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EBF response to EBA consultation paper (EBA/CP/2021/26) on Draft Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)and supervisory stress testing under Directive 2013/36/EU

General Comments

Considering the comprehensiveness of the consultation and the EBF response, we would like to draw attention to certain points which are also discussed in the relevant sections. While this section includes points that are particularly important, the order in which they are included in this general comment section should not be seen as a ranking.

AML/CFT: Inclusion of ML/TF risk in the SREP Guidelines

Regarding the inclusion of ML/TF aspects in the guidelines, it will be important to avoid overlaps between the responsibilities of prudential and AML/CFT supervisors (e.g. risk assessment, reporting, supervisory measures) and we would support that prudential authorities rely on the expertise of the AML/CFT authorities. We support the EBA in adopting an integrated approach, whereby ML/TF risk is assessed in existing sections of the SREP. Besides, in assessing the ML/TF risk, competent authorities should not only consider if an institution carries out activities in high-risk third countries or with high-risk clients, but also take into account the quality of the risk governance and the internal control framework which allow to mitigate these risks. We believe that carrying activity in a high-risk country constitutes a vulnerability only to the extent that the risk is not properly managed by an institution.

Business models: recognition of SPE and MPE structures

The supervisory approach should differentiate between MPE and SPE models and be therefore neutral from this perspective. MPE models normally imply a decentralized management of capital and liquidity and are organized through independent subsidiaries. As such, supervisory activities should be adapted to these models. Actions covering liquidity or business models reviews are those where these different approaches are more relevant. In the case of liquidity directly comparisons between banks following different models might be inaccurate and in some cases lead to incorrect conclusions. Regarding business model analysis the same rationale applies and therefore this independence among subsidiaries should also be taken into account when performing dedicated supervisory activities in this pillar. It would be important that the EBA Guidelines clearly recognise this difference.

Climate risk in P2G

Regarding paragraph 433 and the inclusion of climate risk in the determination of P2G, the inclusion of 'climate risk' in the supervisory activity should be made progressively and proportionally, as stated in the EBA Report on management and supervision of ESG Risks for credit institutions and investment firms. Moreover, a quantitative consideration of these risks should wait for future regulatory and methodological developments, as well as data availability. To achieve a balanced and homogeneous supervisory approach, it would be useful to explicitly mention that supervisors should wait until the related EBA assessments are performed.

Diversification between risks and across geographies

The approach to Pillar 2 should ensure a comprehensive overview of the risk profile of an institution. This can only be achieved by assessing the risk holistically using models or approaches which reflect the benefits of no correlation between the different elements and geographies. Any assessment that does not take fully into account the benefits of diversification (both inter- and intra-risk) would be limited for the purposes of the SREP.

Pillar 2 Guidance: Setting of P2G and the supervisory dialogue

Paragraph 429 of the draft GL state that competent authorities should consider the year when maximum stress impact occurs in relation to the starting point and time horizon of the scenario of stress tests. It is important to look at the stress test impact over the entire time horizon. In the current methodology, the largest impact occurs in the first year, which can distort the results for some banks who have a particular business model, idiosyncrasies, etc.

When exercising their discretion under paragraph 430 to adjust the maximum stress impact, competent authorities should also be able to consider unrealistic of artificial assumptions, like the treatment of the FX devaluation.

Regarding any potential disclosure of the P2G, we would like to highlight that this should not be disclosed to the markets. This information should not be public, otherwise, this risks turning a supervisory expectation into a binding requirement.

Pillar 2 Guidance for risk of excessive leverage (P2G-LR)

There are methodological challenges to properly estimate the impact of the current EU-wide stress test on the leverage exposure and the issue becomes even more acute when it comes to "excessive leverage". We would therefore recommend delaying the imposition of a P2G-LR until an observation period allows to assess its relevance and its reliability.

Pillar 2 Requirement for risk of excessive leverage (P2R-LR)

In relation to the P2R, we would like to highlight that the concept of "excessive leverage" is not sufficiently defined. A clear concept is required to prevent the risk that excessive leverage be considered as putting into question the reliability of internal models for own funds requirement. Moreover, additional capital requirements in respect of the risk of excessive leverage should only be imposed in exceptional circumstances, following the identification of very material risks and on the basis a substantiated analysis. Otherwise, the leverage ratio would cease to be a simple, non-risk-based backstop, as was initially intended.

Proportionality

Even if EBA GL generically recognise the principle of proportionality, the text often gives no specific indications. Please see answer to Question 1 for the detailed proposal.

Temporary capital add-on for model deficiencies should be an exception

We consider that the Guidelines should clearly highlight in paragraph 385 under which circumstances additional own funds requirements should be set as an interim measure while the model deficiencies are addressed. In our view, this should be an exception that only applies when it is not possible to address these deficiencies through other supervisory measures. Moreover, the guidance should include a supervisory obligation to review this decision on an ongoing basis or at least on bi-annual basis. Otherwise, a temporary capital add-on becomes permanent. Overall, it will be important that supervisors review their decisions on a regular basis as remedial actions are assessed according to the roll out of inspections where there can be a bottleneck.

Transparency

We welcome the EBA´s efforts on transparency and the references included in the document requesting that the supervisor provides due justification when any Pillar 2 decision is made, and also the detailed information included in paragraphs 367, 414, 416, 417 and 418 on how the supervisor should apply the risk-by-risk approach when determining the Pillar 2 requirement. Furthermore, while we acknowledge the efforts made by the EBA so far, we think it would be important to have more clarity on the approach used by supervisors to define P2R levels, as happened for the disclosure of P2G methodology following 2021 EBA Stress Test.

Question 1: *How could the guidelines be further simplified in a way that appropriate focus of assessment is allowed while preserving the comprehensiveness of the assessment and ensuring that all aspects are sufficiently covered?*

Proportionality

One of the main challenges for LSIs or small and non-complex institutions in respect to SREP is the proportional application of the EBA GL (and SSM) rules. Even if they generically recognise the principle of proportionality, the text often gives no specific indications.

Furthermore, it is important that size is not the only factor considered in the principle of proportionality.

A positive impact on proportionality could be achieved by adding paragraphs that unambiguously spell out:

i) simplified solutions for roughly differentiating between material and non-material risks

ii) simplified approaches to quantifying the individual material risks under ICAAP (esp. geo-sectorial concentration risk)

iii) guidance on scope, methodologies, scenario and data for small and non-complex institutions' stress testing. In the macroeconomic supervisory stress test, as a first step, there is a need to transpose the stressed macroeconomic variables (energy costs, GDP, unemployment, interest rate, etc.) in a deteriorated credit or market risk profile. This kind of transposition is not easy even if a bank has implemented complex satellite models related to the IRB variables. For small banks, it is almost impossible to estimate an impact in terms of their standardised risk factors (like number of defaults or single name concentration) and in any case the results are highly subjective. A kind of "bridge" should therefore be provided to small and less complex banks in order to let them focus on the impact analysis rather than on the first step.

The text box related to Question 1 states that *"it is particularly important to focus the assessment on the most relevant aspects, while ensuring that all SREP elements are sufficiently covered."* We agree with this statement which is in line with the risk-based approach of supervision. However, in section 2.4 related to the proportionality principle, appears to be focused primarily if not exclusively on the category to which each institution belongs. It should be made clear in the EBA guidelines that the principle of proportionality should also apply irrespective of the size and category of the institution when considering the materiality of specific risks for the institution in question. In other words, this principle should also be applied by the supervisor when conducting the analysis for large category 1 institutions. This is necessary to ensure that supervisory engagement and SREP assessments remain focused on the most impactful risks, even in respect of category 1 institutions. Paragraph 56 does recognize that some areas may require more detailed assessments while others may deserve less scrutiny. However, the wording could be clearer and more prescriptive in this regard, e.g. through the introduction of a dedicated subsection 2.4.5 covering this point.

Question 2: *Do you think that the proposed overall framework for setting additional own funds requirements appropriately incorporates the ICAAP information and estimates?*

While it is clear that ICAAP and ILAAP should remain anchor process in the SREP assessment, their actual use in the setting of additional own funds by the supervisor is not conceptually clear. The ICAAP should be used to inform the analysis of the main risks to which the institution is exposed and the calibration of pillar 2 own funds by the institution. However, it is unclear how key risk components of the SREP assessment such as the Business Model Assessment and the internal Governance and Risk Management can be expected to be captured through the ICAAP.

<u>Setting of additional own fund requirements</u>

Article 368 of the revised SREP guidelines states that "the amount of capital considered adequate to cover each risk identified in accordance with Articles 79 to 85 of Directive 2013/36/EU is not lower than the relevant part of the applicable Pillar 1 own funds requirement covering that risk". These risks correspond to credit and counterparty risk, residual risk, concentration risk, securitisation risk, market risk, IRRBB and operational risks. In other words, Pillar 1 acts as a floor for the own funds requirements. The benefit of intra-risk diversification effect is capped in order to respect a minima Pillar 1 requirements for these risks (Article 92 of Regulation (EU) No 575/2013), as confirmed by article 372 of the revised guidelines. We consider that, in an ICAAP economic perspective, there is no reason to limit the benefit of intra-risk diversification at a single risk level and that the benefit of intra-risk diversification can exceed additional own funds requirements identified above Pillar 1 requirements. Indeed, by applying the Pillar 1 floor risk by risk, as prescribed in Article 368, on each risk type (e.g. credit and counterparty risk) for which the underlying regulatory framework (e.g. AIRB formula) neglects the intra-risk diversification (e.g. by using a single factor model), the competent authorities will not be able to correctly assess the intra-risk diversification effects in additional funds requirements quantification, as prescribed by article 372.

This approach can lead to disregard diversification benefits from banks' business models and overestimates capital requirements for risks under standard approach such as operational risk and credit and credit counterparty risk.

Incorporation of inter-risk and business diversification

The degree of diversification of the institution, across business activities and geographies, can be a key factor in reducing the overall risk profile of the institution and improving the sustainability of its revenues. Yet this dimension fails to be fully recognized in the EBA guidelines for the purpose of calibrating capital requirements. The inter-risk diversification should at least be fully recognized in the evaluation of the business model component of the SREP assessment and this should be more explicitly referred to in the EBA guidelines.

From this perspective, the wording of paragraph 373, which forbids the recognition of diversification between risks in the determination of additional own funds appears too restrictive and should be amended to allow at least room for a qualitative assessment of inter-risk diversification in the evaluation of the business model component of the SREP.

Dialogue with the supervisor

In addition, we note that paragraphs numbered 360 and 361 in the previous guidelines have been removed from the proposed draft guidelines. This is a concern as these clauses were providing the possibility for additional own funds requirements to be set in the light of a reliable ICAAP and dialogue between competent authorities and financial institutions.

Evaluation of the ICAAP models

It has been an important goal of the supervisors to strengthen institution´s ICAAPs. The ICAAP should hence form the main starting point for the determination of the P2R. Only ICAAPs that are overall not sensible and reliable should be supplemented by supervisory benchmarks. In all other cases benchmarks would lead to overly conservative measures because of their unprecise nature. EBA should therefore describe concretely in what cases ICAAPs are deemed overall unreliable and benchmarks are introduced while in all other cases the ICAAP shall be the main starting point for the determination of P2R.

Question 3: *Do you agree with the proposed clarifications on the assessment of the risk of excessive leverage?*

First, we would like to highlight some key high-level considerations:

- We would welcome a clarification from EBA that a P2R-LR should only be applied where there is a demonstrable risk of excessive leverage. Only in exceptional circumstances, where there is no reduction of leverage to the satisfaction of the supervisor, a P2R-LR should be set as an additional minimum requirement.
- The leverage ratio was deliberately calibrated to 3% by the Basel Committee following a long observation period. This level was deemed appropriate in consideration of EU specificities, in particular with regard to the following aspects:

stability of profits, funding, business activity and degree of concentration (EBA-Op-2016-13). However, according to the explanatory box on page 156 of the consultation paper, another assessment of the exact same aspects should be carried out to determine the risk of excessive leverage of an institution. This could be interpreted as a way to compensate for a 3% minimum leverage ratio which would be deemed insufficient, and therefore be viewed as a contradiction with an appropriate calibration by the Basel Committee of this minimum level in the first place.

- The overall concept is clear, but some aspects deserve further discussions. Generally, we think that the SREP GLs should consider the wide varieties of the different banking activities, including the risks that result from those. One example is the custody business, which involves a large volume of deposits which, under IFRS standards, are a deposit liability and thus appear at custodian bank's balance sheet. These deposits are invested at central bank with minor risk. Their accounting mechanically increases the level of leverage of the custodian banks. Therefore, they should be excluded in the assessment of the risk of excess leverage.
- The leverage ratio was introduced in the regulation as a non-risk-based measure and a simple backstop to regulatory capital requirement. The additional requirement in respect of excessive leverage should continue to reflect this approach and should not be interpreted as putting into question the reliability of regulatory capital requirements. In this sense, the application of a P2R-LR should remain exceptional and limited. Should it not be the case, the LR may cease to be a backstop as it was initially intended and may become the primary binding constraint on regulatory capital, over risk-based capital requirements, for a large share of the EU banking industry. This is important at a time where precisely the finalisation of Basel 3 will reduce the dependency on internal models and substantial efforts were put towards the IRB repair program with the purpose of restoring the confidence in the reliability of such models. From that perspective, we observe that the concept of "risk of excessive leverage" and the extent to which it is of a different nature than the risk of losses covered by the regulatory capital requirements is not sufficiently set out in the consultation paper. The risk of misinterpretation concerning the reliability of current capital requirement is heightened when the paper makes explicit reference to "losses" in relation to excessive leverage (e.g in article 393 a iii and d). Competent authorities have already the power to impose P2R to cover the risk of unexpected losses which an institution is facing due to its business model and activities and there should not be an overlap or duplication with the additional capital requirement for excessive leverage.
- It should be made more explicit in the guidelines that additional capital requirements in respect of excessive leverage are only expected to be imposed in special situations where the risk of excessive leverage is assessed and quantified as material by reference to the institution's profile, capital and funding base.
- At this stage, the consultation paper is only identifying situations where a risk of excessive leverage may exist but does not contain any guideline concerning the methodology to be used for the quantification of excessive leverage and the calibration of corresponding additional capital requirement. This leaves a high degree of discretion to each supervisor which is not conducive to a fair and equal treatment of all banks. In order to secure the necessary transparency and level playing field, the methodology, at least in terms of principles, must be given further precision and should be subject to a prior consultation with the industry.
- Given the importance of the introduction of P2 requirements related to the risk of excessive leverage, the industry wish that an impact study had been carried out by the EBA beforehand, in order to allow a quantitative analysis of the topic.

Second, further clarifications are needed, in particular with regard to para. 393 a) and b):

- Paragraph 392: this paragraph mentions, as seemingly an important overarching principle that for the purpose of assessing the risk of excessive leverage, the competent authorities should focus on "potentially elevated vulnerabilities that may require corrective measures to the business activities of the institution that were not envisaged in the business plan". This criterion is too general to allow a proper characterization of situations conducive to excessive leverage and needs to be further precised. We question the necessity to maintain this criterion as worded. The interplay of this criterion with the identification of situations of potential excessive leverage listed in paragraph 393 is not obvious in all cases. The concepts of "potentially elevated vulnerabilities" and adjustments to business plan referred to should be more precisely defined. The reference to business model adjustment should either be deleted or made more precise. It is unclear as to whether this refers only to highly stressed situations where banks may need to "deleverage" their balance sheet within a reasonable timeframe in a context of high pressure on liquidity and funding. This would then imply that the tenor and self-liquidating nature of the assets, the tenor, nature and overall stability of funding or the degree of systemic risk that could translate into a rapid fall of the value of the assets should be considerations to be taken into account.
- With reference to paragraph 393 (a) pertaining to "elements of risk of excessive leverage that are considered not covered or not sufficiently covered" by Leverage ratio own funds requirements, we believe that the clarifications provided do not necessarily point to a need for additional specific provisions regarding the risk of excessive leverage when the underlying risk are sufficiently covered by Pillar 1 requirements. This goes for the factors mentioned in the 3 subparagraphs.
- par. 393 a) ii) "regulatory arbitrage / optimisation of the leverage ratio by exchanging exposures counted in the leverage ratio for economically similar exposures that may be less counted in the leverage ratio exposure calculation (e.g. SFTs to collateral swaps); "
    - This wording is highly ambiguous as it suggests that the nature or structure of transactions is primarily driven by the banks' objective to take advantage of regulatory loopholes to optimise their leverage ratio calculation. In our view, this statement is not quite accurate, because collateral swaps and SFTs serve different business goals. One cannot be fully replaced by the other. For instance, SFTs (under GMRA legal documentation) are providing cash to counterparties willing to finance their securities (typically Hedge Funds, Asset Managers) while collateral swaps (under GMSLA legal documentation) are more used by Securities Lenders (e.g. State Street) managing important securities portfolios and willing to lend one security against another against a fee. Therefore, SFTs and Collateral Swaps are used by different type of counterparties and overlap is limited due to the cost/complexity to maintain 2 different legal agreements (GMSLA, GMRA). In summary, clients who needs cash cannot replace repos by collateral swaps. Collateral Swaps can be used to facilitate bank's inventory management (e.g. lending long positions to borrow securities to cover short positions), but the same can be achieved with repos without any impact on Leverage via accounting netting (same counterparty/currency/maturity date/custodian)
    - We would like to ask what other examples the EBA has in mind and how the decision is taken whether the respective products are optimisations or not. The minimum requirement for the leverage ratio was only introduced with CRR 2 as of 28.6.2021. Reporting of daily values for SFTs has also been introduced. Before requesting SREP measures, this future reporting should be monitored and evaluated; if there are any anomalies on this basis,

transparency should be created by the supervisory authority and subsequently serve as a starting point for a dialog between the supervisory authority and the bank.

- para. 393 a) ii) "regulatory arbitrage / optimisation by minimising the leverage ratio exposure in the form of temporary reductions of transaction volumes in key financial markets (particularly in the money market, of certain activities such as SFTs, but also in the derivative market) around reference dates resulting in the reporting55 and public disclosure of elevated leverage ratios ("window-dressing activities"); and "
    - CRR2 is already tackling this subject with the obligation to declare daily average SFTs balances on a quarterly basis for European Banks (as it is the case for US and UK banks). Indeed, by imposing the reporting of daily averages, the supervisor is already monitoring the volatility of each bank's transaction volumes in order to deter excessive variations (note: a bank's variations in volumes can be linked to its activity but can also be completely disconnected to its own will when it is related to external market factors for example), including those that aim at regulatory arbitrage. Therefore, we consider that the supervisor may use other supervisory measures to control or reduce volatility before resorting to additional own funds requirements.
- para. 393 a) iii) "specific features of the business model, business activities or other bank idiosyncrasies that either increase or decrease the extent to which the institution is exposed to the risk of excessive leverage (e.g. as per the aspects in paragraph 392) but are not covered or not sufficiently covered in the calculation of the leverage ratio. For example, an institution highly exposed to written options on equity, or short positions via credit derivatives, may have an elevated exposure to peak losses as these positions are not fully captured in the leverage ratio exposure (in contrast to, for example, written credit derivatives)."
    - We think it would be important to define the term "highly exposed";
    - Moreover, we would like to point out that options on equity, short positions via Credit Derivatives are actually captured by Leverage Exposure. To illustrate:
        - Written options on equity: although no PFE is calculated on sold options (as no counterparty risk), their exposure is captured via the related "delta hedge" i.e. the long inventory that the bank will have to buy to hedge the option. For instance, a €100m written option on company ABC will have to be hedged via the purchase of €100m of ABC security which will be captured in Leverage.
        - Short positions via Credit Derivatives: buying protection via CDS permits to be covered in case of market downward move. The maximal loss is however capped to the amount of premium paid and this is captured by Leverage via the PFE and RC
- par. 393 b) non-compliance with the leverage ratio should not be addressed within the P2R-LR but need to be addressed by other regulatory measures. Otherwise compliant exclusions as stipulated by the CRR should not be undermined by the SREP GL.
- On paragraph 393.d.:
    - It is not clear the way how it is drafted, in particular as regards the reference made to the "foreseeable impact of current and future expected losses on the leverage ratio".
    - This paragraph seems to suggest that the determination of capital requirements for excessive leverage should also capture the future growth of exposure. As for capital ratio, the capital requirement for excessive leverage should be calculated based on the exposure (restated/economic if need be) at the date of calculation. The ability of capital requirement to

cover future growth of exposure additional exposure should be assessed in the review of the capital trajectory of the institution.

Third, regarding paragraph 429a CRR:

- the CRR explicitly provides for exemptions for authorized exposure in Article 429a CRR. We fear that the exceptions provided for by the legislator will be undermined by this guideline. We ask for clarification that the use of the exceptions cannot be regarded per se as an indicator of a risk of excessive leverage, but that the focus here is exclusively on the verification of compliance with the necessary conditions for the use of the exceptions. The leverage ratio is by its nature a non-risk sensitive measure and the SREP GL should not try to make it risk sensitive by introducing adjustments that were not taken into account by intention when constructing the leverage ratio.
- We would like to point out that the exemptions in 429a(1)(d) ('claims on central governments, regional governments, local authorities or public sector entities in relation to public sector investments and promotional loans') are conditional on an institution fulfilling the criteria of a public development credit institution. Hence, the risk of not meeting the criteria to apply the exemption is directly linked to the business model (in this case a public sector development bank). Hence, the risk of non-compliance is related to elements of the business model risk, and it should be treated as such.

Fourth, paragraph 395 and 398: Unfortunately, the wording suggests that the supervisor will regularly prescribe a P2R-LR. It should be made clear that a P2R-LR should only be applied to outlier with a demonstrable risk of excessive leverage. A P2R-LR can only be the exception and should not be the rule. In any case we deem it appropriate that EBA decides to perform a test run with the NCAs in the upcoming SREP cycle to double check whether a proportionate application of the approach given is possible. The determination of concrete and binding P2R-LRs should only follow in the second step. Moreover, we believe that the rules for applying any P2R-LR capital charge (criteria, calculation) should be clearly stated in the SREP Guidelines and not left at the entire discretion of the supervisor so as to ensure a consistent implementation by JSTs and thus to avoid level playing field issues

Lastly, there is no reference in section 7.3.1 to the ICAAP or the ILAAP. It is very important to include this reference and it seems to us that the omission was unintentional. In the explanatory box of page 156, the EBA reminds that stability of profitability, funding and business activity are criteria to be taken into account by supervisors in their assessment of the risk of excessive leverage. Such analyses are typically addressed in the ICAAPs and ILAAPs of banks; as a result, the outcome of ICAAPs and ILAAPs should be taken into account by supervisors in their assessment of the risk of excessive leverage. This will also be consistent with the approach taken in the assessment of other risks where the outcome of the ICAAP is used in risk assessment (see in particular paragraph 369)."

Question 4: *Do you think that the assessment of dimensions and indicators described in this explanatory box would also be relevant for the assessment of the risk of excessive leverage? Are there any other elements / indicators that you are using in the assessment of this risk?*

Further indicators do not seem to be appropriate. Anyway, the given aspects in the SREP GL should be further clarified. The question here is whether the use of these indicators does not at any time lead to an automatism. For example, if an indicator falls below certain expectations of supervision, a P2R-LR should be used. In particular, no indicators should be used that mix the risk of excessive leverage with other risks; for example, the statement "taking into account the insights gained from the assessment of liquidity and funding risk in accordance with Title 8" is unclear in this context and should be deleted. The reference "when considering the risk of excessive leverage, competent authorities would be expected to look at these prospects through a leverage perspective" should also be made clear: In this guideline only the risk of excessive leverage is considered and there must be no overlaps with respect to P2R based on RWA.

Question 5: *Can you provide examples of situations which in your view might require CET1 instead of other capital instruments to cover potential losses in relation to P2R and P2R-LR?*

We believe that authorities should follow the guidance regarding the quality of capital as stipulated by the CRD. In our view, the Article 104a of CRD 5 already deals with the subject since it states that institutions under ECB supervision can use Tier 1 and Tier 2 capital to meet the additional Pillar 2 requirement (P2R). In total, the P2R can be met with 75% Tier 1 capital including a minimum 75% CET1 capital. Moreover, to be consistent with the Pillar 1 approach for the leverage ratio, we suggest that P2R-LR should be composed of Tier 1 capital. In our mind, the article 104 bis of CRD5 related to P2R-LR already states that P2R-LR should be composed of Tier 1 instruments.

Question 6: *Would you consider the introduction of a standardised template for the communication to the supervised institution of the outcome of the SREP to be beneficial?*

The level of transparency about the calibration of the P2R is an important point and an addition to the previous version of the guidelines. However, the form of disclosure to the institution is not sufficiently clear. The article 362-B requires that the supervisor *"justify all elements of additional own funds requirements for P2R and P2R-LR"*. It is unclear whether this should be interpreted as an obligation for the supervisor to disclose the detailed breakdown of the P2R by risk categories or simply the main deficiencies contributing to the P2R. In any case, it is very important that the institutions obtain full clarity in respect of the main risks and deficiencies contributing to the P2R calibration with at least some form of quantification and hierarchy. It should also be made clear that the reduction in those risks or the resolution of deficiencies should be reflected in a subsequent decrease of the P2R (all things being equal).

Question 7: *What are your views on the guidance for setting P2G and P2G-LR? Is it sufficiently clear?*

<u>Temporary capital add-on for model deficiencies should be an exception (para. 385)</u>

We consider that the Guidelines should clearly highlight in paragraph 385 under which circumstances additional own funds requirements should be set as an interim measure while the model deficiencies are addressed. In our view, this should be an exception that only applies when it is not possible to address these deficiencies through other supervisory measures. Moreover, the guidance should include a supervisory obligation to review this decision on an ongoing basis or at least on bi-annual basis. Otherwise, a temporary capital add-on becomes permanent. Overall, it will be important that supervisors review their decisions on a regular basis as remedial actions are assessed according to the roll out of inspections where there can be a bottleneck.

Guidance for setting P2G (para. 423 and 429)

The guidance for setting P2G-LR is not clear. We suspect that the risk in regard to LR is overestimated and the P2G-LR is calibrated too high. In par. 423 is stated, that P2G-LR should protect against the breach of TSLRR in the adverse scenario. On the other hand, it is stated in paragraph 429 that the maximum stress impact should be covered. Regardless of how far the starting point was above the minimum requirements or how far the minimum requirements were exceeded in the stress, the outcome would be materially different. To make the wording of paragraph 429 slightly clearer (and reflect the discretion of JSTs), we would suggest the following wording (changes in **bold**):

"429. The maximum stress impact ~~**for the purpose of**~~ **considered for** setting the P2G-LR should be understood as the difference between the lowest leverage ratio in the adverse scenario over the stress test horizon and the actual leverage ratio at the starting point"

In addition, there are some entities where the EBA could envisage a more proportional application for the P2G determination. This is because the setting of the P2G is partly dependent on the absolute impact of the adverse scenario. For banks with specific business models (such as promotional banks) this creates an inflated P2G due to the fact that the starting CET1 ratio and the RWA-sensitivity is higher. Even though these banks are considered to be relatively safer, they end up with a higher P2G.

Link between the stress tests and the setting of P2G and P2G-LR (para. 424)

We have strong reservations about the inclusion of a requirement for P2G-LR based on the stress test scenario impact. There are methodological challenges to properly estimate the impact of the current EU wide stress test on the leverage exposure and the issue becomes even more acute when it comes to "excessive leverage".

As far as the stress-tests' methodology is based on a static balance sheet assumption, the only parameter that would be affected by the stressed scenarios is the level of own funds. As a result, we do not clearly understand what would be the added value of the P2G-LR compared to the regular P2G.

We would recommend delaying the imposition of a P2G-LR until an observation period allows to assess the relevance and the reliability of a P2G-LR.

Moreover, currently the framework for P2G-LR is lacking of clarity as i) current EBA ST does not provide good data for conclusions as EAD is kept constant throughout the projection. ii) It is not clear whether P2G and P2G-LR will be based on phased-in or in fully-loaded ratios. iii) There is the risk of overlapping between P2G and P2G-LR.

Proportionality in stress tests (para. 425)

Another topic that deserves more clarifications is the conduct of stress tests on an individual level for small and non-complex banks. These could easily lead to an unlevel playing field and elevated efforts for smaller banks.

Weighting of different years within the stress scenario and its impact on P2G computation (para. 429)

Concerning P2G calibration, the consultation paper makes reference to the impact observed in the worst year over the horizon of the stress test, which is not in line with the current practice of using as a reference the cumulated depletion of capital between the starting point and the 3rd year of the stress test exercise. The question remains whether this reflects an ambiguous wording that needs to be corrected or whether there is indeed an intention to change the policy in terms of the incorporation of the stress test impact in the determination of the P2G. The EBF members are opposed to taking as a reference the worst year in the stress test.

P2G computation based on stress test results should reflect the materialization of the impact of the scenario over the whole stress test scenario horizon. Focusing on the worst year is distorting and may not consider adequately idiosyncrasies tied to business model or risk profile of a financial entity. It is worth noting that the current methodology allocates most of the impacts in the first year of projection making (for instance for capital market activities) which makes the first year not representative of the actual of the overall stress test impact.

Determination of P2G starting point (para. 430)

Regarding adjustments to the P2G starting point it is important to consider any impact from the stress test that may be consequence of an unrealistic/distorting assumption (e.g. FX impact on P&L account of international banks). When the JST considers potential adjustments when defining the level of P2G, we would encourage the JST to take into account those cases. While there is the possibility for JSTs to make adjustments, there is no mention as to which aspects should be considered. The FX assumption would be one example.

Guidance on the composition of own funds to meet P2G (para. 423 and 437)

The guidance in relation to the composition of own funds to meet the P2G is overly restrictive and goes beyond the level 1 text in the CRD, art. 104b. In para. 423 it is stated that P2G should protect against the breach of TSCR in an adverse scenario. However, according to para. 437, competent authorities should communicate to institutions that P2G is expected to be met with CET1 eligible own funds. We see no compelling reason why P2G should be expected to be exclusively met by CET1 eligible own funds in order to protect against the breach of TSCR in the adverse scenario. It would seem logical to differentiate the CET1-ratio stress depletion between effects stemming from impairments vis-à-vis effects stemming from changes in risk weighted assets. In a materialization of a macroeconomic adverse scenario, it is likely that both impairments and risk weighted assets would increase simultaneously. Any increments in impairments would need to be offset by CET1 as loss absorption via P&L whereas effects on the CET1-ratio depletion stemming from increments in risk weighted assets should be allowed to be mitigated via the same capital mix as Pillar 1 and P2R.

The bucketing approach (para. 431)

The bucketing approach should be further clarified with respect to numbers, ranges and possible aspects of adjustments within the buckets. It is important to understand how competent authorities calibrate those ranges and how they will deal with the risk of cliff effect with respect to current P2G levels. It is important to maintain sufficient flexibility, which will allow the supervisors to appropriately interpret the different risk drivers.

P2G and its link with the different types of risks

The P2G should protect against a potential breach of the TSCR in an adverse scenario. Hence, it covers different risks. The competent authority should be very clear which risks are aimed to be covered by the P2G when communicating the level of P2G to institutions. To illustrate this point, paragraph 583 outlines three different situations when an institution does not meet its P2G. The difference between A and B lies in the materialisation of risks the P2G was aimed to cover. Therefore, the supervisory authorities should be transparent as to which risks they intend to cover with the P2G.

Date of application of P2G-LR

The first date of application of P2G-LR should also be clarified. For example, if EBA stress test is the selected supervisory stress test to assess P2G-LR starting point, the next exercise will only take place in 2023. What will be the transitional solution to assess P2G-LR in 2022 and / or 2023? Will the results of 2021 EBA stress test be considered, or will a transitional measure be adopted?

Offsetting P2G and P2G-LR with buffers (para. 423 and 434)

According to paragraph 423, "the level of P2G should protect against the potential breach of TSCR in the adverse scenario". Note that the TSCR of the institution does not include the combined buffer requirement (CBR). In the same logic, it is stated in paragraph 400 that "Competent authorities should not set additional own funds requirements or other capital measures (including P2G) where the same risk is already covered by specific capital buffer requirements and/or additional macroprudential requirements. Any additional own funds requirements or other capital measures should be institution-specific and should not cover macroprudential or systemic risks." At the same time, paragraph 434 indicates that only some parts of the combined buffer requirement can be used to offset P2G, in particular "Competent authorities should offset P2G against the capital conservation buffer (CCB), as P2G and the CCB overlap in nature." While the idea about a similar purpose of P2G and CCB is clear, there is a certain contradiction between the stated purpose of protecting against breaching TSCR and not allowing to deduct other components of the CBR besides CCB.

The same reasoning goes for P2G-LR. Indeed, paragraph 434 states that "competent authorities should not offset P2G-LR against the G-SII leverage ratio buffer requirement specified in Article 92(1a) of Regulation (EU) No 575/2013", which seems be in contradiction with paragraph 423 which indicates that "The level of P2G-LR should protect against the breach of TSLRR in the adverse scenario", given that TSLRR does not include the G-SII leverage ratio buffer.

Paragraph 434 should be amended to align with paragraphs 400 and 423 and allow an offset of the P2G against the systemic risk buffers and an offset of the P2G-LR against the G-SII leverage ratio buffer requirement.

Incorporation of climate risk in P2G (para. 433):

Regarding paragraph 433 and the inclusion of climate risk in the determination of P2G, the inclusion of "climate risk" in the supervisory activity should be made progressively and proportionally, as stated in the EBA Report on management and supervision of ESG Risks for credit institutions and investment firms. Moreover, a quantitative consideration of these risks should wait for future regulatory and methodological developments, as well as data availability. (EBA quote: "The assessment of these ESG risks should progressively and proportionally be incorporated into the supervisory capital assessment […] A more quantitative consideration of ESG risks in the SREP may follow future developments in data quality and methodologies". To achieve a balanced and homogeneous supervisory approach, it would be useful to explicitly mention that supervisors should wait until the related EBA assessments (including the prudential treatment of sustainable assets; guidelines in accordance with Article 16 of Regulation (EU) No 1093/2010 regarding the uniform inclusion of ESG risks in the supervisory review and evaluation process performed by competent authorities, etc.) are performed. Also, considering that climate risk stress tests and the EU-wide stress tests follow different logics, are based on different scenarios, and serve different purposes; we would advise against using the climate risk stress test for the calibration of capital requirements within P2G.

Question 8: *What are your views on possible disclosures, which may be attached to P2G and/or ranges of buckets in case they are identified?*

See Q7. Disclosure is of utmost importance. In any case the initial buckets, based on the stress test impact, and their disjoint ranges should be disclosed as well as the buckets and the range of the P2G starting point. Disclosure should be comprehensive on bank-specific parameters / results, but also the general bucket information across banks (e.g. total number of buckets, bucket ranges, P2G adjustments leading to attribution to different bucket) should be disclosed. Regarding adjustments to the P2G starting point it is important to consider any impact from the stress test that may be the consequence of an unrealistic/distorting assumption (e.g. FX impact on P&L account). In order to do so, it is relevant to understand the basis for making these adjustments.

However, it is not clear whether it is intended to disclose the exact level of P2G to the market. In our view, every bank should clearly know how its P2G has been set (e.g. Stress Test Depletion – Countercyclical Capital Buffer (CCB) + Supervisory Adjustment) but it is very important that the P2G is not made public. The concept of P2G is a non-binding requirement. However, the publication of P2G could make it a binding requirement as it could be enforced through market pressure.

Indeed, a disclosure would be in contradiction with the nature of the P2G, which aims at being a bilateral supervisory tool between the supervisor and the institution, to ensure an adequate level of the institution's own funds. As such, in order to keep a bilateral tool of this nature in their ongoing dialogue with the financial institutions, supervisors and regulators may need to reconsider part of the current supervisory process if the P2G is disclosed. Furthermore, it may impact the recent legislative balance as set out in CRR 2 in relation to the Minimum Distributable Amount (MDA) framework given that, once disclosed, the P2G will be considered binding by the industry / investors, and therefore the distance to MDA would mechanically decrease, removing flexibility in the necessary dialogue between the banks and the supervisors. For the sake of consistency, a potential disclosure of the P2G would have to be considered only in the context of a new Capital Requirement Legislation's review.

Furthermore, European co-legislators have expressly indicated in the framework of Regulation (EU) 2019/876 of 20 May 2019 amending Regulation (EU) No 575/2013 ("CRR2") that the level of P2G should not be subject to a mandatory disclosure. Consequently, recital 64 of CRR2 states the following: "Given that the guidance on additional own funds referred to in Directive 2013/36/EU is a capital target that reflects supervisory expectations, it should not be subject either to mandatory disclosure or to the prohibition of disclosure by competent authorities under Regulation (EU) No 575/2013 or that Directive."

It is also worth noting that the ECB already provides the market with a precise insight on the P2G of banks as it establishes a clear link between their P2G levels and the EU-wide Stress Test results. Therefore, we believe that the extensive disclosure of the Stress Test results already provides investors with most of the critical information embedded into the P2G (i.e. the bank capacity to withstand stress).

Question 9: *What are your views on the capital instruments potentially used to cover losses in relation to P2G-LR? Please provide the rationale or specific examples for your views.*

From a conceptual point of view, we fully agree, that meeting P2G-LR with Tier 1 keeps consistency within the leverage ratio stack based on Tier 1 and would leave the calculation coherent and straightforward. Hence, we ask for clarification in note 437 that P2G-LR is expected to be met with Tier 1 capital.

Also, we would like to ask the EBA to provide additional clarification on the definition of "losses in relation to P2G-LR".

Annex: Other considerations, which are important but not covered by the questions of the consultation

1. Topics where it is important to avoid an overlap with existing regulation, which touch upon the same issues to avoid a dual impact on institutions

1.1. Assessment of the risk of money laundering and terrorism financing (ML/TF risk)

Regarding the approach towards the assessment of ML/TF risk, we support the EBA and their preference for **option 2**, which is presented in the annex of the consultation paper. We consider it important to have an integrated approach that include ML/TF risk in the existing sections of the SREP. Of course, any supervisory measures that are imposed based on paragraph 547 should follow this integrated approach and should not look at ML/TF risk in isolation to other risks.

Furthermore, the assessment of the ML/TF risk will involve NCAs and the forthcoming EU-wide AML authority together with the ECB through the inclusion of provisions in CRD5. We believe that great attention should be paid to the respect of the competencies of each authority and that any qualitative or quantitative supervisory action should duly take into account potential prior supervisory action. To this end we encourage the exchange between the prudential and the AML supervisors to ensure that there is continuous flow of information, which also helps to enhance the efficiency of supervision. In particular, we believe that double reporting, double assessment, and double penalties for a same breach in the context of both AML Directive and SREP should be avoided. To avoid this overlap, we think it could be useful to explain in the guidelines how this can be avoided. It is also important that the expertise of the AML/CFT supervisor be not questioned and that the latter be not subordinated to the prudential supervisor.

As of today, European banks are supervised by national AML/CFT supervisors that ensure that banks correctly assess their risks in relation to their activities and correctly manage them through appropriate customer's due diligences and continuous transaction monitoring. AML/CFT supervisors assess as well the adequacy of the governance with AML/CFT regulation's requirements and the quality of internal control.

We would like to draw the attention of the EBA to the following general comments which are further detailed in the annex to this document:

- ML/TF risk cannot be taken into account in the SREP element as an inherent risk without distorting the SREP assessment and leading to de-risking. Indeed, the AML/CFT framework implies to assess and mitigate ML/TF risk as it is the case with other risk. We note that the EBA guidelines never refers to the quality of the mitigation of the ML/TF risk while it is the case for credit risk, market risk, operational risk, interest rate risk, liquidity risk.
- Only AML/CFT supervisors have the expertise to assess the ML/TF risks. The competent authority should, at all times, rely on the expertise of the latter and not assess itself the ML/TF risk to avoid contradictory positions between supervisors.

For clarification purposes, we would like to point out that footnote 18 on page 19 of the guide refers to the fact that "any reference to risks in these guidelines should include money laundering and terrorist financing risks". Despite this general mention, the guide expressly mentions the risk of money laundering and terrorist financing on a large number of occasions throughout the document. This generates significant confusion, as it is not clear whether the reference to the risk of money laundering should be understood as being made only when this risk is specifically mentioned, or also every time the word "risk" appears in the document. We would appreciate clarification on this point

1.2. Fit and proper, internal governance and reputational risk assessment

Joint ESMA/EBA Guidelines Fit and Proper assessment and SREP scores / P2R calibration (5.2, within 5.3)

We understand that FAP assessment will concern not only key function holders but also the management body with possible consequences on SREP. Therefore, the sanctions regarding fit and proper requirements will be not only those pursuant to the Fit and Proper Guidelines (with the possibility for ECB to dismiss Board Members) but also pursuant to SREP.

EBA Guidelines on Internal Governance and SREP scores / P2R calibration on provisions regarding corporate values and risk culture (5.4)

We believe that provisions in SREP GL which deal with potential conflict of interest resulting from "loans and other transactions" with members of the management body and their related parties are already covered in the GL on internal governance.

ML/TF risks and prudential concerns (5.9)

Without prejudice to the above considerations, it is worth noting that paragraph 147 provides for an assessment of the competent authority of specific requirements concerning the allocation of responsibilities and the suitability of the members of the management body in relation to ML/TF risks, including the member responsible for the implementation of the laws. In this respect it is very important to ensure consistency between the SREP Guidelines and any applicable EBA guidelines or regulations on the topic of ML/TF risk to avoid any contradiction, as well as any level 1 regulation. It could be also considered to provide for a link to the specific guidelines that will be subsequently issued by the EBA.

In any case, please note that Joint ESMA/EBA Guidelines Fit and Proper assessment do not require the management body to have "**individually**" adequate knowledge, skills and experience regarding the ML/TF risks and the relevant procedures (as provided by paragraph 147, lett. b) of the consultation document). As specified in paragraph 55 of the Joint EBA/ESMA Guidelines "the ability to understand ML/TF risks is" only "part of the assessments of the **collective** suitability of the members of the management body"[…].

Assessment of reputational risk (6.4.3)

Whereas it seems understandable to a certain extent to perform an assessment on a member of the management body and to refuse his/her appointment as a board member in case an event has a significant impact on his/her reputation, it seems debatable to include this provision in SREP as it could potentially lead to a double penalty for the same behaviour or even sometimes to a substitution for the judge.

2. Areas that should remain out of the scope of SSM assessment powers

2.1. Assessment of reputational risk (6.4.3)

In the assessment of reputational risk, the revised SREP GL now include provisions on the reputation of "individuals involved in the management" of the institution, with reference to joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders. The concept of "individuals involved in the management" is not defined and we believe that it may be too broad. Therefore, we suggest restricting the application of this requirement to the members of the Management Body as it seems impossible to include all employed staff who act according to their respective function and are therefore not individually involved.

3. Specific comments in relation to section 5.5 Remuneration policies and practices, under paragraph 105

- **Point c.**

We suggest clarifying (changes are indicated in **bold**) the reference of the delegated regulation "*adopted in accordance with Article 94(2) of Directive 2013/36/EU", namely "**(EU) 2021/923)**"* (as in bold format) referred to for staff identification

- **Point d.**

We suggest modifying the paragraph as followed (in bold): "*institutions **have properly allocated the various elements of remuneration between** the fixed and variable elements of remuneration, paying particular attention to the treatment of allowances or role-based payments, guaranteed variable remuneration, severance pay etc;*" That way, it would be more consistent with paragraph 134 of EBA revised Guidelines on sound remuneration policies (as updated on July 2, 2021), which stipulates "*The variable and fixed remuneration of institutions may consist of different components, including additional or ancillary payments or benefits. **Institutions should analyse allowances and allocate them to the variable or fixed component of remuneration**. The allocation should be based on the criteria in section 7.*"

- **Point h.**

We suggest removing the following reference to ESRB (bold type) "*institutions give adequate consideration to restrictions regarding variable remuneration as a consequence of receiving state support or due to recommendations of competent authorities concerning the distribution of variable remuneration **or the European Systemic Risk Board (ESRB)***"

The ESRB is responsible for the macroprudential oversight of the EU financial system and of the prevention and the mitigation of systemic risk. In fulfilling its mandate, it oversees and assesses the systemic risks and, when applicable, issues risk alerts and recommendations to the EU overall, to Member States, to European supervisory authorities (ESAs), to EU oversight authorities in charge of macro- and micro-prudential supervision or to resolution authorities. However, it does not issue recommendations to credit institutions.

4. Other issues

- Operational risk "tolerance": On Par. 279 of draft revised GL, we are unclear on the rationale behind replacing "operational risk tolerance" with "operational risk appetite" and we believe the latter wording should be maintained. Indeed, banks do not have any appetite for operational risks, they just have to tolerate them. By nature, the banking industry takes credit risk, ALM risk or market risk in relation to their activities but it just copes with operational risk, like any other industry.
- According to par. 53 „the scope and depth of the review of the individual SREP elements should be tailored to the specific risk profile of the institution" as far as cat-4-banks are concerned. While we think that this should be the case for all banks the wording is not very precise. In case the paragraph should contain a relief for small banks it needs to be described more concretely.
- Inclusion of a definition of step-in risk: The currently existing references to the step-in risk definition are only included in the Basel Committee Guidelines on the identification and management of step in risk (2017). In these guidelines, the Committee admits that "The diversity of local rules cannot be considered as filling a gap from an international standard-setting body perspective". We consider that the GL should amend the following typo in paragraph 158: Our suggestion is to amend the typo and make reference to two different risks: "strategic and business risk", and "step-in risk" (by adding the comma in between "business risk" and "Step-in risk". We should also avoid overlapping of capital surcharges for step-in risk, given the potential duplication of the requirements for this risk in the regulatory framework: i) CRR2 sets a potential Pillar 1 surcharge (Art.18.5, 18.6a and 18.8): The supervisor has the option of requiring entities to consolidate companies that are likely to generate step-in risk; and ii) SREP GLs set a potential Pillar 2 surcharge: Step-in risk is considered for assessment in the SREP. Therefore, "overlapping" should be avoided in this sense.
- Regarding paragraph 367, we think that competent authorities should pay careful attention when they decide to include into P2R risks that have been excluded or considered insufficiently covered by Pillar 1. In particular, the reasons for the inclusion of those risks into P2R should be substantiated, as excluding them from Pillar 1 does not necessarily mean they should automatically be integrated into Pillar 2.
- Regarding paragraph 190f, we think that the reduction of the exposure to non-EU CCPs (with a particular focus on UK CCPs) and the consequent increase of the exposure to EU CCPs wished by the EBA, should only be implemented (i) by taking into account the capacity of European players to absorb the consequent increase of volume that will be generated, (ii) by ensuring that European banks maintain their ability to fund their European clients under competitive conditions compared to their peers and not being penalized for their international activities (i.e. when they enter into derivative transactions with non- EU counterparties willing to clear on non-EU CCPs) and (iii) by limiting execution risk to a minimum.
- Concentration in the liquidity buffer: With reference to Paragraph 484, 493 concerning the concentration in Liquidity Buffer, it is important to note that the scope of the HQLA concentration analysis should exclude sovereign public debt. The fact that investments from an institution in public sovereign debt could be

limited, would have negative consequential effects as it may lead to the need to purchase other, less liquid and more risky assets such as ABS, MBS or CB from other financial institutions

- According to paragraph 494 supervisors should assess whether „LCP describes clearly that the LCR liquidity buffer is designed to be used in case of stress…”. While we believe a true usability of buffers under stress is desirable the current design of LCR and other buffers contradicts to that and a re-design is necessary. Par. 494 is no viable solution to the flaws of the LCR and the above cited reading should be deleted.
- Consistently with article 8.6 of the Delegated Act 2015/61, paragraph 484.a (2nd bullet point) introduces a necessary monitoring regarding the consistency between the currency denomination of liquid assets and the distribution by currency of the net liquidity outflows. However, the introduction of new paragraph 491.b goes even further by requiring institutions to set limits to ensure consistency between the currency denomination of their liquid assets and the distribution by currency of their net liquidity outflows. This requirement is not aligned with level 1 text where such restriction shall be only set "where appropriate" and "only applied for the reporting currency or a currency that may be subject to separate reporting". This paragraph should therefore be deleted or at least the precision "where appropriate" should be added.
- We suggest replacing paragraph 104 e) "institutions have implemented independent internal whistleblowing procedures and processes that allow information to be submitted in an anonymised way" by the following: "institutions have implemented independent internal whistleblowing procedures and processes allowing to strictly preserve the identity of the persons concerned".
- Indeed, directive (EU) 2017/1937 which is about to be transposed in EU members' national laws does not promote anonymized whistleblowing. Article 6 of the directive even entitles the EU Member States to decide whether it shall be authorized or not. In many Members States (France for instance), it will probably not be. Thus, we suggest deleting the section referring to anonymized whistleblowing and replacing it by a reference to the directive's requirement of protection of the whistleblower's identity in any case.
- With reference to paragraph 104j, since a code of conduct is a general-purpose document which is addressed, in particular, to the employees of the group, who generally do not engage themselves in antitrust practices or tax offenses, we are of the opinion that the list of breaches included in point 104.j should focus less on major economic offenses and more on individual misconducts".
- Even if the Guidelines are in some cases very detailed, we believe that supervisors should take into account the different business/management models of banks under supervision. To be more precise, in some way or another, the CA should supervise banks that are organized as a Single Point of Entry (SPE) or as a Multiple Point of Entry (MPE). The aim of this comment is not that one model should be above another model but at least a recognition of the existence of both models should be included in the Guidelines. There are different examples where supervisors request some information and, in some cases, take decisions without taking into considerations the specificities of each model. It is an important consideration as MPE models normally imply a decentralized management of capital and liquidity and are organized through independent subsidiaries. As such, supervisory activities should be adapted to these models. Liquidity risk and business model reviews are a case in point. In a nutshell, we would welcome if the EBA could at least recognize the differences between both models in the supervisory arena.

4. Proposed amendments to the draft revised SREP Guidelines in the area of ML/TF risk

Text of the Guidelines	EBF Comments	EBF proposed amendments
Definition (page 21): 'Money laundering and terrorist financing (ML/TF) risk' means the risk as defined in the EBA factors Guidelines on the ML/TF risk	*The EBA factors Guidelines on the ML/TF risk do not define the ML/TF risk. As outlined in these Guidelines on page 2, "These guidelines set out factors firms should consider when assessing the ML/TF risk associated with a business relationship or occasional transaction. They also set out how firms can adjust the extent of their customer due diligence measures in a way that is commensurate to the ML/TF risks they have identified."* *We suggest referring to article 1 of the Directive (EU) 2015/849 of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC which states that:* *"3. For the purposes of this Directive, the following conduct, when committed*	'Money laundering and terrorist financing (ML/TF) risk' means the risk ~~as defined in the EBA factors Guidelines on the ML/TF risk~~ **of participating in money laundering or terrorist financing as defined in Article 1 of the Directive (EU) 2015/849 of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC**

	intentionally, shall be regarded as money laundering: *(a) the conversion or transfer of property, knowing that such property is derived from criminal activity or from an act of participation in such activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an activity to evade the legal consequences of that person's action.* *(b) the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of, property, knowing that such property is derived from criminal activity or from an act of participation in such an activity.* *(c) the acquisition, possession or use of property, knowing, at the time of receipt, that such property was derived from criminal activity or from an act of participation in such an activity.* *(d) participation in, association to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the actions referred to in points (a), (b) and (c).* *4.Money laundering shall be regarded as such even where the activities which generated the property to be laundered were carried out in the territory of another Member State or in that of a third country.*	

	5.For the purposes of this Directive, '<u>terrorist financing' means</u> the provision or collection of funds, by any means, directly or indirectly, with the intention that they be used or in the knowledge that they are to be used, in full or in part, in order to carry out any of the offences within the meaning of Articles 1 to 4 of Council Framework Decision 2002/475/JHA. *6.Knowledge, intent or purpose required as an element of the activities referred to in paragraphs 3 and 5 may be inferred from objective factual circumstances."*	
86.e: In the analysis, competent authorities should consider any indications that the business model and activities give rise to increased ML/TF risks, including deposit taking or establishment or use of legal entities in high-risk third countries, as identified in accordance with Article 9 of Directive (EU) 2015/849. Where present, these indications should be complemented by quantitative analysis, as appropriate, focusing in particular on the materiality of the revenues and the income from operations run in such high risk third countries, the concentrations of exposures to customers for which the institution apply enhanced customer due diligence as set out	1. Regarding the consideration of activities with high-risk clients or high-risk third countries: these activities can only be carried out if they are supported by risk assessment and monitoring mechanisms. In order not to distort the analysis of the business model, we recommend taking into account these risk mitigation elements. 2. The analysis of the ML/TF risks presented by an activity can only be carried out by the AML/CFT supervisor, as well as the quality of the regulatory risk mitigation arrangements. We therefore recommend that this element of the SREP be assessed by the AML/CFT supervisor. Furthermore, the risks of double reporting and contradiction between authorities should be avoided.	In the analysis, competent authorities should ~~consider~~ **inform the AML/CFT supervisors on** any indications that the business model and activities give rise to increased ML/TF risks, including deposit taking or establishment or use of legal entities in high-risk third countries, as identified in accordance with Article 9 of Directive (EU) 2015/849. Where present, these indications should be complemented by quantitative analysis, as appropriate, focusing in particular on the materiality of the revenues and the income from operations run in such high risk third countries, the concentrations of exposures to customers for which the institution apply enhanced customer due diligence as set out in Chapter II, Section 3 of Directive

in Chapter II, Section 3 of Directive 2015/849.		2015/849. **The AML/CFT supervisors should provide the competent authorities with their assessment of the ML/TF risks involved in the business model and activities. This assessment should include the quality of risk mitigation measures and monitoring mechanism.**
94.c: Having conducted the BMA, competent authorities should assess the key vulnerabilities to which the institution's business model and strategy expose it or may expose it, considering any of the following: c. excessive concentrations or volatility (e.g. of revenues, earnings, customers subject to enhanced customer due diligence set out in Chapter II, Section 3 of Directive 2015/849, high risk third countries in accordance with Article 9 of that Directive, deposits and asset under custody/management related to such high risk third countries;	Having high-risk customers subject to enhanced customer due diligence cannot be considered a vulnerability. Activities with high ML/TF risks can only be considered a vulnerability if the ML/TF risk management is deficient. We therefore propose to clarify this element. Furthermore, this assessment of the vulnerability of activities should be made by the supervisor with competence in this area.	Having conducted the BMA, competent authorities should assess the key vulnerabilities to which the institution's business model and strategy expose it or may expose it, considering any of the following: c. excessive concentrations or volatility (e.g. of revenues, earnings, customers subject to enhanced customer due diligence set out in Chapter II, Section 3 of Directive 2015/849, high risk third countries in accordance with Article 9 of that Directive, deposits and asset under custody/management related to such high risk third countries **where there are serious deficiencies in the AML/CFT system. The AML/CFT supervisors provides competent authorities with this information**.
100: In line with the EBA Guidelines on internal governance, the assessment of the internal	This assessment is currently done by the AML/CFT supervisors and should remain so	In line with the EBA Guidelines on internal governance, the assessment of the internal governance framework should include the assessment of the existence of governance

governance framework should include the assessment of the existence of governance arrangements and mechanisms to ensure that the institution complies with applicable AML/CFT requirements.	to avoid contradictions between AML/CFT supervisors and competent authorities.	arrangements and mechanisms to ensure that the institution complies with applicable AML/CFT requirements. **This assessment should remain AML/CFT supervisors' responsibility.**
147: In line with the EBA Guidelines on internal governance and Joint ESMA and EBA Guidelines on the assessment of the suitability of the members of the management body and key function holders, competent authorities should assess from a prudential perspective, among others whether: a. arrangements are in place to ensure a clear allocation of competences and responsibilities of the management body and of the internal control functions in relation to ML/TF risks; b the management body has individually and collectively adequate knowledge, skills and experience regarding the ML/TF risks and the relevant procedures; c. without prejudice to the national transposition of Directive (EU) 2015/849 a member of the management body is responsible for the implementation of the laws, regulations and administrative	147.b: With reference to paragraph 147 which refers to joint ESMA and EBA Guidelines on the assessment of the suitability of the members of the management body and key function holders in the context of the adequate individual and collective knowledge, skills and experience regarding the ML/TF risks and relevant procedures (point b), the ECB has already the ability to refuse the appointment of Board members following a negative suitability assessment. So, we suggest deleting the point as there is no reason to reconsider this assessment in the context of the SREP. In addition, it is worth noting that paragraph 147 provides for an assessment of the competent authority of specific requirements concerning the allocation of responsibilities and the suitability of the members of the management body in relation to ML/TF risks, including the member responsible for the implementation of the laws. In this respect , it is very important to ensure consistency between the SREP Guidelines and any other EBA work on the topic of ML/TF risk to avoid any contradiction.	**147:** In line with the EBA Guidelines on internal governance and Joint ESMA and EBA Guidelines on the assessment of the suitability of the members of the management body and key function holders, competent authorities should assess from a prudential perspective, among others whether: a. arrangements are in place to ensure a clear allocation of competences and responsibilities of the management body and of the internal control functions in relation to ML/TF risks; ~~b the management body has individually and collectively adequate knowledge, skills and experience regarding the ML/TF risks and the relevant procedures;~~ c. ~~without prejudice to the national transposition of Directive (EU) 2015/849~~ a member of the management body **or another person in a sufficiently senior position** is responsible for the implementation of the laws, regulations and

provisions necessary to comply with that Directive; d. the management body's responsibility for setting, approving and overseeing the institution's business strategy and risk strategy takes into account the necessity to ensure that at all times effective arrangements for compliance with AML/CFT requirements are in place.	In any case, please note that Joint ESMA/EBA Guidelines Fit and Proper assessment do not require the management body to have "**individually**" adequate knowledge, skills and experience regarding the ML/TF risks and the relevant procedures (as provided by paragraph 147, lett. b) of the consultation document). As specified in paragraph 55 of the Joint EBA/ESMA Guidelines "the ability to understand ML/TF risks is" only "part of the assessments of the **collective** suitability of the members of the management body"[…]. 147.c: EBA guidelines cannot take primacy over national law. Moreover, the comply or explain procedure allows national authorities to declare that they are not in compliance and will not comply with the EBA guidelines if they consider that their national law does not allow it. 147.d: It seems that the paragraph is combining the roles of the management body in its supervisory function and in its management function (cf. "setting, approving and overseeing").	administrative provisions necessary to comply with that Directive (**EU) 2015/849 are defined in compliance with the specific guidelines issued by the European Banking Authority on this topic**; d. the management body's responsibility for setting, approving and overseeing the institution's business strategy and risk strategy takes into account the necessity to ensure that at all times effective arrangements for compliance with AML/CFT requirements are in place. **In this context, both the supervisory and the management function of the management body should act in their respective roles and responsibilities.**

170: In addition, competent authorities should also pay attention to whether ML/TF risks are considered within the context of the credit granting process including whether the institution has systems and controls in place to ensure funds used to repay loans are from legitimate sources in accordance with the EBA Guidelines on loan origination and monitoring.	These assessments are within the remit of AML/CFT supervisors. We draw attention to the need to avoid differences in interpretation between the competent authorities and the AML/CFT supervisors. In addition, we consider it is most useful to focus on the most significant transactions, since they generate the greatest impact in terms of ML/TF risks.	In addition, competent authorities should also pay attention to whether ML/TF risks are considered within the context of the credit granting process including whether the institution has systems and controls in place to ensure funds used to repay loans are from legitimate sources in accordance with the EBA Guidelines on loan origination and monitoring. **Particular attention should be given to the most significant transactions. To this end, competent authorities rely on the AML/CFT supervisors.**
223.d: Competent authorities should take into account whether d. the policies and procedures also specify how ML/TF risks to which the institution is exposed as a result of the credit granting activities are identified, assessed and managed both at the level of the business (in terms of types of customers served, lending products provided, geographies to which they are exposed and distribution channels used) and at the level of the individual relationship (considering the purpose of the credit, the extent to which the counterparty gives rise to ML/TF risk, and the legitimacy of the source of funds used to repay the credit);	These assessments are within the remit of AML/CFT supervisors. We draw attention to the need to avoid differences in interpretation between the competent authorities and the AML/CFT supervisors.	Competent authorities should take into account whether d. the policies and procedures also specify how ML/TF risks to which the institution is exposed as a result of the credit granting activities are identified, assessed and managed both at the level of the business (in terms of types of customers served, lending products provided, geographies to which they are exposed and distribution channels used) and at the level of the individual relationship (considering the purpose of the credit, the extent to which the counterparty gives rise to ML/TF risk, and the legitimacy of the source of funds used to repay the credit). **To this end, competent authorities rely on the AML/CFT supervisors.**

233.d: competent authorities should pay particular attention to whether: d. there are checks in place to identify, assess and manage ML/TF risks to which the institution is exposed as a result of the credit granting activities.	These assessments are within the remit of AML/CFT supervisors. We draw attention to the need to avoid differences in interpretation between the competent authorities and the AML/CFT supervisors.	competent authorities should pay particular attention to whether: d. there are checks in place to identify, assess and manage ML/TF risks to which the institution is exposed as a result of the credit granting activities. **To this end, competent authorities rely on the AML/CFT supervisors.**
278: To determine the scope of the assessment of operational risk, competent authorities should first identify the sources of operational risk to which the institution is exposed. To do so, competent authorities should also leverage on the knowledge gained from the assessment of other SREP elements, from the comparison of the institution's position to peers (including relevant external data, where available) and), from any other supervisory activities including the input from the AML/CFT supervisors, other relevant information received from financial intelligence units and law enforcement authorities where available, other publicly available information and from other relevant information sources.	In our view, only the AML/CFT supervisor should be responsible for identifying the sources of operational risk to which an institution is exposed in the area of ML/TF risks. FIU and law enforcement authorities cannot do so since they have no knowledge of the institutions' internal processes.	To determine the scope of the assessment of operational risk, competent authorities should first identify the sources of operational risk to which the institution is exposed. To do so, competent authorities should also leverage on the knowledge gained from the assessment of other SREP elements, from the comparison of the institution's position to peers (including relevant external data, where available) and), from any other supervisory activities including the input from the AML/CFT supervisors. Other relevant information received from financial intelligence units and law enforcement authorities where available, other publicly available information and from other relevant information sources **should be taken into account after due investigation by AML/CFT Supervisor.**

307: Competent authorities should bear in mind that any institution can be exposed to ML/TF risk regardless of the institution's size or financial soundness. Therefore, sufficient attention should also be paid to institutions that are perceived to be financially sound and may have a good reputation given that these institutions might be specifically targeted for ML/TF purposes. Attention should also be paid to institutions that are very successful in attracting new customers / expanding market share – especially by using non-traditional distribution channels - since this could be related to weak customer due diligence controls at the on boarding phase.	We do not dispute this paragraph, but it seems to us more appropriate to put it in the introduction as it concerns general considerations.	Suggestion to move the paragraph to point 3 "background and rationale", subsection "assessment of the risk of ML/TF"
309: Competent authorities should assess the framework and arrangements that the institution has specifically to manage and control operational risk as an individual risk category. This assessment should take into account the outcome of the analysis of the overall risk management and internal control framework addressed in Title 5, as this will influence the institution's operational risk exposures.	We suggest clarifying that the assessment of operational risk management, measurement and controls in relation to ML/TF risk is the responsibility of ML/TF supervisor. This provision could be inserted in paragraph 309. This would be consistent with paragraph 283.	Competent authorities should assess the framework and arrangements that the institution has specifically to manage and control operational risk as an individual risk category. This assessment should take into account the outcome of the analysis of the overall risk management and internal control framework addressed in Title 5, as this will influence the institution's operational risk exposures. **Regarding ML/TF risk, the assessment is provided by AML/CFT supervisor**
324: Competent authorities should assess whether the institution has implemented	We suggest clarifying that the assessment of reputational risk management, measurement and controls related to ML/TF	Competent authorities should assess whether the institution has implemented adequate arrangements, strategies,

adequate arrangements, strategies, processes and mechanisms to manage reputational risk. In particular, competent authorities should take into account whether: (…)	risk are the responsibility of ML/TF supervisor. This provision could be inserted at the end of paragraph 324. This would be consistent with paragraph 283.	processes and mechanisms to manage reputational risk. In particular, competent authorities should take into account whether (…) on its reputation. **Regarding reputational risk related to ML/TF risk, the assessment is provided by AML/CFT supervisor**
469.e: Competent authorities should assess the appropriateness of the institution's funding profile, including both medium- and long-term contractual and behavioural mismatches, in relation to its business model, strategy and, risk appetite and its exposure to ML/TF risks. More specifically, they should take into account: e. the level of exposure of the institution to money laundering and terrorism financing risk that increase funding risk.	The level of exposure of the institution to money laundering and terrorism financing risk cannot considering without the quality of the risk management system. This global assessment can only be done by the AML/CFT supervisors.	Competent authorities should assess the appropriateness of the institution's funding profile, including both medium- and long-term contractual and behavioural mismatches, in relation to its business model, strategy and, risk appetite ~~and its exposure to ML/TF risks~~. More specifically, they should take into account: e. ~~the level of exposure of the institution to money laundering and terrorism financing risk that increase funding risk~~. **The opinion of AML/CFT supervisor on the exposure to ML/TF risks and the potential deficiencies of the ML/TF risk management system of the institution that could increase funding risk.**
472.e: Competent authorities should consider factors that may reduce the stability of the funding profile in relation to the type and characteristics of assets, off-balance-sheet	As indicate above, the ML/TF risks does not, in themself, induce funding risk. The ML/TF risk should be considered together with the risk management system.	Competent authorities should consider factors that may reduce the stability of the funding profile in relation to the type and characteristics of assets, off-balance-sheet items and liabilities. They should take into account:

items and liabilities. They should take into account: e. funding characteristics that could indicate increased ML/TF risks and concerns from a prudential perspective (such as dependence on non-resident deposits especially from high risk jurisdictions (as identified by the European Commission), deposits with foreign booking locations not coherent with the business model, or unusual interest rate settings compared to peers that are not coherent with the product type or institution's business model).		e. funding characteristics that could indicate increased ML/TF risks and concerns from a prudential perspective (such as dependence on non-resident deposits especially from high risk jurisdictions (as identified by the European Commission), deposits with foreign booking locations not coherent with the business model, or unusual interest rate settings compared to peers that are not coherent with the product type or institution's business model). **Where such characteristics are identified, competent authorities liaise with the AML/CFT supervisor to obtain their assessment on the ML/TF risk management system and determine the impact on the funding risk.**
547: If after liaising with the AML/CFT competent authority, there is a need for competent authorities to address prudential deficiencies/vulnerabilities related to ML/TF risks as a result of the SREP elements assessment, competent authorities should set additional own funds requirements only where this is considered more appropriate than other supervisory measures. If additional own funds requirements are imposed, they should be used as an interim	In our point of view, the competent authority should liaise with AML/CFT competent authority to ask the latter to contribute to the SREP elements assessment. Indeed, ML/TF risk can only have a prudential impact if they are insufficiently or inadequately identified, measured and managed. We request clarification that AML/CFT supervisor is fully associated to the assessment of SREP elements where ML/TF risks are involved.	

measure while the deficiencies are addressed.		
588: Where competent authorities in the course of exercising their supervisory activities have reasonable indications of deficiencies in the institution's systems and controls framework or the internal governance framework that are related to AML/CFT or reasonable grounds to suspect that the institution has increased exposure to ML/TF risks, they should: a. notify the AML/CFT supervisor of these deficiencies and risks as soon as they are identified and in line with the AML/CFT Cooperation Guidelines; b. assess the impact that such deficiencies and risks may have on the prudential situation of the institution; c. liaise with AML/CFT supervisors and in line with the respective authorities' mandates and functions, consider the most appropriate prudential supervisory measures to address these deficiencies and risks in addition to any measures taken by the AML/CFT supervisors.	As a consequence of the above comment, we suggest clarifying that the ML/TF risks are assessed by the AML/CFT supervisor.	Where competent authorities in the course of exercising their supervisory activities have reasonable indications of deficiencies in the institution's systems and controls framework or the internal governance framework that are related to AML/CFT or reasonable grounds to suspect that the institution has increased exposure to ML/TF risks, they should: a. notify the AML/CFT supervisor of these deficiencies and risks as soon as they are identified and in line with the AML/CFT Cooperation Guidelines; b. assess the impact that such deficiencies and risks, **as duly checked with AML CFT supervisor,** may have on the prudential situation of the institution; c. liaise with AML/CFT supervisors and in line with the respective authorities' mandates and functions, consider the most appropriate prudential supervisory measures to address these deficiencies and risks in addition to any measures taken by the AML/CFT supervisors.

610: Competent authorities responsible for the prudential supervision of entities of a cross-border group should, when imposing supervisory or administrative measures including sanctions on institutions for their failure to address deficiencies related to ML/TF risks adequately, liaise with the relevant AML/CFT supervisors in accordance with section 8 of the AML/CFT Cooperation Guidelines.	It is important to respect the respective remit of each supervisor.	Competent authorities responsible for the prudential supervision of entities of a cross-border group should, when imposing supervisory or administrative measures including sanctions on institutions for their failure to address deficiencies related to ML/TF risks adequately, liaise with the relevant AML/CFT supervisors in accordance with section 8 of the AML/CFT Cooperation Guidelines **and in line with the respective authorities' mandates and functions, consider the most appropriate prudential supervisory measures to address these deficiencies and risks in addition to any measures taken by the AML/CFT supervisors.**