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Position of the European Financial Congress[1] in relation to the European Commission's consultation document on implementing the final Basel III reforms in the EU [2]

Methodology for preparing the answers

The answers were prepared in the following stages:

Stage 1

A group of experts from the Polish financial sector were invited to participate in the survey. They received the consultation document and selected consultation questions. The experts were guaranteed anonymity.

Stage 2

Responses were obtained from experts representing:

- banks,
- consulting firms,
- regulators,
- the academia.

Stage 3

The survey project coordinators from the European Financial Congress prepared a draft synthesis of opinions submitted by the experts. The draft synthesis was sent to the experts participating in the survey with the request to mark the passages that should be modified in the final position and to propose modifications and additions as well as marking the passages they did not agree with.

Stage 4

On the basis of the responses received, the final version of the European Financial Congress' answers was prepared.

[1] European Financial Congress (EFC – www.efcongress.com). The EFC is a think tank the purpose of which is to promote debate on how to ensure the financial stability and sustainable development of the European Union and Poland.

[2] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-basel-3-consultation-document_en.pdf

Answers of the European Financial Congress to the consultation questions

Question 1) Views are sought on the relative costs and benefits of the ECRA provided by the final Basel III standards and the SCRA? In particular, how do the two approaches compare in terms of risk-sensitivity, impact on risk-weighted assets (RWAs) and operational burden? Please specify the relative costs and benefits of the two approaches for exposures to i) institutions, ii) covered bonds and iii) corporates. Please provide relevant evidence to substantiate your views.

A comparison of the two approaches supports an expectation for certain differences in credit risk assessment. Conservative banks which use external ratings will most likely deliver higher estimations of RWAs than the other banks, especially in corporate lending. However, for exposures to both institutions and covered bonds, the risk assessment process is much more complicated, and therefore the external rating is a strong support for risk assessment. Nevertheless, in order to properly determine and in some way harmonise the relation between the bank's and the external agency's assessment, as well as to address the accountability of both of them, it would be very advisable for the EBA to develop relevant guidance for banks.

Taking the prudent approach, if external ratings are accepted in the evaluation of credit risk, including creditworthiness (Article 77(2) CRD), assessments of smaller enterprises relying on their ratings should involve assuming a higher risk level than what would follow from the analysis. This requirement could be waived for an agency with a strong experience, documented not just by its years in the business, but also the number of ratings issued or size of rated entities, especially smaller ones.

In addition, it would be appropriate to consider the advisability of monitoring (but not verifying!) the ratings issued by rating agencies. The ratings which turned out to be wrong would be particularly relevant. This could be beneficial even for the agencies themselves, as a default of a highly-rated borrower does not have to arise as a result of a too high rating issued by the agency.

Question 2) Would you deem refinements or clarifications necessary concerning the approach that you generally prefer, and if yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.

There is no doubt that banks find the possibility of using external ratings attractive. However, certain considerations have to be borne in mind:

- A bank assessing credit risk on the basis of a third party rating is not independent in its assessment, and even the requirement of Article 77(2) CRD will not change the situation. Obviously, a rating is not credit risk assessment but, in the nature of things, the bank will always be influenced by the rating, especially if it has been issued by a major rating agency. One needs to be really determined to offer inferior conditions to a highly rated borrower, or even refuse them. The refusal would be perceived as challenging the rating issued by a reputable third party. Furthermore, the bank is always fully accountable for its credit risk assessment, even if in practice a third party is responsible for a certain part of it.

- If a bank were to be fully responsible for a credit approval in both legal and factual terms, it would have to carefully verify the accuracy of the rating. However, in that case the Bank would do without the rating.
- An obvious upside of using external ratings is that they give structure to assessments of the same entity by different banks. Sometimes the credit risk assessment for the same entity differs from one bank to another. At times, the differences are substantial. On the other hand, credit risk management is an art that has been mastered by some banks better than by the others, which allows them to take more risky credit decisions.
- The acceptance of external ratings drives the emergence of new rating agencies (especially in Europe). Their customers are smaller entities, and the rating quality is inferior to that of major agency ratings, for instance due to less experience. Therefore, the use of external ratings issued by smaller and less experienced agencies in credit risk assessments of smaller entities may generate a higher credit risk than in the case of larger customers rated by major agencies.

Question 5) In your view, should the due-diligence requirements differentiate between exposures for which a rating exists and unrated exposures treated under the SCRA (see above 1.1.1.1.), and if so, why? Please elaborate and provide relevant evidence.

Yes, the due-diligence requirements in the two cases should be different. For unrated exposures, the due diligence process should focus on the correctness of the bank's assessment process. For rated exposures, the due diligence process should focus on how much the bank relies on the external rating and to what extent its assessment is independent of that rating, in the first place.

Question 7) In your view, are the quantitative and qualitative criteria for the classification of counterparties into grades sufficiently clear or do you consider more specifications necessary to ensure a harmonised application of these criteria throughout the Union? Please elaborate and provide relevant evidence.

The introduction of an individual quantitative and qualitative assessment of institutional counterparties is a good move, as the current risk-weighting rules (under the standardised approach) for unrated institutions under the CRR focus mostly on the credit rating of the counterparty's country of establishment (as a consequence, a counterparty from a country with a high credit quality rating, despite its own poor financial standing, could be assigned a low RW such as 20% or 50%). On the other hand, due to the fact that most institutions have external ratings from at least one ECAI, it is appropriate to expect that the scope of application of the SCRA approach will be limited.

The quantitative criteria proposed by the Basel Committee are clearly defined, but their practical use can be obstructed by the need to obtain data from counterparties on their minimum capital requirements and buffers (or at least a confirmation that no changes have occurred in relation to previous period) for each reporting date (especially that the obligation would mostly apply to relatively small institutions without external ratings) in order to avoid classification into Grade B or Grade C. The qualitative criteria, on the other hand, provide scope for individual interpretation to institutions determining credit risk RWAs, which could give rise to the expectation that the counterparty credit risk assessment rules currently in place at banks / other institutions will be used to apply them. In this case, as far as – with such general qualitative rules – the interpretations delivered by competent authorities do not force the institutions determining credit risk RWAs to introduce major changes in their risk management approaches, further specifications to the criteria could be unnecessary. This matter should be clarified.

In order to enable banks to make proper assessments, a few more points of concern should be addressed.

- It is not entirely clear if the phrase 'minimum regulatory requirements' includes requirements such as the leverage ratio, TLAC, MREL, and it would therefore be advisable to address them.
- The qualitative criteria are not sufficiently clear and they leave a lot of room for interpretation. There is a risk that evaluation against such risks will depend on the person making the evaluation, which, of course, affects comparability. For example, the statement in the qualitative section "[...]*adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner*." can be quite freely interpreted. As a result, the qualitative criteria will contribute less to the assessment.
- In the description of Grade A, it is unclear which requirement the phrase 'unless they are not made public' refers to. Admittedly, it indirectly follows from the context, but the explanation of the quantitative rules of classification of exposures to 'Grade A' is quite complicated (Grade A is much more clearly defined in paragraphs 21 and 22 of the original BCBS document).
- The description of Grade A includes the phrase 'attracting the lowest RW' – if the definitions from the consultation document are to be used in EU legislation, it would be better to specify the RW value, indicating the consequent RWs for Grade B and Grade C as well.
- It is unclear why the assessment does not consider the impact of complying with supervisory standards of liquidity, especially that the institution's capacity to meet its commitments (together with accrued interest) is stated as a qualitative criterion.

Question 8) What are your views in relation to a potential clarification that also minimum capital and buffer requirements beyond the Basel minima (e.g. higher Pillar 1 requirements pursuant to Article 458 CRR or systemic buffers pursuant to Article 133) should be taken into account for the classification into grades, where applicable in the jurisdiction of the counterparty institution?

If we assume that the requirements of the regulator and supervisor are reasonable, we must recognise that an institution which fails to meet them generates an elevated risk that needs to be taken into account when determining its grade. This is mostly about meeting all capital requirements and buffers imposed on the institutions in line with the rules applicable in their respective home countries. The extent to which they are met allows to take account of the specific home country conditions impacting the risk incurred by the entity and thus the exposure to that risk. This approach additionally minimises the risk of regulatory arbitrage. The approach to individual supervisory decisions adopted in Basel III paragraph 24 (Pillar 2), which requires that individual requirements must be taken into account, or the maximum rating has to be downgraded to B if no information about them is given.

Question 9) Would you deem any other or further clarifications necessary to perform the classification into the three grades? Please elaborate and provide relevant evidence.

No, further clarifications seem to be unnecessary.

Question 11) What are your views on the extension of the scope of the preferential treatment for short-term interbank exposures under Basel III from three to six months for exposures to institutions that arise from the movement of goods across national borders? To what extent would the change in definition change the amount of exposures benefiting from the preferential treatment? Please provide relevant evidence to substantiate your views.

This proposal deserves attention. It takes increasingly more time to close trade settlements, and factoring this in by providing preferential treatment to interbank settlements arising from the movement of goods across national borders for six instead of three months seems legitimate, although any further extension of that period would be too liberal.

According to banks, a vast majority of the exposures have original maturities over 6 months. The extension of the preferential treatment of these exposures from three to six months will increase the number of exposures enjoying preferential treatment, but in most cases it will remain marginal, although a more considerable change cannot be ruled out for certain institutions.

Furthermore, extension of the period of preferential treatment for short-term interbank exposures to six months should support the rebuilding of foundations for cooperation and restoration of trust between banks.

Question 14) What other measures, if any, could be taken to increase the risk-sensitivity of the standardised RW treatment of corporate exposures which currently have no external rating? Please elaborate and provide relevant evidence.

Basel III introduces a more varied set of RWs. Considering the generality of this approach, it does not seem advisable to increase its risk sensitivity.

Question 15) In your view, which other aspects, if any, should be considered in the context of revising the standardised treatment of corporate exposures? Please elaborate.

For exposures to SMEs, the determination of the size of the undertaking and, in consequence, the RW of the exposure, the use of absolute values is misleading because it does not account for the size of the country and the economy in which the undertaking operates. For instance, RWs for exposures to SMEs up to EUR 2.5 million are reduced by a factor of 23.81%. This represents the exemption of the exposures from the recovery buffer. But while an enterprise that is small against the scale of the German economy would be medium-sized in Poland, in a small country it would be considered large, given the scale of its economy. Therefore, it does not seem appropriate for the approach to SME exposures to rely solely on the absolute amount of the exposure. This shows that fixed and absolute parameter values fail to describe the scale of corporate borrowers or the related credit risk. Therefore, to ensure that this approach produces a reasonable risk description, it should refer to relative parameters, e.g. in relation to GDP.

The option of applying a preferential RW of 65% to 'investment grade' corporates should be analysed in terms of the diversity of financial markets across the EU. There are much fewer corporates rated by reputable credit agencies in Poland than there are in Western Europe. The same applies to listed companies. In this context, making the counterparty qualification into 'investment grade' conditional on its rating or stock listing status could unjustifiably inflate the RWs of corporates in Poland.

Question 26) In your view, should the discretion for "national legislated programmes" provided by the Basel III standards should be implemented in the Union? If you disagree, please explain and provide relevant evidence to substantiate your view.

Yes, this option should be implemented in the Union.

Question 27) Would you deem additional safeguards necessary to ensure that only exposures under legislative programmes that effectively reduce the risk can benefit from the preferential RW? For instance, should the preferential RW for exposures subject to national legislated programmes be made dependent on evidence of lower riskiness of respective exposures, and if yes, what kind of evidence would be adequate?

This additional safeguard is necessary. The definition of a national legislated programme in itself does not offer a guarantee of an effective reduction of the risk exposure. Without this reduction, a lower risk rate in relation to other exposures not covered by the programme would not be reasonable.

Question 28) In your view, how should "national legislated programmes" be defined within the context of the Union? In particular, would you deem further refinements or clarifications necessary concerning the existing definition, and if yes, what would those be and what would be their prudential rationale? Please elaborate.

The essence of a national legislated programme is the effective reduction of the risk exposure. It seems that at the current stage it would be difficult to come up with a single universal definition that would be equally relevant in each Member State. An obligation could be possibly introduced to submit national definitions to the EBA which, where necessary, would comment on them and subsequently, after adjustments, approve them and publish on their website. This would be similar to the approach used for equity instruments.

Question 29) Views are sought on the costs and benefits of introducing the sub-asset class of transactors for regulatory retail exposures and specifying the treatment for other retail exposures. In particular, how does the approach provided by the Basel III standards compare with the current approach in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

The proposed approach classifies retail exposures into three categories depending on the risk level, which is reflected by three different RWs attached to each category. A lower RW for exposures to transactors is justified by the short clearing time, along the same lines as the increased RWs for other exposures, which should not be very common. As a result of the change, banks should benefit from an improved match between capital charges and the risk of each category of exposures.

Question 34) Views are sought on the relative costs and benefits of the LS approach and the WL approach provided by the final Basel III standard. In particular, how do the two approaches compare in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

Both approaches permit the portfolio to be divided into risk 'classes', but they provide for a different setup. Both of them are also quite easy to implement. The difference in capital requirements arising from the WL and LS approaches changes in the LTV function, but it is not too large. However, the WL approach which makes the RW of an exposure dependent on the LTV of that exposure, is more risk sensitive and more correct from the methodology point of view. If an exposure is secured by real property to a greater extent, a lower RW for the entire exposure is justified. The implementation of this approach should not entail any significant operational restraints on the banks side (LTV is monitored), however it will necessitate changes to IT systems.

It does not seem appropriate, however, to allow banks to choose their approach. Despite the similarities, the approaches are different. This could lead to regulatory arbitrage and hamper the comparability of data between banks. Therefore, it is not advisable to let individual banks choose the approach in their own discretion. The decision would have to be made by the country regulator. But, given the drive towards cross-border mortgage banking, a mechanism which, in turn, would lead to regulatory arbitrage between jurisdictions should not be introduced. A question would then emerge right away: if a bank originates from a country that uses one approach and it offers lending in a country that uses the other approach, which of the approaches should the bank follow in the host country?

Question 35) Would you deem further refinements or clarifications necessary concerning the approach that you generally prefer, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

The LS approach is very attractive in the context of risk management. It assumes that only loans up to 55% of the real property value are mortgage-backed loans with an RW of 20%, and the remaining part of the loan is an unsecured exposure with an RW appropriate for the borrower (usually 100%). With the WL approach, in turn, the RW gradually increases alongside the LTV. Despite the fact that the final values of capital requirements can be similar in both approaches, the LS approach can be perceived (by bankers and clients alike) as a method which, much more than the other one:

a. prefers housing loans with high own contributions,
b. discourages borrowing the maximum amounts arising from creditworthiness assessments,
c. discourages borrowing for other purposes under the pretence of borrowing for home purchases

From a prudential viewpoint, the WL approach is much safer than the LS approach. In the WL approach, an exposure is composed of two parts with different risk exposures (as confirmed by different WLs) which, however, together form one exposure. If a client were to default, this division would be of no use. The client would default (in appropriate proportions) on the low-RW secured portion of the loan and the high-RW unsecured portion of the loan. Therefore, in practice the division is a mere formality. However, the WL approach is much clearer, and it should also be simpler from the perspective of bank IT systems.

Question 36) What would justify implementing both approaches in parallel from a risk perspective? If both approaches were to be implemented and made available on discretionary basis, how would comparability across institutions be ensured and how would regulatory arbitrage as well as undue complexity be prevented in this case?

It would be irrational to accept both approaches. Firstly, the LS approach entails a lesser capital burden. Therefore we can assume that banks will choose this approach anyway and they will not engage in any arbitrage. If, however, a requirement is introduced to grant a certain percentage of lending using the WL formula, the credit would be more expensive, due to the higher capital requirements. Thus it would be less attractive for clients and, most likely, it would not succeed on the market. Therefore, to accept both solutions would be an utterly irrational and ostensible step taken with the sole purpose of showing that the banks' offerings include lending conforming to the Basel standard, but the clients are not interested.

Question 37) Do you consider the assessment of the condition of "strong positive correlation" on a portfolio basis more appropriate than the assessment based on the individual RE exposure, and if yes, why? Please explain.

IPREs are a particular kind of exposures. The funds for repayment are generated by the property itself and not earned by its owners. Whether a real property will be capable of generating the required income depends on the market situation, quality of the property, its location, fashion trends etc. While the rental market situation is the same for a large group of real properties, which enables the portfolio approach, the real property parameters, the owner's attitude towards rental and a range of other individual factors may vary considerably from one real property to another. This would make the portfolio approach more difficult, if not totally impossible. All in all, IPRE products involve a higher risk which could only be offset by a sufficiently good financial situation of the borrower.

Question 38) If the assessment based on a portfolio basis were introduced, what are your views on whether it should be the only approach available in the Union or it should be an alternative approach to be applied at supervisory discretion on a case-by-case basis? Please explain.

IPREs represent a higher-risk segment of the mortgage lending market. Additionally, the reply to the previous question shows that the portfolio approach should not be used here. On the other hand, the portfolio approach is more attractive for banks, as it does not require any analysis on a case-by-case basis and is therefore less costly. For that reason, if the two approaches were both accepted as alternatives, banks would still seek to use the portfolio approach. However, it is difficult to identify the criteria to be used by a supervisor granting approval to the applicant bank. It might be possible to identify the parameters characterising IPRE exposures for which the portfolio approach could be used, but two methodologies would then be required, entailing higher costs.

Question 39) What are your views on the costs and benefits of implementing the preferential treatment for certain properties under construction as provided by the Basel III standards? Please provide relevant evidence supporting your view.

The preferential treatment for properties under construction as collateral for construction loans is justified. In this case, it is very important that the property is or will be owner-occupied. Experience shows that problems with repayment do not appear until a few years after the construction is completed and the property is occupied, which is when we are dealing with a situation similar to that in which a finished housing unit is purchased and the transaction is financed by a loan. Therefore, preferential treatment would be rational in that case.

Question 40) Do you consider the threshold of one-to-four family residential housing units appropriate, and if not, which other threshold would you consider to be more appropriate? Please provide evidence supporting your view.

It seems that the purpose of restricting the preferential treatment to four residential housing units is to prevent more rental apartments from being constructed with the use of loans with a lower capital charge. Setting the threshold at four residential housing units will meet the demand even of a large family. On the other hand, the number of units is not enough to talk about any economic activity. It needs to be added that the person(s) taking out a loan must demonstrate creditworthiness which means being able to repay the loan using own funds rather than cash flows generated by the rental property, which is the case with the IPREs.

Question 41) Views are sought on the costs and benefits of the valuation criteria provided by the Basel III standards. In particular, how does this approach compare with the current approaches available under the CRR (MV and MLV) in terms of simplicity, comparability, risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

The CRR allows two valuations: MV, a current market valuation, and MLV, known to be more prudent and used in some countries, including Poland. In practice, MLV corresponds to the Basel III approach. The MLV procedure is more complex than the MV procedure, although considering the requirements for MV determination and MV verification by the bank, it can be assumed that the workload and complexity are similar for both approaches.

Question 42) Would you deem additional specifications necessary to clarify how the MV or the MLV currently used by institutions would need to be adjusted to meet the valuation criteria provided by the Basel III standards? Would you deem further clarifications necessary to ensure a consistent application of the valuation criteria across the Union? Please elaborate.

The MLV which is used by mortgage lending banks in Poland comes down to taking account of real property price evolution cycles in valuations. Future developments can be determined based on historical data. MV is used as the point of departure and subsequently adjusted depending on the price evolution cycle phase in which the MV was determined. The goal is to reduce the MV to the level it would reach at the lowest point of the cycle. Owing to that, MLV will be mostly lower than MV, but it will never be higher.

The acceptable principles of valuation of real property collateral have to be clearly specified in the planned legislation. Adequate legislation quality in this respect is necessary in order to maintain sufficient cohesion across the Member States.

Question 43) What other measures could be taken to ensure that the value of RE collateral is sustainable over the life of the loan? Please elaborate and provide relevant evidence.

The approach used in Poland includes safety buffers which additionally reduce MLV in relation to MV. Certainly, in the case of significant changes on the real property market (both decreasing and increasing prices), MLV can be re-established.

Questions 45 to 47

45) Views are sought on the costs and benefits of capping the property value at loan origination. In particular, how does the approach provided by the final Basel III standards compare with the current approach of the CRR in terms of possible cyclical effects on RWs, risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.

46) What other measures or safeguards could be provided to address possible cyclical effects of the re-valuation of real estate property? Please elaborate and provide relevant evidence.

47) In your view, which other aspects, if any, should be considered in the context of revising the requirement for re-valuation of RE collateral? Please elaborate and provide relevant evidence to substantiate your views.

The answers to these questions largely coincide with the replies to Questions 42 and 43. However, the following points should be noted. If real property is valued at the peak of a cycle, the valuation will be lower at any other point of the cycle. This demonstrates that it is not reasonable to cap the property value at loan origination. Using the MLV would be a better approach.

In line with Article 208 CRR, changes must be monitored and, where necessary, property valuation needs to be reviewed. The above approach, which factors in the cyclical changes in property value, avoids most of the problems. Monitoring would consist in checking if the instantaneous property value does not fall below the estimated MLV in a downturn phase. The valuation does not have to be reviewed as long as monitoring does not show that this is likely to happen.

However, it should be borne in mind that aside from the cyclical fluctuations in property prices, there might be permanent trends which should be taken into consideration. This includes a sustained increase in prices. Therefore, capping the property value at loan origination entails a high risk of underestimating the value of collateral. As a rule, mortgage loans are granted for a long period of time, during which property valuations are likely to increase on a permanent basis. Should this be the case, the inability to remeasure the collateral reduces the sensitivity of the model to the actual risk and may unjustly restrict the financing of the economy.

Monitoring should make use of statistical methods as far as possible. Therefore, two additions to the new CRR version would be advisable. Firstly, property valuers in some countries have very broad powers which they use to ensure that every valuation or value review activity can only be carried out by a licensed property valuer, which practically excludes the use of statistical methods. Therefore, the current Article 208 should require rather than only accept the use of statistical methods.

The point of reference should be a relative parameter (LTV) and not the absolute property value. As the exposure decreases, the variability of LTV due to a potential MLV decline becomes lesser and lesser.

Question 48) What are your views on the costs and benefits of replacing the existing treatment of 'speculative immovable property financing' with the treatment of ADC exposures as provided by the Basel III standards?

The Basel III approach is narrower than the current CRR approach. CRR rightly treats all speculative property transactions in the same manner. Purchases of real property for resale always bear the risk of being left with an unwanted property if the counterparty backs off unexpectedly. This risk would be eliminated only if a separate contract was concluded to guarantee that the property will be purchased by the counterparty. But this operation would be of a technical nature and it should not be contemplated here.

Question 49) Would you deem further refinements or clarifications necessary concerning the scope or definition of ADC exposures, and if yes, what would those be and what would be their prudential rationale? Please elaborate and provide relevant evidence.

No, they do not seem necessary. The definition in the CRR is sufficient.

Question 50) In relation to the condition for applying the preferential risk weight of 100% to certain ADC exposures, do you consider further specification necessary to ensure a harmonised application of this condition across the Union, for example by defining or quantifying any of the terms mentioned above? Please elaborate and provide relevant evidence to substantiate your views.

In accordance with footnote 52 in "Basel III: Finalising post-crisis reforms", national supervisors are obliged to give guidance in this respect to be applied in their jurisdictions. On the other hand, the markets of the individual Member States are still very local, which makes them overly different. Therefore, further specification in the context of Question 50, in order to harmonise the application of the preferential risk weight to ADC exposures across the entire EU, would be necessary. The ambiguity of the phrases 'significant portion of total contracts', 'substantial equity at risk' and 'substantial cash deposits' offers an opportunity for abuse and speculation, and leaving the matters of definitions to national supervisors could increase the risk of regulatory arbitrage.

Question 51) What are your views on the costs and benefits of introducing the RW multiplier described above? Please provide relevant evidence to substantiate your views.

Foreign currency mortgage loans for individuals, non-professionals who are unable to hedge against FX risk, endanger borrowers and undermine the stability of banks, or – in specific situations – of the entire financial system of the state. The history of the 1990s crisis in Sweden and Italy clearly shows how great the impact of the crisis can be – the extent and magnitude of losses.

The issue of foreign currency lending should be considered in two categories: new loans (flow) and loans already granted (stock). While the former has almost disappeared and occurs only occasionally in the Member States, the latter is still present and will continue to be repaid even for the next 15 years. During this period, very large and unfavourable fluctuations in exchange rates are likely to occur, against which the borrowers are not hedged. Changes in the interest rates of the loan currency can also be adverse. In addition, they make it difficult for local monetary authorities to pursue their own monetary policies.

Past experience has provided a number of arguments against the return to foreign currency lending. The future currency risk which is likely to materialise additionally justifies the liquidation of the existing portfolio. Recommendation ESRB/2011/1 is very helpful in this context. However, if the interest rates were to rise and a strong interest rate disparity reoccurred, the banks' appetite for foreign currency loans could revive. Therefore, regulatory and supervisory measures are required to safeguard the banking system and its clients against such foreign currency lending. Undoubtedly, introducing the RW multiplier would be a desirable move, as it would significantly increase the capital cost of such loans. This would act twofold: firstly by impacting the current FX loan portfolio and increasing the likelihood of reverting to the national currency, and secondly – which is more likely – it would discourage new foreign currency lending.

It seems, after all, that an increased RW should also be applied in other situations where clients are offered a product with a significant market risk, affecting the clients' ability to repay the debts.

Questions 52 and 53

52) In your view, what other measures could be taken to address the risks associated with currency mismatches? Would the restriction of this measure to retail and residential RE exposures to individuals be appropriate to tackle such risks in the EU? Please elaborate and provide relevant evidence.

53) In your view, which other aspects, if any, should be considered in the context of revising the treatment of exposures with currency mismatch under the SA-CR? Please provide relevant evidence to substantiate your views.

There is a number of instruments which could mitigate or even eliminate the risk of foreign currency lending.

For existing foreign currency loan portfolios, aside from capital restrictions, a requirement should be introduced to perform stress tests assuming the depreciation of the national currency by 30% and an increase in interest rates by 300 bps over the national interest rate level. For individual foreign currency borrowers, there should be a requirement to inform the bank on an annual basis of the borrower's income levels and to estimate the borrower's current creditworthiness on that basis. This would be an additional factor describing the risk of foreign currency loan portfolios. The results of both tests should be taken into account in the annual SREP. The measures would be geared at making the foreign exchange risk assessment for the portfolio of existing loans more realistic. As a side effect, banks might be encouraged to change the loan currencies to the national currency.

That said, the return of foreign currency lending cannot be ruled out. For new loans, the foreign exchange risk and interest rate risk should be approached with great caution. The assessment of creditworthiness should be performed for the credit amount in the national currency plus 30% and an interest rate exceeding that of the national currency by 300 bps. With such buffers, foreign currency loans can only be granted to affluent clients who are much more resilient to foreign exchange risk and interest rate risk. Using this approach, the foreign currency loan portfolio is more resilient to significant exchange rate and interest rate hikes. Moreover, given the considerably higher risk of foreign currency lending, supervisory authorities should take the management of the foreign currency lending segment (existing and new loans) into account in their assessment of whether bank authorities are capable of managing the bank in an efficient and safe manner (the fit and proper test). Foreign currency loans can be financially advantageous to banks and therefore bank shareholders may exert pressure on the bank's authorities so that they do not restrict this business segment. Therefore, the same fit and proper test should apply to the bank's main shareholders.

Question 62) What are your views on the costs and benefits of reducing the scope of internal modelling as described above? In particular, how would this reform impact the robustness and levels of RWAs for the affected portfolios? Please provide relevant evidence to substantiate your views.

The use of internal modelling always offers scope to reduce capital requirements and increase profitability ratios. In consequence, profitability ratios for entities using internal modelling versus supervisory modelling could be incomparable. The introduction of new rules will surely guarantee an improved general comparability of the results published by credit institutions. At the same time, reducing the scope of internal modeling could render credit institutions with simpler business models more competitive, while institutions with more sophisticated portfolios will have to change their profiles or adjust the said models.

The small scale of such transactions and, above all, the low number of defaults in this group makes robust risk modelling difficult. I believe that the model risk is high enough in this case to justify the restriction of the use of AIRBA. The supervisor's modelling (model calibration) capability improves owing to access to a much more extensive database, so taking the FIRBA or SA-CR approach would be more conservative (for FIRBA it would significantly reduce the model risk).

As a matter of principle, we should agree to the restriction of the internal rating method to large portfolios where a robust estimation of risk parameters is possible. This arbitrary restriction in the form of an absolute threshold seems to be clear, but it is irrelevant for smaller economies or banks, and, as part of its individual assessment of IRB applications, the supervisor will or at least should examine the eligibility of the portfolios concerned for inclusion in the scope of application of the A-IRB approach.

The low default models bear an inherent and significant risk of incorrect risk level estimations. The new solution restricts the application of LGD and EAD models to such portfolios. As a result, the approach to LGD and EAD becomes harmonised across all EU Member States.

The LGD and EAD models will be therefore excluded from capital requirement calculations, which does not preclude their use for other purposes, such as economic capital or pursuing pricing policies.

Question 87) Views are sought on the treatment of sovereign exposures proposed in the BCBS consolidated framework referred to above. In your view, how would the exemption from the removal of the IRBA and from the input floors, on the one hand, and the implementation of the remaining reforms of the IRBA, on the other hand, impact the robustness and levels of RWAs for sovereign exposures treated under the IRBA?

In view of difficulties in risk modelling of sovereign exposures (in particular due to rare events of default), the model risk is very high, so a relatively conservative approach is advisable (the input floors should be kept, as a minimum). Another reason is that very low RWs consistently encourage banks to keep treasury bonds in their portfolios. In the context of the so-called diabolic loop problem, it would be advisable not to encourage banks any more to maintain higher sovereign debt exposures.

Question 88) What are your views on the costs and benefits of the proposed treatment of PSEs and RGLAs resulting from the changes applicable to exposures to central governments and exposures to institutions compared to the current framework? Please elaborate and provide relevant evidence.

This is not a good solution. Firstly, as a result of accepting a twofold treatment of PSEs and RGLAs, the RWAs of a single exposure can be different, leading to arbitrage. Secondly, the experience of the last decade shows that exposures to local authorities could entail a much higher risk than exposures to central governments.

Question 106) Would you deem further refinements or clarifications necessary in this context to ensure consistency across the Union? Please elaborate and provide relevant evidence.

For guarantees not covering the entire exposure value, it would be necessary to specify how to calculate the amount of expected loss and what allowance should be used to calculate the IRB shortfall *(EL – SCRA)*.

Question 115) As an alternative option to implementing minimum haircut floors for in-scope SFTs in the prudential framework as provided by the Basel III standards, such floors could be implemented via a market regulation. How would you compare the two alternative options in terms of achieving the prudential objectives? Would one of the two options affect more significantly the SFTs market? Please provide relevant evidence to substantiate your views.

As any other arbitrary method, implementing minimum haircut floors ignores the role of qualitative assessment components. It seems that in this case, the FSB proposal for SFTs is more rational market-wise and will support the development of the security market.

Question 123) How would exercising the discretion affect the link between capital incentives and management of operational risks? Please elaborate.

The new approach to banks with a BI that exceeds EUR 1 billion involves certain dangers.

Firstly, it is up to the supervisor to decide if the capital charge for operational risk will be increased based on loss history or not. We could imagine two similar banks in two different jurisdictions of which the better managed one has an ILM > 1, and the other, poorly managed one incurs higher operational risk losses and has a lower capital charge because its supervisory authorities set the ILM to 1.

Secondly, we can hardly agree that if an institution has experienced greater losses historically, it is more likely to experience such losses in the future. This claim rules out scenarios where the institution makes an effort to improve, in which case the ILM design can have a dissuasive effect on banks. Imagine a bank whose operational risk losses have been consistently growing for a decade. After ten years, the bank decides to take measures to reduce the losses. In the eleventh year, despite the huge effort, the improvement is only nominal and as a result the ILM does not decrease, on the contrary, it goes up. The same thing could happen over the next few years. From the perspective of the bank, the process is not going to be cost-effective. The bank will spend a lot of money to improve the situation, its losses will decrease, but the capital charge is going to rise. This will have a strong dissuasive effect.

Question 124) Would you deem it necessary to mitigate possible cliff effects that might derive from the introduction of an institution-specific ILM? If so, which measures should be considered, for how long should they be applicable, and what would be the prudential rationale to implement them? Please elaborate.

It follows from the standard that ILM is to apply to the entire BIC. This way, in a bank where BI is close to EUR 1 billion, a slight increase in BI would result in a strong increase in BIC. It would be advisable to harmonise the requirements so that ILM only inflates the portion of BIC for which BI => EUR 1 billion.

Furthermore, without questioning the rationale behind sanctioning poor operational risk management, this component should still be calibrated appropriately. 10 years is a very long period, and there might have been successive changes at the bank's top management level. As a result, despite efforts made by its current authorities, the bank would pay for the negligence of their predecessors. First of all, the appropriateness of looking at losses over such a long period should be thought over. It seems that 5 years could be more suitable, and the negative effect described above would be strongly minimised.

Question 125) What are your views on how a loss data threshold that is increased for some institutions may affect the soundness and risk-sensitivity of the operational risk framework, the volatility of the ILM, its comparability between institutions, and the incentive to carefully manage small to medium-sized losses? Please specify your views.

The minimum operational risk capital (ORC) is defined with the tacit assumption that ILM must not be lower than 1, as in that case, the expression determining ORC for buckets 2 and 3 becomes identical to the expression for bucket 1. However, if the Loss Component (LC) is lower than BIC, ILM will fall below unity. For instance, if LC/BIC = 0.9, ILC will equal 0.97; when it falls to 0.75, ILM will equal 0.92. For LC = 0, ILM would be 0.54.

Certainly, this is an extreme case. Theoretically, it could occur in two situations: when the bank brings down all operational risk losses to zero, which is quite unlikely, or if all losses are below the threshold. This is why setting the right threshold is so important, especially when BIC is only a little above EUR 1 billion. The graph of the ILM function would require a thorough analysis.

For example: a bucket 2 bank, BI at 1.1 billion, BIC at 135 million, which means that for an average annual loss of EUR 9 million, LC/BIC ILM equals 1. If the losses are lower, ILM values will decrease along with the losses. Meanwhile, for a somewhat smaller bucket 1 bank with a BI of no more than EUR 1 billion, ILM will always equal 1. This way, the operational risk requirement for the bucket 2 bank can be lower than that for a smaller bucket 1 bank.

Question 126) If the discretion was retained, which conditions and criteria should be introduced in order to ensure a level playing field in its application by supervisors? Please elaborate.

Given the answer to Question 125, two restrictions should be introduced:

Firstly, the condition ILC >= 1 should be added to the expression describing ILM.

Secondly, it seems that raising the thresholds would be aimed at limiting the risk sources generating the highest loss per unit. However, it is easy to imagine a situation where the total loss generated by a bank is large, but it is almost totally made up of a high number of items below the threshold. Therefore, supervisors should use a lot of caution when consenting to a bank increasing its limit to EUR 100,000, because such an operation excludes some losses from the LC calculation, especially for smaller banks. Therefore, it would be advisable to add a new condition such as that once the limit is increased, LC must not be lower than, for instance, 80% of all losses. Then the adverse effect when transitioning from bucket 1 to bucket 2 would be negligible.

The EBA could also potentially develop guidance addressed to local supervisors, specifying the conditions and qualitative criteria, while the quantitative parameters should be calibrated to local conditions and approved by local supervisors. For example, Poland has a loss database in place with a EUR 5,000 threshold.

Supervisor's consent to the application of an EUR 100,000 threshold by bucket 2 and bucket 3 institutions should be subject to the existence of uniform and specific guidelines which will ensure that:

- the related operating losses are aggregated by all institutions in the same, proper way and they are correctly allocated to years,
- in each operational risk category there will be representative operating losses for the institution concerned.

Question 128) What are your views on how this discretion might affect the overall level of own funds for operational risk of bucket 1 institutions and the comparability within bucket 1? Please elaborate your views.

The answer depends on the structure and amount of losses of a bucket 1 bank. If the losses are so high that LC exceeds BIC, the capital requirement for the bank will be higher, and the sensitivity of the method will increase, as the capital required will depend not only on the size of the bank itself, but also on the amount of losses.

On the other hand, by contrast, if BIC is lower than LC, ILM will be less than 1, the use of this option by the supervisor will result in ILM falling below 1, and the capital requirement will be reduced.

Question 129) If the discretion was retained, which conditions and criteria should be introduced in order to ensure a level playing field in its application by supervisors? Please elaborate.

Answers to this question were already given in Questions 125 to 128. It seems that the intention of the authors of the new approach was to increase the capital requirement for large banks (buckets 2 and 3) for which the ILM would need to be not lower than for bucket 1. However, in some situations – depending on the distribution and amount of losses – the ILM parameter can potentially reduce the capital requirement. Therefore, to maintain a coherent approach irrespective of the bank size, one of the following two solutions should be adopted:

- ILM for bucket 1 is constant at 1, and for buckets 2 and 3 ILM is not less than 1; or

- ILM for bucket 1 is variable and it depends on the amount and distribution of losses, and then for buckets 2 and 3 ILM can take any value.

Furthermore, extreme caution should be used when setting the rules for including losses in the LC calculation so that they cover a vast majority of losses, no less than a certain portion of the portfolio. The suggested value is 80% as a minimum.

Question 130) If the discretion was retained, do you consider this could help smoothing the transitioning of institutions from Bucket 1 to Bucket 2? Please elaborate.

In both situations referred to in the question above, and therefore in particular if the discretion was retained, the transition from bucket 1 to bucket 2 and from bucket 2 to bucket 3 would be the same in qualitative terms, so the use of discretion would smooth the transitioning from bucket 1 to bucket 2.

Question 131) What are your views on the discretion for supervisory authorities to request the institutions to use less than 5 years of loss data (when the ILM >1)? In which circumstances would such a request be justified? Please elaborate and provide relevant evidence.

As a rule, a shorter loss history should not be accepted, especially based on an arbitrary decision. The basic reason is that taking a loss history of less than 5 years could lead to distorted results due to the limited representativity of the sample.

If a 10-year time series of losses was retained as the baseline, shortening the data period to 5 years would be justified when:

- Discontinued operations generated a significant loss in a period of more than 5 years.
- In the case of a merger, when the historical losses of the merged entities are not relevant to the current business profile.
- Downsizing of operations (e.g. as a result of financial decisions, regulatory changes or a systemic deterioration of the macroeconomic situation of the country, when the historical losses are not commensurate with the results achieved in the current conditions).
- Significant changes in EUR exchange rates which substantially affect the level of historical losses included in the ILM calculation.
- The institution will factor in good quality data from 5 years and it will extend the period by a successive year of data every year until it reaches 10 years.
- The institution has validation processes in place that operate in a sound and effective manner.
- The institution subjects its risk management processes and measurement systems to regular reviews performed by internal or external auditors.

Nevertheless, there are some exceptional situations where a dilemma arises: is the actual operational risk better described by sufficiently long data series that relate to a different situation than the current one, or perhaps by series of less than five years that relate to the institution's current situation. In such cases, the supervisor should have the option to temporarily shorten the loss history in order to better reflect the current operational risk level of the institution concerned. For example:

- an institution after a demerger – inclusion of data for demerged assets will distort the picture of operational risk of the institution post demerger, which often involves a change of business profile (e.g. from an all-purpose bank to an entity serving a single market segment, or from an all-purpose bank to an entity that has discontinued its ongoing banking operations and only administers selected legacy credit portfolios).

- a merged institution – in accordance with OPE 25.34: the scope of losses and Business Indicator (BI) items used to calculate the operational risk capital requirements must include the acquired business (institution) over the period prior to the merger that is relevant to the calculation of the standardised approach (ten years for losses and three years for BI). Due to business secrecy, the acquiring institution might not have this data over such a long time horizon (for acquired assets), and a calculation of the operational risk requirement including the institution's pre-merger data could significantly distort the operational risk level and the related capital requirement.
- the institution has carried out its operations for less than 5 years and the supervisor recognises that its operating losses correspond to its operational risk exposure.
- for new institutions which do not have a long-term history of losses, there needs to be an option of using less than 5 years of loss data on a temporary basis, provided that this period is successively extended.

Question 132) What would you consider to be the appropriate thresholds for allowing a request for exclusion of loss events from loss data history, for current and divested activities? Please explain and provide relevant evidence to substantiate your views.

The suggestion of 5% of the average annual losses does not seem appropriate. This way high but atypical losses can easily disappear from the history of losses. You could consider the possibility of removing atypical losses after a three-year retention period, provided that the total of losses to be removed is no more than 5% of the portfolio included in LC and the atypical cause of such loss did not recur during that period.

Question 133) What would be in your view an appropriate minimum retention period for the losses that will be excluded from the loss dataset? What would be an appropriate starting point of this period? Please explain and provide relevant evidence to substantiate your views.

The loss retention period should coincide with the period of collection of loss data, which is five years, but for less complex banks and small markets in the development phase, this period could be reduced to three years. Losses under (for instance) EUR 1,000, and not affecting the bank's financial result, should be excluded from the set. Losses affecting the financial result should be included in full. The starting point of the period should be linked to the booking date. All significant losses, e.g. starting from EUR 10,000, and severe losses, e.g. starting from EUR 100,000, should be recorded.

Question 144) Which elements of the revised SA-OR, if any, would you deem particularly challenging to be implemented? Please elaborate and rank your answers from the most challenging to the least challenging revision. Please provide relevant evidence on the one-off costs to substantiate your views.

1. From which day should the EUR exchange rate be applied to calculate the operating losses and the component of the business indicator? If the SMA requirement is calculated in EUR, what EUR exchange rate should be used to report the requirement in national currency? (FINREP).

2. What is the frequency of calculation of the SMA requirement?

3. At the consolidated level, should the SMA requirement be calculated as the sum of SMA requirements across all group companies, or based on the consolidated profit and loss and balance sheet of the Bank as well as the losses of the group of companies?

Question 179) Views are sought on the relative costs and benefits of applying the OF at all levels of the banking group (i.e. individual, sub-consolidated and consolidated) or solely at the highest level of consolidation in the EU. In particular, how do the two approaches compare in terms of impact on RWAs, comparability, complexity and operational burden? Please provide relevant evidence to substantiate your views.

The OF should be applied at each consolidation level. It is relevant to the RWA calculation and the required level of own funds. These figures, in turn, impact a range of parameters that describe the risk associated with the bank's business and the bank's resilience to that risk. Therefore, the parameters are of key importance to the assessment of bank safety, and – for systemically important banks – to the assessment of the stability of the domestic financial system.

The amount of risk associated with the bank's business does not depend on the regulations describing this risk. No matter how we determine the amount of capital necessary to balance the risk generated by the bank's assets, it is still only a measure of this risk defined by the regulator. A regulatory change will not affect the actual risk level but rather the amount of capital we need to balance this risk. Therefore, the discussion about Output Floor should be understood as considerations on the minimum amount of capital required to guarantee that a bank will be safe. If, therefore, OF is set at a lower level, the bank will be less safe, and if OF is higher, the bank will safer, although we should not assume that the bank will really need as much as this higher amount of capital.

How should we understand the considerations on the consolidation level then? Is it possible to impose a requirement increasing the capital requirement at the consolidated level, but maintaining the existing, less stringent approach at the sub-consolidated or individual level? There is no clear answer to this. Most likely yes, if the subsidiaries are small non-complex and not relevant to the group or to the domestic financial system. Certainly not if the group is engaged in cross-border activities and its subsidiaries are located in other countries, are systemically important there or are public companies. In the latter case, the rules applicable to public companies, shareholder rights, have take priority over the prudential rules.

Therefore, for public companies OF needs to be applied at the subsidiary level as well. If the subsidiaries are systemically important in their respective countries, the risk measure, the capital requirement, have to be the same both at the level of the group and at the level of systemic bank subsidiaries, even if a bank is of minor importance to the group but has a systemic relevance in its country. National authorities are responsible for its safety and they must always have the mandate to make final decisions relating to the bank's safety, because they are responsible, together with the institutions of the national safety net. An exception could be groups fully supervised by SSM, covered by the EU deposit guarantee scheme and the resolution mechanism. This rule should apply irrespective of the cost of application of OF at each level, not just the consolidated level.

Attention should also be drawn to the risk of regulatory arbitrage in a cross-border group in which some banks use advanced methods and the other use the standard approach. In such a case, the group could lend to good clients through the banks using advanced approaches and to poor clients via the rest of its banks. As a result of this division, excessive risk would be generated in some countries, but at the consolidated level there would be a reduction in the capital requirement, although the aggregate risk across the group would remain unchanged.

Question 188) Once EUCLID is fully implemented, would you support that the EBA, on the basis of the collected supervisory data from all institutions established in the Union, centrally discloses the information of all those institutions that are subject to disclosure requirements under CRR/D, thereby relieving institutions from mandatory disclosures?

Central data disclosure is different from central generation of data. Harmonisation of data is critical to its comparability. Therefore, it is crucial to develop definitions for all disclosure items using reporting data (CREP, FINREP) and, where necessary, non-reporting data. This standardisation will offer a guarantee of comparability. However, the data disclosed have to be calculated and published by banks themselves.

The disclosures are information allowing market participants to evaluate a bank's financial situation and the risk it generates. This pool of information, being a dataset processed by the bank itself, constitutes information which should encourage the bank's authorities to manage the bank in the best possible manner due to the fact that the data is being made public. And if the information pertains to the bank itself, it should be published on its website in the first place.

Contrary to what the question suggests, there is no added value for banks or market participants in transferring the whole process to the EBA level. Assuming that the process is automated at the bank level, one could hardly argue that banks would be relieved from mandatory disclosures. However, publications will be delayed, to the disadvantage of the market.

The bank should clarify and comment on its operations to the market. Meanwhile, the solution proposed relieves commercial banking institutions from the formal responsibility for the information provided to the market and for the quality of that information. Banks cannot be responsible for the published data since they have not generated the data. The responsibility would rest with the EBA, which in turn would not be responsible for source data. Therefore, the proposal from the consultation document involves a major reputational and legal risk to the EBA.

Data covered by the disclosure may have a significant impact on the market. If certain data is erroneous, this can lead to wrong decisions on the part of market participants. And if the proposal from the consultation document is accepted, there will be many potential sources of errors. The responsibility for this will rest with the EBA as the source of the published data. A bank will be responsible for data submitted to the supervisor, and the supervisor for data sent to the EBA. The data will be often adjusted as a result of a thorough inspection process. This could lead to further errors.

The publication of all bank disclosures in one place, in turn, should be strongly supported. This proposal is easy to implement. The EBA website would be a natural choice of location. Banks would be obligated to submit (most likely via their supervisors) their own disclosures, already published on their websites, and the EBA would replicate them on a special disclosures website.

Question 189) If you support centralising disclosures at the EBA, please explain

i) whether in your view stakeholders (investors, etc.) would have the benefit in accessing disclosures of all institutions in one internet place?
ii) whether in your view a single location policy should be applicable to all type of institutions: small non-complex, large and other institutions?
iii) how responsibilities for the disclosed information should be shared between institutions, competent authorities and the EBA?

Central publication of disclosures submitted by banks by the EBA deserves to be supported.

i) The uniform location of disclosures will ensure greater transparency and comparability of data.
ii) All institutions should disclose their data in the same location, although, in accordance with the principle of proportionality, small and non-complex institutions should have a limited scope of reporting.
iii) The process should be as follows:
    1. Based on mandatory reporting, banks should generate the legally required scope of disclosures that can be developed on the basis of FINREP and COREP.
    2. The EBA should draw up templates for descriptive and qualitative disclosures as well as those going beyond the scope available in FINREP and COREP reporting.
    3. Institutions should fill in the templates ensuring that they reflect the facts and data disclosed in financial statements, they should publish them on their websites together with the tables prepared based on reporting data, and send them to the EBA (via their supervisors).
    4. The EBA should publish the qualitative disclosure templates together with the tables prepared based on FINREP and COREP.

Question 190) If you do not support centralising disclosures at the EBA, please explain why.

The reasons why the disclosed data cannot be generated by the EBA are already mentioned in the reply to Question 188. This means that:

i) The proposal involving the EBA generating the data does not add any value to the market, quite the contrary.
ii) It is hard to imagine doing such calculations for all banks, even the smaller ones. However, they are not excluded from the disclosure process. Therefore, large banks would be exempt from this process and small banks would have to do all the work on their own. This would be a peculiar way to apply the principle of proportionality.
iii) Banks and supervisors would be relieved from responsibility for data quality. The disclosed items would be calculated and published by the EBA. Even if an error occurred at some point in the process, it is difficult to imagine a public search for the source of error and the responsible institution, especially that the EBA would have to put its signatures under the data.
iv) The EBA would have to hire a large number of new staff, which means additional costs that ultimately would have to be borne by banks.

Question 191) In your view, which further measures, if any, could be taken to incorporate ESG risks into prudential regulation without pre-empting ongoing work as set out above? Please elaborate and provide relevant evidence to substantiate your view.

At this stage it is difficult to suggest any further viable measures. The three measures proposed in the consultation document should be sufficient for the time being. Only if they turn out to be ineffective, will it be necessary to employ new measures designed based on the experience acquired to date.

If ESG is to be effective, it may turn out that soft measures, such as recommendations, do not work as expected. This would require the use of harder measures, such as the introduction, in any form, of a capital charge proportionate to the ESG exposure (higher RWA increase, additional capital charge, special reserve).

Most importantly, a measure should be applicable to all banks, otherwise it will be ineffective. In an attempt to circumvent the law, investors could use loans from banks / countries that do not respect the recommendations of regulators. This would make an excellent source of income for those banks.

Question 192) What would be the benefits and drawbacks of including the requirement for competent authorities to perform a fit and proper assessment of at least some key function holders in the CRD?

The requirement for supervisory authorities to assess and approve certain key functions at the bank has a positive effect on bank management quality. Certainly, even the best international standards or EBA guidelines will not guarantee that in every country the approach of supervisory authorities will be fully consistent with these documents and sufficiently conservative. Nevertheless, the mere fact that a supervisory approval is required has a positive impact on the quality of candidates, and the assessment process offers the opportunity to the supervisor to decline a candidate where necessary. It is important, however, to maintain comparable conditions across the European Union.

The extension of this requirement to certain key function holders may be controversial at times, and one of the arguments used is the principle of proportionality understood as limiting the requirements for smaller banks. As a matter of fact, the list of key functions is definitely shorter for smaller banks than it is for larger institutions. But, at the same time, smaller banks are more likely to have problems finding people with appropriate qualifications for key positions.

Question 193) In your view, would it be useful to identify key function holders in a descriptive manner, and/or to specify certain roles as belonging, by default, to the set of key function holders? Please consider the practical implications of each option and the need for clarity and consistent application across institutions and competent authorities. Please elaborate and provide evidence.

The identification would have to be descriptive only. Otherwise it would impose a rigid management structure.

Question 194) Were the CRD to specify a number of roles that would be considered, by their very nature, to be occupied by key function holders, which specific roles should, in your view, be included in this list?

The key management functions are the president of the board and the board member with responsibility for risk management. It should be considered here if both roles should be subject to approval, independently of the bank size. It seems that in small banks with small boards it would be sufficient to have the president of the board approved by the supervisor.

Question 195) Views are also sought as to whether the scope of key function holders subject to fit and proper assessment should be limited to those holding these positions at group level or whether it should also include key function holders at the level of each institution? Please elaborate and provide evidence.

This requirement should apply to every bank, and the bank size should be the only parameter determining the scope of the approval. Subsidiary banks are usually public companies, which entails some special obligations. These include management quality.

Excluding subsidiary banks from this regime could, in some cases, lead to the parent bank filling key positions in the subsidiary bank with its employees who would not be allowed to perform their functions were it not for the exclusion. This could lead to a particular situation where a key function holder in a small local bank would have to meet more stringent requirements than one in a large bank that is a subsidiary of another institution.

It is also appropriate to refer to Commission Delegated Regulation (EU) No 604/2014 with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile. We can hardly assume that these criteria could not apply to subsidiary banks, especially large banks that are listed on stock exchanges or systemically important. Such a situation could give rise to a number of risks, starting with systemic risk.

Question 196) Should the key function holders be subject to fit and proper assessments by competent authorities, on what criteria could this assessment be performed?

At least two criteria: appropriate knowledge and documented, sufficiently long (at least two years') experience in managerial positions at banks.

Question 197) Please explain what you consider to be the advantages and disadvantages of competent authorities conducting ex ante and ex post approval, respectively, of suitability of members of the management body.

Ex ante and ex post approval are similar. In both cases, holding certain key functions at a bank requires approval from the supervisor. Most likely, the assessment criteria would be similar in both cases. They should include a formal assessment of knowledge and experience as well as self-presentation (interview with the supervisor). On the other hand, things such as unethical behaviour or breaking the law should disqualify the candidate. What makes the two approaches significantly different is the course of the process and the resulting potential risks. The differences, in turn, can affect the effectiveness of the approval process.

If the ex post approach is used, the person taking up the office undergoes assessment at a certain point. Until that time, they perform their function, but without approval. It is to be understood that they nevertheless enjoy all the powers associated with their function. In the meantime, for a number of reasons, some of which go beyond the merits, the approval process can be protracted. If approval is denied, the whole process restarts and the moment when a person approved by the supervisor takes up their office is further postponed. In a particular situation, this can take a long time. Meanwhile, in the transitional period before the board member is verified by the supervisor, a person unfit for managing the bank could potentially make some poor decisions.

With the ex ante approach, the person does not take up their function until they are approved by the supervisor. Certainly, the board cannot proceed without this function, so someone is performing it as a substitute, which is less than optimal. The bank needs to address this and procure that the person obtains the supervisor's approval as soon as possible. Thus the whole process is much faster.

If one of the criteria is period of service in management positions, in the ex post approach it would have to be determined if the period in service at the institution between appointment and approval should be taken into account. In the ex ante approach, the candidate needs to demonstrate adequate length of service before they take up the function. In the case of ex post evaluation, the same length of service before taking up the function can be certainly required, but on the other hand, a question arises why this additional period of service is not taken into account. Therefore, it would be possible to delay the approval of the candidate.

This dichotomy is not a good solution and it may lead to regulatory arbitrage in the EU market. It is therefore important to make the practices consistent across all Member States.

It should be noted that the ex ante approach has a preventive element to it, which offers a better guarantee of safe management for institutions, and has an ultimate effect on the level of risk taken by institutions and, as a result, the systemic risk of the sector. Independently of the ex ante assessment, institutions should carry out a periodic ex post assessment (on an annual basis) to ensure that members of the management body continue to meet the fit and proper requirement. This assessment should also be carried out in the event of any negative reasons disqualifying the person holding the office in question. This is important in view of the new challenges in the banking sector, the need to continuously improve competences and ensure understanding of new phenomena and considerations at the board level, such as the use of machine learning and artificial intelligence models in the management of credit risk at banks. This assessment should form part of the SREP process, and it should even be considered by supervisory boards when they make decisions to grant a discharge to board members.

Question 199) One issue that has been raised in the past in relation to ex ante assessment is avoiding vacant positions on the board. Please explain, based on your experience, to what extent this can be overcome (if it is an issue in the first place) giving examples and making reference where appropriate to succession planning and procedures in place for identifying skills/experience that could be particularly difficult to replace.

The reply to this question can be found in the second paragraph of the answer to Question 197.

Question 200) Which specific positions within the board and/or senior management of institutions do you believe should be considered as part of an ex ante assessment, given the responsibilities they hold and the risks they may pose? Please provide evidence and/or examples to support your views.

Same as in Question 197. In Poland, the approval requirement applies to the president of the board and board member with responsibility for risk management. Both functions are approved ex ante. In an operating bank, until the candidate is approved by the supervisor, the function is performed by another board member. The supervisory board presents its candidate in advance to shorten the period between the formal application and approval. In a newly established bank, the supervisor is informed about the candidates in advance.

Question 201) Considering a scenario in which at least some fit and proper assessments were to be conducted by competent authorities ex ante, what would be, for you, the costs and benefits of a deadline for the assessment of proposed board members being set in the CRD? What would you consider a reasonable period of time for the assessment?

The question of costs and benefits, in the context of guaranteeing high quality of people performing key functions at the bank, involves an inherent contradiction. In an extreme case, it could lead to the conclusion that an inferior approach should be chosen because it entails lower costs. Therefore, we should be guided by the added value of the fit and proper assessment, and not by its costs.

The ex ante approach entails the risk that a bank will temporarily operate with vacancies in its statutory bodies. In the longer term, however, this approach should lead to responsible selection of candidates for these functions by the board. Knowing that an unfit candidate will not obtain the supervisory approval, board members will be encouraged to propose the candidate responsibly, after having verified or even preliminarily clarified with the supervisor whether the candidate meets the requirements. This offers a chance to shorten the procedure.

In the ex post approach, on the other hand, a supervisor which has significant concerns about a board member who is already in office, although not yet approved by the supervisor, will always have a dilemma: whether to approve a person already in office or reject them, which will mean that the board will have to look for another candidate, appoint them and then await the supervisor’s decision. Even if the next candidate who meets all the requirements is better, the subsequent change would negatively affect the functioning of the bank. Therefore, there is a high risk that the supervisor will accept the first candidate, even at the expense of management quality.

It is difficult to identify an optimum time frame for the approval process. The situation will be different for a candidate who already has been performing or has performed the same function – the supervisor will have previous insights and the process will be resolved quickly. If not, and the candidate has reached this governance level at a bank for the first time, the approval process will take longer. In some cases it will be impossible to reach a quick conclusion, for various reasons, for example missing documentation which is not supplemented by the document, lack of access to data, and other reasons. The supervisors themselves or, specifically, the people involved in the approval process, will have a greater say. However, it must always be borne in mind that safe and stable management of the bank is critical, and a poor process of approval or rejection of a candidate for a certain function can put the bank in danger.

Nevertheless, the approval process should be completed within three months, and in exceptional and particularly difficult cases requiring a number of additional steps, the maximum time allowed should not exceed six months. On the other hand, for persons who have already been approved by the supervisor at least once and no objections have been raised against them since, the supervisor should decide within one month.

Question 202) Do you currently use, or have you envisaged, other timelines for approval, e.g. whereby institutions only have a limited time to provide the additional information requested, or where the length of the assessment period depends on the specific type of position? If so, please explain the rationale for these timelines.

No, this approach is not used.

Question 203) If competent authorities had a fixed time period for giving their approval to proposed new board appointments, would you nonetheless consider it preferable for a decision to be issued in cases where the competent authority decides to approve a candidate? Could you instead envisage a system of "tacit approval" (i.e. whereby, if no decision has been issued by the deadline, the institution can consider the candidate approved)?

No, this is not the right approach if the purpose of the approval process is to ensure stable and safe bank management. A rational approach implies that both sides aim to finish the approval process as soon as possible. This assumption rules out stalling by either of them. If so, the tacit approval approach would run counter to the fundamental objective of the approval process, which should in any case result in a positive or negative decision of the supervisor. Moreover, tacit approval of the function would mean that approval is given by a procedure instead of a supervisor's decision, and the supervisor would not be responsible for this approval.

Question 204) Should the scope and format of fit and proper assessments be adapted to take into account the principle of proportionality, including in relation to any new provisions such as those discussed in Sections 9.2.1.1. and 9.2.1.2.? Please elaborate on your reply and provide examples.

The principle of proportionality should also apply to the board member assessment process, even if not according to the simple principle of bank size, then certainly according to the complexity of the institution's processes. Board members of banks engaged in simple standing operations for retail clients should be assessed differently from board members of banks active in corporate client portfolios, treasury markets, or those which additionally pursue investment activities. As regards the time of assessment, there is no strong justification to differentiate the assessment time depending on the bank's size, looking from the bank's perspective. However, a justification can surely be found from the point of view of supervisors, which as a matter of principle should also focus on systemic, sectoral risks. Given the above, it seems obvious that faster and more accurate screening of candidates who are to manage systemically important banks should be a priority.

Question 206) What specific risks do you see in allowing some degree of proportionality in the application of any new provisions, such as those discussed in Sections 9.2.1.1. and 9.2.1.2., on the timing of the approval of board members by competent authorities and of key function holders?

The principle of proportionality should not apply to the time taken to decide on the suitability of the applicant. The expectation is that every application will be considered without undue delay. And if, as already said, we assume that the supervisor takes a rational and fair approach towards the candidate, it should be assumed that the reasons for which the processing time can be extended could be either formal problems with the application or issues relating to the candidate. A decision to shorten the time in this case would contradict the purpose of the assessment.

We can speak about proportionality, however, referring to the requirements for the candidate and the documentation which must be submitted to the supervisor. Smaller and less complex banks and simpler tasks mean less stringent requirements or expectations for candidates. And this, in turn, means less time needed to process the application.

Question 207) What would be the benefits and drawbacks of designing an accountability regime whereby the management body of each institution would be required to draw up a statement of responsibilities of each of its members clearly identifying the activities for which they are responsible, beyond the sole responsibilities linked to their membership of specialised committees (e.g. risk committee, remuneration committee)?

Identifying the responsibility areas for individual board members and assigning them to specific individuals would be too far-reaching an interference in the management structure and governance of the bank. Obviously, certain areas, such as risk management, sales or IT, are autonomous and can be clearly assigned to specific individuals. But a bank may have its own vision of how responsibility is to be divided across the board and it cannot be restricted in this respect.

However, this problem can or even should be approached differently. A number of business areas should be identified within the bank and specific board members responsible for supervision should be clearly assigned to each of them, but without imposing a fixed governance structure on the bank. In smaller banks with fewer board members, one board member could be responsible for supervising several areas. In a large bank, every board member would be responsible for one area. A bank may have more board members than areas to supervise. A bank may perceive the need to strengthen supervision in certain areas, and it may also recognise the need to appoint a board member or members whose responsibilities would cover certain non-routine areas. In addition, this approach would not interfere too much with the governance of the bank.

Question 208) How might the collective functioning of the board be affected by the introduction of a system where each individual has a defined set of responsibilities? Please consider the possible effects on both individual conduct and the board as a whole (e.g. the impact on the collective responsibility of the board, or on the quality of its discussions).

Allocating responsibility for specific bank areas to individual board members does not relieve any of them of their responsibility for the bank, as the individual responsibility for a certain bank area does not preclude collective responsibility for the institution as a whole. In this respect, a bank's board is no different than any other collegial body. The collegial responsibility of the supervisory board, including the members of the committees appointed by the supervisory board, does not interfere with the possibility of having each member assessed on an individual basis, both by the supervisory board and by the owners of the bank. There is no need to formally assign individual responsibilities to each supervisory board member, as is the case for members of the bank's board of directors. Sound provisions in the bank's statute and a set of internal rules of procedure for the supervisory board are sufficient.

Question 209) What would be the benefits and drawbacks of designing a similar accountability regime for key function holders (e.g. information on key function holders, their responsibilities, details of the firm's governance and structure)?

This would be an even farther-reaching interference. Instead, it would be sufficient, as in the answers to the previous questions, to define a number of key functions to which the bank should assign appropriate persons – key function holders. Every such function should be taken up by a suitable individual. This must not, however, affect the appointment of persons other than those covered by the regulations who are also key function holders by the bank.

Question 210) Would the assessment of individuals proposed for positions on the board or as key function holders be more accurate and/or reliable if the responsibilities the individual would be taking on were clearly defined, including in relation to any new provisions, such as those discussed in Sections 9.2.1.1 and 9.2.1.2?

A more specific definition would always be helpful, but on the other hand, too much regulation has the opposite effect instead.

Question 211) Do you consider that corporate culture could and should be taken into consideration as part of the fit and proper assessment? If yes, please explain how this could be most effectively achieved.

This element could distort the assessment of the candidate. The corporate culture is intrinsic to the institution and very stable. It is an important feature of every institution, underlying its individual characteristics. It should be borne in mind that a corporate culture can be either a useful tool supporting a board in its efforts, or an obstacle for a board which intends to address poor habits inherent in that culture. If corporate culture is included in the fit and proper assessment process, both of those situations should be taken into account. Irrespective of the situation at the bank, this is a key issue that should always be taken into account and thoroughly analysed in the assessment process.

Question 212) What do you consider would be the benefits of, and/or difficulties encountered in, including the ability to create and promote the organisation's desired culture as part of the "fit and proper" assessment of members of the management body?

As stated above, this ability could be helpful or even needed in some special cases, but only as an additional and particular expectation from a candidate. By no means can this be treated as one of many managerial skills, because including the adjustment of corporate culture in a set of typical management activities when a bank does not need to change this culture can only harm the institution, and it certainly will not help.

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