

# Consultation Paper

## Draft Regulatory Technical Standards

Specifying the range of scenarios to be used in recovery plans under the draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms



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# Consultation Paper on Draft Regulatory Technical Standards specifying the range of scenarios to be used in recovery plans under the draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms

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# 1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in point 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to [EBA-CP-2013-9@eba.europa.eu](mailto:EBA-CP-2013-9@eba.europa.eu) by 20.08.2013, indicating the reference 'EBA/CP/2013/09' on the subject field. Please note that comments submitted after the deadline, or sent to another e-mail address will not be processed.

## Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

## Data protection

Information on data protection can be found at [www.eba.europa.eu](http://www.eba.europa.eu) under the heading 'Legal Notice'.

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## 2. Executive Summary

The proposal<sup>1</sup> for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms (the Recovery and Resolution Directive or RRD) sets out a Union-wide new framework for crisis prevention, management and resolution of credit institutions and investment firms. Such framework *inter alia* requires credit institutions and investment firms (henceforth 'institutions') to plan in advance in order to strengthen their ability to restore financial and economic viability when they get under situations of severe stress.

In a number of articles the proposed RRD contains specific mandates for the EBA to develop draft Regulatory or Implementing Technical Standards (RTS and ITS) related to different elements of the proposed framework. These standards will be part of the single rulebook strengthening regulatory harmonisation in Europe with the particular aim to enhance financial stability, reduce moral hazard, reduce the probability of a systemic banking crisis and minimise taxpayer exposure to losses from financial support to failing institutions.

The present draft RTS is developed by the EBA pursuant to Articles 5(6) of the proposed RRD and relates to the range of scenarios of financial distress against which institutions shall test the impact and feasibility of their recovery plans. These recovery plans set out the arrangements which institutions have in place and the measures that would be adopted to take early action to restore its long-term viability in the event of a material deterioration of financial situation in situations of severe stress.

To the extent that the text of the RRD adopted following the legislative process changes with respect to the Commission's proposal, the EBA may need to adapt the draft RTS accordingly to reflect the relevant developments. The EBA may also introduce other changes into its draft RTS in order to appropriately reflect comments received, including in response to this consultation paper. The EBA will, subject to the requirements that the final RRD places upon, submit the final draft RTS to the Commission within twelve months from the date of entry into force of the RRD.

### Main features of the RTS

This consultation paper puts forward the draft RTS according to Article 5(6) of the proposed RRD, where the EBA is mandated to specify through an RTS the range of scenarios to be used by firms to test their recovery plans, as stipulated by Article 5(5) of the RRD.

The draft RTS is structured into 5 articles. The first article establishes the subject matter. The second article provides definitions used in the RTS. Article 3 and 4 provide design principles for the range of scenarios and the range of scenarios to be considered. Finally, Article 5 determines when the regulation enters into force.

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<sup>1</sup> Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, published on 6 June 2012. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:EN:PDF>

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### 3. Background and rationale

At the international level the initiatives on recovery and resolution planning are carried out under the auspices of the Financial Stability Board which in its Key Attributes of Effective Resolution Regimes for Financial Institutions<sup>2</sup> identifies the essential elements of recovery and resolution plans, and recommends recovery and resolution plans to be in place at least for any financial institution that could be systemically significant or critical if it fails.

At the EU level, following the Conclusions of the Council of the European Union on Crisis Prevention, Management and Resolution of 18 May and 7 December 2010, the European Commission (EC) adopted on 6 June 2012 the proposal for the Recovery and Resolution Directive (COM(2012) 280 final).

This proposal is currently being examined and discussed by the Council and the European Parliament as EU legislators in the framework of the Treaty's legislative procedure. In anticipation of the finalisation of the legislative text, the EBA has developed this draft RTS in accordance with the mandate contained in Articles 5(6) of the proposed RRD, which mandates the EBA to specify through an RTS the range of scenarios to be used by firms to test their recovery plans, as stipulated by Article 5(5) of the RRD.

Given the considerable number of technical standards/guidelines that the EBA is required to produce within twelve months from the date of entry into force of the RRD, the EBA has decided to proceed with a consultation at this early stage. This early consultation ensures that potential respondents have the fullest opportunity to comment and that the EBA is able to meet the demands that the proposed RRD places upon it.

The EBA may need to adapt the draft RTS in accordance with the final version of the RRD text before submitting it to the European Commission for adoption; if the required changes are substantial another consultation may be required. The EBA may also introduce other changes into the text of draft RTS in order to appropriately reflect comments received from interested stakeholders, including amendments in response to this consultation paper.

#### The nature of RTS under the EU law

The present draft RTS are produced in accordance with Article 10 of Regulation (EU) No 1093/2010.<sup>3</sup> According to Article 10(4) of that regulation, the RTS shall be adopted by means of a regulation or decision.

According to EU law, EU regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States and that their implementation into national law is not only unnecessary but also prohibited by EU law, except in so far this is expressly required by them.

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<sup>2</sup> Key Attributes of Effective Resolution Regimes for Financial Institutions, FSB, October 2011.

<sup>3</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

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Shaping these rules in the form of a regulation would contribute to a level-playing field by preventing divergence of national requirements.

#### Rationale and regulatory approach followed in the draft RTS

In its proposal for the Recovery and Resolution Directive on 6 June 2012 the European Commission requires that each institution draws up and maintains a recovery plan providing, through measures taken by the management of the institution or by a group entity, for the restoration of its financial situation following significant deterioration. Furthermore, the draft RRD stipulates in Article 5(5) that competent authorities shall ensure that firms test their recovery plans against a range of scenarios of financial distress, varying in their severity including system wide events, legal-entity specific stress and group-wide stress. At the same time the Article 5(6) of the draft RRD would mandate the EBA to develop, in consultation with the European Systemic Risk Board (ESRB), draft technical standards specifying the range of scenarios to be used for the purposes of Article 5(5).

Following this mandate, the present draft RTS is prepared taking into account the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions and current supervisory practices. The draft RTS covers the key elements and essential issues that should be addressed by institutions when developing financial distress scenarios against which the recovery plan will be tested.

Drafting a recovery plan is a duty of institutions or groups undertaken prior to a crisis in order to assess the potential options that an institution or a group could itself implement to restore financial strength and viability should the institution or group come under severe stress. A key assumption is that recovery plans shall not assume that extraordinary public financial support would be provided. The plan is drafted and owned by the financial institution, and assessed by the relevant competent authority or authorities. The objective of the recovery plan is not to forecast the factors that could prompt a crisis. Rather it is to identify the options that might be available to counter; and to assess whether they are sufficiently robust and if their nature is sufficiently varied to cope with a wide range of shocks of different natures. The objective of preparing financial distress scenarios is to define a set of hypothetical and forward-looking events against which the impact and feasibility of the recovery plan will be tested. Institutions or groups should use an appropriate number of system-wide financial distress scenarios and idiosyncratic financial distress scenarios to test their recovery planning. More than one of each scenario is useful, as well as scenarios that combine both systemic and idiosyncratic events. Financial distress scenarios used for recovery planning shall be designed such that they would threaten failure of the institution or group, in the case recovery measures are not implemented in a timely manner by the institution or group.

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## 4. Draft Regulatory Technical Standards specifying the range of scenarios to be used in recovery plans under the draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms

### Questions for Consultation

|      |                                                                                                                                                                                                                                   |
|------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Q01: | Have you already drafted financial distress scenarios for the purpose of testing a recovery plan or are you in the process of doing so? If so, are these financial distress scenarios in line with the contents of the draft RTS? |
| Q02: | Have you developed group or solo specific scenarios to test the adequacy of the recovery plan?                                                                                                                                    |
| Q03: | Do you believe that the draft RTS on the range of scenarios for recovery plans is adequate to ensure that firms test their recovery plans against a range of scenarios of financial distress?                                     |
| Q04: | How many scenarios have you been required to develop to test the adequacy of the recovery plan? Have you included slow or fast moving events?                                                                                     |
| Q05: | Have you used reverse stress testing as a starting point for developing financial distress scenarios?                                                                                                                             |
| Q06: | What are the additional costs to develop financial distress scenarios in respect to the current practices of reverse stress testing?                                                                                              |
| Q07: | Do you believe that the events that institutions or groups need to consider and include where relevant are most suitable? If not, what other events ought to be taken into account?                                               |
| Q08: | Do you have any general or specific comments on the draft RTS?                                                                                                                                                                    |
| Q09: | Are the definitions and terminology used in the draft RTS clear?                                                                                                                                                                  |

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**DRAFT COMMISSION DELEGATED REGULATION (EU) No .../..**  
**supplementing Directive xx/XX/EU [RRD] of the European Parliament and of the Council with**  
**regard to regulatory technical standards specifying the range of scenarios to be used in**  
**recovery plans**  
**of xx.XX.2014**

**THE EUROPEAN COMMISSION,**

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive xx/XX/EU of the European Parliament and of the Council of [ddmmyyyy] establishing a framework for the recovery and resolution of credit institutions and investment firms (Directive XXXX/xx/EU [RRD]), and in particular to Article 5(6) thereof,

Whereas:

- (1) The objective of preparing scenarios of financial distress is to define a range of hypothetical events against which the impact and feasibility of the recovery plan shall be tested.
- (2) Taking into account the proportionality principle, institutions should use an appropriate number of financial distress scenarios against which to test their recovery plans. While the risks which particular institutions face vary significantly, these technical standards should specify factors to be taken into account in determining the appropriate number.
- (3) The range of scenarios of financial distress should include at least three scenarios, in order to ensure coverage of a system wide event, an idiosyncratic event and a combination of system wide and idiosyncratic events.
- (4) In order to provide an effective test of a recovery plan, scenarios of financial distress used for recovery planning shall be designed such that they would threaten to cause the failure of the institution or group if recovery measures were not implemented in a timely manner.
- (5) Reverse stress testing can be seen as useful as a starting point for developing financial distress scenarios as the purpose of reverse stress-testing is to identify and consider scenarios that would lead to an institution's or a group's business model becoming non-viable.
- (6) In order to ensure that recovery plans are tested against the main types of system wide and idiosyncratic events when designing scenarios, institutions and groups should be required to take into consideration specific types of event which most typically threaten the failure of institutions or groups. However, the overriding principle should remain that the scenarios should be based on the events that are the most relevant to the institution or group, which could mean using different events where those are more relevant.
- (7) This Regulation is subject to determinations made regarding the extent to which details of recovery plans apply in accordance with Article 4 of Directive XXXX/xx/EU [RRD].



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This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority (EBA) to the Commission.

The EBA has developed the draft regulatory technical standards on which this Regulation is based in consultation with the European Systemic Risk Board and has conducted open public consultations on those draft regulatory technical standards, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010.

HAS ADOPTED THIS REGULATION:

### ***Article 1. Subject matter and scope***

This Regulation specifies the range of scenarios of financial distress to be used for the purposes of Article 5(5) and Article 7(5) of Directive xx/XX/EU [RRD].

### ***Article 2. Definitions***

For the purposes of this Regulation the following definitions apply:

- a. 'system wide event' means an event that risks having serious negative consequences for the financial system or the real economy;
- b. 'idiosyncratic event' means an event that risks having serious negative consequences for a single institution, a single group, or an institution within a group.

### ***Article 3. Design principles for the range of scenarios***

1. Each scenario of financial distress within the range of scenarios shall be designed to meet each of the following requirements:
  - a. the scenario is based on events that are most relevant to the institution or group, taking into account, among other relevant factors, its business and funding model, its activities and structure, its size or its interconnectedness to other institutions or to the financial system in general, and, in particular, any identified vulnerabilities or weaknesses of the institution or group;
  - b. the events foreseen in the scenario would threaten to cause the failure of the institution or group, unless recovery measures are implemented in a timely manner;
  - c. the scenario is based on events that are exceptional but plausible.

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2. Each scenario of financial distress within the range of scenarios shall include, where relevant, an assessment of the impact of the events on at least each of the following aspects of the institution or group:
    - a. available capital;
    - b. available liquidity;
    - c. business model;
    - d. profitability;
    - e. payment and settlement operations;
    - f. reputation.

**Article 4. Range of scenarios of financial distress**

1. The range of scenarios of financial distress shall include at least one scenario for each of the following types of events:
  - a. a system wide event;
  - b. an idiosyncratic event;
  - c. a combination of system wide and idiosyncratic events which occur simultaneously and interactively.
2. In designing scenarios based on system wide events, institutions and groups shall take into consideration the relevance of at least the following system wide events:
  - a. the failure of significant counterparties affecting financial stability;
  - b. a decrease in liquidity available in the interbank lending market;
  - c. increased country risk and generalized capital outflow from a significant country of operation of the institution or the group;
  - d. adverse movements in the prices of assets in one or several markets;
  - e. a macroeconomic downturn.
3. In designing scenarios based on idiosyncratic events, institutions and groups shall take into consideration the relevance of at least the following idiosyncratic events:
  - a. the failure of significant counterparties;
  - b. damage to the institution's or group's reputation;

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- c. a severe outflow of liquidity;
  - d. adverse movements in the prices of assets to which the institution or group is predominantly exposed;
  - e. severe credit losses;
  - f. a severe operational risk loss.
4. Paragraphs (2) and (3) are subject to the general principle in Article 3(1) that scenarios shall be based on events that are the most relevant to the institution or group and shall therefore be based on different events where those are more relevant.
5. The range of scenarios shall include both slow-moving and fast-moving adverse events.
6. The number of scenarios of financial distress shall take into account, in particular, the nature of the business of the institution or group, its size, its interconnectedness to other institutions and to the financial system in general and its funding models.

#### ***Article 5. Final provisions***

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

*For the Commission*

*The President*

*On behalf of the President*

*[Position]*

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## 5. Accompanying documents

### 5.1. Draft Cost-Benefit Analysis / Impact Assessment

#### Introduction

This note outlines the assessment of the impact of the draft RTS concerning the scenarios to be used to test recovery plans. The development of the draft RTS stems from the requirement presented in Article 5(6) of the RRD proposal.

Pursuant to Article 10(1) of Regulation (EU) No 1093/2010 any draft implementing technical standards/regulatory technical standards developed by the EBA shall be accompanied by an Impact Assessment annex which analyses ‘the potential related costs and benefits’ connected with the proposal. Such Impact Assessment shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

This note outlines the main expected impacts of the proposed provisions and provides a summary of the nature and expected magnitude of costs and benefits arising from the requirements.

#### Problem definition

##### *Issues addressed by the European Commission regarding EU framework for bank recovery*

As documented in the European Commission’s impact assessment of the RRD, during the financial crisis, many institutions or groups did not have plans to achieve recovery in various situations of financial distress. Institutions or groups were therefore insufficiently prepared to adopt and implement appropriate measures to promptly address issues such as severe liquidity shortages and capital depletion.

The Commission proposed that credit institutions and investment firms prepare recovery plans in which they set out the arrangements they have in place or the measures that they themselves would adopt to take early action to restore their long-term viability in the event of a material deterioration of their financial situation in situations of financial stress. Institutions or groups would be required by supervisors to test their recovery plans against a range of scenarios of financial distress, varying in their severity including system wide events, legal-entity specific stress and group-wide stress. For groups, recovery plans at both group and individual level would be necessary.

##### *Issues addressed by the RTS and objectives*

The European Commission’s RRD proposal mandates the EBA, in consultation with the ESRB, to develop draft technical standards specifying the range of scenarios to be used for the purposes of Article 5(5). This is to avoid that national supervisory authorities make substantially divergent requirements to these financial distress scenarios, which may create uncertainty regarding the effectiveness of recovery plans to tackle problems detected early by national supervisors and to propose the right set of recovery options.

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The RTS will contribute to fulfilling the RRD objectives of increasing the preparedness of institutions for crisis situations and ensure that recovery plans are tested against the same benchmark scenarios across the single market.

#### Technical Options considered

When preparing the RTS the EBA considered whether:

- ▶ A1 - to add the requirement of producing an upside and downside case for each scenario tested, to test for possible extreme positive and negative events of the stress considered in each scenario; or
- ▶ A2 - not to require any additional test of extreme positive and negative events in addition of the stress parameters already considered in each scenarios.

The EBA decided to abstain from adding this specification and to choose option A2. This decision was motivated by the fact that option A1 would create an excessive burden to institutions by unnecessarily increasing the number of scenario against which they need to test their recovery plans. Besides, the added benefit of testing against a less severe scenario next to a severe (financial distress) scenario would be in some case very limited: if an institution is capable of implementing recovery measures in a severe scenario, it will most likely also be able to implement these measures in a less severe scenario.

The EBA considered also whether:

- ▶ B1 - to specify a fixed type and number of scenarios to be tested; or
- ▶ B2 - to leave the discretion to the national supervisory authorities (NSAs) on the type and number of scenarios that will need to be tested.

Given that the design of the appropriate scenarios depends on the specific characteristics of each institution (activity, size, interconnectedness, business and funding model, etc.), the RTS cast on institutions the responsibility for selecting relevant scenarios and vest NSAs with the task of assessing the appropriateness of chosen scenarios. However, at least three scenarios are required by the draft RTS (one covering a system wide event, one covering an idiosyncratic event and one covering a combination of both types of events), and in order to build these scenarios the events identified in Article 4 of the draft RTS must be duly considered by institutions/NSAs while designing/assessing the scenarios. However, considering that the quality and effectiveness of the scenarios is strictly dependent on firm's characteristics and weaknesses, the institutions can build the relevant scenarios considering events different from those provided by Article 4. This option shall be duly motivated by the institution and assessed by the competent authority.

#### Impact of the proposals

##### Costs

The costs of testing recovery plans against scenarios are mainly driven by the requirements incorporated in the RRD itself. The draft RTS specifies only the range of scenarios against which

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recovery plans have to be tested. As a result, this RTS will generate additional compliance costs within those Member States where fewer scenarios than those proposed by the RTS would have been required. Such costs will mainly affect institutions, which will have to test these scenarios, and to a lesser extent NSAs, which will have to verify whether the scenarios have been properly designed and tested.

### *Benefits*

By specifying the range of scenarios that institutions or groups should use when testing their recovery plans, this RTS ensures that recovery plans are effectively tested according to similar benchmarks. It will ensure the existence of common minimum standard on the quality of the recovery plans of institutions established in the EU for the benefit of the proper functioning of the single market.

### *Proportionality of the proposal*

When developing the requirements proposed in this RTS, the EBA has taken in account the proportionality of its proposals on institutions and other stakeholders. The requirements laid down on the range of scenarios for the recovery plan will depend on many factors (for instance the nature of its business, its size or its interconnectedness to other institutions on funding conditions or on the economy in general). In general, the more an institution (or banking group) is large, complex and interconnected with other institutions, the more resources it will need to design and develop the scenarios proposed.

**Q10: Do you agree that, for an institution, the costs of developing financial distress scenarios to test a recovery plan are likely to be proportional to the size/complexity of the firm and so of the costs its failure may create? If not, could you explain why?**

**Q11: Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?**

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## 5.2. Overview of questions for Consultation

|      | <b>Questions related to the draft RTS</b>                                                                                                                                                                                         |
|------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Q01: | Have you already drafted financial distress scenarios for the purpose of testing a recovery plan or are you in the process of doing so? If so, are these financial distress scenarios in line with the contents of the draft RTS? |
| Q02: | Have you developed group or solo specific scenarios to test the adequacy of the recovery plan?                                                                                                                                    |
| Q03: | Do you believe that the draft RTS on the range of scenarios for recovery plans is adequate to ensure that firms test their recovery plans against a range of scenarios of financial distress?                                     |
| Q04: | How many scenarios have you been required to develop to test the adequacy of the recovery plan? Have you included slow or fast moving events?                                                                                     |
| Q05: | Have you used reverse stress testing as a starting point for developing financial distress scenarios?                                                                                                                             |
| Q06: | What are the additional costs to develop financial distress scenarios in respect to the current practices of reverse stress testing?                                                                                              |
| Q07: | Do you believe that the events that institutions or groups need to consider and include where relevant are most suitable? If not, what other events ought to be taken into account?                                               |
| Q08: | Do you have any general or specific comments on the draft RTS?                                                                                                                                                                    |
| Q09: | Are the definitions and terminology used in the draft RTS clear?                                                                                                                                                                  |

|      | <b>Questions related to the Impact Assessment</b>                                                                                                                                                                                                               |
|------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Q10: | Do you agree that, for an institution, the costs of developing financial distress scenarios to test a recovery plan are likely to be proportional to the size/complexity of the firm and so of the costs its failure may create? If not, could you explain why? |
| Q11: | Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?                         |