

Response from CVA Services GmbH



CVA Services GmbH
Bettinastraße 30
60325 Frankfurt am Main
Germany

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA| UK

18 March 2016

Re: European Banking Authority “Consultation on the Guidelines on stress testing and supervisory stress testing (EBA/CP/2015/28)”

Dear Sir/Madam,

CVA Services GmbH would like to thank EBA for the opportunity to comment on the Consultation on the Guidelines on stress testing and supervisory stress testing (EBA/CP/2015/28). Please find attached our response to the consultation.

We would be happy to discuss with you, in further detail, any further comments you may have. Please do not hesitate to contact Thomas Schwiertz on +49 69 974 611 43 or by email: Thomas.Schwiertz@cva-services.eu

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Stefan Zur', with a long horizontal flourish extending to the right.

CVA Services GmbH
Stefan Zur
Managing Director

A handwritten signature in blue ink, appearing to read 'Schwiertz', with a long horizontal flourish extending to the left.

CVA Services GmbH
Thomas A. Schwiertz
Head of Financial Engineering

CVA Services GmbH Response to the Consultation on the Guidelines on stress testing and supervisory stress testing (EBA/CP/2015/28)

INTRODUCTION

We are pleased to respond to the EBA consultation on the Guidelines on stress testing and supervisory stress testing.

We acknowledge EBA for being an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector, its maintenance of financial stability in the EU, and its role as a safeguard for integrity, efficiency and orderly functioning of the banking sector.

CVA Services GmbH is a leading consultancy firm in Germany in the field of financial risk management. Our consultancy expertise is centered on market, credit, liquidity and operational risk management and extends from accounting to IT service implementations within the risk control and trading departments of financial firms. Providing managed services for CVA and exposure calculations based on Basel III and IFRS our company is in the process of extending our activities to the European markets. Most of our clients incur considerable costs for implementing and following new regulations or requests to respond to consultations such as QIS or CP. Those costs are part of what we refer to as RVA (regulatory value adjustments).

In particular we support our clients in change management within their IT systems regarding new regulations e.g. MiFID II /MIFIR or in the restructuring from Value at Risk to Expected Shortfall measures and in the implementation of reverse stress tests.

Please find below our response on questions stated and draft RTS/ITS/Guidelines/advice below our general remarks.

General remarks

Our comments focus on the quantitative aspects and its technical implementation within IT systems rather than the organisational requirements.

General comment on “institution’s stress testing”

Financial institutions’ stress tests are often defined by historical scenarios.

Such stress scenarios and the liquidation periods as well as periods of market turmoil, which should define the simulation time horizons are not always captured properly. As set out in the consultation paper we support the idea of internal model approaches. Business and portfolio dependencies of financial institutions must be reflected in the selection of scenario levels and other key principles.

Although we support ideas of standard approaches which serve as a floor for capital requirements in an internal model framework, we think stress tests should be excluded from this rule. Loan portfolios of regional and smaller banks are a good example.

There should be an incentive for banks to develop internal models to best reflect correlations with statistical significance. Identifying the statistical significance of these correlations is one way to assess the quality of these identified risk factors, but in traditional risk management frameworks e.g. significance tests have not been practicable due to the amount of historical data of large movements of risk factors over time. Any guidelines which do not support this idea or ease incentives to develop internal models should be avoided. We would like to state here that the statistical significance of risk factors is taken into account in new risk management frameworks such as Financial Network Analysis.

General comment on “supervisory stress testing”

In Top-down stress tests we are concerned about the execution of inappropriate technical calculations for embedded options on termination. Some of our clients are German mortgage banks using interest swap derivatives to hedge their issued credits or in some cases they use interest rate swaps as asset swaps. On the capital markets side a general stress scenario, i.e., interest rates up or interest rates down does not take into account the terminable structure (possibility to terminate the trade without any material fees or payments) of its business with its counterparty, which is usually a closely linked institution. In contrast to an exercise of a break clause, which usually quits business relation with the respective counterparty, the termination does not harm the overall liquidity or ability to pursue trading activities. Furthermore big swings (i.e. 300 basis points – *“The 2014 EU-wide stress test results show an overall impact of the adverse macroeconomic scenario on the CET1 ratio of 260 basis points over 3 years, with CET1 decreasing from 11.1% in 2013 to 8.5% in 2016. The joint effect of the AQR and the stress test is 300 basis points.”*) in the key-rates do not occur within a one day horizon. However, such scenarios were technically applied to a static end of day portfolios. The trading department (often Treasury and Capital Markets front-offices are combined at mortgage banks) would never quit hedging during such an adverse macroeconomic scenario over years. The possibility to reflect termination should always be covered completely by using delta adjustments within any RTS.

Even when holding a very small non-performing loan portfolio, no equity and only investment grade exposure such a 300 basis point technical ad-hoc scenario overestimates risk not only due to the fact that it is applied to a static portfolio, but also by neglecting the terminable structure of its interest rate swap portfolio. Therefore this issue should be covered by mandatory delta adjustments. The same should be applied to terminable loans (i.e. “kündbare Kreditgeschäfte”, in particular German BGB §489 for mortgage banks). The same applies to any other specialized loan bank with embedded termination. The supervisor must be able to rely on the internal models of the banks. A general framework or final mandatory RTS which do not reflect termination properly could lead to an improper evaluation.

Solvency stress test

Please refer to our comments above. Although we support ideas of standard approaches which serve as a floor for capital requirements in an internal model framework, we think stress tests should be excluded from this rule. For operational risk we face situations in which institutions using an AMA (Advanced Model Approach) instead of BIA (Basis Indicator Approach) end up with higher equity capital demands because a historical event (black swan) realized once upon a time and has not been foreseen before creates demands for higher capital measurements after being identified in a back-testing framework. The BIS published the “Pillar 3 disclosure requirements - consolidated and enhanced framework - consultative document” on 11 March 2016. The “Standardised Measurement Approach for operational risk - consultative document” was published 4 March 2016. From technical and mathematical perspective stress tests and operational risk models are very similar. Both use extreme value statistics, heavy tails and diverse tail adjustments for modelling. In contrast to daily available market risk data a backtesting of stress tests should not be used to assess the quality of an internal model due to the lack of sufficient quantity of data.

For any stress test we face similar issues due to the fact that the amount of stress data of any risk factor is statistically not significant or comparable with relevant data available every day. As mentioned above, modern Financial Network Analysis can be a solution to those issues.

Liquidity stress test

Please refer to our comments above. Although we support ideas of standard approaches which serve as a floor for capital requirements in an internal model frameworks we think stress tests should be excluded from this rule. We recommend internal liquidity models and to allow the capital requirements to be based on those as an exception to numbers like the LCR (liquidity coverage ratio) or NSFR (net stable funding ratio). For definition 10. (2) (p. 13 of the CP) we would delete “including on its minimum or additional requirements”. In summary we recommend “excluding”.

Bottom-up stress test

We strongly support the idea of bottom-up stress tests and its definition, i.e., 10 (3) (i-iv). Furthermore we recommend to promote bottom-up stress tests in favour of top-down stress tests and incentivize those in the future development of an European stress test framework.

Comments on individual consultation questions and draft RTS/ITS/Guidelines/advice

D. Options considered

Neither Option 1 nor Option 2 should be favoured.

For some financial institutions Option 1 (not draft updated guidelines) is appropriate. We think Option 2 should also continue to exist, but certain financial institutions must be excluded in the final guidelines. See above the outlined example: mortgage banks. Especially for smaller banks new guidelines would increase costs that are part of what we refer to as RVA (regulatory value adjustments).

If in Option 2 the guidelines do not include a detailed methodology for future EBA stress tests but will at least provide the context to facilitate discussions on the future of EBA stress tests, we support Option 2.

We support a categorization of institutions set out in F.

E. Cost-Benefit Analysis

We recommend Option 2.

F. Preferred option

“The cost-benefit analysis in section (vi) indicates that Option 1 should be excluded as it produces a negative net impact.” We support this idea.