Response on the EBA “Discussion paper on the future changes to the EU-wide stress test” (EBA/DP/2020/01, 22 January 2020)

Stress test – status quo

The European Banking Authority (EBA) conducted its first EU-wide stress test in 2011. It is based on a constrained bottom-up approach. The initial aim was the identification of risks through the use of internal models and to increase the development of efficient risk management practices. The balance sheet is taken as given at the reference date. Possible actions for mitigating the impact of shocks by the management are not taken into account. The exercise featured constraints to prevent banks from making overly optimistic projections and for assuring the consistency and comparability of results. Most of the features have remained unchanged since the first stress test.

Main reasons for a new proposal

The current bottom-up approach incentivised banks to invest in their risk models. It also allowed supervisors to better understand the mechanics of banks’ internal models. Benefits are continuity and consistency of data, as well as the possibility of comparing different banks.

The EBA wants to start assessing potential longer term changes to the EU-wide stress test by issuing a discussion paper as the first step due to some concerns regarding the current stress test methodology.

One area of concern is according to the EBA the lack of clarity and prioritisation of the stress test objectives. Some objectives are conflicting. The new approach should lead to a clear definition of objectives, in particular whether the exercise aims to identify banks’ specific risks or system-wide risks in the EU banking sector. The stress test should be less integrated in the regular supervisory process. Some methodological constraints, for example the static balance-sheet assumption without considering management actions, make it difficult to convert the stress test capital depletion into a meaningful supervisory capital add-on (i.e. P2G) without further adjustments.
Another concern is the ownership of the results. Currently, banks provide projections that can be overridden by the supervisory benchmarks and challenger models. Banks are asked to confirm the figures before publication. However, they do not necessarily need to agree with them.

An additional concern is related to the resource-intensive nature of the exercise for all parties involved. The exercise should become more cost-efficient.

**Basis and criteria for a new proposal**

The new framework confirms that the stress test is primarily a micro-prudential exercise. Main objectives are the identification of risks and the assessment of banks’ capital adequacy. For supervisors, it is a support for the SREP and the assessment of capital planning. For banks, it should complement their internal capital adequacy assessment process (ICAAP) and improve their internal risk management practices.

According to the EBA the changes should fulfil four criteria – relevance, comparability, transparency and cost-efficiency of the exercise.

Relevance – stress test projections should be as close as possible to the actual impact on capital should materialise an adverse scenario.

Comparability – facilitating a level playing field across banks and jurisdictions in the EU. Parallel considering banks’ specificities and individual risk profiles.

Transparency – allowing markets and the wider public to gain information from the supervisory stress test.

Cost-efficiency – fulfilling the stress test objectives with commensurate resources from both supervisors and banks.

**Two leg approach**

The proposal is based on two legs. The supervisory leg should be a basis for supervisory decisions, directly linked to the P2G setting, and a constrained approach. The bank leg should focus on disclosure and market discipline – and allow more flexibility.

**Supervisory leg**

The supervisory leg should be based on a constrained bottom-up approach (similar to the current framework). Banks’ projections should be challenged and the quality be assured by supervisors using various challenger models and benchmarking tools. Due to the ownership by the supervisor and the lighter QA interaction, as well as the
potential usage of top-down features, the new framework could deviate from the current approach in the following aspects:

- The static balance-sheet assumption could be relaxed by allowing the incorporation of certain actions implemented before the end of the QA phase.
- A limited set of methodological constraints could be relaxed (but not to the same extent as could be the case for the bank leg).
- The granularity of templates could be reduced (especially in connection with the potential top-down features).

**Bank leg**

The bank leg should be obtained by using a flexible bottom-up approach. The methodology should be less prescriptive but still be based on the same scenarios and templates that are common for all banks in order to have a comparable data set across banks. The results would not be quality assured by the supervisor, giving full ownership of the results to banks. Nonetheless, supervisors could conduct basic checks.

**Communication of stress test results**

Two different stress test results would be obtained, reflecting the supervisory leg and the bank leg. Both results should be disclosed to increase the relevance of the exercise. The EBA would disclose, bank by bank and on aggregate, the results derived from the supervisory leg, limited to the capital ratios which are relevant to capital distribution and key drivers for each scenario. The EBA would additionally disclose, bank by bank, granular data based on the bank leg, based on common disclosure templates similar to the EBA transparency templates of the 2020 stress test. Since two different results would be disclosed, an explanation of the differences between the two would have to be provided.

**Advantages of the new approach according to the EBA**

The EBA sees advantages of the new approach in all of the before mentioned four criteria.

Relevance – The bank leg increases the relevance for banks’ own risk management because the possibility of deviating in the bank leg from methodological constraints would allow banks to leverage more on their own models. The supervisory leg increases the relevance for supervisors. The relaxation of some constraints will make the results more realistic. The supervisory leg assures the reliability of the projections by using a combination of a constrained bottom-up approach, potential top-down features and supervisory QA. The overall relevance would be achieved due to a clear ownership of results. The bank leg would be owned by banks, which would decide how to model the projections, while the supervisory leg would be owned by the supervisors.
Comparability – In general, the bank leg results will not be directly comparable because banks may make stronger use of own models. In addition, the absence of supervisory QA will make these results less comparable. The lower comparability would be mitigated by disclosing information in a standardised format on their deviation from the constrained bottom-up approach, explaining which constraints they have relaxed. The comparability of the supervisor leg results will remain high due to the presence of methodological constraints and to the consistent application of supervisory models.

Transparency – Transparency would remain at the level by the current stress test or slightly increase.

Cost-efficiency – Banks would have to produce two sets of results. Providing an additional set of results for the bank leg will require extra efforts. That would be reduced by a lighter QA process and fewer iterations with the supervisors in the supervisory leg.

BSG position on status quo

The BSG welcomes the initiative of the EBA to consider methodological changes on the current EU-wide stress test. Almost ten years after the introduction of the first stress test by the EBA quite a lot of experience has occurred that should be incorporated to strategically further develop the stress test. The BSG agrees with the EBA that there is room for improvement in both conceptual and practical areas. The BSG sees some weaknesses of the current stress test, for example:

- Conceptually, a top down approach cannot adequately reflect the specifics of business models of an individual bank.
- Closely connected to that, communication with market participants who expect a close linkage between stress results and business model is difficult in a top down approach.
- Results have to be generated by models that are not really sound from the perspective of the respective bank using different internal models.
- Closely connected to that, results lack a high degree of relevance because they just partially reflect the specifics of the banks’ business model.
- The exercise is time consuming and less meaningful due to the supervisory stress models and constraints.

BSG concerns on the discussion paper

From a conceptual point of view it is difficult to understand the rationale of EBA decision to incorporate two approaches. The bank leg is based on a bottom up approach whereas the supervisory leg follows another bottom up approach. In line with this, it is not entirely clear why at least two bottom-up based legs should be followed. It seems that the EBA would like to combine two different aspects. On the one hand bank specific business models should be illustrated within the stress test, on the other hand a high degree of comparability to be achieved. There is always a tension between individuality and comparability. The BSG doubts whether delivering
two outcomes using two approaches can solve this tension. The BSG suggests to add further clarity on the objectives, while to consider that maintaining several objectives casts doubt to whether the proposal is manageable.

When following two different approaches the relevance of the results for both banks and market participants could be questionable. Both approaches are bottom-up. The bank leg is not entirely following the internal models used by banks. As both measurement methods are based on different grounds (with less flexibility regarding the supervisory leg and more regarding the bank leg) the outcome cannot be verified by comparing the results. They are not two sides of the same coin. From a conceptual point of view, the question remains what result reflects the reality of the individual bank in a proper way. It would be clearer if the EBA would categorise their proposal as two versions of the same approach rather than “two conceptually different approaches”.

In the bank leg there are quite many restrictions required by the EBA to be fulfilled. Banks are not free to just present data produced from their own internal models. Therefore, the examination of the bank leg wouldn´t be in line with the specifics of the respective banks. Therefore, banks themselves would hardly use the results of this part of the stress test for management purposes.

The BSG draws the attention of the EBA to the US experience where a dual method is already used but largely criticised. The FED therefore started to provide more transparency on its modelling and results. Banks in the US have hardly been able to truly explain the differences between bank leg and supervisory leg.

The BSG sees difficulties in analysing results from stress tests as, at least, three different stress tests outcomes have to be disclosed – supervisory leg, bank leg, and ICAAP. For analysts the question might arise which outcome shows the reality in the best way or which figure is the correct one. Maybe analysts would assume that the bank leg would be closest to the internally used models and therefore think that the results represent the bank´s internal view best. However, due to the restrictions mentioned in the discussion paper regarding the measurement, it doesn’t really reflect the perspective of the individual bank. Furthermore there might be a large difference in the results between the bank leg and the supervisory leg. Analysts will ask for clarifying the differences in the outcome of both legs of the stress test. So, both the bank leg as well as the supervisory leg would have to be verbally clarified extensively (even if a reconciliation would have to be disclosed) – as regards the bank leg: because it doesn’t really represent the view of the bank; and the supervisory leg because it is so much restricted by constraints of the EBA that the result is even farther away from the bank´s internal risk management.

If figures don’t stand for themselves but need to be clarified intensively, market participant always get a bit suspicious whether the results can be trusted. There would always be some mistrust in the market when the expectation of a bank leg will be that it is more or less in line with internal models which, in reality, according to the proposal of the EBA will not be the case. The name bank leg gives the impression that it reflects the bank’s perspective based on their internal models. The BSG proposes that that the bank leg is, as far as possible and agreed with the supervisor, aligned with internal models used for ICAAP”.

Regarding the supervisory leg, analysts might see an advantage that the results could be better compared between different banks because of the many restrictions in calculation provided by the EBA. Therefore, the supervisory leg might be seen as a figure with a minimum chance of manipulation and the highest level of comparability. Due to the restrictions in calculation, the difference between the calculated results to the real risk of the respective bank might be large.

That all may end up in a far more complex analysis. Banks could see the necessity to provide market participants with more distinct capital analyses than really needed. Therefore, the BSG warns of the danger of a higher level of confusion and mistrust by market participants as they might misunderstand the different numbers according to the different stress tests.

Assuming that, the EBA should follow either a bank leg or a supervisory leg approach, the BSG recalls the advantages of aligning the use of internal models with the stress test. As the BSG welcomes a further development of the stress test, it might be fruitful to develop the current approach in the direction to identifying risks being specific for the respective bank which would be more aligned to the bank leg rather than of the supervisory leg. If the EBA would like to adopt the proposal of the discussion paper, then the bank leg should be further developed towards aligning with ICAAP.

In contrast to the suggestion of the EBA, BSG advises to consider to further align the stress test with ongoing supervision. Generally, BSG is of the opinion that there is some more room for improving the harmonisation in legislation between ICAAP and stress tests. Maybe in the CRD VI there could be a mandate for EBA to formulate level 2 legislation or at least guidelines on methodologies and stress scenarios.

Regarding the future development of the stress test, the bank leg analysis should be a harmonisation of ICAAP (with common guidelines for all entities). A possible precondition, for example, could be an annual consultation between the bank and the competent supervisory authority in order to decide which models and approaches are (from their point of view) robust and therefore can be approved. The advantage would be that the outcomes are more P2G-relevant. Some further constraints into that approach might be included. The BSG sees a need for a respective dialogue which should not be eliminated. That could be combined with a proposal that in cases where inspections identify clear weaknesses in internal models, banks would fall back to more conservative supervisory models. That would set clear incentives for banks to improve their ICAAP.