

**EAPB Position Paper on EBA Draft Guidelines on stress testing & supervisory stress testing**

18 March 2016

**1. General Remarks**

***General***

The European Association of Public Banks (EAPB) welcomes the draft of the European Banking Authority (EBA) on “Guidelines on stress testing and supervisory stress testing”. The draft guidelines contain several valuable proposals which may enhance the internal organisation of a bank’s stress test. Nevertheless, the EAPB believes that the guidelines are overly prescriptive and would significantly reduce the leeway in an institution’s stress testing. In example, certain aspects of EBA’s draft guidelines seem to be too targeted towards “best practices” as prevalent in big banking institutions instead of offering a set of practices which would reflect the versatility of the European banking sector. Moreover, the timeline of the implementation of the guidelines on stress testing and supervisory stress testing seems too ambitious. EAPB believes that the fourth quarter of 2016, the currently foreseen starting date of the guidelines application as communicated by EBA, is a too early starting date for the application of the entire guidelines and would not leave enough time for banking entities to adjust to the new guidelines. In this context, it would be advisable to apply a phased approach differentiating which aspects of the guidelines would have to be implemented by the end of 2016 and which could be kept for implementation at a later stage. This is particularly important given the high number of stress test exercises and other regulatory requirements scheduled in 2016 such as the EBA stress test or the Supervisory Review and Evaluation Process (SREP) related stress test. Further clarification would be useful on the link between the stress testing framework as suggested in EBA’s draft guidelines and the SREP framework as laid down in EBA’s guidelines on common procedures and methodologies for the SREP.

***Proportionality***

EAPB would like to highlight the importance of the principle of proportionality which has to be adhered to in the development of these guidelines. This is particularly important given the fact that EBA’s draft guidelines on stress testing and supervisory stress testing imply a pillar II measure. However, the current draft guidelines do not seem to consistently capture proportionality principles since some abstracts in the guidelines would specifically mention proportionality considerations while others would not. To solve any uncertainty arising from this inconsistency, it would be helpful to explicitly emphasise the principle of proportionality under part 4 on the draft guidelines of the draft document instead of having it only mentioned in the part 1 on the executive summary. Here, EAPB would like to stress that proportionality considerations should not only apply to small banks but also to large banks

which display of very low risk profiles such as it is the case for promotional banks involved in the financing of low risk areas including social housing, municipalities, SMEs or export credits.

### ***Reverse Stress Testing***

In the draft guidelines, the role of reverse stress testing seems overrated despite of the fact that this practice was showing limitations in the context of recovery planning. For banking entities disposing of a high level of capitalisation stress testing built up on “near default scenarios” could lead to distorted results and would imply a lower credibility of the actual stress testing exercise. Therefore, EAPB considers that it would be important to leave enough flexibility for banking institutions in the design, planning and implementation of the stress testing.

### ***Operational Risk***

In the draft guidelines, the requirements on stress testing for operational risk are formulated for all banks equally irrespectively of the approach applied to assess the exposure to operational risk. In view of the recent debates at the Basel Committee on Banking Supervision (BCBS) regarding operational risks and the ongoing BCBS work streams on the standardised approach for operational risk, all stress testing considerations regarding operation risks should be dealt with at a later stage once the BCBS proposals and European Union (EU) legislation would be harmonised. By doing so, additional adjustments could be avoided and a level playing field would be guaranteed.

The requirements on stress testing for operational risk and conduct related risk are formulated separately, though conduct risk is included in the scope of operational risk as a part of legal risk. It is not clear why parts of the scope of operational risk should be considered separately for stress testing purposes and how such results should be integrated in the bank wide stress testing scenarios. The separation of the scope for the quantitative assessment would also pose a particular challenge for banks using the advanced measurement approach (AMA) for operational risk due to the fact that the relevant losses resulting from the legal risk or conduct risk events are considered within the AMA models being often developed and calibrated for the full scope of operational risk losses. Therefore, further clarification on regulators’ expectations regarding the structure of stress tests for operational risk would be highly appreciated. As it stands now, many requirements formulated in the consultation paper (e.g. the requirements of the items 132 and 140) represent general requirements on operational risk management process or risk inventory process. Such requirements should be included in the operational risk management guidelines or general guidelines on ICAAP and should be excluded from the Guidelines on Stress Testing (being part of the ICAAP process).

## **2. Detailed Remarks**

### ***Definitions/Taxonomy (Item 10)***

According to Item 10(10), properties (i) to (iv) are all attributable to reverse tests. However, this is questionable, and it would be preferable if "one or more" could be used instead of "all".

According to Item 10(11), second round or feedback effects generally lead to intensification of the original shock. EAPB would assume, however, that a reduction of the original shock may also occur, and therefore suggests to adjust the wording accordingly.

### ***Stress testing programme (Item 13–23)***

#### **Item 19**

The quantitative "backtesting" of stress scenarios, in example for the occurrence of extremely rare incidents, is difficult, so the term "plausibility of assumptions" seems more appropriate in this context.

#### **Item 21**

While the requirements of the stress test programme documentation are considered as valid, still it would be important to give enough scope for flexibility when carrying out case-based stress tests. However, the very detailed documentation as specified under Item 21 may have a counterproductive effect. It is therefore recommended that institutions are given more freedom and a broader scope for case-based stress tests.

#### **Item 22**

The key role of the business units when challenging the stress testing programme as stated in Item 22 appears unfeasible, especially as it hardly seems realistic that, as first lines of defense, individual business units can scrutinise overriding issues in their entirety. This requirement should be amended.

### ***Governance aspects of stress testing (Item 24–33)***

#### **Item 26**

According to Item 26, management actions should be discussed with the relevant supervisor. However, it should be clarified that in this regard the management body must only be in the position to explain such "actions", and that these do not need to be approved ex-ante by the supervisor.

### ***Data Infrastructure (Item 34–47)***

Item 35

Item 35 makes a reference to the Basel Committee on Banking Supervision (BCBS) principles for effective risk data aggregation and risk reporting. However, the scope of application of these BCBS principles is restricted to SIBs. Other institutions do not need to take this into account which should be made clear in the text.

Item 47

According to Item 47(b), the institutions should make sure that the results of the stress test reflect the banking risks "in an exact manner". This is not possible for either risk measurement under normal market conditions, or measurement under stress conditions, because each quantitative risk assessment is individual and subjective to a certain extent. It is therefore suggested for this passage to be removed.

***Scenario Analysis (Item 70–76)***

Item 71

According to Item 71, external data should also be included in the analysis – where possible – as part of the scenario analysis. The EAPB doubts, however, that it is possible to obtain external data from a bank with a "similar risk environment" and "similar business model". This usually involves strictly confidential data, so this requirement should be deleted.

Item 73

According to Item 73, the scenarios should at least have characteristics as listed under a) to f). Characteristic e) in particular is far too ambitious (innovation, technological developments, sophisticated financial products), and should therefore not already come into force by the end of 2016.

***Severity of scenarios (Item 77–81)***

Item 77

The "degree of severity" of the stress test is defined in Item 10 (12). However, there is no uniform system with which to determine the degree of severity. Due to the qualitative nature of the stress test, it is questionable as to whether a uniform assessment scheme can exist. The degree of severity of the stress test is therefore only measurable and comparable to a limited extent. In order to prevent the risk of unfair treatment of institutions arising, more accurate information on the degree of severity would be useful.

In Item 77(a), it is expected that the analysis of the stability of the financial system will be included in the scenario analysis. However, EAPB considers this rather to be a duty of the supervisor, and not of the bank. In addition, it would be difficult to meet the requirements, because of insufficient or missing data. This passage should therefore be removed.

Item 80

In Item 80, it is only permitted to focus on the current economic situation in relative scenarios, not in absolute ones. This differentiation is hard to understand, and should be discontinued. It is helpful to consider the current situation for both types, so as to assess the severity of the scenario.

***Reverse stress testing (Item 81–94)***

Item 83

The use of reverse stress tests to determine the severity of ICAAP and ILAAP scenarios does not seem feasible. In the overall context, it is reasonable to use reverse scenarios as plausibility instruments. The determination of the severity, however, should be carried out based on risk appetite, as well as the coherent scenario specification, which is comprehensible for the management.

Item 86

Item 86 states that institutions must identify measures which trigger an alarm as soon as a scenario becomes a reality. This potentially too one-dimensional approach is difficult to comprehend, especially since scenarios never unfold exactly as expected. Reference to the recovery indicators to be developed as part of the recovery plans would be more useful.

Item 92

The requirements for the quantitative "reverse engineering" of the specifically required stress parameters sometimes appear to be too theoretical, and do not necessarily add any additional insight. It would be however more practical and more comprehensible for the management if a certain number of alternative scenarios is shown, which cover the target loss. It would thus be reasonable to refrain from the requirement for a quantitative calculation.

***Recovery actions and recovery planning (Item 95–99)***

The overall classification, i.e. the relationship between ICAAP stress test (or regular scenarios) versus inverse scenarios versus recovery planning scenarios and their interaction during calibration seems unclear.

Item 96

According to Item 96, stress tests for ICAAP and ILAAP purposes, as well as the recovery planning, should not be combined, but should however be comparable. In terms of content, in Item 96 there appears to be a contradiction in the requirement that stress scenarios and ICAAP/ILAAP stress tests should not be interlinked, since this is asked for in other parts of the draft guidelines (i. e. item 224).

***Credit and counterparty risk (Item 102–115)***

Item 112

In Item 112, it is assumed that PDs used for the calculation of capital requirements are "usually" TTC PDs. This is not the case, as in many ratings systems there are also mixed systems of PIT and TTCs. The insertion regarding PDs is misleading, and should be removed.

***Market Risk (Item 123–138)***

Item 128

Item 128 demands that "fat tail risk issues" in particular should be taken into account, as part of the stress test. While this is reasonable in general, it should be added that institutions are only obliged to do this if non-stressed VaR and IRC (if determined) are in a position to take fat tails into account in an appropriate manner.

***Operational Risk (Item 130–138)***

The relationship between the business activities, the losses incurred by operational risks and gross income that is to be analysed represents a new requirement. EAPB assumes that an implementation of this requirement could have a major impact on IT.

It should be pointed out that the presumed linkage here between the development of employee numbers, the balance sheet total and the operational risks is not considered appropriate. Further explanations of the required analysis of the so-called "complexity", the required analysis of "changes to significant elements of the IT infrastructure", the required analysis of the "complexity of processes and procedures, products and the IT system", and the required analysis of "the susceptibility to model risks" would be very helpful.

Item 133/134

There is uncertainty as how to stress test "business environmental and internal control factors" (BEICFs) if indicators are used in a purely qualitative manner or show only a potential change in risks. Clarification of this matter would be appreciated.

Item 135

Regarding the analysis of a possible interrelation between losses from operational risks, credit risks, and market risks, there is uncertainty as to whether a quantitative analysis of correlations or a qualitative analysis of causalities should be carried out. An explanation would be helpful here.

Item 137

Item 137 refers to risk type-specific stress tests. An explanation of how these are embedded in the overall context of stress testing would therefore be useful.

***Application of stress testing programmes (Item 185–197)***

Item 187

A minimum period for ICAAP stress testing would not be appropriate, because ICAAP should consider all overarching scenarios, including fast-acting ones. At best, the demand to consider at least one scenario with a minimum term of at least two years seems appropriate.

***Supervisory assessment of the institutions' stress testing (Item 198–200)***

Item 200

According to Item 200 a), the supervisor should use internal bank stress tests in order to validate the quantitative risk measurement results of the internal models. However it is doubtful whether this analysis would be useful. In general, internal models are not developed under the assumption of a stress situation but under fundamentally different conditions which would make it nearly not feasible to validate these internal models based on stress test results. The last passage of Item 200 a) should thus be reconsidered.

***Quantitative assessment of institutions stress tests done for ICAAP purposes (Item 212–218)***

Item 218

According to Item 218, supervisory bodies should take regulatory changes of which they are already aware into account when assessing the results of the stress test (provided that these affect the institute within the time line of the stress test). Looking at it from the other side, institutions must also take into account potential future regulatory changes in the stress tests. However, it should be noted here that, in the past, this has not often proven to be sufficiently possible, due to uncertainty regarding the final requirements.

***Supervisory stress testing (Item 222–240)***

Item 230

According to Item 230, the supervisors should check whether pre-defined "target capital ratios" (hurdle ratios, pass mark ratios) should be defined. Specification of such ratios, however, is not considered to be suitable and Item 230 should be reconsidered.

Here, it should be also pointed out that, wherever the pass mark is set, this will ultimately be an artificial, arbitrary level. In consequence, reaching or failing to reach the minimum ratio constituting the pass mark will be an arbitrary result. The absolute level of a capital ratio can never serve as the only indicator of a bank's likelihood of becoming insolvent. In addition, the appropriate level of capital that a bank should hold will depend on its business model. A one-size-fits-all pass mark therefore makes no sense whatsoever. What is more, such an approach suggests – wrongly – to the general public that a bank which exceeds the pass mark is "safe" while a bank which fails to reach it is on the brink of insolvency. Yet the subsequent financial difficulties experienced by banks which easily "passed" EBA's stress test were a major reason for that test's bad reputation. It is vitally important to make it clear that the information value delivered by a stress test will necessarily be limited.

For these reasons, it would be recommended to drop the idea of a pass mark given the potential for misinterpretation by the general public. A sounder approach would be to focus when analysing and communicating the results on the sensitivity of the capital ratios as a measure of participating banks' vulnerability to the adverse scenario. The published results could focus on the absolute and percentage reduction in capital ratios on the day at the end of the simulation as a measure of the severity of the scenario's impact.

#### Item 245

According to the specifications of Item 245, the supervisors should also take the probability of scenarios into account as part of their analyses. Typically, these probabilities cannot be appropriately and precisely quantified. Even the drawing up of a hierarchy would be difficult. It is therefore recommended for this requirement to be removed. The same applies for Item 247 (a).

### **3. About EAPB**

The European Association of Public Banks (EAPB) represents the interests of 31 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 93 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.