach to capital) that they believe this terminology represents. Please see our discussion in the “Capital Adequacy” section of our response.