

Draft Regulatory Technical Standards (RTS) on the range of scenarios to be used in recovery and resolution planning¹

a response from the British Bankers' Association

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services, representing members on the full range of UK and international banking issues. It has almost 200 banking members that are active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK and a range of other banks from the Middle East, Africa, South America and Asia, including China. The integrated nature of banking means that our members are engaged in activities, ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking activities to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management.

We are pleased to be able to respond to the European Banking Authority's draft regulatory technical standard on the range of scenarios to be used in recovery and resolution planning and welcome the emphasis that scenarios should be used to test the recovery plan to facilitate its assessment and the ability of the group to recover, rather than the building of recovery plans around a given set of scenarios.

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?*

In the UK, stress scenarios have been used as a tool for capital and liquidity planning but the competent authorities have not specifically required the testing of Recovery Plans using stress scenarios. Recovery Plans have been developed as a menu or range of options from which the most appropriate action can be selected at the time of a stress, depending upon the exact nature, severity and circumstances of the stress. Accordingly the Recovery Plan should already contain the most material actions available.

Scenario testing seeks to validate how the senior management of an institution might react tactically to plausible future scenarios and test the ability of their recovery plans to mitigate the stresses which a negative scenario could bring about. The real benefit of scenario planning is to provide a contingency planning 'flight simulator' that enables management of the bank to test responses to different scenarios and build up a degree of foresight about how they might react in different scenarios. In our experience these are best developed and used in a qualitative framework rather than as a predominantly quantitative exercise.

¹ <http://www.eba.europa.eu/documents/10180/205759/EBA-CP-2013-09---CP-on-Draft-RTS-on-Scenarios-For-Recovery-Plans.pdf>

Scenario testing can also provide insights into strategic actions that could be taken, perhaps by altering the business model, to address identified weaknesses in order to reduce a stressed scenario's severity.

Quantitative scenario planning tends to overly focus on metrics rather than actions and these metrics can often suffer from the lack of statistically significant historical data. Whilst we can understand that competent authorities might wish to view scenario testing as a mechanism for producing model outputs and challenging assumptions we advise against this – scenario planning is about telling stories rather than analysing numbers and so should accommodate a mix of qualitative and quantitative approaches.

For this reason we advise a change to Article 3 para. 2 as follows:

2. ~~Each scenario of financial distress within the range of scenarios shall include, where relevant, an assessment of the impact of the events on at least each of the following aspects of the institution or group:~~

Where it is relevant to the scenario of financial distress an assessment should be included of the impact of the events of one or more of the following aspects of the institution or group:

- a. available capital;*
- b. available liquidity;*
- c. business model;*
- d. profitability;*
- e. payment and settlement operations;*
- f. reputation.*

We suggest excluding the “payment & settlement operations” from the assessment requirements for a recovery scenario as this concern in our view is more appropriate to the resolution of the institution. Additionally it could be argued that “profitability” and “reputation” are sub-categories of the categories “capital”, “liquidity” and “business model”.

Our amendment is designed to emphasise that scenarios should not be designed around specific metrics as this would risk constraining the scenarios a bank developed. Banks should not be asked to ensure that each scenario is relevant to all of the factors listed as this may not always be the case – for example, in some scenarios there may be significant impact on capital but little reputational damage. We hope our suggested amendment clarifies that the impact of a stress on each and every one of the listed factors does not have to be taken into account.

Many BBA member banks have used scenario testing for a number of years based on an idiosyncratic event, a system wide event and a combination of the two, which is a Prudential Regulatory Authority requirement. In our view the requirements of the draft RTS are in line with this industry best practice.

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

In some instances the concept of group versus solo scenarios is perhaps less relevant than group wide versus country specific scenarios - these concepts are similar but not the same.

Most of our internationally active member banks will develop group wide scenarios which can be used to address for example counterparty, market or country risk concentrations. The important consideration here is that the scenarios should be flexible enough to be used both at a group level, as well as, where necessary, at an individual entity level within a particular country.

This is based on our conviction that recovery planning - and therefore the scenarios that inform it – should be supported by governance structures that ensure group wide plans are properly embedded at all levels of the institution and are regularly tested, both on a group wide but also on an entity basis, where that entity is a material part of the group and wishes to develop additional scenarios tailored to their own particular business mix and market place.

We further believe that the scope of scenarios to assess a recovery plan should reflect the scope of the recovery plan being tested. For instance testing a Group recovery plan should be done on a Group level, as only this allows the most comprehensive view on the recovery opportunities that the entire Group offers and ensures that the interdependencies within the Group are properly reflected.

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?

Yes we believe that the draft RTS is adequate but re-iterate our slight concern that Article 3 2 lists factors that should be kept in mind as scenarios are constructed, rather than being a prescriptive requirement to construct scenarios that would impact each and every one of them, which we would not support.

We appreciate the re-iteration in the RTS that the scenarios used should be relevant to the characteristics of the particular institution.

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?

We note that Article 4 makes a distinction between the slow-moving or fast-moving unfolding of events in a scenario. We think this may be over-complicating the assessment and that rather the recovery plan on which the scenario is based should contain an indication of the likely time-frame for the deployment of different recovery options. We therefore recommend the deletion of Art 4 5 as follows;

~~5. The range of scenarios shall include both slow-moving and fast-moving adverse events.~~

Our larger members indicate that they generally develop three to five scenarios and do not generally subscribe to the view that 'more scenarios is better'. Too many scenarios will have the effect of providing too much analysis and too much detail for senior management to use effectively.

What matters is that time and thought has been devoted to generating scenarios, which are plausible, in the context of the institution's business model, and aligned with the stresses that ICAAP and ILAA plans are based on.

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

Our members do not generally use reverse stress testing as a mechanism for developing stressed scenarios in a recovery context. Rather we view reverse stress testing as a useful risk management tool to identify potential business vulnerabilities that could lead a bank to the point of non-viability. Reverse stress testing can also be used to explore the effectiveness of potential mitigating actions that have been identified in the recovery plan.

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

Our members envisage developing scenarios for testing recovery plans building upon existing scenarios used for capital and liquidity planning including ICAAPs and ILAAs, rather than reverse stress tests. Reverse stress testing demands a different approach to building a set of economic or financially stressed scenarios and we would not advocate the use of reverse stress testing to do so. The purpose of scenarios is to provide a credible test of the recovery plan and there is a tradeoff between extremity of scenarios and their plausibility. Reverse stress testing is good risk management, but should not be mandatory in recovery plans. For this reason we would not recommend mandating it.

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?

We believe that the range of events contained in Article 4 is appropriate and would not advocate including more. It is best to provide the flexibility for the bank itself to consider other scenarios that are relevant to its own particular circumstances. We reiterate that requiring an excessive number of scenarios is likely to be detrimental to the overall benefit of the scenario analysis.

In this context, we would not support a mandatory list of events to be reflected in the scenarios but rather suggests that institutions should have the flexibility to prioritise the events to be included in their scenario. Banks should, however, provide a justification for their prioritisation such that regulators can easily understand and, if appropriate, challenge that prioritisation.

In our experience, particularly for our smaller member banks, the potential failure of a significant counterparty, for instance its payment clearing or correspondent bank is the most significantly negative scenario so we support the inclusion of this particular event.

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

Article 3 requires each stress scenario to be designed to meet each of three requirements, one of which is that “the events foreseen in the scenario would threaten to cause the failure of the institution or group, unless recovery measures are implemented in a timely manner”. We wonder if this requirement is necessary? It might lead to a lack of flexibility in identifying appropriate stress scenarios.

Alternatively we would suggest that Article 3.1 allows for less severe scenarios to be used as well as more severe scenarios that threaten the viability of the institution.

The current drafting of Article 4 2 appears to suggest that each of the events listed in subparagraphs a, b, c, d, and e should be considered for a system wide event. All events may not be appropriate (or relevant) for a specific system wide event identified in the recovery plan. This should be reformulated as follows so that at least one event is required to be considered but not necessarily all events:

4 2. In designing scenarios based on system wide events, institutions and groups shall take into consideration the relevance of at least one or more of the following system wide events...”

The same point applies to Article 4 3 which we propose should be amended as follows:

4 3. In designing scenarios based on idiosyncratic events, institutions and groups shall take into consideration the relevance of at least one or more of the following idiosyncratic events...”

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

Yes.

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?

We agree that the costs of developing financial distress scenarios to test a recovery plan are likely to be proportionate to the size and complexity of a bank's operations although our largest banks will likely retain standing recovery planning teams, which make the costs arising from people governance and monitoring more fixed in nature. Larger BBA members tell us that they have established significant project teams, including people responsible for developing scenarios, to meet the FSA/PRA recovery planning requirements although it is to be expected that as recovery planning is further embedded as a business-as-usual business, process these costs will decrease somewhat.

Our smaller banks however are likely to have to bear a minimum set of initial costs to develop and assess scenarios which are likely to proportionately greater than for their larger competitors.

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?

Yes.

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