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## 2023 EBA Stress Testing Methodology

### AFME's feedback on the draft ST methodology

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#### Introduction

AFME and its members welcome the continuous effort by the EBA to evolve the European Stress Testing (ST) methodology. Valuable lessons have been learned over the years and the robustness of the tests has improved significantly. The results of the STs are closely followed by the market, highlighting the utility of the tests. AFME and our members also agree with the EBA that further work on streamlining the objectives of the EU ST framework would help mitigate the burden for the industry as well as the supervisory community. Furthermore, we appreciate the limited number of changes made compared to the 2021 STs under the current economic circumstances.

AFME and its members are keen on engaging with the EBA and/or ECB in their deliberations to develop the top-down models for NFCI. We note that there is very little information on how the existing data will be used for arriving at appropriate calibration and sensitivity to individual banks' business models and geographical footprints.

Separately, AFME and our members caution the authorities regarding the new sectoral templates. The implementation effort at that late stage of preparations (test runs are well under way) is vast, and it hasn't been communicated to the industry what the motivation and purpose for the late introduction of the templates is. Also, the allocation of model outcomes to NACE sectors will introduce comparability issues as this is done manually or via specifically designed allocation algorithms. We would welcome further engagement to better understand the benefits of the additional exercise with a view to potentially introducing this ahead of the 2025 ST. Clear guidance is required on the purpose of the sectoral cuts and requirements ahead of the actual exercise. As of today, banks are already in full preparation of next year's stress testing exercise and such significant methodological and data gathering changes would be difficult to accommodate, and at large costs.

We provide further detail below on the industry's main concerns regarding the updated methodology. The list of issues raised is not exhaustive but focuses on the key themes that are consistent across AFME membership participating in the European ST exercises. We continue to support robust European ST framework and remain at your disposal to contribute to the development of the framework.

Sincerely,

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### **Net fee and commission income**

AFME notes that the approach contradicts the relevance objective as stated in the EBA discussion paper (EBA/DP/2020/01), to allow banks to leverage on their own data and models to better reflect the institutions' business model, market environment and business practices. The methodology as currently written is also unclear as it refers to "prescribed growth rates", suggesting an imposed haircut, but also to caps and floors.

More specifically, we have concerns how the bank specific growth factors (or floors and caps) will be determined. While the data on the growth assumptions for banks that have participated in the exercise over the years can be leveraged for determining the bank specific outcomes, it is unclear how this data will be used and modelled. For example, the past data has sufficient granularity to apply the factors at country or business line levels, while the current input sheet only has one line for NFCI. We believe that further granularity in the current exercise is warranted for this data category. We also highlight that unlike in some of the other areas of the 2023 STs, the caps and floors for NFCI are not described and will potentially be part of the scenario release. Further clarity on this area would be much appreciated. It is also unclear what the EBA plans to do with banks participating in the exercise the first time.

In AFME's view, it would be desirable to apply haircuts at the level of business line to arrive at appropriate haircuts for individual banks based on their business mix. This could potentially be leveraged and applied to the growth expectations and/or haircuts based on the business mix of banks participating in this study the first time.

### **Sectoral cuts for credit risk**

AFME and its members caution against the new sectoral templates in the 2023 stress test. We would welcome further engagement to better understand the purpose and benefits of the additional exercise with a view to potentially introducing this ahead of the 2025 ST.

Introduction of such a vast supplementary data gathering should be carefully considered and the benefits of the additional work should clearly outweigh the considerable costs. At this juncture, it is not clear whether sector specific detail will be provided in the scenarios, how the regulator intends to use this additional data nor what the benefits of this additional data gathering are for the overall credibility of the exercise.

Furthermore, it is worth noting that in most cases the models used by banks are not driven by NACE codes and allocating projections based on sectoral codes would require considerable manual effort and development of allocation algorithms. It is also questionable if the sectoral cuts will provide further comparability of projections across banks, as portfolios and clients vary considerably across banks and within the NACE code categories. Therefore, clear guidance is required on the purpose of the sectoral cuts and requirements ahead of the actual exercise. As of today, banks are already in full preparation of next year's stress testing exercise and such significant methodological and data gathering changes would be very difficult to accommodate.

### **Treatment of Single Resolution Fund**

Paragraphs 479 and 490 need to be updated to reflect the end of building the SRF over a period of 8 years (2016-2023). Currently, paragraph 479 assumes that contributions cannot fall in absolute value below 2022 levels, significantly overstating the level of contributions for participating banks.

## **Treatment of Share based long-term incentive plans**

In the 2023 EBA EU-wide Stress Test Draft Methodological Note, on one hand paragraph 489 was not modified to incorporate Share based long-term incentive plans in the list of events eligible for one-off adjustment, and on the other hand paragraph 526 remained unchanged, thus not allowing any increase in equity reserves. In our opinion, this asymmetry will not allow banks to provide the right representation to the incentive plans in terms of their impact on capital ratios, and thus banks that have long-term incentive schemes covering the 2022 – 2025 time horizon would be unduly penalised if the treatment is not addressed and aligned with accounting practices.

Accounting treatment of such incentive schemes falls within IFRS2 – Share-based payment, as they are equity settled: that is, the bank receives a service (employees' job performance) in return for its capital representing instruments (own shares). Specifically, the costs of the long-term incentive plans are accounted for in the P&L among personnel expenses (i.e. "Administrative Expenses" in FinRep reporting) and do not translate into a cash expense but are neutralized through an increase in equity reserves of an equal amount. The employee may receive the shares or the cash equivalent. This does not exclude the equity settled nature as the bank will in any case settle the liability with its own shares and such shares may be sold on the market.

It is worth highlighting that, after the initial share capital increase which represents a cost for shareholders in terms of dilution, the scheme is – apart from tax efficiencies – essentially neutral in terms of regulatory impacts as the cost is booked in the P&L only for accounting purposes and then offset by an equal increase in equity reserves.

In the previous exercise, the methodology of the Stress Test prescribed that the value of long-term incentive plans awarded in 2020, being classified as personnel costs (as mentioned above) should be projected throughout the 3-year time horizon of the exercise (2021-2023), with a floor represented by the 2020 level. At the same time, the increase in equity reserves that would have occurred concurrently in accounts over the stress test time horizon was not allowed. To address this anomaly, an FAQ was raised by an AFME member. The EBA's answer states that *"In line with the static balance sheet assumption, the amount of capital instruments is expected to stay throughout the projection horizon constant at the end of 2020 level, as stated in paragraph 526 of the EBA Methodological Note. Capital instruments are not expected to increase also in case they are issued in favour of internal stakeholders (e.g. as part of a compensation scheme such as equity-settled share-based payment transactions)."*

AFME and our members believe that projecting the operating costs related to these incentive plans without recording the corresponding increase in equity reserves was inconsistent with what occurred in practice and unduly penalized banks for having used an innovative and efficient incentive scheme, instead of a simple cash distribution of equivalent amounts. The resulting impact on CET1 ratios were material under the adverse scenario for some of our member banks.

## **Profit of investments in subsidiaries, joint ventures and associates accounted for using the equity method**

In line with the previous exercise, the 2023 ST Methodological Note imposes a cap on share of the profit of holdings at equity method (75% in presence of a model, 50% otherwise, please see paragraph 477 Methodological Note) which, especially for a Financial Holding, is excessively severe. In case of a controlled insurance company, indeed, consolidation with equity method is a regulatory requirement which is applied even if such a company is fully owned and integrated within the group business. A severe add-on may be justified, on the other hand, for companies not fully owned by the parent group and where the group has a lower degree of influence and/or knowledge of the business and capability to predict the impacts of a stress

scenario. To increase the credibility of the ST, groups should be allowed to achieve the benefits from business diversification that a scenario may imply.

### **Conduct risk and other operational risks**

We acknowledge the attempt to make data request within the Stress Test exercise more comparable with the figures provided in the context of COREP reporting (see the end of paragraph 426). It should be noted, however, in general the burden for participating banks, in the context of historical figures for operational risk, is mostly represented by the different extraction rules, even though (as required) the same underlying database is used. As an example, it is worth mentioning the fact that, for COREP purposes, the losses previously accounted and never reported (due to delays in the registration in the internal operational risk database) must be included in the first useful reporting cycle; instead, in the Stress Test, these losses are to be reported in the correct accounting reference years or are even excluded because they were accounted prior to the time-window relevant for Stress Test purposes.

In addition, in light of the fact that in general banks record operational losses applying a minimum threshold, the change in the first bucket for the submission of observed data (0-20k€ vs. 10k-20k€ required in the previous Stress Test exercise) reduce the comparability among players and may affect common level playing field (in the 0-20k€ bucket each bank will represent number of loss events and amount of gross losses by applying its own internal mandatory threshold). While the mentioned change is expected to have a negligible impact in terms of amounts submitted, it could instead result in significant distortions in terms of number of loss events.

### **Process and timeline**

It is worth noting from a process perspective that the data gathering exercise will run concurrently with the ICAAP process, applying pressure on same resources across the two exercises. The ICAAP process has been brought forward by a month, submissions to the SSM now due by end of March. Ideally there should not be an overlap between the two processes to ensure sufficient resources are available for both projects. The industry would appreciate if the EBA can reconsider the timing of the process in this regard and ask for the first submissions after the ICAAP process has been completed.

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