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Finance for Europe

Association for Financial Markets in Europe

EBA draft revised guidelines on recovery plan indicators

AFME consultation response

18 June 2021

Introduction

The Association for Financial Markets in Europe (AFME)[1] welcomes the opportunity to comment on the European Banking Authority's (EBA's) draft revised guidelines on recovery plan indicators under Article 9 of Directive 2014/59/EU (the Bank Recovery and Resolution Directive)[2].

AFME has been very supportive of the development of an effective recovery and resolution framework in Europe. We continue to support the overarching aims of ensuring firms have sufficient recovery plans, including the capabilities to monitor relevant indicators and escalate early warnings as appropriate.

It is our strong view that there should be a clear distinction in the roles different indicators play, their relative significance to an institution, and therefore what actions should be taken upon their breach. We agree with the EBA's statements in the draft guidelines that all indicators play a signalling role, and none should be deemed triggers for an automatic application of recovery options. Indeed breaches will need to be assessed internally and notified to the relevant authorities when it is appropriate to do so. It is in our view however that it is necessary for the EBA to reflect upon this further in the revised guidelines, as not all indicator breaches will warrant such escalation and notification. This is true in particular for indicators that are not institution specific, e.g. macro-economic indicators and some market indicators. Adjustments to the escalation and notification requirements put forward by the EBA are therefore necessary to avoid excessive and burdensome requirements, and importantly to not dilute the importance of breaches which should be escalated and notified.

In calibrating indicators it is important to consider the existing requirements surrounding regulatory minimums, and the flexibility that is purposely included within the Capital Requirements Regulation. This is certainly the case when it comes to liquidity requirements and we highlight below in our response our concern at setting certain recovery indicators above regulatory minimums when the use of liquid assets such that requirements are temporarily breached is permitted. In setting recovery indicators above regulatory minimums here it may risk further stigmatising the use of buffers in a stress scenario. This is not an desirable outcome and should be avoided.

We comment on these issues further below in answer to the specific questions posed, and highlight areas where further clarity is needed.

[1] The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

[2] EBA draft revised guidelines on recovery plan indicators under Article 9 of Directive 2014/59/EU, EBA/CP/2021/13, 18 March 2021 - https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2021/Consultation%20on%20draft%20revised%20Guidelines%20on%20recovery%20plans%20indicators/964093/CP%20on%20draft%20revised%20GL%20on%20recovery%20plan%20indicators.pdf

Responses to questions provided

1. Do you have any comments on the general requirements that should drive the calibration of recovery indicators as proposed in paragraph 27 of these guidelines?

Whilst we can appreciate and understand the views expressed in the EBA's draft revised guidelines on the potential need for sufficiently high thresholds for recovery indicators, such that more breaches are observed in a crisis scenario, we are concerned that setting indicators too high may dilute the signalling function that they are meant to serve. This is particularly concerning if the calibration of indicators are adapted so that breaches occur too early on such that they do not lead to any recovery actions being taken, and merely lead to administrative notifications.

We strongly believe that indicator breaches should be escalated where they are informative and indicative of a potential need for action, or at least the consideration of which actions could be prepared if further indicators are breached. We also agree that it is important to ensure appropriate escalation so that the management body are engaged when necessary. What we do not agree with is the calibration of thresholds and imposition of notification requirements such that this becomes a potentially meaningless occurrence that would not have a bearing on the actual recovery needs or capacity of the institution. This may be particularly true for recovery indicators that the institution itself has no control over, or which are not institution specific (e.g., macroeconomic indicators).

In our view it seems counterintuitive to require banks to set recovery thresholds very high, distorting the definition of recovery thresholds as limits where the institution is likely to need to take action. We believe that additional guidance is needed here to further explain how the many factors should be combined to appropriately calibrate a given threshold (e.g., the entity's overall recovery capacity, timeframe and complexity of recovery options, stage of the crisis, pace of deterioration and risk management framework). Within such further guidance the concept of 'forward looking' should also be further clarified as it could be understood in different ways. We understand this to refer to forward looking indicators institutions already have such as macro or market indicators to anticipate future issues, but would welcome clarification on this.

Whilst we fully agree with the statement in paragraph 27 (e), (that an institution should ensure that the calibration of its recovery indicators is consistent with its risk management and risk appetite framework (e.g. early warning and limit framework)), one particular consequence of this is that at no time should the maximum alert level of the recovery dashboard for any indicator be above or equal to the corresponding Risk Appetite Statement (RAS) Limit. The ECB does not ask RAS Limits be set above supervisory requirements. Hence it should be authorized to set maximum alert levels of the recovery dashboard under minimum supervisory requirements level when needed. We would appreciate the EBAs reflection on this in the final guidelines.

Further to this, we would like to confirm whether all indicators should be included in the risk appetite framework. Some recovery indicators may be included in the recovery plan but may not be included in the risk appetite framework. This of course does not mean that the bank is not managing it, but the risk appetite framework includes a reduced number of indicators, selected by the Board, that may not include the complete list of EBA indicators.

2. **Do you have any comments on the requirement that there should be no automatic recalibration of recovery indicators upon the application of temporary supervisory relief measures, however it could be allowed by competent authorities in those cases specified in paragraph 31 of these guidelines?**

The calibration of risk appetite metrics and recovery dashboard thresholds should take into account regulatory requirements from time to time. If relief measures, such as those observed in the Covid-19 crisis like the relaxation of counter-cyclical buffers, are taken by supervisors, they should be reflected in recovery dashboard thresholds. This otherwise defeats the purpose of counter-cyclical buffers, for example, which is to adjust the regulatory requirement according to positions in the cycle.

The draft revised guidelines make reference to a supervisory consent that we understand applies only in the case of the recalibration of indicators following any application of relief measures, where an institution wishes to subsequently recalibrate their thresholds. In such cases it is not clear whether institutions could calibrate a new threshold independent of existing ones based on the application of relief measures absent supervisory approval, whereby the factors as set out in paragraph 27 are fully taken into account. Clarification on this would be welcomed in the final revised guidelines, as well as a clearer description for the process of "requirements for the calibration of the indicators" and separately the process concerning "requirements for recalibration in case of supervisory relief measures (when supervisory approval is needed)".

3. **Do you have any comments on guidance introduced in relation to actions and notifications upon breaching recovery indicators, including the proposed timelines for internal escalation and notification to the competent authorities?**

We welcome the additional guidance given on the timeframe to escalate and notify a recovery indicator breach, together with the information that the competent authorities expect to receive. We do however have some thoughts on the need to ensure notification and escalation requirements are tailored to the relevance of the indicator in breach.

Not all recovery indicators have the same influence on the financial position of the bank (e.g., liquidity and capital indicators are primary and more relevant compared to secondary indicators such as asset quality or profitability indicators, and tertiary indicators such as some market-based indicators or macroeconomic indicators). We therefore believe that not all types of recovery indicator breaches should necessarily be notified to the relevant supervisors or, at least, not with the same timeline.

In this respect, while a specific timeline for the notification of breaches is welcome as it removes uncertainty, a longer notification process in case of asset quality, profitability, market-based and macroeconomic indicators should be envisaged. For the same reason, alerting the management body of the institution within 24 hours seems excessive in some instances, and should not always be required. Alternative escalations could instead be envisaged, e.g., referring to the CEO and/or CFO should be deemed sufficient, especially in cases of asset quality, profitability, market-based and macroeconomic indicator breaches.

With regard to market based and macroeconomic indicators specifically, we do not see the need for a sole breach of such an indicator always requiring a communication to the management or the competent authorities. First, those indicators are public therefore it does not make sense to inform on this. For competent authorities, the result is that all banks are likely to be affected similarly and a breach of a market based or macroeconomic indicator on its own does not necessarily lead to a need for dialogue. Furthermore, internally, this leads to communications to the top management, for example notifying them of a decrease in GDP growth figures, which will involve an often-strict internal governance process for a piece of information where we do not see any added value. If such indicators are to be required, we believe that it is appropriate to modify the

governance and escalation requirements where a breach is not accompanied by an institution-specific indicator.

As stated above, it is our view that notifications to the relevant supervisors and the appropriate escalation procedures internally should be proportionately tailored to the relevance of the indicator in breach in order to avoid "over notification". Many macroeconomic and market-based indicators are intended as signals and not triggers, and some secondary indicators are unlikely to warrant immediate action. The guidance should therefore reflect this.

4. **Do you have any comments on introducing a possibility for competent authorities to request institutions to provide a full set of recovery indicators (breached or not)?**

The draft revised guidelines indicate that competent authorities may request the timely submission of indicators upon request, but does not clarify if this is to occur at any point in time, or following a breach. If the intention is for the competent authority to have the power to request this information at any time, as the question may suggest, this should be made clearer in the final revised guidelines.

Paragraph 38 suggests a monthly frequency (at least), even if values of the indicators have not changed. In order to ensure proportionality and appropriate prioritisation when imposing the monthly production of indicators, we suggest a differentiated view to the extent that not all indicators should be produced with the same frequency. For example, we would expect liquidity-based indicators to be required at a higher frequency than asset quality indicators.

5. **Do you have any comments on the proposed threshold calibration of regulatory capital indicators at levels above those requiring supervisory intervention and therefore to be generally calibrated above the combined capital buffer requirement while still allowing calibration within buffers only under certain conditions?**

We believe the current 'traffic light approach' already includes a sufficient progressive measure which guarantees that management will have sufficient time to act effectively in a crisis even if the maximum alert thresholds are set lower than what the EBA indicate as being preferable. Indeed, with this approach, the lowest alert levels are by definition highly conservative and their progressive deterioration comes to the attention of senior management very early. Therefore, there is no reason to be too conservative in the calibration of the maximum alert level (i.e., setting it over the regulatory requirement).

With respect to calibrating a recovery trigger for both capital and MREL at levels above 'regulatory minimums', we do not agree with the removal of "*but without taking into account any buffer requirements set out in Chapter 4 of Title VII of Directive 2013/36/EU)*" in paragraph 43 and the comment in paragraph 45 that '*generally, capital indicators should be calibrated above the combined capital buffer requirement*' as we do not consider it appropriate to consider potential recovery action while a firm's capital levels exceed both the regulatory minimum and the combined buffer requirement.

While the proposed draft amendments provide flexibility (for both capital and MREL) for entities to calibrate recovery indicators at levels below their combined buffer requirement, further emphasis should be placed on this approach, given buffers (as below in answer to Q7 for liquidity) are allowed to be used in a stress: (45) '*Where an institution calibrates its capital indicators within the buffers, it should clearly demonstrate in its recovery plan that its recovery options can be implemented in a situation where the buffers have been totally or partially used'*. Calibration of indicators at a level above the combined buffer requirement may be appropriate for a very-early warning indicator, but this may itself prove to be of limited value if no recovery action, or preparation for recovery action is every likely to follow.

6. **Do you have any comments on the proposed calibration of the recovery threshold for MREL?**

We believe that it would be helpful to further specify in the final guidance if (and if so how) the possibility of rolling over MREL instruments should be considered within the calibration of MREL indicators.

7. **Do you have any comments on the proposed threshold calibration of regulatory liquidity indicators (LCR and NSFR) above their minimum regulatory requirement i.e. 100%?**

Calibration above 100%

We are concerned with the consistency of the proposed calibration of the regulatory liquidity thresholds and the prudential requirements that apply. In particular, we do not see how it can be compatible to request an LCR recovery threshold above 100% when regulation allows it to be temporarily below that level:

- BCBS Basel III - The Liquidity Coverage Ratio and liquidity risk monitoring tools (January 2013): "*During a period of financial stress, however, banks may use their stock of high-quality liquid assets (HQLA), thereby falling below 100%, as maintaining the LCR at 100% under such circumstances could produce undue negative effects on the bank and other market participants. Supervisors will subsequently assess this situation and will adjust their response flexibly according to the circumstances*".[3]

- Capital Requirement Regulation (CRR) (Article 412(1) of Regulation (EU) No 575/2013): *"… During times of stress, institutions may use their liquid assets to cover their net liquidity outflows."*[4]

- LCR delegated Act (Article 4(3) of Delegated Regulation (EU) 2015/61: "*By derogation from paragraph 2, credit institutions may monetise their liquid assets to cover their net liquidity outflows during stress periods, even if such a use of liquid assets may result in their liquidity coverage ratio falling below 100 % during such periods.*"[5]

A firm in recovery would be subject to the provisions of article 414 of the CRR, i.e., it would be required to notify the authorities of the fact its LCR ratio has fallen below 100% and would be required to provide a plan to restore the ratio to above 100%. By setting an expectation that firms should be above 100% LCR at all times the EBA is contributing to widely held industry concerns that LCR buffers are not fully useable in a stress, and that additional buffers (buffers on buffers) must be held to cope with day-to-day volatility in liquidity positions as well as stress periods. This tends to encourage firms to run higher liquidity buffers, reducing scope for banks to lend or otherwise deploy excess funds in both normal and stress times.

As a consequence, the sentence "*The thresholds for indicators based on regulatory liquidity requirements (LCR and NSFR indicators) should be therefore calibrated above the minimum requirements of 100%*." should be deleted.

Interaction with the Liquidity Contingency Plan

The articulation between the recovery plan and contingency plans is important so that each process is not confused with the other. This has consequences for the calibration of the recovery plan indicators.

In an emerging or actual liquidity crisis, the Liquidity Contingency Plan (LCP) would be first considered and potentially activated with its LCP mitigation actions. The LCP has its own monitoring metrics with

[3] https://www.bis.org/publ/bcbs238.pdf
[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN
[5] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN

accompanying threshold and governance to activate the LCP. The LCP mitigation actions would typically affect only marginally the institution’s business model.

To the extent that the LCP mitigation actions would be deemed insufficient to restore a satisfactory liquidity position, more impactful actions would be needed, and the recovery plan would typically be considered and activated if need be. This would enable the activation of the recovery plan mitigation actions which would cover a larger scope of actions with potential modifications to the institution’s business model. It should be noted that LCP mitigation actions would still be fully or partially available when triggering the recovery plan.

Hence, to the extent that the LCP mitigation actions would be deemed sufficient to restore the liquidity position, there would be no need to activate the recovery plan. The two processes should not be confused.

<u>Asset Encumbrance</u>

The EBA guidelines have introduced a requirement to set a recovery indicator on asset encumbrance. In our experience, the utility of this metric varies considerably between different types of firm. For traditional banking entities, it may be relevant given lending books may be available to raise liquidity from central bank facilities, and hence increasing levels of encumbrance may indicate that the balance sheet is under increased strain. However, for securities entities, it is typically less relevant given the majority of this business is undertaken on a secured basis, with large portions of the balance sheet (excluding HQLA) typically being pledged and re-used as collateral. We do not believe it is appropriate to include this as a mandatory indicator.

We note that paragraphs 23-24 specify that all the minimum indicators listed by the EBA are in theory rebuttable, but in practice many competent authorities expect firms to uniformly include all the minimum EBA indicators in their plan. For some firms, this will result in inclusion of a metric that is not reflective of liquidity risk in their business and is unsuitable as a recovery indicator. We would propose this indicator be moved from Annex II (minimum required indicators) to Annex III (illustrative list of additional recovery plan indicators).

Further to this, cross-references with corresponding existing regulatory reporting – if any – would be helpful and would support consistent definition of indicators.

8. Do you have any comments on the proposed threshold calibration for the indicator of liquidity position?

The EBA guidelines also introduce a requirement for a recovery indicator on the firm’s ‘liquidity position’. We agree with the need to use liquidity metrics that are used for internal risk monitoring as part of the recovery plan framework, and the proposed language in Annex II is general enough to accommodate this outcome. However, we would welcome modifications to the language in paragraph 55 to further clarify the EBA’s intent, and remove reference to counterbalancing capacity (CBC) which could easily be conflated with CBC as measured in the C66 ALMM template. The latter is not appropriate as a measure of liquidity due to known assumption limitations in the C66 (e.g. assumes all SFTs mature, even if covering short positions that may need to be maintained over a longer time period). We would therefore suggest paragraph 55 be modified to read:

> *“To calibrate the thresholds of the liquidity position, institutions should consider* ***other liquidity metrics used for internal monitoring, including those incorporated into their risk appetite, and reflecting their own assumptions on the liquidity that could realistically be derived from sources not taken into account in the LCR metric, e.g. securities that do not qualify as HQLA or*** *~~at least the amounts of the counterbalancing capacity (CBC) and when relevant, institutions should also consider other liquidity sources (e.g.,~~ deposits with other credit institutions~~)~~**.** When establishing forward looking indicators, the institution~~’~~s*

should assess which maturity to consider, according to the institution's risk profile, and then take into account the estimated inflows and outflows."

It is also important to consider that the recovery plan indicators should relate to risks being considered, i.e. indicate changes in the risk drivers or in risk measurement. However, changes in risk drivers do not mechanically translate into higher risk positions, as it does not take into account the available mitigants. Conversely, risk mitigants may be valuable to monitor though they don't necessarily convey the actual risk of the institution.

In the case of CBC, which is a risk mitigant, in isolation it conveys only limited information on the actual risk of the institution which results from the comparison between the CBC and the potential net cash outflows (NCO's) that it would help mitigate. Hence, having an increase in CBC while NCO's could be increasing even more does not provide relevant information, and could actually provide an incorrect or misleading signal, as it could be perceived as a less risky position. For this reason we believe that the CBC and the liquidity position are not relevant recovery plan indicators.

Further to this we would reiterate our point here, as expressed in our answer to question 7 above, that the calibration of indicators above regulatory minimum requirements should be considered in the context of the ongoing discussions around ensuring the usability of buffers in times of stress.

9. Do you have any comments on the proposed changes to the minimum list of recovery plan indicators?

Market based & Macroeconomic indicators

As above - market based and macroeconomic indicators should not trigger requirements for communications to the management body or the competent authorities. If those are to be captured within recovery indicators, governance for those should be modified. At least, the sole breach of an indicator should have a different process of notification and escalation.

We welcome any questions or views you may have on this response and we are very happy to discuss these issues further.

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