

**Guidelines on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive**

**(EBA/GL/2014/09)**

These Guidelines will assist the competent authorities on the type of tests, reviews or exercises that may lead to capital shortfalls that may be eligible to be covered by public recapitalisation under the exception specified in Article 32(4)(d)(iii).

The Guidelines specify the main features of the tests, reviews or exercises, a quality review process, a common methodology and, where relevant, a macro-economic scenario and hurdle rates, as well as a timeframe to address the shortfall.

The Executive Commission of Banco de España adopted these guidelines as their own on October 5th 2015.

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The Executive Commission of Banco de España, in its capacity as supervisory authority of less-significant credit institutions, adopted these guidelines as their own on October 5th 2015.

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EBA/GL/2014/09

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22 September 2014

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## Guidelines on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive

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# 1. Executive summary

1. Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions, investment firms and related entities (the Bank Recovery and Resolution Directive – BRRD) sets out a Union-wide framework for crisis prevention in relation to these entities and the management and resolution of these entities.
2. The BRRD objective is to avoid the need to use taxpayers' money as far as possible when dealing with unsound or failing credit institutions and investment firms. It therefore sets out a harmonised framework for resolving institutions at Union level. Within that regulatory framework, resolution should be primarily and almost exclusively financed by private resources.
3. In accordance with Article 32 of the BRRD, the need for extraordinary public financial support for an institution should be considered as an indicator that this institution is failing or is likely to fail, and therefore triggers the need for resolution. However, the BRRD also acknowledges the existence of situations where extraordinary public financial support may not be in itself a condition that sufficiently demonstrates that an institution is failing or will fail in the near future.
4. In particular, extraordinary public financial support taking the form of an injection of own funds or purchase of capital instruments to a solvent institution in order to address capital shortfall resulting from stress tests, asset quality reviews or equivalent exercises may not be considered as a trigger for resolution when it is provided to remedy a serious disturbance in the economy of a Member State and to preserve financial stability with respect to all the conditions laid down in Article 32(4)(iii).
5. These EBA Guidelines specify the main features of the types of tests, reviews or exercises that may lead to support measures. These features include a timeline, a scope, a time horizon and reference date, a quality review process, a common methodology and, where relevant, a macro-economic scenario and hurdle rates, as well as a timeframe to address the shortfall. These elements are designed to assist the competent authorities when they are conducting such tests, reviews and exercises where institutions may not be able to address the capital shortfall resulting from the test, review or exercise and would, in that situation, be a potential candidate for resolution in accordance with Article 32(4)(iii) of the BRRD.

## 2. Background and rationale

6. Article 32(4) of the BRRD stipulates that an institution shall be deemed to be failing or likely to fail whenever one or more of the following circumstances occur or will occur in the near future:
  - a. a breach of the requirements for continuing authorisation in a way that would justify the withdrawal of authorisation (Article 32(4)(a) of the BRRD);
  - b. assets less than liabilities (Article 32(4)(b) of the BRRD);
  - c. inability to pay obligations when they become due (Article 32(4)(c) of the BRRD);
  - d. a need for extraordinary public financial support, subject to exceptions specified in Article 32(4)(d) of the BRRD;
7. This can be determined either by supervisory authorities after consulting with resolution authorities, or by the resolution authorities after consulting with the supervisory authorities, depending on the option that the jurisdiction in question decides to take.
8. Whilst the provision of extraordinary public support means that resolution action must be taken, the BRRD provides an exception according to which resolution action should not be taken on the sole basis of extraordinary public support if all the conditions listed in Article 32(4)(d) of the BRRD are met. Neither the circumstances referred to in point (a), (b) or (c) of Article 32(4) nor the circumstances referred to in Article 59(3) can be present at the time the public support is granted. The support will be provided at prices and on terms that do not confer an advantage upon the institution, will be granted only to a solvent institution, will be of a temporary nature and proportionate to remedy the consequences of a serious disturbance in the economy of a Member State and preserve financial stability, cannot be used to offset losses that the institution has incurred or is likely to incur in the near future and is subject to final approval under state aid rules.
9. Moreover, when this public support takes the form of an injection of own funds or purchase of capital instruments, these injections of funds must be ‘necessary to address capital shortfall established in the national/Union/SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by ECB/EBA/national authorities’.
10. In this regard, Article 32(4)(d) stipulates that the EBA shall issue guidelines on the type of tests, reviews or exercises that may lead to capital shortfalls that may be eligible to be covered by public recapitalisation under the exception specified in Article 32(4)(d)(iii), provided that all other conditions are met.

# 3. EBA Guidelines on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive

## Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of 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 as subsequently amended by Regulation (EU) No 1022/2013 (the 'EBA Regulation'). In accordance with Article 16(3) of the EBA Regulation, competent authorities, resolution authorities and financial institutions must make every effort to comply with these guidelines.
2. Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities, resolution authorities and financial institutions to which guidelines are addressed to comply with guidelines. Competent authorities and resolution authorities to which guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

## Reporting requirements

3. In accordance with Article 16(3) of the EBA Regulation, competent authorities and resolution authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise provide reasons for non-compliance, by 01.12.2014. In the absence of any notification by this deadline, competent authorities and resolution authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided in Section 5 to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu) with the reference 'EBA/GL/2014/09'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities and resolution authorities.
4. Notifications will be published on the EBA website, in line with Article 16(3).

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## Title I - Subject matter, scope and definitions

### Subject matter

5. Pursuant to Article 32(4) of Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms<sup>1</sup> ('Directive 2014/59/EU'), these Guidelines specify the types of tests, reviews or exercises that may lead to capital shortfalls that may be eligible to be covered by public recapitalisation not triggering resolution referred to, as an exception, in Article 32(4), letter (d), (iii) of the Directive 2014/59/EU — provided that all other conditions specified in that Article are met.

### Definitions

6. For the purpose of these Guidelines, the following definitions apply:
- 'tests' means stress tests that are tools, coordinated at the national, Single Supervisory Mechanism ('SSM') or Union level, designed to assess the resilience of a group of institutions against hypothetical adverse market developments.
  - 'reviews' means asset quality reviews consisting in assessments, coordinated at the national, SSM or Union level, of the quality of the accounting or prudential framework applied by a group of institutions, including an assessment of the risk management framework, loan classification, collateral valuation and loan origination and arrears management.
  - 'exercises' means tests or reviews coordinated at Union level and conducted on a population of institutions over multiple jurisdictions. The assessment carried out in these exercises is based on the consistency, transparency and comparability of the outcomes across institutions.

<sup>1</sup> In O.J.E.U. L 173 of 12 June 2014, p. 190.

- d) 'competent authorities' are authorities identified as competent authorities in Article 4(1)(a) and 4(1)(d) of the EBA Regulation.

## Scope and level of application

7. These Guidelines are addressed to competent authorities to establish consistent, efficient and effective supervisory practices within the European System of Financial Supervision, and to ensure the common, uniform and consistent application of the third subparagraph of Article 32(4), letter (d) of Directive 2014/59/EU.
8. These Guidelines do not affect nor prejudice in any way the competent authorities' obligation to verify on a continuous basis whether an institution is deemed failing or likely to fail pursuant to the remaining paragraphs of Article 32(4) of Directive 2014/59/EU.

## Title II – Types of tests or reviews

### Main features of a test or review

9. The main features of a test or a review should be a **timeline**, a **scope**, a **time horizon and reference date**, a **quality review process**, a **common methodology and, where relevant, a macro-economic scenario and hurdle rates, as well as a timeframe to address the shortfall**.
10. A test or review should have a precise **timeline**, including a launch date and a deadline for the institutions subject to the test or review to provide their results to the relevant competent authorities. It should also include a deadline for the communication (publication) of the results of the test or review by the relevant competent authority or the coordinator of the exercise. For exercises, the coordinator should be clearly identified and the coordination process with all the competent authorities and the institutions involved should be clearly defined and understood ahead of the performance of the test or review.
11. A test or review should have a predefined **scope**. The sample of institutions subject to the test or review should be clearly defined. It should cover a material sample of institutions in terms of risks and assets. An explanation of the macroeconomic and/or prudential reasons for determining the sample should also be provided. This explanation can be based on absolute or relative qualitative figures and support the materiality of the sample defined.
12. A test or review should have a **time horizon and/or reference date**. A test or review should be carried out on the basis of financial statements and supervisory figures with reference to a predefined date. The purpose of the time horizon is to establish the length of time over which the scenarios will be applied, i.e. over a specified number of years. The time horizon and the reference date for the test or review should be clearly identified in the test or review's common methodology and should influence the timeframe required to implement measures.

The time horizon and the timeframe required to implement measures may depend on the risk characteristics of the analysed exposures and on whether a test (dynamic and long-term perspective) or review (point in time and short-term approach) is conducted.

13.A test or review should have a deadline for the competent authorities to conduct their **quality review process** and assessment and to provide the results of the institutions concerned to the coordinator in an exercise. Banks' figures, approaches and projections should be subject to thorough plausibility checks in the quality assurance analysis, including a comparison against relevant benchmarks. This may lead to requests for revisions to banks' figures and projections in the context of the quality assurance process.

14.A test or review should be supported by a clear and detailed **common methodology**. Tests should also be supported by one or more **macro-economic scenarios**. The methodology, without necessarily being a pass/fail test approach, should also include a range of hurdle rates or indicators that represent the quantitative references used to help assess the appropriate supervisory reaction function, including additional capital needs. When the test or review is concluded, institutions should be positioned according to the hurdle(s) rate(s) defined in the test or review methodology. This assessment may identify the need for institutions to fill a capital shortfall depending on different hurdle rates. When a capital shortfall is identified, competent authorities should request institutions to address this shortfall by private means. Institutions should address this shortfall through private capital increases or other measures to be taken by the institution within a **specific timeframe**, which should be defined in the exercise or pursuant to the criteria indicated in the exercise.

### Title III – Final provisions and implementation

These Guidelines should be implemented in national supervisory practices by competent authorities by 1<sup>st</sup> January 2015.

## 4. Accompanying documents

### 4.1 Cost-benefit analysis / impact assessment

#### **Problem definition and objective**

Following the relevant provisions of the BRRD, these guidelines specify the types of tests, reviews or exercises that would identify capital shortfalls that, in turn, may be eligible for public support/recapitalisation without triggering resolution referred to, as an exception, in Article 32(4)(d)(iii) of the BRRD.

To this end, the guidelines provide definitions and other clarifications in relation to ‘tests’, ‘reviews’ and ‘exercises’. In turn, the current impact assessment (IA) aims to provide evidence as to whether the implementation of definitions and other clarifications will have any impact. The IA assesses only the additional impact that may result from implementing the guidelines. It does not consider the impact that has already been experienced by the national authorities, the EBA and credit institutions with respect to other supervisory requirements.

#### **Options**

The current IA has not considered any policy options as it is intended only to provide clarification regarding the existing Level 1 framework which, in turn, would help supervisors to identify the credit institutions that may be eligible to public support.

#### **Cost–benefit analysis**

##### **General costs**

The guidelines use the term ‘tests’ to refer to ‘forward-looking’ tools (e.g. stress tests) that use hypothetical adverse market developments to predict the resilience of credit institutions in the future; the term ‘reviews’ is used to refer to ‘point-in-time’ assessments (e.g. asset quality reviews) that assess the resilience of the banking sector either accounting for the current market conditions or incorporating future conditions that are likely to happen (e.g. full implementation of a regulation that has already been published). Finally, the term ‘exercises’ is used to describe the cases when tests and reviews are being conducted at EU level.

The national supervisory authorities and the EBA have already structured the framework for conducting regular tests, reviews and exercises along these lines, i.e. these actions have not been triggered by the specific guidelines. It is therefore expected that there will be no additional costs arising from the conduct of these actions for the BRRD.

## Specific costs

The guidelines specify that the main features of the test or review should be a **timeline**, a **scope**, a **time horizon and reference date**, a **quality review process** and a **common methodology**.

The costs of the implementing the definitions/clarifications regarding the elements specified above is estimated as follows:

**Timeline:** No additional costs are expected as the timeline is not specified in concrete terms and therefore cannot be compared with the current practices followed by the national supervisory authorities;

**Scope:** When conducting tests and reviews, the majority of national supervisory authorities follow the principles described in the relevant part of the guidelines. However, there may be negligible costs (man hours spent) in relation to the drafting of the rationale behind the decision to choose the institutions included in the sample and the macro-economic reasons that led to this decision;

**Time horizon and reference date:** No additional costs are expected, as the time horizon and/or reference date (or even the frequency) for tests and reviews are not specified in concrete terms and therefore cannot be compared with the current practices followed by the national supervisory authorities;

**Quality review process:** The quality review process has already been conducted by national supervisory authorities and the EBA for other supervisory purposes. Therefore, there will be no additional costs in relation to the implementation of the specific provision.

**Common methodology:** Since neither the operational requirements nor the hurdle rates/indicators are specified, it is not possible to assess whether this provision deviates from the existing practices and whether it may result in additional costs.

## Benefits

The main benefits of implementing the existing guidelines relate to maintaining the financial stability of the EU banking system. However, these benefits have already been addressed by other supervisory requirements described either in the CRR-CRD IV or in the Level 1 text of the BRRD. Therefore, the additional benefit is expected to be close to zero.

## Net impact

Having taken into account this cost-benefit analysis, the net impact from implementing the existing guidelines is estimated close to zero.

## 4.2 Views of the Banking Stakeholder Group (BSG)

This section sets out the BSG comments on draft Guidelines on the tests, reviews and exercises that may lead to support measures.

### General comments

The BSG welcomes the opportunity to contribute to the debate on the types of test, reviews or exercises that may lead to public financial support measures under conditions for resolution of the BRRD. The BSG strongly supports the establishment of clear rules that tackle bank crisis pre-emptively and safeguard financial stability across the region, while minimising taxpayers' exposure to losses in insolvency. We support the general objective of ensuring consistency of approach in the bank resolution regime as between different countries.

In this sense, the BSG considers that banks should be allowed to fail and private creditors must absorb their part of the losses in the resolution process. In addition to this, the BSG thinks that the conditions of entry into resolution should be clear and objective as they are defined in Article 32 of the BRRD. A particular topic of discussion is the role of the extraordinary public support as a circumstance that might be used to define if an institution is "failing or likely to fail". For those reasons, it is key to clarify when the need for extraordinary public financial support for an institution should be considered as an indicator to trigger the need for resolution.

The BSG fully agrees with Article 32 of BRRD that establishes that extraordinary public financial support resulting from tests, reviews or equivalent exercises may not be considered as an automatic trigger for resolution when the institution fulfils the current minimum capital regulatory requirement and such support is provided (in accordance with the State Aid framework) to remedy a serious disturbance in the economy of a Member State and to preserve financial stability.

In this regard, it must be kept in mind that stress tests can be a key instrument for the early detection of a weak bank as a part of the recovery plan. Stress testing is not only a useful process, but also a means to engage in a direct dialogue between the supervisor and the bank in order to identify potential weaknesses in a forward-looking manner, and to alert bank managers to take the necessary corrective actions. Stress test results are one of the instruments used by supervisors to inform the overall decision about corrective action, given that the degree of formalism of stress testing processes will differ depending on the size and complexity of the bank. In a nutshell, the extraordinary public financial support resulting from tests when institution fulfil capital requirement should be considered more a recovery trigger than a resolution one.

In the following section the BSG submits detailed responses to the specific questions identified in the Consultation Paper.

## Replies to Questions

***Do you agree with the definitions provided by the Guidelines for test, reviews and exercises? Do you think that the draft Guidelines lists all the correct elements to identify test and review, or do you think that any elements are missing and / or other areas and features should be covered?***

Regarding the criteria defined in the consultation paper, we consider that the principles set are correct and defined in an extensive, and flexible, way (time, definition of entities under the exercise period of time, a quality review and methodology). This broad approach is flexible enough to address all the possible future needs in any type of stress test, namely:

- to define which authorities (European *versus* national) are responsible for the exercises. .
- to define a methodology wide enough to include hurdle rates, different capital level requirements, or additional indicators as the leverage ratio.

We would also like to point out that the main features (timeline, scope, quality review process, etc.) of the measures in the Guidelines should only be read as an exemplary description. This would ensure that the test or review will remain within the definition even if one of the features is not met. This would ensure that, in the case where not all of the features are met, the bank will not be subject to a different treatment.

We welcome the assurance given in the costs-benefit analysis that the net cost impact from implementing existing guidelines is estimated to be close to zero.

In conclusion, we consider that the overall approach of the consultation paper is the correct. We look forward to reviewing the final guidelines that EBA is expected to publish by January 2015 in accordance with Article 16 of Regulation (EU) No 1093/2010 on the type of test, reviews or exercises referred to above.

### 4.3 Feedback on the public consultation and on the opinion of the BSG

The EBA publicly consulted on the draft proposal contained in this paper. The consultation period lasted one month and ended on 9 August. In total, 3 responses were received. They are all published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

#### **Summary of key issues and the EBA's response**

The Banking Stakeholder Group of the EBA and many respondents to the public consultation supported the EBA's emphasis in paragraph 8 of the "Background and Rationale" section of the CP that none of the other conditions for resolution in Article 32(4) of the BRRD may be present at the time the public support is granted. It is clear from article 32(4) of the BRRD that public support measures can be granted only in exceptional and specific circumstances to institutions that are not deemed to be failing or likely to fail except from the outcome of the tests, reviews and exercises identified in this article which would call for an exceptional public support.

Some respondents also supported paragraph 14 of the draft Guidelines stating that identified capital shortfall after a test, review or exercise should be addressed by private means. Indeed, the spirit of the BRRD is to shift the burden of resolution to private stakeholders and the draft Guidelines is aligned with such objective.

#### **Specific comments to question 1: "Do you agree with the definitions of tests, reviews and exercises provided by the Guidelines?"**

Some respondents suggested that the definition of "tests", "reviews" and "exercises" are amended to clarify that they refer to "stress tests", "asset quality reviews" and "equivalent exercises". Since Article 32(4) of the BRRD states that "support measures under point d(iii) of the first subparagraph shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central bank, EBA or national authorities, where applicable, confirmed by the competent authority", it is clear that the EBA mandate aims at these "stress tests", "asset quality review" and "equivalent exercises". The definition of "tests" and "reviews" was therefore amended in the "Definitions" section of the Guidelines in order to be aligned to the wording of the BRRD. However, the definition of "exercises" initially provided by the Guidelines appeared clear enough and was therefore maintained.

All the respondents proposed that the definition of "tests" and "reviews" are amended in order to clarify that they should not include tests or reviews applied to a single institution. In order to

avoid that specific tests or exercises are conducted to address with public support the situation of a single institution, the “Definitions” section of the Guidelines has been modified accordingly.

A respondent also suggested restricting these definitions to tests and reviews coordinated at an EU level. However, such limitation would be in contradiction with article 32(4) of the BRRD which states that “support measures under point d (iii) of the first subparagraph shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central bank, EBA or national authorities, where applicable, confirmed by the competent authority.”

**Specific comment to Question 2: “Do you think that the draft Guidelines list all the correct elements to identify tests and reviews?”**

One respondent suggested that the materiality requirement for the scope of a review or exercise should be strengthened. However, the Guidelines states that “a test or review should have a predefined scope. The sample of institutions subject to the test or review should be clearly defined. It should cover a material sample of institutions in terms of risks and assets. An explanation of the macroeconomic and/or prudential reasons for determining the sample should also be provided. This explanation can be based on absolute or relative qualitative figures and support the materiality of the sample defined.” Such explanation appears sufficiently precise whilst leaving enough flexibility to competent authorities to determine the scope of a test or exercise.

All respondents underlined that it should be clear from the Guidelines that the supervisory assessment and reviews in the course of the ordinary supervisory process such as the Supervisory Review and Evaluation Process and Pillar 2 assessments should not be considered as tests, reviews and exercises for the purposes of Article 32(4)(d). However, considering the amendments made to the definitions of “tests” and “exercises” (see above), the exclusion of tests or reviews conducted as part of the SREP or Pillar 2 assessment appears sufficiently clear from the text

Some respondents also suggested that “tests” or “reviews” should include a public announcement of the results. However, the decision to publish tests, reviews or exercises’ results belongs to competent authorities. And such decision would depend on the test, review or exercise features.

Finally, some respondents underlined that it should be made clear that a test or a review should be supported by a clear and detailed common methodology. Since such emphasis is already made in the draft Guidelines and in particular in its paragraph 14 which states that “a test or review should be supported by a clear and detailed common methodology “, the Guidelines was not modified.

## 5. Confirmation of compliance with guidelines

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Date:

Member/EEA State:

Competent authority

Guidelines:

Name:

Position:

Telephone number:

E-mail address:

I am authorised to confirm compliance with the guidelines on behalf of my competent authority:

Yes

The competent authority complies or intends to comply with the guidelines:  Yes  No

Partial compliance

My competent authority does not, and does not intend to, comply with the guidelines for the following reasons<sup>2</sup>:

Details of the partial compliance and reasoning:

Please send this notification to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu)<sup>3</sup>

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<sup>2</sup> In cases of partial compliance, please include the extent of compliance and of non-compliance and provide the reasons for non-compliance for the respective subject matter areas.

<sup>3</sup> Please note that other methods of communication of this confirmation of compliance, such as communication to a different e-mail address from the above, or by e-mail that does not contain the required form, shall not be accepted as valid.