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Finance for Europe

Association for Financial Markets in Europe

Consultation response

EBA CP 2021/26 on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing

28 September 2021

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the EBA's consultation paper on **its common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing.** We also appreciate that the EBA organised a public hearing on the consultation in August.

Our response starts with our overarching comments which summarise key themes of our response, is followed with more detailed responses to the individual questions posed in the consultation, and closes with additional comments set out in the annex that we believe are important for the EBA to consider but are not directly related to the questions posed in the consultation.

Executive Summary

AFME and our members welcome the consultation paper and the implementation of CRD5 changes. We consider that many of the proposals will enhance the current framework by adding more clarity on certain aspects and by ensuring greater harmonisation.

We particularly welcome the proposals for supervisors to provide due justification when any Pillar 2 decision is made and 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 Pilar 2 requirement.

Overall, it is important to ensure a proportionate approach that, in addition to taking into account an institution's size and complexity, includes a risk dimension so that immaterial activities/risks do not receive undue focus of high supervisory scrutiny.

Key points of our response include:

1) Integration of AML/CFT
    - While the inclusion of AML/CFT risks has the potential to enhance the SREP supervisory framework, it is important to note that the impact of AML/CFT risks is already considered as part of operational risks under the additional own funds requirement. Therefore, the explicit inclusion of the assessment of AML/CFT should not automatically translate into a downgrade of the SREP score or an increase of additional own funds. Competent authorities should take a holistic approach to avoid that the inclusion of this new risk category into different SREP components result automatically in downgrading of the SREP score. For example, the AML/CFT risk associated with the business model can be mitigated by the robustness of governance and controls.
    - It is critical that in all instances, competent authorities rely on AML/CFT supervisors' assessments to draw any conclusion on the SREP assessment of supervised entities.

- In assessing the ML/TF risk, competent authorities should not only consider if an institution is carrying activity in high risk third countries, but also if the processes implemented by the institution enables an appropriate management of the risk. 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. Competent authorities should established their ML/TF assessment of an institution based on residual risk.

2) P2R-LR
   - We would welcome if the EBA clarified 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 concept of "excessive leverage" is not sufficiently defined. A clear concept is required to avoid the risk that excessive leverage might be considered as putting into question the reliability of internal models for own funds requirement.
   - The methodology for measuring excessive leverage and calibrating corresponding additional own funds needs to be further clarified to ensure transparency and a level playing field.
   - The guidelines should be more explicit 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.

3) P2G-LR
   - We have strong reservations about the inclusion of a 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". In particular the static balance sheet assumption and the resulting static exposures over the three years of projections are not a realistic assumption in an adverse scenario. This is true of risk weighted ratios and even more so of the leverage ratio. 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.

4) P2R
   - With regards to setting additional own funds requirements, we believe that the EBA should recognise that the flooring implied in paragraph 368 seems at odds with the ECB Guide to ICAAP and could likely distort the relative risk assessment both across and within risk types, thereby reducing the relevance of internal risk quantifications in steering the risk profile of the institution.

5) P2G
   - AFME strongly opposes to request banks to disclose P2G information to the market. CRR2 clearly states that the P2G is a non-binding capital target that should not be subject to mandatory disclosure.

6) Miscellaneous
   - The guidelines should recognise the benefit of business and inter-risk diversification (while the concentration risk is flagged as a penalising factor in many instances). This dimension should at least be a strong focus of the business model assessment.

- We welcome that the guidelines request that supervisors provide more information to banks on factors that contribute to their individual P2R calibration. However, the guidelines could be more explicit on the extent of information to be provided to banks, for instance in terms of quantification of the P2R.
- Temporary capital add-on should be an exception only where it is not possible to address deficiencies through other supervisory measures, and any decision should be reviewed on an ongoing basis to adjust the sizing of the add-on based on the remediation already delivered. Otherwise, a temporary capital add-on becomes permanent. We also consider that the Guidelines should make clear under which circumstances additional own funds requirements should be set as an interim measure while the model deficiencies are addressed.

Responses to the individual questions

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?

Further simplification and readability of the text could be achieved through graphs, e.g. illustrating values and stacking order including the proposed leverage ratio requirement.

Preparing a standardised template for the communication of the SREP outcome as suggested in the text box related to question 6 is also a way of simplifying the guidelines as it would allow the CAs and the industry to have a simplified view of the required content and structure of SREP decisions. *Please also see our response to Question 6.*

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, 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 apply 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 recognise 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 an anchor process in the SREP assessment, their actual use in the setting of additional own funds by the supervisor is conceptually unclear. 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>
We believe that paragraph 368: "Competent authorities should ensure 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" seems at odds with the ECB Guide to ICAAP that states in paragraph 77 that "The Pillar 1 capital requirements are, however, not expected to be regarded as a floor in the internal risk quantifications of the institution" and the premise that ICAAP is an internal process, where the amount of capital should be commensurate with the risk that the institution is exposed to.

An implicit floor to internal risk quantification (via Pillar 1 requirement) will likely distort the relative risk assessment both across and within risk types, thereby reducing the relevance of internal risk quantifications in steering the risk profile of the institution. 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 asses the intra-risk diversification effects in additional funds requirements quantification, as prescribed by article 372.

We recommend that paragraph 368 is amended to align with the ECB Guide to ICAAP paragraph 77: "Competent authorities should ensure that the overall level of conservatism in the assumptions under the economic perspective is generally at least on a par with the level underlying the risk quantification methodologies of the Pillar 1 internal models."

Incorporation of inter-risk and business diversification
We are concerned that the proposed approach can lead to disregard the diversification benefits from banks' business models and overestimates capital requirements for risks under the standardised approach such as operational risk and credit and counterparty risk. 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 recognised in the EBA guidelines for the purpose of calibrating capital requirements. The inter-risk diversification should at least be fully recognised 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 prevents 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
We are of the view that the guidelines are insufficient in prescribing the need for supervisory dialogue, as effective communication is one of the key component of the usefulness of the SREP, and banks require and benefit from clear explanations and substantiated findings. More specifically, with respect to section 2.1.3 - Dialogue with institutions, application of supervisory measures and communicating findings – we believe that the text could be clearer in signalling the responsibility of competent authorities in this regard.

We note that paragraphs 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. The 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?

A high degree of clarity about supervisory evaluation and methods is welcome. However, the guidelines do not allow to make a distinction between risks that are already covered by the existing Pillar 1 requirements

and those that are not covered and can be the basis for the definition of a possible P2R-LR. The guidelines may therefore not ensure a uniform application.

We would therefore support introducing additional requirements in the form of P2R and P2G for the leverage ratio only after first considering any findings from the new reporting under the leverage ratio minimum requirements.

Overall, we would welcome if the EBA clarified 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.

General considerations on content of the guidelines

- The leverage ratio was deliberately calibrated to 3% by the Basel Committee following a long observation period. This level was deemed appropriate in the consideration of EU specificities, in particular with regards 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 a 3% leverage ratio minimum deemed insufficient, and therefore be viewed as a contradiction with an appropriate calibration by the Basel Committee of this minimum in the first place.
- The leverage ratio was introduced 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 become a backstop as it was initially planned, and may become more binding than regulatory capital requirements for the industry. This is important at a time where 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 further clarified and should be subject to prior consultation with the industry.

- Given the importance of the introduction of P2 requirements related to the risk of excessive leverage, the industry wished an impact study would have been carried out by the EBA beforehand, in order to enable a quantitative analysis of the topic.

We have noted that further clarifications are needed in respect of the following paragraphs:

- Paragraph 392: this paragraph mentions as 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 characterisation of situations conducive to excessive leverage and needs to be further clarified. 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.
- Paragraphs 395 and 398: If, on the basis of SREP findings and the ongoing reporting, it became apparent in individual cases that there is a demonstrable risk of an excessive leverage at an institution, in the first instance a dialogue should take place between the supervisor and the bank. Currently, the wording of paragraphs 395 and 398 suggests that the supervision will provide a P2R-LR on a regular basis. We would welcome if the EBA clarified 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.
- Paragraph 393: it is important to consider that the minimum requirement for the leverage ratio was only introduced with CRR 2 as of 28 June 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, clarity should be provided by the supervisory authority and subsequently serve as a starting point for a dialogue between the supervisory authority and the bank.
- In addition, we would welcome further explanation in regard to the e.g. SFTs to collateral swaps. We cannot recognise any arbitrage through a physical exchange of securities by an SFT given 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 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 need cash cannot replace repos

with 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).

- Paragraph 393 a) iii): 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.

- Paragraph 393 d): This paragraph as drafted is unclear, in particular as regards the reference made to the "foreseeable impact of current and future expected losses on the leverage ratio". The 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.

The CRR explicitly provides for exemptions for authorised exposure in Article 429a. We fear that the exceptions provided for by the legislator will be undermined by this guideline. We would welcome 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.

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 reiterates 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?

Please also see our comments on the introduction of additional capital requirements under Question 3.

The question 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 clarified: In this guideline only the risk of excessive leverage is considered and there should 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. Article 104a of CRD 5 (following corrigendum published on July 3, 2020) 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?

We welcome the approach to provide further clarity on the results of the SREP to banks, including how these translate towards the established P2R. Standardisation in the coordination between the supervisory authority and institutions can support this aim. The introduction of a standardised template could be beneficial as it would:

- give the CAs and the industry a simplified view of the required content and structure of SREP decisions (in line with the concern expressed by the EBA in the text box related to Question 1);
- help enhance harmonisation of supervisors' practices and supporting the EBA in its peer reviews, as greater supervisory convergence is one of the EBA's objectives; and
- allow institutions conduct a comprehensive comparison with previous results if all items/risks to be examined were explicitly listed with corresponding references.

In addition, it could also be helpful to provide benchmarking results to provide further transparency on benchmarking across institutions.

Notwithstanding the above, it is important that the introduction of a standardised template would not limit the ability of supervisors to take into account each bank's individual circumstances.

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. Paragraph 362b 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?

Please also see our comments on question 2 and 3.

<u>P2G-LR considerations</u>

With regards to P2G-LR, 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", in particular linked to the EBA stress test methodology's static balance sheet assumption, which is not realistic in an adverse scenario. We would recommend delaying the imposition of a P2G-LR until an observation and use test period allows to assess the relevance and the reliability of a P2G-LR. A use test period is required as for any new regulatory development and would help identify issues highlighted below such as the risk of double counting between P2G and P2G-LR.

Should the P2G-LR be implemented, the above should at least be taken into consideration.

Currently, the framework for the setting of P2G-LR raises methodological challenges and, as it stands, does not seem to provide added value in addition to the P2G:

- the current EBA ST does not provide good data for conclusions as EAD is kept constant throughout the projection (see above);
- there is a risk of overlap between P2G and P2G-LR: on the basis of a static-balance-sheet assumption, the only parameter that varies is the own funds and, in this context, we fail to see the use of a stressed leveraged ratio, with the guidelines not providing any further clarity on this point.

We would like to note that paragraph 423 states 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 material different.

From a composition perspective, P2G-LR is to be filled with Tier 1 capital as a base case. It should be avoided that some authorities require P2G-LR to be filled with CET1.

The first date of application 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?

P2G considerations

With regards to P2G, computation based on stress test results should reflect the materialisation of the whole scenario. Focusing on the worst year may distort results 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 results from this first year not realistic enough.

For adjustments to the P2G starting point it is important to consider any impact from the ST that may be 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.

Regarding paragraph 433 and the inclusion of conduct risk, pension risk, climate risk or some elements of credit concentration risk in the determination of P2G, careful consideration should be made to the fact that these risks are, or at some point may be, also part of the P2R and overlapping should be avoided.

Considerations applicable to both P2G & P2G LR

When setting the P2G and P2G-LR starting points, competent authorities may consider, where relevant, other adjustments to the maximum stress impact related to the static balance sheet assumption or the different time horizon between the stress test exercise and the time of the starting point. It is also important to consider whether potentially unrealistic and artificial methodological assumptions (e.g. the treatment of the FX devaluation) should also be total or partially offset.

We would welcome clarification that in general there is no (non-institution specific) minimum (floor) P2G and P2G-LR.

Members have also noted some concerns on the wording in paragraph 431 where the discretion for Competent Authorities to "…assign a range outside for the relevant bucket, based on institution-specific considerations" could signal a move away from harmonisation of criteria.

Offsetting P2G and P2G-LR with buffers

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.

It is therefore important that paragraph 434 is 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

The consultation paper recommends that climate risk should be included in the series of additional risks that may be considered when assessing the stress test impacts and the calibration of P2G. This can create ambiguity as to the interplay between the climate risk stress test to be carried out from 2022 and the European-wide macro-economic stress test. Those stress tests follow different logics, are based on very different scenario and do not serve the same purpose. The climate risk stress test should be used to identify risks and help evaluate

the adequacy of governance and processes but should not at this stage be used to directly calibrate capital requirements within the P2G.

As previously stated by the EBA, the assessment of 'climate risk' as part of supervisory activity should be incorporated progressively and proportionally[1]. Moreover, a quantitative consideration of these risks should follow future regulatory and methodological developments, as well as consider the availability of necessary data.

To ensure a balanced and homogeneous supervisory approach, it would be useful to explicitly mention that supervisors should wait until the related EBA assessments are performed (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.).

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?

Whilst the methodology for calculating P2G has been clarified, European banks would still require further detail to be able to estimate their P2G and P2G-LR starting points (step 1 in P2G/P2G-LR methodology) and the link between the starting point and the final value of the P2G and P2G-LR (step 2). In each step, competent authorities should clearly explain to banks what elements have been taken into account to determine the starting point (ie paragraph 430) and to determine the final P2G and P2G-LR, in particular the bucketing approach followed by the competent authority (paragraph 431). This will support banks in their capital planning process.

AFME however is strongly opposed to the disclosure of P2G information to the market for the below reasons. Unlike Pillar 1 and Pillar 2 requirements, the P2G is a non-binding supervisory recommendation that provides guidance to banks, based on qualitative and quantitative supervisory assessment, how much capital supervisors expect banks to maintain to be able to withstand situations of severe financial stress.

Since the stress-tests are already in the public domain, we do not see a reason why the subsequent non-binding supervisory recommendations would also need to be made public. Until now, banks do not generally publish P2G because supervisory and regulatory authorities have publicly declared P2G to be non-binding.

Moreover, it is important to recall that P2G does not have any direct effect on triggering the automatic restrictions of the distributions nor on calculating the maximum distributable amount (MDA) (Article 104b paragraph 6 of Directive 2013/36/EU amended by Directive (EU) 2019/878 of 20 May 2019 ("CRD V")). On this basis, EU 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:

Recital 64 of CRR2 clearly states that "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."

We believe it is important to consider that:

[1] As stated in the EBA Report on management and supervision of ESG risks for credit institutions and investment firms, "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".

- 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, 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.
- It may also impact the recent legislative balance as set out in CRR 2 in relation to the MDA framework given that, once disclosed, the P2G will de facto 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.
- Markets may quickly adjust to the P2G becoming a "binding requirement" for banks, reducing also the flexibility banks have in managing their capital and adjusting to the changing P2G recommendations and targets set internally. In essence, it could become a market determined binding requirement above which banks would need to maintain a management buffer and therefore disclosure of it may result in a significant increase in effective capital requirements.
- This would contradict the aim for instance of the SSM to allow banks flexibility to operate below the P2G levels. For example, under the current conditions the ECB is determined to "allow banks to operate below the P2G and the combined buffer requirement until at least the end of 2022, as clarified in July 2020. This leeway should continue to provide temporary capital and operational relief to banks during the coronavirus pandemic, enabling them to absorb losses and support the economy by providing credit to households, small businesses and corporates".
- Any disclosure of P2G may necessitate a review of the capital requirements legislation (level 1), which we do not believe could be the intention.

The ability to maintain the level of the P2G confidential between the institution and its competent authority is strictly linked to the nature of capital guidance to address specific scenarios beyond risks covered by Pillar 2 (P2R). In addition, confidentiality is strictly related to non-binding guidance nature of P2G as it is aimed at capturing forward-looking scenarios.

Besides, the basis for determining banks' P2G levels is how banks perform in the regular EU-wide stress tests, which place banks in one of the four determined buckets, according to the depletion of their capital ratios in the stress test. ECB has already shared information on the P2G range in basis points applicable to each bucket.

In the second step, supervisors set the final P2G for each bank within the range of the bucket, or exceptionally outside that range, taking into account banks' individual situations, such as their risk profiles. As such, the ECB has made public precise insights on the P2G and clear links between P2G levels and the EU-wide Stress Test results (that are already disclosed).

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.

With regard to P2G-LR, please also see our comments on question 3 on postponing the introduction.

From a conceptual point of view we 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 would welcome clarification in paragraph 437 that P2G-LR is expected to be met with Tier 1 capital.

Annex: Further considerations

We have set out additional comments below that we believe are important for the EBA to consider but are not directly related to the questions posed in the consultation.

Recognition of the benefits of 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 risk diversification brought by the different elements. Any assessment that does not take fully into account the benefits of diversification would be limited for the purposes of the SREP.

Concentration in the liquidity buffer
With reference to paragraphs 484 and 493 concerning the concentration in liquidity buffer, it is important to note that the scope of the HQLA concentration analysis excludes sovereign public debt. The fact that an institution public sovereign debt is limited, this may lead to the need to purchase other, less liquid and more risky assets such as ABS, MBS or CB from other financial institutions.

Temporary capital add-on 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 in order to adjust the sizing of the add-on based on the remediation already delivered. Otherwise, a temporary capital add-on becomes permanent.

The lifting of additional own funds requirements applied for model deficiencies are dependent on remedial actions that are assessed through inspections carried out by the supervisor. It is important that the decision to lift the additional own funds should not be unreasonably delayed by the inability of the supervisor to carry out the roll out of the various inspection missions. Good practices as to the normal turnaround time for validating remedial actions could be defined.

Incorporation of AML/CTF

In assessing the ML/TF risk, competent authorities should not only consider if an institution is carrying activity in high risk third countries, but also if the processes implemented by the institution enables an appropriate management of the risk. 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. Competent authorities should established their ML/TF assessment of an institution based on residual risk. We would welcome for this to be acknowledged more clearly in the guidelines, for example in paragraphs 86e and/or 94c.

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 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 request clarification on this point.

The new approach to the assessment of the risks of money laundering and terrorist financing in the guide entails a possible risk of overlap between the prudential and anti-money laundering supervisory functions. It would be desirable to define more clearly how double reporting, double assessment, and double penalties for the same breach in the context of both AML Directive and SREP are to be avoided.

Regarding the incorporation of money laundering risks in the SREP, we find that an intermediate or hybrid solution combining options 1 and 2 would be the most desirable. This would involve including the AML risk review within the existing SREP sections, but with an individualised assessment or scoring for anti-money laundering risks.

In paragraph 147(b), we suggest to delete *"individually and"* as we cannot expect the same level of expertise in respect of each of the directors. What matters is that, collectively, there is a proper awareness of ML/TF risks.

P2R risks

Regarding paragraph 367, we think that competent authorities should pay careful attention when deciding to include risks in P2R 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.

Risk assessment

Paragraph 158 appears to miss a comma between "strategic and business risk" and "step-in risk". We would welcome if the guidelines were to be updated. Additionally, we would like to propose the inclusion of a "step-in risk" definition, given that 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) which state that "The diversity of local rules cannot be considered as filling a gap from an international standard-setting body perspective".

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

- 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
- SREP Guidelines 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 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 parties to absorb the consequent increase of volume that will be generated, (ii) by ensuring that banks maintain their ability to fund their European clients and are not penalised for international activities (ie where 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.

With respect to paragraph 238, it would be helpful to understand whether the expectation is to estimate basis risk as a separate risk class by aggregating all identified basis risks across asset classes, or to treat basis risk as an inherent risk in our market risk stress test.

On paragraph 279, we note that "operational risk tolerance" has been replaced with "operational risk appetite". It is important to consider that banks do not have any appetite for operational risks, they just have

to tolerate them. For example, the banking industry takes credit risk in relation to their activities but it just copes with operational risk, like any other industry.

With regards to paragraph 297, the inclusion of model risk could clash with some of the ad-hoc scenarios that reference model parameters. It would be helpful to get a better understanding of how to incorporate model risk in banks' stress testing process, given it has been identified by banks as a separate risk to other risk types.

Macroprudential requirements
We would welcome clarification as to why paragraph 400 proposes the deletion of the references to "macroprudential requirements". Given that P2R and P2G should reflect a purely microprudential perspective this appears to be counter-intuitive. The paragraph as drafted therefore seems to suggest that the CA does not need to consider macroprudential elements when they set additional own funds requirements.

Also on the topic of macroprudential requirements, we see a propensity for double counting of risks in the capital requirement setting process. Where macroprudential or systemic risks are identified at the level of a Member State (per CRR Art. 458), we would not expect these same risks reflected in banks' additional own funds (per CRD V, Art 104a(1)).

SPE and MPE considerations
We believe that supervisors should take into account the different business/management models of banks under supervision. In this regard, the EBA should also recognise that banks that are organised as a Single Point of Entry (SPE) or as a Multiple Point of Entry (MPE) for the purposes of resolution training. While both of these models can be equally suitable, members have reported of instances where supervisors request information and take decisions without taking into considerations the specificities of each model, for example on liquidity risk.

Scenarios
In relation to the scenarios there is mention in paragraph 134 of "occurrence of probability" and "relevance to the business model". It would be helpful to understand in more detail what is expected in order to determine the occurrence of probability and how it relates to the business model, from a scenario selection point of view.

Avoiding overlap with existing requirements

There are a number of areas where we believe it is important to avoid an overlap with existing regulation and requirements that consider the same issues, to prevent a dual impact on institutions. These are laid out below.

AML Directive, assessment of ML/TF risk and SREP scores / P2R calibration (5.9)
The assessment of this risk will involve competent authorities 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. In particular, we believe that double penalties for a same breach in the context of both AML Directive and SREP should be avoided.

Joint ESMA/EBA Guidelines on suitability and SREP scores / P2R calibration on provisions regarding ML/TF skills (5.9)
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.

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. With this regard, it should be taken into account that another consultation document was published by the EBA on this specific topic on 2 August 2021 and that the relevant comments are expected until 2 November 2021 ("Draft Guidelines On policies and procedures in relation to compliance management and the role and responsibilities of the AML/CFT Compliance Officer under Article 8 and Chapter VI of Directive (EU) 2015/849"). From this perspective, it is very important to ensure consistency between the two Guidelines and avoid any contradiction. It could be also considered to provide for a link to the specific guidelines that will be subsequently issued by the EBA.

Please also note that the 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 147b) 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"[…].

Consequently, we propose to amend paragraph 147 as follows:

"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:

[…]

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~~ the responsibilities for the implementation of the laws, regulations and 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~~;~~

[….]"

Joint ESMA/EBA Guidelines Fit and Proper assessment and SREP scores / P2R calibration (5.2, within 5.3)
We understand that Fit and Proper assessments 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.

It is important that the existing requirements under the Fit and Proper guidelines are also taken into account with regards to the promotion of diversity in paragraph 102.c, to ensure that an overlap is avoided.

General internal governance and institution-wide controls (5.1)

Paragraph 97 refers to "the extent to which the institution complies with the applicable EU and national requirements regarding sound internal governance arrangements " but it is not clear as to scope of national requirements – we assume this to refer to prudential legal requirements (translation of CRD-V into national legislation) but not explicit that it would not extend to more general corporate governance / developments in corporate law.

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.

Regarding the provisions in 104.h on the diversity of staff, including with regards to recruitment policy, we would like to stress that that many countries have already integrated binding requirements in national law which take into account national labour laws. Therefore it is important that the EBA consider this and any potential overlap with the SREP guidelines to ensure a coherent application.

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 significative 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.

Areas to remain out of the scope of the SSM assessment
Some areas should remain out of the scope of SSM assessment powers, as detailed below.

Assessment of reputational risk (6.4.3)
In the assessment of reputational risk, the revised SREP guidelines 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.

Comments in relation to section 5.5 Remuneration policies and practices, under paragraph 105

- *Point c.*

We suggest clarifying 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: "*institutions* ***have properly allocated*** *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;"*

- *Point h.*

We suggest removing the reference to ESRB as followed (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 has responsibilities in the macro-prudential supervision in 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.