Consultation Response

Draft Guidelines on Internal Governance under Directive 2013/36/EU

30 October 2020

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the **DRAFT GUIDELINES ON INTERNAL GOVERNANCE UNDER DIRECTIVE 2013/36/EU** ("the Guidelines"). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

We welcome the opportunity to provide comments on the updated Guidelines on Internal Governance and the work that the EBA has done to bring the Guidelines in line with recent legislation. We raise a number of specific points below for each question, but would like to highlight the following priority areas:

- There are some instances in which the proposed requirements relating to anti-money laundering and terrorist financing should be amended to take into account differing corporate structures;
- Some of the proposed requirements relating to ESG are not completely clear and we suggest that it may be better for the EBA to progress its ongoing work in this area before detailed changes to the Guidelines are drafted; and
- The changes relating to loans and transactions with members of the management body and their related parties go extensively beyond the CRD 5[1] mandate, particularly in the extension to cover transactions other than loans, and in the disclosure requirements. We request that this is amended to fit with the CRD 5 mandate relating only to loans and documentation.

[1] Directive (EU) 2019/878

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Questions

Question 1: Are subject matter, scope of application, definitions and date of application appropriate and sufficiently clear?

In relation to the scope of application, we note that this does not currently extend to all financial services firms, for example payments providers. We suggest that the EBA considers how this could be achieved.

We note that the definition of "prudential consolidation" differs between these Guidelines and the accompanying EBA-ESMA consultation on the guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU ("Suitability Assessment Guidelines")[2]. We suggest that both definitions should be amended as is proposed in these Guidelines. However we would also welcome proportionality of application in relation to prudential consolidation, particularly for those entities which are not directly supervised by the ECB.

In relation to the date of application of these Guidelines and the Suitability Assessment Guidelines, which is currently proposed as 26 June 2021, we request confirmation that this date would be amended in the event of translation delays or delays in the transposition of CRD 5 by Member States.

We would also like to raise the following points which do not fit under the remaining questions in this consultation:

We note that the Guidelines refer in several places to *"offshore financial centres"* (for example Legal Basis paragraph 14, Organisation Framework in a Group Context paragraph 84), which is not a clearly defined term. We suggest that the Guidelines use a consistent and more legally clear term such as *"third country"*, unless a distinction is established between third countries and offshore financial centres.

Role and responsibilities of the management body: In paragraphs 21-22, it is unclear why the final sentence has been moved. We consider that the sentence would be better retained under paragraph 21, as it does not only refer to the management board in its supervisory function.

Outsourcing: The former section 8 on Outsourcing has been removed. We note that the EBA Guidelines on Outsourcing Arrangements[3] make reference to these Guidelines and suggest this may require additional cross-checking as these Guidelines are updated.

Risk culture: paragraph 92 makes reference to *"righteous"* culture, which is not defined. We suggest that this may cause unnecessary confusion.

Business continuity management: a reference has been added in paragraph 223 to *"core human resources"*. We suggest that this is changed to *"core staff"* or *"core employees"* to distinguish it from the Human Resources Department within a firm.

Business continuity management: we request clarity as to how the addition of *"drivers of"* is intended to change the meaning of this requirement.

Question 2: Point (d) has been added, throughout the Guidelines references to money laundering and terrorism financing and the institutions obligations have been added, are those references sufficiently clear?

We suggest that point d of paragraph 23 should be incorporated into point c, so as to avoid the risk of creating dual internal control structures. For example:

"c. an adequate and effective internal governance and internal control framework that includes
i) a clear organisational structure and well-functioning independent internal risk management,

[2] https://eba.europa.eu/calendar/eba-and-esma-launch-consultation-revise-joint-guidelines-assessing-suitability-members

[3] https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-outsourcing-arrangements

ii) compliance and audit functions that have sufficient authority, stature and resources to perform their functions;

iii) compliance with applicable requirements also in the context of the prevention of money laundering and terrorism financing."

In relation to paragraph 32, which relates to assigning responsibility for the bank's compliance with Directive 2015/849/EU, we believe that it is overly prescriptive to require this to be assigned to a specific member of the management body. We would note there is difference between being 'responsible' for the bank's compliance framework and being 'responsible' for executing the compliance against that framework under which there would typically be an allocation of responsibilities. The proposed text may not be aligned to Directive 2015/849/EU which refers to responsibility for implementing laws, rules and administrative provisions necessary to comply with the Directive. Furthermore, how this has been transposed may vary between Member States and, in some cases, may be assigned to senior management who may not necessarily be members of the management body. In addition, a requirement on an institution to identify such person may be left to the discretion of the competent authorities. It is therefore not appropriate to suggest that responsibility sits with one member of the management body and AFME suggests that firms should be free to determine their own arrangements. If it is to be retained, we request clarification that this is in the context of 'joint and several' liability of all board members for all topics regarding the organisation of the group (while a primary responsibility can be included, it does not remove this corporate law position). Furthermore, the execution of this responsibility is likely be delegated to the head of the respective function rather than being retained by the named board member.

The reference to *"national implementation"* should also consider the global responsibilities of the management body and therefore make reference to including *"all applicable local legislation"* whether implementing the directive or not.

In relation to paragraph 61 on risk and nominations committees, we request clarity that the factors listed (including the new reference to *"AML/CFT compliance"*) should be read as each applicable to one or both (but not necessarily both) committees.

In relation to paragraph 143, we request clarification that the reference to compliance may be covered by a separate Anti-Financial Crime (AFC) function, if this exists within an organisation. Similarly, in relation to paragraph 166, it would be better to include AFC in the definition of Compliance or to separately include in second sentence before internal audit.

In relation to paragraph 164, we suggest that it may be clearer to incorporate the new sentence into the existing second sentence in the paragraph. For example *"The NPAP should set out the main issues to be addressed before a decision is made. These should include regulatory compliance; accounting; pricing models; the impact on risk profile, capital adequacy and profitability; the availability of adequate front, back and middle office resources; ~~and~~ the availability of adequate internal tools and expertise to understand and monitor the associated risks; and~~. Furthermore~~, to comply with their obligations under Directive (EU) 2015/849, ~~credit institutions should identify and assess~~ the ML/TF risk associated with the new product or business practice~~, and set out the measures to take to mitigate those risks~~."*

Question 3: Paragraph 24 regarding ESG factors has been added, is it sufficiently clear?

We are concerned that the addition of paragraph 24 does not add sufficient clarity and suggest that it is not a helpful addition, particularly prior to the EBA producing further work on sustainable finance.

In particular, there is ambiguity as to what is meant by ESG factors in this case. For example, we would interpret this to refer to ESG risks for the bank and its financial position. In terms of extending this consideration to wider ESG societal impacts, we would note that reputational risk, including ESG reputational risk, will be taken into account by the management body where it has a material impact on the financial position of the firm i.e. there is a connection and impact on the firm. However, we would caution against extending this beyond ESG factors that do not have a connection to firm in some form, as

this could appear to impose a subjective moral standard of judgment on members of the management body. Furthermore, AFME notes that ESG factors will be taken into account as part of the management body undertaking some of the duties listed in paragraph 23, particularly 23a *"the overall business strategy and the key policies of the credit institution within the applicable legal and regulatory framework, taking into account the credit institution's long-term financial interests and solvency"*. However, including an additional paragraph 24 to cover ESG suggests that all the duties listed under paragraph 23 are relevant, which is not the case – for example, the approval of the liquidity management framework under point f. We therefore suggest that paragraph 24 is removed until the EBA has completed further work on sustainable finance, at which point a more specific amendment to these Guidelines can be considered, preferably as part of paragraph 23.

Later, in paragraph 149 we request a similar clarification, i.e. whether ESG is viewed as a type of reputational risk or if some other risk is intended (i.e. to external stakeholders). If the former, we note that reputational risk is already included in this list.

Question 4: Paragraph 84 and 86 have been amended to reflect changes to CRD. Are those paragraphs sufficiently clear?

AFME has no comments in response to this question.

Question 5: Are Paragraphs 98 and 99 sufficiently clear?

While we note that the EBA Guidelines on gender neutral remuneration policies are yet to be written, we support the outcomes-focused language that has been used in these paragraphs.

In relation to the drafting of paragraph 99, we note the potential for inadvertent conflict that the desire for gender neutrality could prevent the implementation of policies which specifically target an underrepresented gender. This could be alleviated by amending the drafting as follows *"Credit institutions ~~policies should be gender neutral and credit institutions~~ should implement measures that ensure equal opportunities for all genders, including with regard to career perspectives and to improve the representation of the underrepresented gender in management positions"*.

We also request clarity as to what is meant by *"career perspectives"* in paragraph 99 and suggest that the reference to *"equal opportunities"* may be sufficient to cover this.

Question 6: Point (c) of paragraph 101 has been amended to reflect the EBA's work on dividend arbitrage schemes. Is point (c) sufficiently clear?

While we support the EBA's focus on addressing financial misreporting and misconduct, economic and financial crime, we suggest that the inclusion of a specific reference to dividend arbitrage schemes is more granular than the other offences listed in this paragraph and that it may be better to retain higher-level categories such as "tax offences".

If the reference to such schemes is retained, we would also raise a concern with the use of the language *"illicit dividend arbitrage schemes"* (emphasis added) as it suggests that it is specifically within the remit of these Guidelines to declare particular practices illicit.

Question 7: Section 11 has been added to provide guidelines on loans and transactions with members of the management body and their related parties, reflecting changes to CRD. Is the section appropriate and sufficiently clear?

As an overall comment, we suggest that it may be more consistent to retain this within the previous section on Conflicts of Interest, as this section is now very granular for a single conflict. It will also be more relevant to credit institutions than to investment firms.

In relation to the scope, we note the CRD 5 Article 1(23) mandate "*in Article 88(1), the following subparagraph is added: 'Member States shall ensure that data on loans to members of the management body and their related parties are properly documented and made available to competent authorities upon request*". On this basis, the proposed Section 11 goes beyond the scope of the provisions at Level 1 in two ways:

- First, by expanding the scope to cover transactions other than loans; and
- Second, by requiring more than data to be documented and made available on request, e.g. the proposed requirements of limits that should be put in place, reporting to shareholders etc.

While we agree that banks should have in place robust policies to cover all manner of conflicts of interest, including as set out in the existing Guidelines, and that the EBA should be able to obtain data on loans to members of the management body, it is not appropriate to include these additional granular requirements as part of these Guidelines since this is not part of the CRD 5 mandate. The CRD 5 did not provide the EBA with a specific mandate to elaborate or interpret the new provisions of Article 88.

We therefore strongly suggest that the Guidelines should be amended only to include the requirements insofar as they relate to the provisions under CRD 5, i.e. only loans, and only related to data and documentation.

We also note that some national legislative frameworks (which may constitute a transposition of CRD) already impose requirements with respect to related party lending, and in some cases these may be legally binding and enforceable. Further detail or harmonisation would be best left to EU legislation (Level 1), rather than guidelines which may overlap or conflict with binding national rules and lead to uncertainty.

Further to this point of principle, we would also like to raise the following concerns:

Proportionality: we suggest that the EBA Guidelines should focus on requiring a framework that ensures that loans are entered into on normal market terms or that they are otherwise reasonable from the perspective of the institution and of the shareholders.

If our suggestion is not adopted, we request that the EBA considers how situations in which there is no conflict of interest can be excluded from additional requirements, e.g. loans between the institution and a commercial entity where the Board Member has no influence (for example where the Board Member holds a non-executive directorship and where decisions are taken collectively).

Definition of "related parties": the addition in paragraph 116 that Member States may consider widening the definition is outside the scope of CRD 5 and should be removed. Furthermore, banks are already subject to conflicting definitions of the term under national regulations, e.g. those relating to listed companies, meaning that a further proliferation of definitions would add to this complexity.

Application to banking groups: it is not clear if - within a banking group - the requirements apply to the loans granted by each bank to its own Board members or also apply to the loans granted by each bank of the banking group to the Board members of the Parent Bank. In any case, it would be useful to specify that such requirements are not applicable to loans granted to Board members of other group entities, being only addressed to loans made by the Parent Bank to its own Board members and their related parties.

Additional documentation requirements for loans exceeding €200,000 (paragraph 112(g)): we believe that this goes beyond the intended aim of this section which relates to conflicts of interest and abuse of position. Banks are subject to separate requirements regarding large exposures, which are, in any case, unlikely to be triggered by a loan to a Board member. Paragraph 112(g) should therefore be removed. If this is to be retained, however, we suggest that the threshold should be set by each individual bank in

accordance with its own size and risk appetite, rather than being imposed as one-size-fits-all. In addition, the requirement in 112gii is particularly onerous and does not appear to bring a significant benefit – we suggest that this is removed at a minimum.

Timing for provision of information to competent authorities (paragraph 114): we do not believe that it should be necessary to specify that the information must be provided "without undue delay". If a specific timeline is meant, additional implementation time may be needed, given the size of the data challenge as currently drafted.

Disclosure to shareholders (paragraph 115): In accordance with International Accounting Standards (IAS24), institutions already provide in their financial statements disclosure about transactions with their related parties. There would also be potential for conflicts with banking secrecy laws, and may therefore be subject to consent requirements, particularly since Boards are often not large enough for aggregation of data to mitigate this risk. We suggest that this paragraph is deleted.

Based on our comments above, we suggest the following amendments to the drafting of this section in line with the CRD 5 mandate:

> *"107. The management body should set out a framework for granting loans ~~and entering into other transactions (e.g. factoring, leasing, property transactions, credit facilities etc.) with~~ to members of the management body and their related parties. Such framework should consider the actual or potential conflicts of interest and other risks when setting ~~include~~ limits for loans ~~and transactions (e.g. per product type)~~ and ensure that they are conducted at arm's length. Changes to such limits should require an approval by the management body. The management body should also set out the applicable decision processes for granting such loans ~~and entering into other transactions~~. This framework should ensure any loans ~~or transactions~~ are concluded on normal market terms or are otherwise fair and reasonable from the perspective of the institution and of the shareholders. ~~may provide for a differentiation between standard business transactions entered into in the ordinary course of business and concluded on normal market terms, staff loans and transactions, which are concluded on conditions available to all staff, and other loans and other transactions that are fair and reasonable from the perspective of the institution and of the shareholders or owners and could also be granted to some third parties. Furthermore, the framework may differentiate between material and non-material loans and other transactions. The framework and decision making process may be different for different types of loans and other transactions, also taking into account their volume and the level of actual or potential conflicts of interest they may create.~~*
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> *108. ~~Decisions on material loans or other material transactions with members of the management body or their related parties that have not been concluded under standard conditions or normal market terms should be made by the management body.~~ The individuals personally concerned by a loan to or other transaction with a member of the management body or their related parties should not be involved in the decision making.*
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> *109. Credit institutions should ensure that all relevant internal control procedures fully apply to such loans ~~and other transactions~~ and that an appropriate oversight framework is in place. ~~For non-material loans and other transactions that are concluded on standard conditions or normal market terms as referred to in paragraphs 107 and 108, t~~ The management body in its supervisory function should establish an internal procedure to periodically assess whether the conditions for such loans ~~and other transactions~~ are fulfilled. ~~The same should apply, where the decision on a material loan or a material other transaction in line with national law has been taken only by the management body in its management function.~~*
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> *110. ~~When deciding on a loan or other transaction with a member of the management body or their related parties institutions should assess before taking a decision: a. the risk to which the institution might be exposed due to the transaction; and b. whether or not the transaction is fair and reasonable from the perspective of the institution and of its shareholders or owners.~~*

~~*111. Where loans are arranged as a line of credit (e.g. overdrafts), the initial decision and amendments thereof should be documented, while any use of such agreed credit facilities within the agreed limits should not be considered as a new decision on a loan to a member of the management body or their related party. Where an amendment of a line of credit is material, a new assessment and decision according to the guidelines in this section should be made.*~~

~~*112.*~~ *Credit institutions should document data on loans to members of the management body and their related parties properly, including at least: a. the name of the debtor and his status (i.e. member of the management body or related party) and regarding loans to a related party, the member of the management body concerned and the nature of the link with the related party; b. the type/nature of loan and the amount; c. the terms and conditions applicable to the loan; d. the date of approval of the loan; e. the name of the individual or body and its composition who has taken the decision to approve the loan and the applicable conditions; f. information supporting that the loan was in line with the internal framework* ~~*at arm's length., including conditions available to all staff or conditions that are fair and reasonable from the perspective of the institution and of its shareholders or owners (e.g. information on interest rates, fees, commissions, information on comparable loans and transactions with third parties); g. for loans above an amount of EUR 200 000: i. the percentage of the loan and aggregated exposures towards the same debtor compared to the total eligible capital and common equity Tier 1 capital of the credit institution and whether the loan is a large exposure; and ii. the relative weight of the loan and the aggregated exposures, calculated as percentage by dividing the amount of the approved loan and the aggregated exposures by the total amount of loans to members of the management body and their related parties.*~~

~~*113. Credit institutions should properly document all other material transactions with members of the management body and their related parties taking into account the requirement applicable for the documentation of loans.*~~

114. Credit institutions should ensure that the documentation of all loans to members of the management body and their related parties is complete and updated and that the institution is able to make available to competent authorities the complete documentation in an appropriate format upon request ~~*without undue delay*~~*.*

~~*115. Credit institutions should make available annually to their shareholders or owners appropriate aggregated information on loans and other transactions with members of the management body and their related parties.*~~

~~*116. Without prejudice to the implementation of Directive 2013/36/EU by Member States, credit institutions may consider additional categories of related parties to whom they apply, in whole or in part, this section (e.g. it could be considered, at least, to apply those guidelines to qualified shareholders of the credit institution and the companies on which the credit institution exerts control or significant influence).*~~*"*

Question 8: Paragraph 126 has been added, is it sufficiently clear?

We suggest that this should be integrated with paragraph 125, i.e. that the policy could set out the way in which conflicts of interest are mitigated and when they may be considered acceptable.

Question 9: Paragraph 140 has been added, is it sufficiently clear?

We suggest that AML should not be included with the overarching 'internal controls' section. It should instead be included within its own sub-heading as a sub-topic.

Next steps

AFME welcomes the opportunity to submit comments, and would be pleased to engage further as the regulatory process continues.

AFME Governance

We confirm that AFME has put in place internal arrangements to manage our work in compliance with the conditions set by the EBA on Adam Farkas' appointment as CEO of AFME. As part of these arrangements, Adam Farkas has not been involved in the preparation of this consultation response.

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