German Banking Industry Committee

Die Deutsche
Kreditwirtschaft

Comments

on the EBA *Draft Guidelines on stress testing and supervisory stress testing*

Register of Interest Representatives
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GBIC comments on EBA Guidelines on stress testing

Dear Sir,
Dear Madam,

On 18 December 2015, the EBA published *Draft Guidelines on stress testing and supervisory stress testing*. We are grateful for the opportunity to comment on these and are pleased to do so as follows:

1. General comments

Overarching points

The EBA draft guidelines on stress testing contain a number of suggestions that can contribute to the further development of banks' internal stress tests. At the same time, they are, in our view, too detailed and too prescriptive in many cases and unduly reduce the amount of discretion and freedom essential in stress testing and thus cannot be applied flexibly enough.

In some areas, which we will look at later, the ideas appear to be guided too much by best practice and too little by the status quo of European banks. While supervisory proposals going beyond the status quo are, in principle, necessary and sensible for the further development of stress testing programmes in the medium term, they should not be prescribed as mandatory and relevant for SREP assessment from the fourth quarter of 2016. Further in-depth discussion with the industry on the direction this further development should take would be advisable. We are available for such discussion at any time.

Institutions should be given enough time to further develop their stress testing internally through adequate implementation periods, since the new requirements go beyond the CEBS Guidelines. We therefore suggest making a distinction as far as possible in all areas of the guidelines between requirements that have to be complied with, at a minimum ("at least"), from the end of 2016 and further requirements. For these further requirements, staggered, gradual implementation over a period of several years should be specified.

When setting the requirements that have to be complied with, at a minimum, from the end of 2016, it should be borne in mind that a large number of parallel stress testing requirements are currently set at national and international level (e.g. EBA 2016 stress test, SREP exercise, ICAAP and ILAAP).

Overlap of guidelines

In order to avoid deviating requirements from different guidelines, any potential overlap of frameworks should be ruled out. We strongly recommend separating general requirements on risk management frameworks from specific stress testing guidelines. For example, stress testing guidelines for operational risk (paragraph 132), conduct risk (paragraph 140) and recovery planning (paragraph 99) include general requirements for operational risk management processes. Such requirements should be removed from the stress testing guidelines to ensure a consistent risk management framework.

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Proportionality

As guidelines under Pillar II, the entire stress testing guidelines should, in our view, be applied with the principle of proportionality in mind. This is not always made clear enough in the wording of the guidelines, however. For example, some sections (2, 3 and 4) contain a proportionality proviso, others do not. In contrast, the *Background and rationale section* (p. 6-8) accompanying the guidelines contains a very clear statement on how proportionality could play out in smaller financial institutions. We therefore suggest incorporating this section into the wording of the actual guidelines (from p. 10). Paragraph 57, too, contains an important statement on proportionality which would gain in value by being applied to the guidelines as a whole.

Stress testing types

Particularly in section 4.5, the draft guidelines set requirements that make internal bank stress testing extremely burdensome. This section calls for various analyses and calculations for which, in turn, further requirements (for each analysis and calculation) are set. The resulting amount of stress test analysis that has to be performed is excessive, as is shown by the following cumulative requirements.

- Mechanisms for demonstrating the link between risk factors and risk parameters are called for (paragraph 59). These mechanisms should, in turn, consider institutional historical experience, external data and supervisory guidance (paragraph 60) and, at the same time, the impact of the assumptions used on stress testing results has to be assessed on a regular basis (paragraph 61 (c)).

- Sensitivity analyses have to be performed at the level of individual exposures, portfolios and institution-wide (paragraph 64). In addition, different degrees of severity should be calculated. The required sensitivity analyses are thus multiplied if different degrees of severity have to be analysed at several levels. On top of this, there are the multi-risk factor analyses, though these are not to define stress scenarios (paragraph 68). If different degrees of severity and different levels are to be considered here, too, the number of analyses required will be increased many times over.

- The same applies to the requirements for stress test scenarios, which will increase the number of analyses many times over if, again, different events and degrees of severity are to be considered (paragraph 72).

- Credit risk stress testing should encompass everything from simple sensitivity analyses to stress scenarios (paragraph 105). It should be performed both at different levels – market-wide, counterparty-specific, sector-specific – or a combination of these (paragraph 105) and with different time horizons (paragraph 107). In the process, the numerous sensitivity analyses required under paragraph 64 ff. of the draft guidelines, must be considered.

- The large number of stress tests is again increased many times over if the impact of stress testing before and after management actions has to be explained (paragraph 195).

Seen cumulatively, these examples show that an overall reduction in requirements is needed to avoid an exorbitant number of stress test analyses.

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Reverse stress tests

The role of stress tests is strengthened significantly in the present consultation paper although stress tests displayed evident weaknesses in recovery planning. In the case of well to very well-capitalised institutions, reverse stress tests or near-default scenarios produced scenarios of little relevance in management terms. There is, moreover, the danger of non-acceptance of stress testing results. The targets communicated in the consultation paper (such as identifying current and potential vulnerabilities, identifying business model and business strategy risk or assessing the sustainability of business models) can be achieved just as well through the use of "*severe but still plausible scenarios*". We believe institutions should be allowed some degree of discretion when performing stress testing.

We welcome, in principle, linking reverse stress testing and recovery planning scenarios. Reverse stress testing is always performed at individual institution level under these guidelines. In the case of recovery planning, institutions which belong to an institutional protection scheme are given the option of conducting recovery planning at individual institution level or at institutional protection scheme level. It should therefore be ensured that this option for institutions belonging to an institutional protection scheme is not impaired by linking recovery planning and reverse stress testing.

Operational risk

The terms and definitions used in the stress testing document should be consistent with any further guidelines. We refer mainly to the following articles:

- According to Article 252 of the SREP Guidelines, conduct risk (section 4.6.5) is included in the scope of operational risk (section 4.6.4). Therefore, suitable standards are necessary.
- According to Article 235 (b) of the SREP Guidelines, model risk relating to the underestimation of own funds requirements by regulatory approved models is not part of the operational risk assessment (contrary to paragraph 132, point h)).

The operational risk stress testing requirements are formulated for all banks, irrespective of the approach applied to assess the exposure to operational risk, with some specific requirements for AMA banks. Considering the outstanding Basel Committee guidelines on the standardised approach to operational risk and related discussion on the possible abolishment of the advanced approach, the consultation on stress testing requirements should be prolonged to ensure proper consideration of the latest developments in the area of operational risk.

The requirements for stress testing of operational risk and conduct-related risk are formulated separately, though conduct risk is included in the scope of operational risk as part of legal risk. It is not clear why parts of the scope of operational risk should be considered separately for stress testing purposes and how such results should be integrated into bank-wide stress testing scenarios. The separation of the scope for the quantitative assessment would pose a particular challenge to AMA banks due to the fact that the relevant losses resulting from legal risk or conduct risk events are considered within the AMA models often developed and calibrated for the full scope of operational risk losses.

Level playing field - Awareness of the different requirements for AMA and non-AMA institutions within the stress testing guidelines:
As part of the AMA model in accordance with Article 322 of the CRR, AMA institutions already comply with several articles (cf. Articles 136, 137. 140, 143, 146) in calculation of their own funds requirements

through the integration of operational risk scenarios. In order to avoid double counting, we suggest that these risk scenarios fulfil the function of the required stress events and analysis of exposures.

Increased burden:
The requirements for loss data collection in stress testing go beyond the currently existing requirements for operational risk. Compliance with these would impose a considerable implementation burden.
The terms and definitions used in the stress testing document should be consistent with any further guidelines. We refer mainly to the following article: According to Article 252 of the SREP Guidelines, conduct risk (section 4.6.5) is included in the scope of operational risk (section 4.6.4). Therefore, consistent standards are necessary (see "*Overlap of guidelines*"). These passages should be deleted in the stress testing guidelines.

2. Specific comments

Definitions/Taxonomy (paragraph 10)

According to point (10), reverse stress testing has all the characteristics set out under points (i) to (iv). We question this and would prefer it if "*all*" were to be replaced by "*one or more*".

According to point (11), second-round or feedback effects generally amplify an original shock. We assume that they may mitigate an original shock as well and suggest amending the wording accordingly.

The taxonomy surprisingly lacks a definition of the key term "stress test". Such a definition should be included because various national supervisors have drafted their own definitions of "stress test". This definition should also make clear where stress scenarios stand in relation to the implicitly or explicitly used scenarios in "regular" risk measurement. This question basically concerns all types of risk, but can be illustrated particularly well by taking operational risk as an example: institutions which use the AMA must use scenario analyses as an element in calculation of their own funds requirements. Where do stress scenarios for operational risk stand in relation to AMA scenarios (when it comes to the frequency of occurrence, level of loss parameters, etc.)?

Stress testing programme (paragraphs 13-23)

Paragraph 19

Quantitative backtesting of stress scenarios, i.e. extremely rare events, is likely to be difficult, in our view. We believe the term "*plausibility of assumptions*" would be far more suitable at this point.

Paragraph 21

In principle, we believe that the requirements set for documenting stress testing programmes are understandable and right. When applying case-based stress tests, the persons entrusted with conducting the stress test need enough freedom to be able to consider new ideas and potential threats ('thinking outside the box'). In this case, the documentation defined in full in paragraph 21 may be counter-productive. We recommend allowing institutions a certain amount of freedom when documenting case-based stress tests.

In addition, it should be made clear in paragraph 21, point d) that only IT applications that are used additionally and exclusively for stress testing should be included. Where a central inventory exists, reference can be made to it.

Governance aspects of stress testing (paragraphs 24-33)

Paragraph 24

While the management body will stipulate scenarios and have key results reported to it, its full involvement in the design and implementation of a stress testing programme is not practicable for large and complex institutions. The involvement of the management body should be inversely proportionate to the size of an institution: the bigger the institution, the more the stress testing programme will be delegated to senior management and committees. The definition of "*management body*" should therefore also cover dedicated stress testing committees.

Paragraph 26

According to paragraph 26, management actions are to be discussed with the competent authorities. We would welcome clarification to the effect that the management body should merely be able to explain such actions and does not have to have them approved in advance by the competent authorities.

Data infrastructure (paragraphs 34-37)

Paragraph 35

Paragraph 35 requires institutions to refer to the Basel Committee on Banking Supervision principles for effective risk data aggregation and risk reporting (bcbs239). The scope of these principles is confined to SIBs, however. Other institutions do not have to refer to them. This should be made quite clear in the wording.

Paragraph 47

According to paragraph 47, point (b), institutions should ensure that stress testing results reflect bank risks "*in an exact manner*". This is not possible through risk measurement under normal market conditions or through measurement under stressed conditions. Measuring risk is not a science – any quantitative assessment of risk is individual and subjective to a certain extent. This passage raises false expectations and should therefore be deleted.

Stress testing scope and coverage (paragraphs 48-56)

Paragraph 50

The requirement that correlations should, in principle, be increased in all scenarios is one we do not understand. Instead, case-by-case analysis of how certain correlations behave in scenarios is required. We thus recommend wording the requirement more precisely so that institutions also have to analyse in stress testing whether the correlations set may increase.

Paragraph 54

Paragraph 54 calls for stress testing also at group level. For complex institutions, this imposes a considerable burden. The requirement should thus be confined to entities whose risks are material in a group context. This is also in line with the supervisory assessment under paragraph 221. Such entities are also covered at individual level.

Scenario analysis (paragraphs 70-76)

Paragraph 71

According to paragraph 71, external data should also be included – as far as possible – in scenario analysis. We doubt whether it is possible to obtain external data stemming from banks with "*similar risk environments*" and "*similar business models*". This will usually be strictly confidential data. The final sentence of paragraph 71 should therefore be deleted.

Paragraph 73

According to paragraph 73, stress test scenarios should meet the requirements set out in points a) to f). Particularly the requirements in point e) are much too ambitious (innovation, technological developments, sophisticated financial products) and should therefore not have to be complied with as early as the end of 2016.

Severity of scenarios (paragraphs 77-81)

Paragraph 10, point (12) defines the degree of severity of stress tests. There is as yet no uniform mechanism for assessing the degree of severity, however. It is questionable whether, because of the qualitative nature of such assessment, there can in fact be any uniform mechanism. The degree of severity of stress tests is thus only measurable and comparable to a limited extent. To avert the danger of unequal treatment of institutions, we believe that further details with regard to the degree of severity are required.

In paragraph 77, point a), scenario analysis is expected to also include an analysis of financial system stability. We believe this is the job of supervisors, and not banks. In any case, the latter do not have the sector-wide aggregated data required for this purpose at their disposal. The requirement should thus be deleted.

Paragraph 80
In paragraph 80, institutions are only allowed to base the degree of severity on the current economic situation in relative scenarios, but not in absolute scenarios. We do not understand this distinction and believe it should be dropped. With both types of scenario, it makes sense to consider the current economic situation when assessing the degree of severity.

Reverse stress testing (paragraphs 82-99)

Paragraph 83
The use of reverse stress testing to determine the severity of ICAAP and ILAAP scenarios is impracticable, in our view. Reverse scenarios may well make sense as a tool for assessing plausibility in an overall context; severity should, however, be determined via risk appetite and coherent scenario specifications that management can understand.

Paragraph 86
Paragraph 86 requires institutions to identify measures that provide alerts when a scenario turns into reality. This (potentially too one-dimensional) approach basically only makes sense to a limited extent, as scenarios never materialise exactly as anticipated. Instead, we believe that reference to the recovery indicators that are to be developed as part of recovery plans would be more sensible.

Paragraph 90
Paragraph 90 correctly says that reverse stress tests should be seen as complementing the internal models used to calculate capital requirements. It also says that they are designed to reveal inadequacies of these internal models. We do not understand this. These models were not normally developed on the assumption of a stress situation, i.e. under fundamentally different environmental conditions. Validation of these internal models on a stress-test basis is not possible. The requirement should be deleted.

Paragraph 92
The requirement for quantitative reverse engineering of the specific stress parameters needed appears rather academic and does not necessarily deliver any additional insight. Instead, it may be more practicable and easier to understand for management to set out a series of alternative scenarios that cover the target loss levels. It would therefore be advisable not to stipulate any quantitative analysis.

Paragraphs 95-99 (Recovery actions and recovery planning)
What is missing, in our view, is the overall context, i.e. ICAAP stress scenarios (or regular scenarios) versus reverse scenarios versus RP scenarios and their interaction in calibration (paragraph 97) is unclear. Paragraph 99 does not fit into these guidelines, in our view, but more into guidelines on recovery planning.

Paragraph 96
According to paragraph 96, stress tests for ICAAP and ILAAP purposes and recovery planning should not be interlinked but compared to one another. The requirement in this paragraph that stress scenarios and ICAAP/ILAAP stress tests should not be interlinked appears to be a contradiction, since it is stipulated elsewhere that ICAAP/ILAAP scenarios and reverse scenarios on the one hand and reverse stress tests

and stress analysis on the other hand should be interlinked. Paragraph 224 evidently also assumes interlinking*.

We wish to point out that this conflicts with the provisions of the *Minimum Requirements for the Design of Recovery Plans* (MaSan) applying in Germany. According to these, stress analyses in recovery plans can be based on reverse stress testing. The guidance on MaSan provided by the Federal Financial Supervisory Authority (BaFin) reads in section E. 3.3 (unofficial translation): "*The stress tests in accordance with AT 4.3.3, including the reverse stress tests in accordance with BTR 3.2 of the Minimum Requirements for Risk Management (MaRisk), may be used as the starting point for potential stress scenarios to enable depiction of relevant crisis situations for the institution."* As we believe this makes sense, the ban on interlinking should be removed.

Paragraph 99, point d)
This paragraph calls for "*additional recovery actions to address residual risks"*. Given that stress scenarios for recovery planning follow the "near-default" criterion set by the German regulations ("MaSan AT 4.3.3."), i.e. they are severe enough (but not more severe) that the institution can only restore capital and liquidity by conducting all realisable private recovery measures available to the institution, there will – by definition – be no further recovery measures available. We therefore recommend withdrawing paragraph 99, point d).

Credit and counterparty risk (paragraphs 102-115)

Paragraph 112
In paragraph 112, it is assumed that PDs applied in the calculation of capital requirements are "*usually*" through-the-cycle (TTC) PDs. This is not correct. As far as we know, the majority of rating systems use a combination of point-in-time (PIT) and TTC PDs. As a consequence, paragraph 112 should be deleted because the basic assumption behind the paragraph is not correct.

Market risk (paragraphs 123-129)

Paragraph 128
Paragraph 128 says that particularly fat tail risk should be considered in stress testing. This is, in principle, understandable. However, wording should be added stating that institutions are only obligated to comply with this requirement to the extent that stress VaR and IRC (where determined) are not already demonstrably able to take adequate account of fat tails.

Operational risk (paragraphs 130-138)

Paragraph 131
The term economic loss is not nearly defined in the context of operational risk loss even for AMA banks. From our point of view, "near misses" and "losses of future revenues" are not mandatory elements of operational risk loss data collection. Such elements of operational risk losses may be collected for operational risk management purposes by AMA banks and are not included in the scope of operational risk loss for the calculation of capital requirements for operational risk (except for material uncollected revenues, as referred to in Article 28, point (e) of the Final Draft Regulatory Technical Standards on the specification of the assessment methodology). A new regulatory requirement to consider such elements for stress testing purposes would require significant efforts from banks to extend their loss data collection and to adjust or at least to re-calibrate AMA models in order to accommodate new elements.

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Paragraph 132
Do the provisions of paragraph 132 mean that the P&L effect of the factors listed in points a) – h) should be assessed? Is a quantitative assessment with respect to internal capital expected from AMA banks?

Considering the number and scope of risk factors to be at least considered under the operational risk stress testing programme, we kindly request clarification of whether any quantitative stress test assessment for purely macroeconomic scenarios (e.g. downturn scenarios for market and credit risk) should be also considered mandatory for operational risk stress testing.

a) Analysis of the correlation between business activities, operational losses and gross income is a new requirement, in our view. We wish to point out that operationalisation of this requirement involves a significant impact on IT.
c) We wish to point out that we regard the implicit correlation here between the evolution in headcount, balance sheet size and operational risk as inappropriate.
   We kindly request further explanation of the required analysis of "*complexity*", as referred to here.
d) We kindly request further explanation of the required analysis of "*changes to significant elements of the IT infrastructure*".
f) We kindly request further explanation of the required analysis of the "*complexity of processes and procedures, products and IT systems*".
h) We kindly request further explanation of the required analysis of the "*vulnerability to model risk*". According to Article 235 (b) of the SREP Guidelines, model risk relating to the underestimation of own funds requirements by regulatory approved models is not part of operational risk assessment.

Paragraphs 133/134
It is unclear how the business environment and internal control factors (BEICF) are to be stressed if indicators are merely qualitative or only show a potential change in risk. We kindly request clarification.

Clarification would also be helpful to understand what is meant by "*such risk factors*" in the requirement in paragraph 134 to "*consider the interactions of and individual exposures to such risk factors*". Does it mean the idiosyncratic risk factors referred to in paragraph 133 or other factors?.

Paragraph 136
Scenario analysis is a mandatory element of an AMA model. Can the requirement in paragraph 136 be seen as fulfilled by banks applying the AMA for the calculation of their own funds requirements if stress testing is performed using the same model?

Paragraph 137
As we understand it, paragraph 137 is geared to risk type-specific stress testing. We should appreciate an explanation of how this is embedded in the overall stress testing context.

If different assumptions from those in market and credit stress scenarios are used for operational risk stress testing, will the results still have to be integrated into bank-wide macroeconomic stress scenarios?

Paragraph 138
According to Article 322 (4) of the CRR, institutions using the AMA should determine and use relevant external data. Concerning point a), we assume that the guidelines do not require additional impact stemming from changing scaling factors in stress situations. However, this point needs to be clarified in order to avoid misleading assumptions. The wording of point b) creates the impression that banks should

also use external data that is not relevant for their business model even in stress situations. This requirement would be misleading in the context of the CRR.

Conduct related risk and associated litigation costs (paragraphs 139-146)

Paragraph 140
It is unclear here whether an approximate evaluation of loss data is sufficient for assessing the relevance and significance of the exposures listed or whether a separate quantitative or qualitative analysis is required for each exposure. We kindly request clarification.

Paragraph 141
It should be clearly stated that requirements specified in this paragraph are addressed to banks which do not use an internal model for computing stress tests for operational risk.
We kindly request clarification on how reputational loss, which is to be explicitly separated from operational risk and not assessed quantitatively, should be taken into account.

Paragraph 142
As is known, future losses are duly covered by means of provisioning under accounting rules. We do not consider it appropriate to assess expected losses in excess of existing accounting provisions and factor these in projections.

Paragraph 144
This paragraph stipulates requirements for an institution's ICAAP process. These do not directly refer to an institution's stress testing programme or processes and should therefore be excluded.

Concentration risk (paragraphs 169-176)

Paragraphs 172, 175
With regard to concentration risk, correlations between risk factors are to be increased and extreme changes in risk parameters to be stressed, taking into account second round effects in the process (paragraph 172). Such deliverables can only be computed on a statistically uncertain basis and do not lead to more acceptance of stress testing among decision-makers in institutions. The concentration risk indicators mentioned in paragraph 175 (Herfindahl-Hirschman Index (HHI) and Gini coefficients) produce pressure on institutions to justify themselves if they do not use these indicators. It would be better not to mention any indicators here. These indicators should, at any rate, only be mentioned as possible aids to analysis and not specified in the form of an exhaustive list.

Furthermore, we regard the established indicators such as marginal value-at-risk as appropriate and adequate to capture concentration risk in credit risk.

FX lending risk (paragraphs 177-194)

Paragraph 177
Point a): We believe that FX lending to "*unhedged borrowers*" should be confined expressly to retail clients and SMEs (similar to paragraph 2 of the *Final Guidelines on capital measures for foreign currency lending to unhedged borrowers under the SREP* of 20 December 2103).

In this context, we refer to the German Banking Industry Committee's comments of 28 August 2013 on the above-mentioned guidelines. These comments outline the problems posed by widening the definition of "*unhedged borrowers*" beyond retail clients and SMEs.

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„… This applies in particular given that, in our view, the boundaries between "hedged" and "unhedged" are unambiguous only for private borrowers. Both in the present Consultation Paper but also in the recommendations by the European Systemic Risk Board published on 21 September 2011, it has been repeatedly emphasised that regulatory needs primarily affect private individuals and small SMEs without any cross-border activities. In our experience, when it comes to international players with subsidiaries in various countries as well as funding transactions in different foreign currencies, it may be assumed that the company is aware of the FX risks and manages them proactively. Hence, a general categorization of such companies as "hedged" should be permissible. Consequently, we suggest confining the regulatory scope of special rules on FX loans to credits to private households …".

Implementation of the *Final Guidelines on capital measures for foreign currency lending to unhedged borrowers under the SREP* (paragraph 9) is required from a materiality threshold of 10%:
"*These guidelines apply on an institution-by-institution basis wherever the following threshold of materiality is met: Loans denominated in foreign currency to unhedged borrowers constitute at least 10 % of an institution's total loan book (total loans to non-financial corporations and households), where such total loan book constitutes at least 25 % of the institution's total assets.*"
Only once this threshold is exceeded do significantly expanded risk management requirements – stress testing, for example – apply.

In our view, this materiality threshold should be taken into account in the present consultation paper. We believe this is necessary to ensure uniformity in the treatment of F/X lending to unhedged borrowers under the SREP.

Paragraph 182
According to point e) of paragraph 182, IRBA models should be able to capture client-related FX lending risk through higher risk weighting of assets. This is an additional IRBA minimum requirement that would have to be inserted in the CRR, where it is not mentioned. As the guidelines are not allowed to alter "Level 1 rules", point e) of paragraph 182 should be deleted.

Application of stress testing programmes (paragraphs 185-197)

Paragraph 187, point c)
For globally active institutions that also have to use the ICAAP in the APAC region, the requirement to perform "*comprehensive institution-wide stress testing …reflecting all entities*" poses considerable problems. The APAC ICAAP is, as has been demonstrated, subject locally to other rules that are not compatible with the European approach. Should European and APAC rules not be aligned, we kindly request deletion of this paragraph.

Paragraph 187, point d)
A minimum period for ICAAP stress tests makes no sense, in our view, because the ICAAP should cover all overarching scenarios, also rapid impact ones. At best, a requirement to at least assess a scenario with a minimum duration of two years makes sense. In addition, it should be explained how the two-year time horizon is to be understood. Does it mean a rolling period of two years from the date the stress test is set up, the next two accounting reference dates, or the earliest future accounting reference date that is more than two years after the date of the stress test?

Supervisory assessment of the institutions' stress testing – preliminary remarks (paragraphs 198-200)

Paragraph 200

Under point a) of paragraph 200, competent authorities are to use institutions' internal stress testing to validate the quantitative risk measurement results produced by internal models. Such an analysis does not make sense. These internal models were not usually developed on the assumption of a stress situation, i.e. under fundamentally different environmental conditions. Validation of these internal models based on stress test results is not possible. The final sentence of point a) in paragraph 200 should be deleted.

Quantitative assessment of institutions' stress tests done for ICAAP purposes (paragraphs 212-218)

Paragraph 218

According to paragraph 218, competent authorities should consider all known future regulatory changes when assessing stress test results (if these affect institutions within the time horizon of the stress test exercise). This means, conversely, that institutions would also have to consider all known future regulatory changes in their stress tests. We wish to point out that this was frequently not possible to a sufficient extent in the past due to uncertainty about the final regulatory requirements.

Supervisory stress testing (paragraphs 222-240)

Paragraph 230

According to paragraph 230, competent authorities should consider whether to set pre-defined target capital ratios (hurdle ratios, pass mark ratios).

We would like to point out that, wherever the pass mark is set, this will ultimately be an artificial, arbitrary level. As a consequence, reaching or failing to reach the minimum ratio constituting the pass mark will be an arbitrary result. The absolute level of a capital ratio can never serve as the only indicator of a bank's likelihood of becoming insolvent. In addition, the appropriate level of capital that a bank should hold will depend on its business model. A one-size-fits-all pass mark therefore makes no sense whatsoever.

What is more, such an approach suggests – wrongly – to the general public that a bank which exceeds the pass mark is "safe" while a bank which fails to reach it is on the brink of insolvency. Yet the subsequent financial difficulties experienced by banks which easily "passed" EBA's stress test was a major reason for that test's bad reputation. It is vitally important to make clear that the information value delivered by a stress test will necessarily be limited.

For these reasons, we would recommend dropping the idea of a pass mark, given the potential for misinterpretation by the general public. A sounder approach would be to focus, when analysing and communicating the results, on the sensitivity of the capital ratios as a measure of participating banks' vulnerability to the adverse scenario. The published results could focus on the absolute and percentage reduction in capital ratios on the day at the end of the simulation as a measure of the severity of the scenario's impact.

We recommend deleting paragraph 230.

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Using the quantitative outcomes of stress tests for capital adequacy assessment purposes (paragraphs 241 – 250)
Paragraph 245

According to paragraph 245, competent authorities should also consider in their analysis the probability of scenarios materialising. The probability of materialisation cannot usually be quantified accurately enough. Even establishing a probability ranking is likely to be difficult. We therefore recommend deleting this unrealistic requirement and to stick to plausibility (“severe but plausible”). The same goes for point a) of paragraph 247.

Yours sincerely

on behalf of the German Banking Industry Committee
Association of German Banks

Dirk Jäger   Dr Uwe Gaumert