
AFME Position Paper

ECB Draft Guide to On-Site Inspections and Internal Model Investigations

15 September 2017

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to contribute to the ECB's consultation on its "**Draft Guide to On-Site Inspections and Internal Model Investigations**".

AFME represents a broad array of European and global participants in the wholesale financial markets. We are contributing to this consultation on behalf of our Special Committee on European Supervision (SCES) which, in its SSM configuration, provides a platform for the most systemically relevant banks who are lead-supervised by the SSM to engage with the ECB's supervisory function and, in its full configuration, is a vehicle for engagement on the future development of supervision within the EU more generally.

General Comments

AFME welcomes the publication of the ECB of this guide as a positive step to improving communication between the ECB SSM and supervised entities by clarifying the process for on-site investigations (OSIs) and internal model investigations (IMIs), as well as the rights and duties of both the supervised entities and supervisors during this process.

We welcome the particular focus the SSM has placed on having an open dialogue with the institution, not only during the fieldwork phase itself, but also during the drafting phase of the report and after the exit meeting. The possibility for both the institution as well as the Head of Mission (HoM) to instigate meetings during the inspection, as well as the introduction of a feedback process through the 3-column template, are positive developments. This open dialogue and exchange process is in our view an important step in the right direction to ensure that investigated entities understand supervisory expectations.

We provide detailed comments on the draft guide in the second section of this response after highlighting our members' overarching comments and key concerns in the present section. These include:

- **Scope of the onsite mission must be sufficiently specific:** The guide should clarify that the scope and subject matter of the mission will be set out in a sufficiently specific manner, as per Article 143 of the SSM Regulation. While we appreciate that the HoM may require some flexibility, should it become apparent during the course of the mission that its scope requires significant change, this change must be subject to a new ECB decision. In all cases, clear communication to the supervised entity on the revised objective of the mission (and an adjusted period of time to pursue it accordingly) are required.
- **The independence of the HoM must be balanced with the need to conduct efficient missions:** While we agree that the HoM/inspection team must be independent from the JST, our members experience unnecessarily duplicative requests for the transmission of information from the inspected entity to the ECB (i.e. via both the JST and OSI team(s)). This must be avoided. Our members have encountered cases where OSI teams lack knowledge of the institution they are investigating. Moreover,

their experience has shown that inspection teams hold meetings with senior level executives covering the same issues that have already been discussed in detail with the JST. This duplication of information needs to be resolved. The preparatory phase of a mission should therefore not be neglected; it is essential that this be used to coordinate between the JST and the OSI appropriately to reduce this burden on inspected entities. In addition, we would encourage JST participation in the OSI team, with the JST member ensuring that such inefficient are avoided by playing an on-going coordination role.

- More detailed timelines and information on the different phases are welcomed:** We generally find that there is a lack of specific deadlines between the various phases described in the draft guide and more detailed timelines would be welcome in the final guide. We provide our views on the time periods that are mentioned in the draft guide in our detailed response below, however it is important to point out that, a clear maximum timeline for the ECB to deliver the final decision/letter should be provided for in the final guide. This should be set at 2 months following the closing meeting for OSIs and 2 months from sharing the draft decision/letter in the cases of IMIs and model change requests in particular. Further specification of the different stages in the process is also required, especially with regards to the steps following the final recommendation letter and submission/follow up of the firm’s action plan. The chart below illustrates our best practice understanding of the various steps involved in the OSI process, including the additional steps regarding the action plan (that should be set out in the guide):

TIMELINE OSI-IMI PROCESS		
Notification Letter		CLOSING MEETING
1st Info / Data Request		BANK REPLY
START ON-SITE KICK-OFF MEETING		FINAL LETTER
END ON-SITE		ACTION PLAN
Draft Report to BANK		JST VALIDATION
EXIT MEETING		END ACTION PLAN
BANK REPLY		JST VALIDATION
FINAL REPORT		
DRAFT LETTER		

- **The relative importance of findings/supervisory expectations should be visible:** Both in the context of the OSI findings (report) and the letter setting out supervisory expectations, we would welcome a ranking of the findings/expectations according to their relative importance so that firms know which areas they should address as a matter of priority.
- **Guaranteed confidentiality when using 3rd party resources is essential:** We recommend that external resources be employed in situations that do not involve exposure to key proprietary information/strategic plans and recall that it is the responsibility of the ECB to ensure confidentiality in such cases. We further recommend the ECB provide greater legal comfort to supervised entities, for instance by disclosing the confidentiality agreements in place with 3rd parties.
- **Full transparency with respect to inspection outcomes resulting in operational acts should be ensured:** In cases of supervisory decisions, institutions have a “right to be heard” and, as last resort, can appeal a decision through the Administrative Board of Review. We would welcome more information in the guide as to the process that can be adopted if supervisory expectations, set out in operational acts, are deemed not be respected by the SSM on the one hand, or are deemed to be disproportionate/inappropriate by the inspected entity on the other. While we recognise that the process surrounding the closing meeting is likely to be helpful in clarifying the supervisory expectations and understanding of both parties, our members remain concerned that there is a transparency gap in this area.
- **Changes are required to the drafting dealing with the level of representation of the inspected entity in OSI meetings:** The representation of the firm at various meetings (kick off meeting, exit meeting, closing meeting, etc.) should be a function of the objectives/scope of the mission. The choice of individual(s) representing the firm should be a decision of the inspected entity if the individual(s) are sufficiently senior to engage with the HoM and his/her team, possess the required knowledge and have the appropriate delegations from the firms’ senior management. A number of drafting changes in the guide are required to reflect this.
- **Information requirements and meetings requests must be proportionate:** The SSM should review that not only the documents/files requested are necessary for an appropriate execution of the inspection but also the number of meetings and the targeted executives of the meetings. Here, the HoM and the JST must consider during the preparatory phase the various supervisory activities already implemented within the supervised institution.
- **Communication with competent authorities is a sine qua non condition in cases where MoU have not yet been put in place:** In the context of relationships with the third countries where no MoU has yet been agreed between the SSM and the relevant 3rd country authority, the SSM should ensure that it informs and communicates clearly to the local competent authority and in accordance with local legal requirements.
- **Further clarifications would be welcome:** The introduction specifies that the guide does not apply to “Joint Supervisory Team IMIs which are not performed as on-site inspections under Article 12 of the SSM Regulation”. The concept of Joint Supervisory Team IMI is not clear and we would welcome an explanation of the steps and timelines involved in this process, stressing the difference with (on-

site) IMIs. More generally, similar guides setting out the objectives, expectations, rights, duties, information flow, process steps and timelines involved in other ECB supervisory activities such as deep dives, thematic reviews, etc. would be welcome in due course.

Detailed comments on the Draft guide

Chapter 1: General Framework for inspections

- **Role of the JSTs (page 5 of the guide).** With respect to investigations, the draft guide defines this role as “*communicating with the inspection team*”. This should be refined as coordination between the OSI team and the JST is important not only during the inspection itself, but crucially also before fieldwork starts. We would therefore welcome specification in the guide of the preparatory phase of the inspection and the JSTs role in providing the relevant background material and information on the entity that it has to investigate. This will greatly reduce the burden for institutions on the one hand but will also improve the efficiency of the mission itself from the point of view of the inspection team. See also our comments above regarding the coordinating role JSTs can play within the OSI team.
- **Decision making process for inspections (pages 5 and 6 of the guide).** AFME welcomes the recognition that the number of inspections included in the annual plan can be adjusted during the year. Here, it should be clarified that this adjustment can be bi-directional.
- **Objective of inspections: scope and timeframe (page 6 of the guide).** Article 143 of the SSM Regulation states that the ECB decision instructing the OSI shall specify “the subject matter and the scope of the OSI”. In our view, it is key for the final guide to clarify how the predefined scope and subject matter should be specified, with sufficient level of clarity and detail. Our members have noted that the scopes of OSIs are, more than often, defined in very broad, unspecific terms which are not sufficient to provide the addressee of the notification with an adequate understanding of the intended perimeter. As a practical example encountered by members: “An on-site inspection will take place [...] with the purpose of assessing: trading business and processes” - this is clearly not sufficient information for the inspected entity to prepare for an OSI.

Moreover, an excessively broad scope definition provides the HoM with the possibility to adjust the scope of the mission on a discretionary basis, which we think is contradictory to Article 143. We therefore find that footnote 10 of the draft guide, i.e. “If deemed necessary the scope and timeframe of the inspection can be changed during the inspection” requires deletion. While we appreciate that there may be a need for some flexibility during the mission, should the scope require significant change, this requires another ECB decision, and cannot be solely at the HoM’s discretion. In all cases, clear communication on the revised aim of the mission and an adjusted period of time to pursue it accordingly are required. This should be specified in the guide.

Finally, with respect to timeframes, a clear and precise indication of the expected duration of the fieldwork phase prior to starting the mission is needed: the level of preparation required by the inspected entity is clearly different in the case of a 5 week mission (that may be extended by a week or two) compared to a 25 week inspection.

- **Objective of inspections: supervisory principles (pages 6 and 7 of the guide).** AFME welcomes the alignment of inspections with the supervisory principles for the functioning of the SSM. We would nevertheless add that these principles should also reflect the specific objective of the inspection. Moreover, we would welcome inclusion in the principles that OSIs should avoid duplicative supervisory requests (e.g. requesting the same information or meetings with the same people for the same purposes as the JSTs). For banks, there is just one supervisor no matter if the staff members in question work for DG MSIV, are members of the JST based in Frankfurt, work for an NCA, are part of an OSI team, etc. This is particularly important for the ECB teams to bear in mind when meeting with Board Members or Senior Executives.
- **Independence of OSI teams (page 7 of the guide).** Even if, as stated in the guide, the implementation of the inspection is under the sole responsibility of the HoM, the JST must play a role, at least during the preparatory phase and in ensuring coordination generally. This is crucial for inspections with a broad scope where a proper knowledge of the bank is a must.
- **Composition of the inspection team (page 8 of the guide).** AFME acknowledges the possibility that the need for the SSM to use external resources (i.e. external consultants) may surface given the number of inspection activities in comparison with internal resources. However, the SSM should be aware of the confidential nature of the information (e.g. sensitive business data, strategic processes or proprietary knowledge) shared with OSI teams and, in this regard, should take the required steps to avoid scenarios e.g. where an OSI member joins another bank or works as a consultant for other banks right after an OSI. From our members' point of view, there is currently no guarantee that such information will not be used by 3rd parties in the context of other work that may be performed for competitors. We therefore think there is a need for the ECB to adopt a strict and clear policy to implement Article 27 of the SSM regulation so as to frame the use of external consultants in OSIs. This policy should at least provide that:
 - The ECB informs the bank, sufficiently in advance, of its intention to use third parties in a given mission.
 - The ECB should avoid having recourse to external consultants for OSI covering business sensitive areas or highly proprietary processes if the inspected bank opposes such use with legitimate reasons.
 - In cases where external consultants do form part of the inspection team, the bank should be given a copy of the confidentiality agreement between the ECB and the consultants, and the HoM shall make his/her best efforts to ensure that sensitive information is adequately protected.

Irrespective of the above, ensuring confidentiality remains the responsibility of the ECB.

Finally, in order to ensure good coordination and reduce the burden of inspections on supervised firms, and given the difficulty for the inspected bank and its teams to deal with an OSI team that may vary in size/composition, we recommend that section 1.6 of the guide also clarify that the number of inspectors be defined at the beginning of the mission and remain stable during the course of the OSI. Unless the inspection is driven by exceptional circumstances, the size of an inspection team should therefore be limited.

- **Cooperation across jurisdictions (page 8 of the guide)** Inspections should take into consideration not only cooperation arrangements or agreements with local supervisory authorities but also, more generally, any local regulation that may impact on the inspection process such as banking secrecy, requirements to inform local regulators (particularly when MoUs may not yet be in place), etc. Any resulting OSI recommendations, including those that are group-wide must also take local regulations into account.

Chapter 2: Inspection process

Inspection Phases

- **Preparatory phase (page 9 and 10 of the guide).** AFME appreciates the efforts to clearly set out the various steps involved in an inspection. However, there is no reference to coordination with the JST. In this regard, in the first request for information, the HoM should avoid asking for information that is already available to the JST or information that is public. In order to avoid these redundancies, the HoM should have preparatory meetings with the JST in order to understand the issue that should be investigated and the information that justified this investigation taking place. As such, this preparatory phase is as important as the investigation phase itself.

It would also be particularly useful to use the preparatory phase to discuss the delivery of large data requests, which can be particularly time consuming, with the institution.

- **Investigation phase (representative of the firm in kick-off meeting) (page 11 and 12 of the guide).** Regarding the kick-off meeting notification, the SSM should bear in mind that in case the period of time between the notification and the kick off meeting taking place is short, the degree of seniority in the meeting will be hindered. As such, the SSM should find the proper balance between flexibility and seniority.

In addition to this, we consider that the required presence of the CEO or a member of the management body is beyond supervisory powers and this reference should be deleted from the guide. Particularly in the case of organisations that are D-SIB/G-SIBs, this type of requirement would not be in line with the proportionality principle. Instead, the level of representation should depend on the size of the institution, which would then contribute to the effectiveness and efficiency of the on-site process. We suggest revising as “An appropriately senior representative of the inspected legal entity should attend the kick-off meeting” and deleting the sentence “This should be either the CEO or a member of the executive board”.

- **Reporting phase (page 12 and 13 of the guide).** From the language used in the draft, it is not clear whether the two-week notice to present comments to the draft report takes place before the exit meeting or after it. Moreover, “a few days” is insufficient time to prepare for an exit meeting. We consider that the exit meeting should be used not only to discuss the draft report but also the comments of the institution to that report and, as such, the draft report should ideally be delivered two weeks *before* the exit meeting. In addition to this, depending on the scope/extent of the inspection, a two week period for submitting the feedback template after reception of the draft report could be

very tight and generally speaker, longer period could be welcome. We suggest that two weeks be considered a *minimum period* for submission of this feedback after the exit meeting.

Moreover, we would appreciate the introduction of a maximum amount of time for the delivery (from ECB to inspected entity) of the Final Report. The guide should specify the maximum time (i.e. 2 months) between the closing meeting and the final follow up letter sent to the inspected legal entity. This is particularly important for instance in the context of material change requests to internal models for planning purposes.

Finally, both the draft and final reports, as well as any other official supervisory communication, should always be shared with both the supervised entity and the Parent in a Group situation.

Inspection outcomes

- **Presentation of the requested remedial actions (pages 14 and 15 of the guide)** Both in the mission report and in the letter expressing supervisory expectations, a ranking of the various follow-ups (and explanatory note) would be helpful for the institution to give the correct priority to the required actions.
- **Recommendations and action plan (page 16 of the guide)** The time period specified for the inspected entity to respond to the final follow-up letter/decision by the ECB should not be less than 2 months. Moreover, we would appreciate communication to the entity/validation from the JST of the action plan (within 1 month from its delivery to them).

Follow up phase (page 16 of the guide). We would welcome more clarity on how an institution will be informed if the JST considers that the follow-up (or actions forming part of it) are considered complete/closed. We suggest that the additional steps of the OSI process involving the validation of the firm's action plan and the follow-up phase of this action plan are duly detailed in the guide, including relevant steps and timelines.

Chapter 3. Applicable principles for inspections

Rights of inspected entities

- **Possibility to comment on the facts and findings (page 20 of the guide).** The emphasis on comments focussing on the executive summary and key findings is not appropriate. If the inspected legal entity has the right to comment on the draft report, that right must extend to the entire draft report.
- **Need to be informed of the inspection outcomes (page 20 of the guide):** this section describes a rather unidirectional flow of communication where the inspected legal entity informs the Head of Mission. Interim meetings should be used to share impressions and concerns from both sides and should be a two-way communication process, where the HoM could provide indications of information that would be relevant/helpful, etc. In this context, it may be useful to present the sections of the guide relating to the status meetings (page 12) and the interim meetings requested by the inspected entity in tandem.

- **Supervisor’s expectations of the inspected legal entities (page 21 of the guide).** We would welcome reinforcement of the fact that the inspection team will apply the proportionality principle when asking for information and try to request those documents and meetings that can be useful for the scope of the inspection and not documents and meetings that go beyond that scope.
- **Cooperation expected, seniority of staff (page 22 and 23 of the guide).** See our comments above – it is not likely to be proportionate to expect a CEO or other member of the Management Board to attend such meetings. As long as the member of staff representing the firm is a duly appointed representative of his or her firm, there should be no requirement for a CEO or other members of the Management Board to attend meetings. The last sentence of the section “Seniority of the inspected entities’ representatives” should be deleted.
- **Point of contact (page 23 of the guide)** When an inspected entity has designated a central point of contact for SSM supervision, this organisational structure must be respected by the ECB, and by both JSTs and HoMs. These processes are set up to ensure operational efficiency and are beneficial for both parties. The last paragraph of the section (appointment of a point of contact) should be amended accordingly. Any deviations from this principle should be clearly communicated to the supervised entity, particularly in relation to the attendance of meetings.
- **Language (page 23 and 24 of the guide).** Even if the bank has decided to use English as the language to communicate with the SSM, it should be noted that for certain inspections, or for certain parts of an inspection, it may be more practical to change the language to the domestic language of the bank. We note that banks can change the language of communication at their convenience.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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