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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

EBF Draft Response to EBA consultation on Draft Regulatory Technical Standards specifying the range of scenarios to be used in recovery plans under the draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms (EBA/CP/2013/09)

The EBF welcomes the EBA draft RTS specifying the range of scenarios to be used in recovery plans under the draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms. Recovery plans will play a major role in the supervisory toolbox, and their appropriate development is crucial for global banks. These plans could contribute to enhancing cooperation and restoring confidence among supervisors, banks and supervisors, and as a result could limit the pressure to protect domestic financial systems while reducing the risk of ring-fencing.

However, regarding the design of scenarios proposed in this regulatory technical standard (RTS) we have several comments:

General Remarks

The credibility of a recovery plan relies first on a large and diversified list of options addressing a wide range of cases. This often comes from a diversified business model that many (if not most) G-SIFIS have. The emphasis on stress testing does not sufficiently reflect this point. It is not possible to predict what the next crisis will be. The most serious crisis in the past were those that had not even been imagined. For this reason, stress testing against scenarios remains a theoretical exercise and as such should not contain too many details, nor become an additional process to identify risks (identification of vulnerabilities is more the usual risk management business). As a consequence, stress-testing should remain rather high level (global impacts and applicable tools). Nevertheless, we acknowledge that scenarios can be useful to assess the financial soundness of banks within specific and likely stress situations (which can be updated according to macroeconomic developments).

In our view, scenarios developed with the purpose of assessing the feasibility of recovery options are very different from those used in other supervisory tools such as ICAAPs or stress-test. The EBF believe more flexibility should be given to banks to determine to what extent these (recovery) scenarios will coincide with other plans (e.g. liquidity stress testing and ICAAP). Since the bank owns the recovery plan, it is important that the bank is able to formulate the plan in the manner deemed most appropriate.

Additionally, to be useful in a recovery plan, more emphasis on qualitative than on quantitative aspects of scenarios is needed. In this way, scenarios will become a more useful tool to identify in which circumstances, the institution may activate specific recovery measures, instead of focusing on identifying if the institution could enter in recovery over the following months. Scenarios in a recovery plan are not aimed at forecasting the next crisis but at identifying which actions could be implemented by an institution in order to cope with an extreme adverse situation and at assessing the final impact of the feasible measures in such a situation.

Therefore, the interaction and differences among scenarios for ICAAP or stress test exercises and for recovery plans requires further clarification in the RTS.

1. More detailed comments are the following: Qualitative elements of the scenarios should be prioritized

According to the draft RTS, scenarios for a recovery plan should only provide the threat of failure to a bank, but without leading to a resolution process. This seems like a very fragile balance. In our view if the purpose is to test the feasibility of recovery options, a good description of channels of impact of different scenarios and qualitative elements should be more important than precise quantifications of the final impact of those scenarios.

In this approach, analysing channels of impact on banks becomes critical to help identify suitable options in each scenario. As an example, for global banks, closure of wholesale markets would limit the recourse to this funding in one or more jurisdictions or a debt crisis in a specific geography would make it very difficult to sell assets located in that country.

Additionally, capital and liquidity channels of impact are very different in nature and a better understanding of the dynamics and qualitative elements should be more helpful to discuss which options could be implemented in different slow- and fast-moving channels.

2. The combination of systemic and idiosyncratic scenarios raises some concerns

In this same vein, if the plan includes idiosyncratic and systemic scenarios that are each severely stressed, or threaten failure to the institution, a combination of two extreme situations would add both impacts driving the institution inexorably into a resolution instead of a recovery for two main reasons: i) the extreme magnitude of the combined scenario and ii) the more limited number of recovery options feasible in this scenario. Thus, the usefulness of a combination of scenarios should not necessarily be an accumulation of all adverse effects but a combination of selected effects of systemic and idiosyncratic scenarios.

3. Anchoring to a starting point is a key difference with ICCAP and stress test scenarios

Scenarios for a recovery plan should not consider a specific point in time as the starting point and, in the same philosophy, should not display particular paths for any variable. Anchoring the starting point could become a strong determinant of the degree of severity of scenarios. As a matter of fact, if a bank is overcapitalized and/or has a very comfortable liquidity situation, recovery scenarios that would threaten failure to the institution, would be extremely severe, while they might be very moderate for other banks. Whereas this outcome is expected, main concerns arise when these scenarios are used for analysing the feasibility of recovery options. Paradoxically, for well-capitalised institutions with very

severe recovery scenarios, fewer recovery options may be feasible or their impact may be subject to significant haircuts due to the severity of those scenarios.

4. Role of the reverse stress-test exercises should be clarified

We are opposed to the mandatory development of reverse stress-tests, even if they can be used by some institutions to elaborate scenarios (as explained in the introductory part and in the FSB guidelines). Requiring a bank to focus on its weaknesses is not useful for recovery planning. On the contrary plans should rather rely on banks' strengths.

5. The purpose and design of slow and moving scenarios is undefined

The difference and purpose of slow and fast-moving scenarios is not clear. It should be clarified if it refers to different channels of impact within the same scenario or to different scenarios. Being aware that capital and liquidity have different dynamics, further clarification of the aim and design of these scenarios is needed.

6. Interaction between supervisors in defining recovery scenarios is crucial

For global banks, scenarios should be consistent between parent and subsidiaries. In this sense, cooperation among supervisors is needed and common guidelines are important. This is especially important for banks with subsidiaries located outside Europe. The degree of severity of scenarios could be very diverse in different geographies, and this factor could influence the feasibility and financial impact of recovery options in those different geographies, likely distorting the comparability of recovery measures in different areas.

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Related documents: <http://www.eba.europa.eu/documents/10180/205759/EBA-CP-2013-09---CP-on-Draft-RTS-on-Scenarios-For-Recovery-Plans.pdf>

Response to Discussion Questions:

Q01 - Have you already drafted financial distress scenarios for the purpose of testing a recovery plan or are you in the process of doing so? If so, are these financial distress scenarios in line with the contents of the draft RTS?

The process of implementing recovery plans in the European banking community is ongoing since 2012. The minimum requirement to have a system wide event scenario, an idiosyncratic event and a combined system wide idiosyncratic event for testing the adequacy of recovery plans is consistent with the current practice in most European Banks. This allows banks to build what they find to be the most appropriate aggravated stress scenarios to test recovery plans, and to adjust them to each institution's own characteristics and reality.

On average, banks developed 3 to 6 scenarios, consisting of system wide, idiosyncratic and combination scenarios.

Q02 - Have you developed group or solo specific scenarios to test the adequacy of the recovery plan?

Some European banks have developed group and individual recovery plans, but many/most have developed group plans only. The EBF advocates that the recovery planning should be adapted to the business model to reflect a centralised group or decentralised group approach to recovery in the going concern.

Q03 - Do you believe that the draft RTS on the range of scenarios for recovery plans is adequate to ensure that firms test their recovery plans against a range of scenarios of financial distress?

Article 4 needs clarification:

- Since a system wide event does not need to have simultaneously all the disturbances that are listed in paragraph 2, these disturbances should be seen as suggestions only. In our understanding paragraph 4.4 clarifies, that paragraphs 4.2 and 4.3 contain possible examples for scenario definitions/creation. Not all of these examples, however, have to be included in the stress scenario set, in particular, if they are not relevant for the group recovery plan;
- It is important to define “slow-moving” and “fast-moving” in the adverse events that are mentioned in paragraph 5;
- It is important to clarify paragraphs 4 and 5.

Q04 - How many scenarios have you been required to develop to test the adequacy of the recovery plan? Have you included slow or fast moving events?

Please read the answer to Q01.

On average, banks develop 3 to 6 scenarios, consisting in system wide, idiosyncratic and combination scenarios.

Q05 - Have you used reverse stress testing as a starting point for developing financial distress scenarios?

The EBF advises caution on the use of reverse stress testing for the purpose of recovery planning. The Reverse Stress testing concept and its calibration aim at the point of non-viability after mitigating measures (gone concern) while recovery plans are based on stressed but going concern situations. Thus, the reverse stress test concept is not necessarily suitable for the stress scenarios in the recovery plan. The conditions which lead to recovery will naturally deviate very significantly from the modelling assumptions needed to be used in reverse stress testing, as the latter are based on historically observed relationships. Some, or all of the statistical relationships relevant for balance sheet modelling would break down in a situation which implies, that the recovery plan is activated. Reverse stress testing assumes that these relationships are static, i.e. as in business-as-usual. Therefore, any reverse stress testing will be either a very partial analysis or based on assumptions which are unrealistic.

While it is impossible to model all unprecedented events, the range where statistical models are meaningful to use coincide with the “business as usual stress” which is covered/described in the ICAAP reporting.

We encourage the use of “environments” to evaluate recoverability. An environment is characterised by a number of assumptions about the “economic environment”. The ability to recover a balance sheet which has broken its recovery triggers is then evaluated against these stylised environments. This procedure avoids detailed discussions/modeling of the avenues to recovery which is not helpful for the broad discussion of the efficacy of the recovery options. This approach puts emphasis on the ability to recover a weak balance sheet under adverse economic conditions, rather than focusing on the dynamics of the potential paths from business as usual to the distressed situation.

Q06 - What are the additional costs to develop financial distress scenarios in respect to the current practices of reverse stress testing?

Building a coherent financial and economic environment/story to provide for the intended end effects under a reverse stress testing procedure is of a more complex nature than simply running an economic/financial stress scenario.

Q07 - Do you believe that the events that institutions or groups need to consider and include where relevant are most suitable? If not, what other events ought to be taken into account?

Please read the answer to Q03.

Generally we cannot see a benefit with more than -3-6 scenarios. The scenarios as such must be adjusted to the respective institution. However, it is relevant to distinguish between a systemic crisis and an idiosyncratic event for the institution, and evaluate the efficiency of the different recovery options against such diverse financial environments.

Q08 - Do you have any general or specific comments on the draft RTS?

No comments.

Q09 - Are the definitions and terminology used in the draft RTS clear?

Please read the answer to Q03.

Article 3.1.b needs clarification in the definition of “*failure*”. Several options can be used to define failure, such as being “below regulatory minimum capital”, “lack of liquidity”, or “need to resort to emergency backstops” (would it include the ones of temporary nature?).

It will generally be necessary to take initiatives and concrete steps to ensure harmonisation of the terminology used on a global scale. In this respect, the EBA must ensure that the terms used in a European context are aligned with the global definitions, such as set out by the FSB.

Q10 - Do you agree that, for an institution, the costs of developing financial distress scenarios to test a recovery plan are likely to be proportional to the size/complexity of the firm and so of the costs its failure may create? If not, could you explain why?

The preparation of recovery plans is a very time consuming task, since the level of information that is requested is very high, and the analysis that is needed to perform is profound and meticulous. In every bank, several departments have to be involved in the preparation of the information and the recovery plans.

Smaller banks that have narrower structures and less physical resources than larger institutions, felt that the costs and the time of producing recovery plans were not proportional to their size and complexity. But the complexity also rises as groups are concerned and in that sense there might be reasons to expect that costs only start being diluted when a significant dimension is achieved. So, small to medium size groups may be particularly impacted on a relative basis.

Q11 - Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?

No comments.

