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EBF response to the EBA discussion paper *On the future changes to the EU-wide stress test* (EBA/DP/2020/01)

Proposed new framework

Question 1: What are your views on the proposed framework in general?

The European Banking Federation (EBF) welcomes the initiative of the European Banking Authority (EBA) to review the current stress testing framework. The EBF highly appreciates EBA's efforts to evaluate the framework and increase its relevance, comparability, transparency and cost-efficiency. However, if any structural changes to the current framework are made, the EBF proposes to postpone the implementation of these changes to 2023 instead of 2022, as the implementation of such changes would be expected to be very demanding (following the delay in 2021 for the next stress test exercise, the EBF also suggests to organize future stress test every two years, in odd-numbered years). The quality of the revised framework should be the main priority and the implementation should also consider the experience from the upcoming 2021 stress test. The EBF stands ready to continue the dialogue in this respect beyond the conclusion of the current consultation. Therefore, the implementation of any structural adjustments should not be rushed.

With regard to more specific comments on the discussion paper, although the EBF members recognise the shortcomings of the current framework, the EBF does not agree with the conclusion that this necessarily means that the stress test should be split up into a supervisory leg and a bank leg. The EBF would like to emphasise that the current proposal of a stress test that consists of a supervisory and a bank leg is expected to be highly burdensome from an operational point of view with no increase in relevance.

Thus, when comparing the current methodology with the proposed methodology of the discussion paper, the EBF finds that **the status quo is clearly more desirable than the proposed framework.**

First, under the current proposal banks would have to run three very complex stress tests: one for the supervisory leg, one for the bank leg and one for the internal capital adequacy assessment process (ICAAP). Second, banks would have to analyse and explain the differences between the outcome of the supervisory leg and the bank leg, which is expected to be very resource-intensive particularly due to a lack of transparency on the supervisory leg. This would further add to the operational burden of stress tests, which is already very high and should rather decrease than increase.

However, the current framework could be improved, in particular by removing certain restrictions, which would allow banks to model their situation more realistically (cf. response to question 7).

The EBA discussion paper mentions a trade-off between the various criteria against which the new framework will be judged. However, the right balance has not been struck. Therefore, in order to assess the framework in more general terms, the EBF would like to establish a number of principles according to which the new stress testing framework should be designed.

The principles – against which proposals for an improvement of the current stress testing framework should be tested – are as follows:

- **Considerations on P2G**
  - **No disclosure of pillar 2 guidance** (P2G), but more objectivity and transparency in the P2G setting.
  - **Insufficient clarity of the EBA discussion paper** on the following points:
    - The definition, meaning and use of P2G.
    - The link between the stress testing outcome and the P2G setting is not clear. Objective and transparent criteria should be introduced.
    - P2G should be a bank-specific metric, it should capture as many idiosyncrasies as possible.
- The **operational burden** of the supervisory stress testing framework **should not increase**
- **Single disclosure:**
  - The stress test result should be published as a single outcome for each bank, with common equity tier 1 (CET1) depletion as a single figure.
  - If a bank leg is introduced, which is not an option that enjoys the support of the industry, the results should not be disclosed. The results should only be used for the supervisory discussion.
- **Maintain the bottom-up constrained approach with progressive removal of constraints:**
  - The starting point of the process should be the use of ICAAP stress testing models with EBA starting point values and scenarios defined by the European Systemic Risk Board (ESRB).
  - EBA could then impose a limited set of compulsory constraints that would apply to all banks to ensure comparability (e.g. restricted list of remediation actions that can be considered).
  - EBA would also identify additional constraints that only apply to banks that cannot demonstrate the adequacy of the sophistication of their ICAAP stress testing models.
  - Finally, the supervisor would keep the possibility to impose add-ons following the Quality Assurance. The rationale for those add-ons should be made transparent to the banks as part of the dialogue with them.
  - The framework should set incentives that promote dynamic balance sheet models.
- **Importance of the supervisory dialogue:**
  - In the spirit of an improved dialogue between banks and the supervisors, banks' models should be judged with regard to their use in the EU-wide stress test earlier on, possibly as part of the Supervisory Review and Evaluation Process (SREP) process.

- More transparency on the models used by the supervisors would be particularly important if the principle of a supervisory leg that drives the P2G is maintained. Else, the ambitions in terms of transparency cannot be met. In case of a single disclosure, transparency on top-down models would ease the supervisory dialogue and make it more efficient, with less "bargaining".

Elaborating on the principles defined by the industry, the EBF would like to highlight the following concerns.

The EBF supports the aim to explore the possibilities for improving the current EU-wide stress test framework. However, as the operational burden of that framework is already high, it should rather decrease than increase unless an increase also implies significant benefits for the participating banks. Given that starting point, EBF prefers a single leg framework over a dual leg framework, because a dual leg framework will create an extra complex stress test on top of the supervisory stress test and the internal ICAAP stress tests, which is extremely burdensome.

The general preference of the industry is to publish the outcome of the stress test as a single figure. The experience with the US stress test Comprehensive Capital Analysis and Review (CCAR) has shown that the market only focuses on the outcome of the supervisory stress test, because it is the result that is binding for banks. This takes away the main justification for publishing the bank leg results, which would be the enforcement of market discipline.

However, the EBF is aware that a single outcome which is truly reflective of the banks' condition under stress can only be accomplished with an effective dialogue between supervisors and banks. To improve the dialogue, the EBF suggests that the dialogue happens much earlier in the process than is currently the case and that the banks' models are judged early on. This would greatly enhance the relevance of the framework. The possibility of using internal models, with possible distinction by risk type, could be an output of the SREP.

In general, the EBF favours the use of ICAAP stress testing models. ICAAP stress testing models could be given a stronger role in the current stress testing framework. This would address one of the major shortcomings of the current stress testing framework, which is that the EU-wide stress test is not seen as an adequate risk management tool. In addition, an improvement of the ICAAP models would also be in line with the supervisory priorities of the Single Supervisory Mechanism (SSM).[1] The use of ICAAP stress testing models would set incentives for banks to further invest in those models, which would have a positive impact on the banks' internal risk management. This is true even if they are admitted under certain restrictions preceded by an assessment of their robustness and reliability. However, the EBF understands that there is scepticism in the supervisory community about the use of those models. In any case, the EBA should maintain the status quo and enhance the current approach by reassessing the constraints that are to be applied during the stress test.

Furthermore, it is important that supervisors are more transparent on their models. Some jurisdictions like the US[2] are already moving into that direction. This is a very welcome development as increased transparency can remedy accountability problems of otherwise highly opaque stress tests.

[1] ECB Banking Supervision: SSM Supervisory Priorities 2020
[2] https://www.bis.org/review/r200121d.htm

Two very important points relate to the topic of disclosure: P2G and the results of the bank leg. Neither the P2G nor the results of the bank leg should be disclosed. First, the P2G should not be disclosed because the P2G concept is a non-binding requirement. However, the publication of the P2G could make it a binding requirement as it could be enforced through market pressure. Besides, disclosing the results of the bank leg would imply that banks have to analyse and explain the differences between the outcome of the two legs. It is expected to be very resource intensive notably due to a lack of understanding of the supervisory leg.

Question 2: What are your views on determining the supervisory leg (a constrained bottom-up approach such as the current approach or a hybrid approach with top-down models replacing some bottom-up elements)?

As explained in our response to question 1, the introduction of a two-leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress tests for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

However, should the EBA maintain its position of having a two-leg framework, determining the supervisory leg through a constrained bottom-up approach, such as it is today, would not improve the relevance of the exercise. One would observe the same drawbacks as those described by the EBA in the first section of their document.

Should there be even more constraints as observed in 2020 for Net Interest Income (NII), starting with Credit Risk and Net Fees and Commission Income (NFCI), the framework would even be going in the opposite direction to the objectives set forth by the EBA. The main objection would be the loss of relevance and risk sensitiveness as the stress test results would be farther from representing what would be the actual impact on capital should an adverse scenario materialise. The EBF does not see the purpose of standardising the calculations when banks have invested a lot in the development of models that are relevant and used for their risk management. In general, the EBF members do not support imposing further top down features to the already highly standardised methodology. At the same time, the EBA should think about how the methodology can be improved in terms of providing more flexibility.

The deterioration in relevance would not be compensated by an improved cost-efficiency. Banks would have to invest significantly in the understanding of the differences between the supervisory and the bank leg.

The deterioration in relevance would neither be compensated by an improved transparency, because P2G will be solely based on the supervisory leg, for which there will be no detailed disclosure. Banks would not be able to explain the gaps between the supervisory and the bank leg due to the partial information they would get on the supervisory calculations.

More generally, the EBF believes that the supervisors should provide individual credit institutions with more transparency on the outcome of the supervisory leg (transparency on supervisory models, benchmarks and add-ons as well as rationale for the adjustments to the figures provided by them).[3]

[3] In this perspective, it can also be interesting to recall the current evolution in the US where the FRB intends to provide more transparency on the models used in CCAR see Vice Chair Quarles speeches to the American Bar Association Banking Law Committee on 17 January 2020 and at Yale Law School on 11 February 2020.

The opacity of the calculation would impede credit institutions to understand and anticipate the depletion of capital ratios resulting from the supervisory leg. Credit institutions should be given sufficient information to anticipate the outcome of a supervisory action with certainty and, therefore, be able to prepare the communication to financial markets, which are strongly influenced by the results of the stress testing exercises.

Question 3: What are your views on determining the bank leg (a prescribed methodology with the possibility of relaxing constraints)? What are your views on the possibility to use ICAAP as the basis for the bank leg? What are the areas where ICAAP would not be suitable for this purpose?

As explained in our response to question 1, the introduction of a two leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress tests for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

Question 4: What are your views on the alternative proposal to publish one single CET1 capital depletion which would result from a dialogue/synthesis between the competent authority and banks?

In order to avoid any ambiguity, as explained in question 1, banks are not in favour of a solution with two legs. If, however the EBA decides to move forward with a two-leg approach, the EBF thinks that there should be only one single CET1 capital depletion published.

In general, this option is definitely the preferred one, for reasons of relevance, transparency (incl. clarity for the market compared to the introduction of a potential confusion in the case of a two leg approach), quality of the supervisory dialogue with banks and better cost-efficiency; see also answer to question 1.

From our perspective one key factor in determining the suitability of the new framework is the resources that banks will have to spend on executing the new stress tests. As of this moment, the workload and operational pressure on the participating institutions is very high. The EBF understands that this assessment is also shared by policy makers. Designing the new stress tests with two different legs would add additional work on top of the existing workload. At the same time, the EBF does not share the assessment about the potential benefits of the framework, especially when it comes to transparency and relevance in general. Consequently, the only way forward is to publish one single CET1 capital depletion and the EBF strongly recommends the EBA to reconsider the proposed two leg approach.

Regarding the proposal to publish one single CET1 depletion, the EBF has the following suggestion for improvement: The relevance of this proposal could be enhanced by further reassessing some constraints, which would increase the relevance of the EU-wide stress testing exercise due to an enhanced level of realism. However, for this proposal to be successful, the EBF would encourage the authorities to think – together with financial institutions – how the dialogue can be improved. The current proposal seems to reduce the interaction between banks and authorities, which is regrettable. This seems to be the case for example with the proposed framework's suggestion to only have two turns of data collection and no responsibility to explain the setting of P2G. Even though it is true that increased interaction incurs costs in the short term, the EBF considers the overall benefits of an improved dialogue with institutions to outweigh the disadvantages.

Question 5: What are your views on the consideration of the bank leg outcome in forming the final supervisory outcome?

As explained in our response to question 1, the introduction of a two-leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress test for the supervisory leg, the one for the bank leg and the ICAAP. This has a strong negative impact on the EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

Question 6: What are the costs of the new proposed framework and where do they come from? What are the benefits? How can the bank leg and supervisory leg be structured to mitigate costs and increase benefits?

For banks, the costs of the new framework would increase significantly. This would reinforce a feature of the current framework that is considered as a major drawback and it would be in contradiction with one of the main targets claimed in the discussion paper. These costs would come from:

- The production of the supervisory leg. These costs would be very similar to the current ones.
- The production of a bank leg that would be different from the supervisory leg and different from the ICAAP stress test.
- The analysis of the differences between the supervisory and the bank leg. This part would be particularly expensive, as banks would have to execute several runs to measure the impact per source of discrepancy. The more the supervisory leg is top-down, the more difficult this will be as banks would have limited understanding of the inputs to the supervisory leg.
- Moreover, banks have to review and implement methodological changes in the supervisory models and the respective data. A more intensive dialogue with the supervisor does only account for a relatively small portion of the costs and does even foster the understanding of the stress test.

As explained in previous questions, the most relevant way to mitigate the costs and increase the benefits would be to have a single disclosure, or by default a supervisory leg starting from the bank leg with less and less constraints, eventually reaching convergence with the ICAAP stress tests. This would reduce the production costs and avoid the cost of analysing the differences between supervisory and bank legs.

Question 7: Which constraints should be relaxed to improve realism (some of the constraints are listed in Annex 1)? Please rank the constraints by their importance in improving realism.

Eventually, as confidence grows in the banks' ICAAP, the goal should be to drop all constraints. However, the following list contains the constraints with the biggest impact on relevance or comparability between banks.

Indeed, some of the current constraints impact very significantly the relevance for all banks.

1. No use of internal **ALM models** for Non-Maturity Deposits, Loan Prepayments etc.:
    a. No internal characteristics for sight deposits or other internal model assumptions such as prepayments. The EBA imposes among others in its scenarios that 1-month sight deposits be remunerated, which is not consistent for all banks
    b. Constraints on the reference rate pass-through rate
2. The **constant balance sheet assumption**, even in the proposed manner, introduces economic inconsistencies, the most important adjustments that could be made in order to make the balance sheet evolution more economically relevant are as follows:
    a. **Allow cures from stage 3** assets in particular and cure rates in general. Considering current defaults as defaulted in the future seems excessive. In the non-performing loans (NPL) calendar (Annex VIII of the methodological note from the original 2020 EU-wide stress test), no assumption can be made regarding the cure of NPLs. This should be allowed, especially as it would also be more consistent with loss given default (LGD) calculations.
    b. No requirement to reinvest interest rate derivatives at any time
    c. Abolish the current treatment of **short-term** credits: under the current guidelines, banks would renew transactions that are not in their credit standards
3. Internal models developed by the banks to project their **Net Fees and Commissions Incomes, Charges and other revenues outside the scope of consolidation** should be better recognised. The caps and floors currently included in the guidelines are unduly penalizing and limit the incentive for banks to further improve their approaches.

    In particular, the prescribed caps for the **share of the profit of investments in subsidiaries, joint ventures and associates outside the scope of consolidation** are particularly high, with a haircut on this source of income of -25% for modelling banks and even -50% for non-modelling banks. For banks that own insurance companies it denies any diversification effect that insurance companies can bring in a scenario adverse to banks.
4. Constraints related to **market risk in the trading book**:
    a. Remove the floor on **trading losses based on FINREP values**: the application of the comprehensive approach is granular and severe enough to consider the riskiness of the portfolio including the hedges. The application of a loss that does not consider the scenario definition/portfolio composition does not capture the specificity of the bank as well as of the scenario and the floor, as designed, is not risk-sensitive.
    b. **Net trading income baseline values** prescribed as the minimum of the averages across the last 2, 3 and 5 years (the 2-year average floored at 0). With the current approach, the aggregate Net Trading Income (NTI) is effectively wiped out for three years, strongly penalizing the banks with important market activities (both in absolute terms and in comparison with peers, depending on their business model).
    c. In the EBA's 2020 methodology, a minimum of 25% of **client contribution** is lost given the floor mechanism. This should be amended and brought in line with other revenues such as fees and commissions (10% for modelling banks) when the EBA decides on the revised methodology. Banks could use 2020 data to demonstrate that client contributions can be maintained in a volatile environment. Client contributions should be stressed separately from trading profit & loss (P&L) while the client contribution formula refers

to historical NTI. Trading P&L is already stressed separately in the Full Reval template. The haircut of 25% gives also no incentive to banks to model their client contributions. The behaviour of client contributions during the Covid-19 should be an opportunity for the EBA to improve its methodology on client contributions in adverse market conditions.

   d. Recognition of gains from credit valuation adjustment (**CVA) hedges** cannot offset the CVA impact (para 272)
   e. The shock on **market risk reserves** is too high under the current methodology and does not allow any decrease of reserves in years 2 and 3 of projections when market parameters can be assumed to return progressively to more usual levels.

5. Eliminate **inconsistencies in foreign exchange (FX) risk treatment**. For example, the 2020 methodology included an FX shock on banking book positions. As only part of assets and liabilities are subject to this shock (in particular deposits that could finance banking book assets in the same currency are not subject to this FX shock) the methodology creates FX positions that do not exist in banks' balance sheets. If FX impacts are included in the P&L or other components of the exercise, the methodology would need to be adjusted to ensure consistency (e.g. fees, operating costs and provisions would need to be impacted accordingly).

6. **Treatment of equity risk risk weighted assets (RWAs)**: The EBA methodology (Art 151) provides that the value of banking book assets should remain constant for purpose of risk exposure amount (REA) estimation. For equity exposures this creates a distortion between the P&L & other comprehensive income (OCI) treatments of such exposures, which are stressed, while corresponding risk weighted assets remain flat. Equity risk weighted assets should be calculated consistently with the stressed value of the corresponding equity exposures to ensure consistency across the stress test exercise

7. **Securitization**: The current treatment of securitization RWAs is excessively severe leading to securitization RWAs after stress that are out of proportion when compared against the CoR generated (even in stress) by these positions or when compared against the shock applied to other types of credit exposures.

In addition, some of the constraints, in addition to not being economically relevant, introduce a bias in conservativeness between banks depending on their business model. This is for us a flaw that needs to be addressed as a matter of priority due to the un-level playing field situation that it creates.

This is particularly true for the market risk in the trading book. Indeed, **the stress test process for trading book exposures is not efficient and the multiplication of shocks** (full revaluation, reserves, client contributions) **is punitive for global markets franchises**. Industry discussions should take place to define a methodology that is less punitive while sufficiently comparable and conservative.

In addition to the points already addressed above, one should note that a **full revaluation** of trading books is an expensive exercise that is difficult to execute and review. Indeed, proper implementation requires drawing on the resources of banks' front offices. Moreover, the results thus obtained are then generally overridden by a floor mechanism, which has no economic ground (multiple of trading assets). Eventually, the quality assurance of full revaluation numbers proves also challenging, as reported sensitivities cannot fully explain P&L movements, making reconciliation difficult and time consuming, for both supervisors and banks teams. The process should be simplified.

In the same manner, the absence of homogeneity in the treatment of FX risk is particularly impacting for banks that have developed their activity in countries where the FX scenario is most severe. Indeed, as described above, the 2020 methodology included an FX shock on banking book positions creating FX positions that do not exist in banks' balance sheets. This should not be the case when the activity is done from the country with cost bases and funding in the same currency.

Question 8: For generating the bank leg, would you prefer that banks have a discretion to relax certain methodological constraints or have a common methodology that would be less constrained than the one in the supervisory leg?

As explained in our response to question 1, the introduction of a two-leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress tests for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on the EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

Question 9: How different is the ICAAP approach from the supervisory leg (assuming the methodology is the same as in the current framework) if all constraints are dropped?

Should all constraints be dropped (with no additional mechanistic approach, and with the list of constraints being larger than the one presented in appendix as it should include all caps and floors and the value at risk (VaR) multiplier), the main differences are:

- The dynamics of the balance sheet
- The idiosyncratic elements
- The management actions

The difference between the ICAAP and an unconstrained bottom-up approach would be essentially in the scenario development. For an equivalent severity and probability of the scenario, the ICAAP would have generally less shock on traditional risks but would include more idiosyncratic items which are relevant for pillar 2 assessment.

Question 10: Would banks benefit from setting some assumptions for specific risks and giving general guidance, even if they are allowed to use their own models without constraints?

Yes, banks could leverage on supervisory benchmarks and assumptions in reviewing their own models and in preparing the discussions with supervisory authorities as long as these benchmarks and assumptions are no binding constraints and are communicated at an early stage of the process, ideally as part of the scenario definition.

Question 11: What are the benefits of the bank leg and how would you increase them?

As proposed currently, the bank leg has very little benefit. It would not be useful for the banks' own risk management and would not be relevant for markets - nor really considered by them - as it does not contribute to the supervisory leg, hence the P2G setting.

Question 12: What are your views on the possibility of having limited supervisory QA to the bank leg?

As explained in our response to question 1, the introduction of a two-leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress test for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on the EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

Question 13: Which dynamic effects do you find are important to consider?

As described in question 7, some adjustments should be made to the static balance sheet assumption to make the stress test more relevant, in particular for short term credits, cure rates and reinvestment of interest rate derivatives.

Communication of stress test results and disclosure

Question 14: What are your views on the proposed granularity of disclosures? Is the granularity appropriate and does it contribute to an improved quality of banks' stress test deliverables and practices?

The disclosure as it is proposed currently is not adequate.

Indeed, as the P2G is only based on the supervisory leg, the EBF believes that the market analysts will not be interested in the granular disclosure of the bank leg. They would rather be interested in understanding the granular elements of the supervisory leg.

The argument often cited for publishing two results, the results of the bank leg and the supervisory leg, is that the publication of the bank leg would enforce market discipline. The experience of the US stress test CCAR suggests that the market only focuses on the outcome of the supervisory stress test, thereby, taking away the main reason for disclosing the results of the banks assessment of their own capital situation under stress.

As described today, the disclosure of a granular bank leg would be expensive for banks with limited to no added value. This is one of the reasons that the EBF has a strong preference for maintaining a single leg framework.

In all cases, but in particular should the ICAAP be the basis for the bank leg, it is essential that banks only disclose the adverse scenario, as it is the case in all other jurisdictions. No disclosure of the central scenario should be considered as it would correspond to a full disclosure of a bank's 3-year plan, which is a confidential information for understandable reasons.

Should EBA maintain its proposal to introduce a two-leg framework and require the disclosure of the results of the bank leg, the granularity should not exceed the global precedent and should be accompanied with sufficient disclaimers. Moreover, market discipline is less driven by detailed disclosures but by relevance and comparability. The EBF hence proposes to reduce the size of the templates significantly.

Finally, the EBF would like to strongly underline that it should be formally specified that the P2G buffer has to be not publicly disclosed in Europe. P2G is not a binding constraint as any breach does not result in any automatic Maximum Distributable Amount (MDA) restrictions, as stated in Capital Requirements Directive V (articles 104b (5) and 104b (6)). Hence, there is no direct link with the distribution of dividends or coupons on Additional Tier 1 instruments (AT1 instruments) that could impact investors. A breach of the P2G rather results in a dialogue between the supervisor and the institution.

We also consider that the initiation of the dialogue with the supervisor does not constitute in itself an inside or material non-public information as defined in Article 7 (1-4) of Regulation (EU) No 596/20146 and should be disclosed to the market.

If the P2G was to be publicly disclosed, market practice shows that P2G would automatically become a pillar 2 requirement (P2R) requirement. Hence this P2R increase would mathematically decrease the bank management buffer.

Question 15: What are your views on the disclosure of granular information based on the bank leg? Do you think that the bank view is the best option for providing transparency to the markets?

As explained in our response to question 1, the introduction of a two-leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress test for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

Question 16: What are your views on a limited disclosure of the supervisory leg, mainly focused on the capital depletion from the stress test results? Do you see challenges in maintaining the overall comparability across banks?

In our view, there should be a single disclosure with sufficient information for the market analysts to understand the conclusions of the exercise.

Instead of disclosing only the capital depletion, EBA should also communicate on the post stress capital ratios and ratios requirements, as it is done in the US. The post-stress ratio should show the effect of the reduction or even cancellation of countercyclical buffers. It is important that the ability to use countercyclical buffers is made more explicit.

The European capital requirement cumulative approach makes the buffers implicitly "unusable" for the determination of P2G even though they are explicitly meant to be used in times of stress or extraordinary circumstances.

As recommended by the Basel Committee on Banking Supervision (BCBS), "capital buffers […] – which comprise the capital conservation buffer, and by extension the countercyclical capital buffer and buffers for systematically-important banks, complement the Basel III minimum capital requirements. […] The committee continues to be of the view that banks and market participants should view the capital buffers set out in the Basel III framework as usable in order to absorb losses"[4].

Question 17: How could the current transparency templates of the EU-wide stress test be improved? Please specify in detail what information should be included in or excluded from the transparency templates.

The transparency templates are already very rich and they should not be materially extended. The articulation with pillar 3 disclosures could be better organized to avoid duplication of information. The comparison between the solvency ratios post stress and the relevant binding constraint should be clearer than how it is done in the 2020 template.

[4] Basel Committee on Banking Supervision's newsletter on buffer usability, October 2019, https://www.bis.org/publ/bcbs_nl22.htm

Question 18: Is the granularity of the transparency on exposures and credit risk impairment deemed useful for market discipline? What are the potential drawbacks of such a granular disclosure?

The granularity seems adequate for market discipline. Too granular disclosure would lose the readers in excessive details.

Question 19: What are your views on the proposed publication of two different CET1 capital depletions (i.e. the bank leg and supervisory leg)? How would you interpret two different outcomes?

As explained in our response to question 1, the introduction of a two leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress tests for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced. This is one of the reasons that the EBF has a strong preference for maintaining a single leg framework.

Question 20: What are your views on the disclosure of the bank leg knowing that the supervisory involvement would be limited to basic data checks of the starting points?

As explained in our response to question 1, the introduction of a two-leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress tests for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on the EBA's objective of increased relevance, increased transparency and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

Question 21: What would the challenges be in explaining differences between the bank leg and the supervisory leg? Are there limitations for the computation of the standalone impact of each driver of differences (e.g. from the removal of each constraint in the bank leg)?

Banks would be in a position to explain the differences between the bank leg and the supervisory leg only to the extent that they are themselves able to understand how the supervisory leg is calculated.

In the current proposal, there is no guarantee that this would be the case, as detailed in paragraphs 43 and 44. Indeed, these refer to "supervisory models […] requiring banks to deliver mainly starting points and possibly some historical information but no projections", and "authorities using all of the tools and information available".

In any case, this process would be expected to be very burdensome. This is one of the reasons that the EBF has a strong preference for maintaining a single leg framework.

Question 22: What are your views on a possible disclosure of the differences between the bank leg and the supervisory leg? What level of detail of such a disclosure would you consider appropriate?

As explained in our response to question 1, the introduction of a two leg system would represent an additional operational burden on banks' resources as it would mean that banks have to run three very complex stress tests, the stress tests for the supervisory leg, the bank leg and the ICAAP. This has a strong negative impact on EBA's objective of increased relevance, increased transparency, and increased cost-efficiency as well as detrimental impacts on the other objectives and should therefore not be introduced.

For example, the topic of disclosure is very burdensome as banks have to perform a fully comprehensive disclosure of the sources of differences between the two legs and under a standardised disclosure template. This means that too much energy is spent on understanding and explaining the gaps, which could otherwise be used for risk management and providing relevant information to the market.

Question 23: Do you identify benefits in following any of the three possibilities for a disclosure of stress test results that is more aligned with the final P2G?

The three options are quite equivalent in terms of disclosure. The disclosure of P2G would gradually lead to a situation where the P2G becomes binding, therefore eliminating the differences between P2R and P2G. Therefore, disclosing the P2G is not supported by the industry (see response to question 24).

Question 24: Do you know of any drawbacks of publishing the banks' final P2G?

The EBF would like to strongly underline that it should be formally specified that the P2G buffer has to be not publicly disclosed in Europe. P2G is not a binding constraint as any breach does not result in any automatic MDA restrictions, as stated in CRD V (articles 104b (5) and 104b (6)). Hence, there is no direct link with the distribution of dividends or coupons on AT1 instruments that could impact investors. A breach of the P2G rather results in a dialogue between the supervisor and the institution.

If the P2G was to be publicly disclosed, market practice shows that P2G would automatically become equivalent to a P2R requirement, under market pressure. Hence, this P2R increase would mathematically decrease the bank's management buffer whereas nothing has changed in the risk profile of the bank.

Question 25: What is your view on the public communication by banks of their management actions to restore the capital position and their capacity to distribute dividends?

We strongly oppose the proposal to disclose management actions, as they are sensitive. Any disclosure can put banks at an unfair disadvantage and also lead to a lot of misinterpretation for a hypothetical scenario. The disclosure that under certain circumstances the bank would expect a certain price for certain divestments may even make these divestments impossible when actually needed. Comparing the EBA proposal with the US practice, the CCAR/ Dodd-Frank Act stress test (DFAST) process also does not require banks to disclose management actions. The only additional disclosure is capital actions under the Capital Plan Rule. Similarly, disclosing capacity to distribute dividends is not mandatory in other international regimes. The EBF believes that such a disclosure would again lead to confusion, given that it is a hypothetical scenario. For example, the bank may choose to reduce or suspend capital distributions under a certain level of stress. If this is disclosed, it may lead to a lot of confusion among banks. Further, such disclosures tend to be asymmetrical in nature, thereby not facilitating a good comparison.

Assessing success criteria

Question 26: Does the proposed framework fulfil the assessed criteria better than the current framework?

As mentioned in the answer to question 1, the EBF assessment is that the current framework is definitely preferable when compared to the proposed framework. Even if the current framework suffers from drawbacks, the suggested evolution is deemed less efficient as it would increase significantly the costs without really improving relevance.

Question 27: Please provide your assessment of the criteria for the new framework in the matrix below, explaining, for each leg, how it fulfils the criteria, followed by an overall assessment of the new framework. Please assess the new framework against the current one, indicating firstly if the criterion increased, decreased or stayed the same, followed by an explanation.

	Bank leg	Supervisory leg	Overall exercise
Relevance			Likely to decrease over time as mechanistic top-down elements are introduced for the supervisory leg
Comparability			Mostly unchanged
Transparency			Reduced: - two different outcomes with the two legs - Less granularity for the leg that drives P2G setting Please see the below comment on transparency for further elaboration
Cost-efficiency			Sharply decreased for banks (strong increase of cost) Increased cost-efficiency for EBA and ECB

Explanation of the assessment:

The EBF does not provide an assessment of the individual legs, because the EBF does not consider this individual assessment as meaningful. The EBF holds the view that the overall assessment is what matters.

From a relevance point of view, the proposed approach would be less relevant as the capital depletion would be solely based on the supervisory leg that would be more constrained and less aligned with the banks' own risk.

From a cost effectiveness perspective, the proposed approach may be less expensive for supervisors as they would have a limited QA to perform. However, this comes to the cost of relevance and EBA understanding of the bank leg.

On the other hand, the burden would be much higher for banks who would have to run 3 different stress tests: one to contribute to the supervisory leg, one to produce the bank leg and one for its ICAAP. In addition, the banks would have to perform multiple runs to detail the waterfall from the bank leg to the supervisory leg (should they have sufficient information on the supervisory leg to do so).

Regarding transparency, the proposed approach would not improve the existing situation. With the double disclosure there are two serious risks that should be considered:

1. With a double disclosure that would not be consistent, markets would receive a blurred message. Policy makers should keep in mind that more information as such does not guarantee transparency. For true transparency, market participants need to be able to understand and process the provided information. However, if too much information is released, this could make the understanding of the stress test outcome very difficult and lead in turn to a confusion regarding the interpretation of the stress testing outcome.
2. At the same time, it could also happen that market participants would only be interested in the supervisory leg that impacts the capital depletion, because this is the one that contributes to P2G. However, there would be no granular information to help them understand the dynamic of the result and how it could evolve over time.

Considering those two side effects of the double disclosure, the EBF does not see any benefits in providing market participants with the results of the bank leg.

From a comparison perspective, the situation would be very similar to today's situation.

Feasibility of introducing changes to the scenarios' design

Question 28: What are your views on the consideration of two common adverse scenarios?

This would (again) roughly double the workload, while it is questionable how the market will react. The question is whether or not they will look at the worst outcomes, the average outcome, etc. Also, the EBF expects them to compare the results of both scenarios, which can lead to cumbersome communication as each scenario has many parameters that differ.

The EBF would also like to highlight that it is important to design consistent scenarios. Scenarios should be severe, but plausible and designed consistently for all the geographical areas. It should be avoided to have different crises in different geographies. This is even more pertinent after the COVID-19 crisis, with its global impact.

Question 29: What are your views on the consideration of two asymmetric adverse scenarios?

No comments

Question 30: What are your views on the use of sensitivity analyses to complement a single adverse scenario?

The additional value of sensitivity analysis to complement single adverse scenario is not obvious.

Question 31: What are your views on the use of exploratory scenarios to address risks in a longer term perspective?

From a risk management perspective, it is beneficial to consider exploratory scenarios. This would be meaningful for long-term analysis such as climate risk or business risk analysis. However, these strategic stress tests should have no impact on capital ratios.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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