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FBF RESPONSE TO EBA CONSULTATION PAPER ON 2018 EU-WIDE STRESS TEST METHODOLOGY

I- General comment

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's Consultation on "*2018 EU-wide stress test methodology*".

The FBF reiterates its support for a stable and resilient European financial system, while facilitating economic growth. To this end, while we support the EBA's initiative to update and refine the stress test methodology, we believe that the proposed amendments do not take sufficient account of the very significant changes that happened since the 2016 stress test exercise was organised.

Summary of key comments:
- ✓ The interactions between IFRS 9 and credit risk must be specified both concerning the starting point and the projections of the stress test exercise,
- ✓ The EBA definition of "trading income" should be revised, whereas technical and reporting constraints remains in the draft methodology,
- ✓ The current methodology could discriminate banks in regards to their business mix of revenues and the frontier between trading book revenues and banking book revenues should be clarified,
- ✓ Material conduct losses are exceptional events. This is contrary to the perspective that the same errors occur again,
- ✓ The non interest income data projections are difficult to adapt to the FINREP 22.01 granularity required by the stress test methodology.

Please find below our detailed comments to the questions raised in the consultative document.

a) Credit risk

A. Do the core assumptions for the implementation of IFRS 9 in the 2018 stress test (see Box 1) make sense in relation to your institution's approach to stress testing under IFRS 9? In particular, what is your view on the assumption of perfect foresight and on the assumption that, after the end of the scenario horizon, the adverse scenario stage transition probabilities and the corresponding LGD across stages revert to the baseline horizon credit parameters? Are there additional provisions that need to be specified in the methodology?

The assumption of a perfect foresight is methodologically sound and could underline the potential volatility of the IFRS 9 framework. However, it is not realistic in practice: A formula where a more progressive recognition of the impact of the worsening of the economic scenario over the 3 years would be better.

The reversion of stage transition and LGD to the baseline scenario after 3 years is a simplifying assumption, however it seems a reasonable balance between complexity and easiness of implementation. Instead of the baseline scenario, would it be possible to revisit the approach defined through the cycle?

After the first 3 years of the stress test exercise, which scenario would be used? Should credit institutions have to use the 2020 baseline scenario after 2020? Is a reversion to TTC values allowed when used in the internal IFRS 9 models, since it is not a specific scenario? Those points should be specified.

In the current draft methodological note, it should be highlighted that the DTC (Deferred tax credit) is more conservative than the baseline.

It would be necessary to specify if at the starting point in time [paragraph 58], the provisions should be the one registered in the accountings and how this datum must be reconciled with the split between S1 and S2 [paragraph 50]?

Moreover, it would be necessary to specify how provisions should be depreciated over all the stress test period. Should we depreciate provisions during the 2018-2020 time period? How to depreciate provisions after the first 3 years?

B. Are there any difficulties your institution may face in the implementation of the draft methodology and templates with respect to data availability and granularity and modelling capabilities for (i) historical data; (ii) starting point data; and (iii) projections?

IFRS 9 offers several methodology options. For the stress test exercise, it is suitable to communicate to credit institutions all the underlying information necessary to credit institutions to develop their own IFRS 9 methodology. The current elements oblige to risky extrapolations.

Moreover, the IFRS 9 norm allow for a range of approaches, including simplified approaches which rely on expert-based provisioning rate, devoid of a $PD_{pit}*LGD_{pit}$ decomposition. Due to differences in materiality, complexity and date of acquisition, a given asset class in a given geography can be covered by an advanced approach in one entity and a simplified approach by another. As a result PD_{pit} and

LGD$_{pit}$ parameters should be reported only for perimeters where these perimeters are expected by the institutions to be used at the 2018/01/01 date. Where other approaches will be used for the effective determination of provisions, institutions would directly integrate them in the corresponding impairment flows columns. Institutions choosing to do so could provide a separate template covering only the exposures and impairment flows associated to the simplified approaches. The EBA should be aware than the simplified approach for IFRS 9 was selected when data was insufficient or not representative to build PD$_{pit}$ and LGD$_{pit}$ models. Consequently, the date will likely be equally unfit to derive stage migration models. The methodology should allow the bucket migrations to be expert-based on the simplified approach perimeter.

Historical data: The proposed approach does not seem realistic since IFRS 9 data are not currently in the IT system and the requirement to provide 2015-2017 data on transitions to S2 status looks impossible to implement.

Starting point data: We do not see how to provide some data particularly the "LGD12m" data. Some additional guidance (worked examples) should be delivered by the EBA.
In all cases, the definition of "significant increase of credit risk" (SICR, see below) should be as simpler as possible to allow all the required data simulation.

C. Do the proposed minimum criteria for the SICR (see paragraph 48) pose challenges for your institution?

The current definition is not relevant to our portfolios at least for all of the investment grade segment. A simpler approach should be proposed: i.e. minimum level of PD by product type. If the definition of minimum criteria for SICR ("significant increase of credit risk") is too complex, the simulation of S2 could be impossible to perform and control.

It should be recognized that future cash flow projections depend more on the business model of the credit institution than on the development of new bucketing.

We also would like to emphasize that introducing a common SICR definition, while reducing the heterogeneity of S2 bucketing criteria between banks, will distort the level of provisions in economically non-representative ways as depreciation methodologies were not calibrated around this criterion. Added to the fact that historical coverage ratios are heavily dependent on the selectivity of internal staging criteria, this SICR might make it more difficult to compare and interpret stressed cost of risk between institutions.

D. Should additional guidance be given for the migration of exposures from S2 to S1 during the exercise?

The constant maturity assumption, which used to be a consistent way of imposing a static balance sheet in an IAS 39 accounting environment, is no longer acceptable in an IFRS 9 one, since it is equivalent to significant Stage 2 origination, which is proscribed by the IFRS 9 norm. In order to safeguard the static balance sheet assumption while being IFRS 9 compliant, we would recommend:
   ✓ S2 exposures mature according to institutions internal models (alternatively, according to contractual maturity);
   ✓ Maturing S2 exposures are replaced with S1 exposures with the distribution of credit properties (PD, LGD, maturity) as end-of-year of their asset class.

Trades which terminate should not have their rating modified, but new trades should be generated in S1.

Globally, all additional details on guidance are welcome to normalise the approach between the participating banks.

E. Is the proposal for movement from S1 to S2 workable and in line with industry practice?

The current proposed methodology seems too complex given the fact that we have seldom historical data on the evolution of IFRS 9 provisioning. A simpler approach based on migration from S1 / S2 to S3 and simplification of the treatment of S1/ S2 provisioning is necessary. For instance minimum guidance on the evolution of IFRS 9 provisions based on PD_{Pit} S3 could be used.

PD should be calibrated product by product. More criteria are needed.

b) **Market risk, CCR and CVA**

A. Do you see a challenge in providing monthly data for client revenues as defined in paragraph 181 for the last 5 years as well as stress projections for this item (see paragraph 238)?

First of all, the EBA methodology defines client revenues as those included in the Net Trading Income (NTI) excluding the results due to price variations. It is specified that the NTI covers also the bid / ask margin that reflects the trading income, the trading fees, the commissions, and other paid services. This definition is not in line with the one used in the FINREP where the NTI is not only the sum of the client revenues and market moves. It also integrates the impact of the CVA, the cost of reserves, collateral & liquidity… Computing the NTI as requested is a difficult and laborious task.

Providing monthly client revenues over the past 5 years is clearly not feasible:
- ✓ The NTI is built on a quarterly basis when producing the FINREP: we can't provide monthly data of this item. We would like to have the possibility to provide these data on a quarterly basis. It is therefore necessary to ensure that the quarterly option can be used.
- ✓ Moreover, providing data with a 5Y historical depth is also a strong challenge: for comparison, 3 years of history are required for the Credit Risk template. We ask for an alignment of the depth of the history with the credit risk approach.

As a consequence, from our perspective, a revision is needed on this issue as it is explicitly stated that if a bank is unable to provide these data a penalty will apply to the Comprehensive Approach (NTI = 0). A possible solution could be to declare economic data and not FINREP data.

Beyond the monthly character of the data delivery, the requirement to supply mark to market data is only possible for trading operations registered in a trading portfolio, but not for all the market operations.

Also, it is necessary to highlight, that it will not be possible to calculate historical reserves on shifting markets.

Finally, the distinct axis under which data are required are operationally very binding.

B. How will in your view the change in the floor for the full revaluation approach (see Box 13), the cap on client revenues (see Box 16) as well as moving from three scenarios to one scenario affect the impact of the market risk stress?

This method penalizes banks whose activities have been restructured or whose level of market risk is limited. Regarding the number of scenario, we have no objection.

It should be useful to plan that desk can have more business and more profitable business during a crisis.

We support the idea to use one scenario and not 3.

C. What is your view on the additional stress requirements for L2/L3 instruments (see paragraph 234)?

Given technical constraints, such split is very difficult: this split can be done for the starting point and by risk factors however we will not be able to break down the result of the stresses according to L1 / L2 / L3. This would require major developments in credit institutions tools.

Besides this point on L2/L3 instruments, here are some other points to be highlighted on the Market Risk perimeter:
- ✓ It has to be noted that technical constraints also make it very difficult to report figures by type of pay-off (optional or not).
- ✓ Isolating HFT deals that hedge non-HFT positions may be infeasible as some hedges are global (i.e. hedging positions in HFT and not in HFT).
- ✓ All credit institutions may not be able to compute reserves in a shifted market and in the past.

c) Net Interest Income

First, we would like to stress out that a large part of the decrease in NII identified through the stress tests exercise results from the increasing proportion of non-performing loans (NPL) in the balance sheet. However, in practice this proportion should remain stable in the central scenario.

3 elements explain this methodological bias within the current stress test exercises:
- ✓ The general assumption of a static balance sheet that creates an accounting mismatch: in practice, the excess cash flows generated by NII are reinvested in order to decrease the funding need, or to generate new performing assets. Since the current methodology doesn't allow this reinvestment, the proportion of NPL grows mechanically. In reality, the NII decrease due to NPL should be compensated by the income generated by the excess cash flows' reinvestment. As such, we believe that a dynamic approach would be more appropriate in order to calculate NII projections.
- ✓ The one-way migration from performing to non-performing: this assumption is arguable since a significant part of non-performing assets is usually reclassified as performing assets. As such, a two-way migration including the reclassification from non-performing to performing for part of the NPL exposures would be more realistic.
- ✓ Finally, the assumption of a 0 recovery rate for NPL is way too conservative: as an illustration, LGD in France for mortgage loans is around 1% so that 99% of NII should be taken into account for mortgage NPL exposures.

These revisions are all the more necessary that the current methodology could discriminate banks in regards to their business mix (consumer finance with larger proportion of NPL vs. mortgage loans for example).


A. Could the combination of caps and floors as summarised in Box 18 lead to any unintended consequences for the projections of your institution specifically vs other institutions and, if so, which and why?

Box 21 limits the adverse NII up to the initial NII and according to the dynamic of provisions.
If the opposite scenario corresponds to an increase of interest rates whereas the NII tend to increase, the cap should become active. The stress on the NII should only correspond to the appliance of the credit risk cap.

Over long time periods, banks have experienced very different rate and liquidity environments. In France, the graph below shows that the outstanding amount of current accounts (non-interest bearing demand deposits) has kept increasing steadily over time, despite periods of relatively high market rates (from December 2005 to December 2008, and from December 2010 to June 2012).
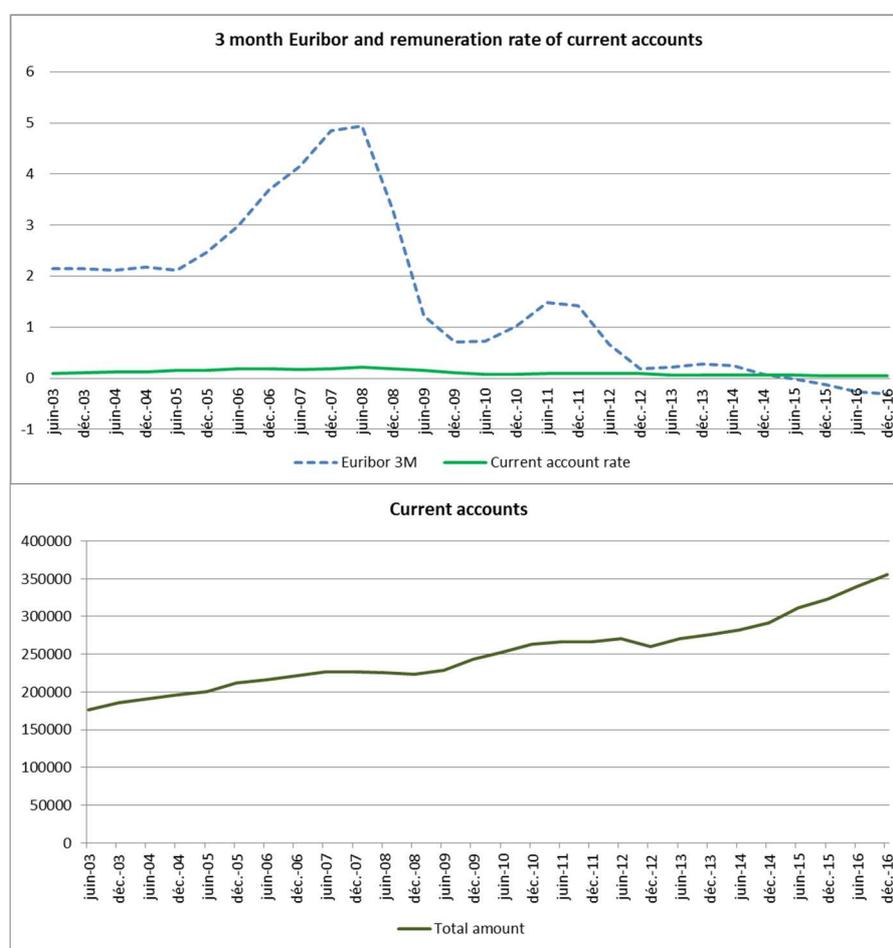
Source: Banque de France

Net Interest Income (NII) arising from trading activities

Paragraphs 180 and 269 indicate that banks should remove NII from NTI and report trading book NII as part of NII. This is problematic since for most banks internal accounting systems do not include this information for trading instruments, at least in a comprehensive manner. Indeed, isolating the trading book NII requires in theory to compute interest accrued on the trading book which is impossible for banks to perform.

As such, a good proxy would be to use the Eonia rate as the applicable rate on the trading net total assets. It should adequately reflect the funding cost of trading transactions by the banking book, and thus suppress the accounting mismatch that would exist otherwise.

d) Conduct risk and other operational risk

> **A. The methodology could include also a binding floor for material conduct risk. Such a floor could be defined, similar to the floors on non-material conduct risk and other operational risks (see section 5.4.2), based on historical material conduct risk losses. Two separate binding floors would then apply to conduct risk, one for non-material conduct risk losses and a second for material conduct risk losses. What challenges would you see for the design and calibration of such a floor for material conduct losses?**

Material Conduct Risk events must be investigated on a case-by-case basis, so these severe incidents cannot be averaged to calculate a floor on the projection.
On the other hand, defining a floor would rely on a few events, which is therefore insufficiently representative and would lead to unreliable results.

The introduction of a binding floor in the methodology would raise several inconsistencies in the framework:

- ✓ Material conduct losses are rather exceptional events with a low probability of occurrence, therefore it sounds odd to predict the realization of such event within the forthcoming three years of the scenario while the past years were highlighted by many litigation closing across the industry ;
- ✓ The estimation of such floor based on past events would suppose that the same errors occur again; this disregards all efforts that banks performed to avoid it. Besides, since losses are appreciated on a case by case basis, how can we assess the magnitude of the loss? Even for similar event, banks did not loss the same amount due to idiosyncratic considerations;
- ✓ Should such a floor be decided, it level should not be greater than the average historical loss; the multiplier would be far below the current level in the framework for recurrent losses.

e) Non-interest income, expenses and capital

A. Do you think that the use of banks' own models for NFCI in the adverse scenario projections (with the inclusion of an overall cap to ensure a minimum level of stress) will allow capturing the dynamics of the items included in this section in a more representative way?

We think only internal models developed by credit institutions for internal annual budgetary and stress test process (3 ongoing years) allow to conduct reliable projections at a bank level.

Anyway these models are based and developed on an approach by business line and/or by types of fees and commissions and may be thus difficult to adapt to the FINREP 22.01 granularity of projections required by the methodology of the stress test.

B. Does the defined reporting of NFCI according to FINREP 22.01 pose specific implementation challenges for your institution?

Yes it does as banks do not use FINREP 22.01 granularity in order to project NFCI through a model or another projection mode.
The use of internal mode of projections would allow obtaining more reliable projections in line with the business models of the different banks.