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## Response to the Committee of European Banking Supervisors

### CEBS draft revised Guidelines on Technical Aspects of Stress Testing under the Supervisory Review Process

The Association for Financial Markets in Europe (“AFME”), the British Bankers’ Association (“BBA”) and the International Swaps and Derivatives Association (“ISDA”) are pleased to respond to the consultation on the draft updated guidance on stress testing.

Section 1 covers the key issues. Section 2 contains comments on the main parts of CP 32 and section 3 details our remarks on the guidelines. We have not provided detailed comments on the individual risk annexes, as we recommend that these be excluded from the final guideline. These Annexes appear to be targeted at IRB, IMM and AMA firms, rather than the generality of institutions, given the introductory commentary and the level of detail. We also think that they are rather prescriptive in nature and potentially double count risks, which are covered, or are in the process of being addressed, in other regulatory initiatives.

#### 1 Key messages

CEBS’ proposed guidance incorporates many elements that we support and we found the high level principles useful. The draft guidance provides a practical framework for promoting dialogue within a firm, and between a firm and its supervisor. We believe that this dialogue will support strategic planning and capital management. In our comments below there are repeated references to the importance of engagement and dialogue between supervisors and firms. This reflects our members’ strong view that stress testing should be seen as an enabler for further regulatory discussions along a “comply or explain” basis.

**Balance between qualitative and quantitative:** We agree that stress testing is an important risk management tool for firms. We note that the guidelines indicate that there needs to be balance struck between quantitative measures and critical qualitative application. Stress testing is an evolving discipline. Developing approaches to scenario selection and embedding stress testing in internal governance processes will continue to be challenging for firms as this is a very

complex area. A qualitative approach will be essential when assessing the robustness of stress tests and their impact.

**Proportionality:** We fully support CEBS' comments that indicate a need to take account of the nature, scale and complexity of firms' operations. We would also underline that the guidelines need to be applied pragmatically. The human resources, data and infrastructure required to support some of the stress testing envisaged by CEBS should not be underestimated. It is important that supervisors bear this in mind before asking firms to run, or report on, multiple stress tests. Stress tests should be targeted and appropriate for the institution concerned.

**Risk management:** Risk management and corporate governance are key to addressing the issues identified as a result stress testing. Stress test results should not lead to an automatic increase in capital or liquidity buffers. Consideration must be given to a firm's risk management and any mitigating actions it takes in response to stress test outcomes.

**Governance:** While the guidelines properly consider governance, they do not sufficiently differentiate between the roles of the management body (whatever form it takes) and senior management. The management body must be sufficiently independent to provide robust challenge and there must be scope to delegate responsibilities to senior management where appropriate.

**High level principles rather than checklists:** We support CEBS general approach to developing high level principles, which can be adapted to individual firms and business models, rather than prescriptive checklists. It is important to focus upon communicating regulatory expectations rather than defining best practice. However, we are concerned that in a number of areas the guidance could be regarded as prescriptive, for example the presentation and contents of Guideline 3. We believe that there is no need for supervisors to issue definitive metrics. Any metrics mentioned should be kept as examples that firms may want to use.

**Timetable for implementation:** We note the proposed implementation date for supervisors of 30 June 2010 and the indication that flexibility should be given to firms to implement the changes necessary to comply on a phased basis. We support such a phased implementation because of the systems changes that will be necessary to extract the information required from existing systems and to modify or develop systems and to conduct the stress tests required. The amount of time to make system or database changes should not be underestimated and we would expect each firm to agree with its supervisor an appropriate timetable.

**Multiple application of tests:** We are concerned about the level of stress testing that the guidelines imply and the consequences that result. There are two manifestations of this issue:

- Supervisor vs. Firm

We have identified that firms will be potentially subject to three levels of mandatory stress testing: compulsory tests determined by the institution's consolidating supervisor, tests required by the college of supervisors, and tests set by various national or regional authorities. A balance needs to be struck between testing undertaken by the firm to support the use test and the testing mandated by supervisors. Over emphasis on supervisor-mandated testing risks crowding firms' own risk management and will potentially lead to double counting.

- Group vs. Solo

Stress testing is resource intensive and we are concerned that considerable stress testing will be required at the legal entity level. Undertaking stress testing at this level is burdensome and risks conflicting with firms own risk management processes where portfolios are looked at on a group wide basis. Moreover, a combination of stress testing at the solo level and a direct link between stress test results and capital requirements could lead to significant capital resources being locked up in individual subsidiaries severely restricting a firm's ability to manage its capital effectively. We understand that the purpose of these draft guidelines is to promote stress testing rather than to mandate the location or level of capitalisation within individual legal entities. We support such an approach, as we believe that firms should be encouraged to maintain a holistic view of their risks and operations at the group level, and continue to manage their capital resources in an efficient manner reflective of the risks being assumed. Furthermore, for some institutions, decision making authorities are not aligned to solo entities, limiting the value of stress testing at that level.

**International coordination:** The EU is home to a significant number of internationally active financial services firms. A globally consistent and coordinated regulatory approach is important to support the strengthening of global risk management practices. Coordination between local, regional and international authorities will help the sequencing of multiple supervisory stress tests as well as avoid unnecessary duplicate testing and reporting.. International cooperation is also particularly important in the context of reverse stress testing where regulators should seek to align the definition of business failure, and to have firms apply these tests at the consolidated level so as to fully consider cross-border outcomes. The college of supervisors, or core college (as appropriate), led by the consolidating supervisor, and with full firm engagement, will be key to this process. Stress testing methodologies and processes should be an important aspect of the college's discussions. Stress testing is an issue that extends beyond the EU boundary for many firms and coordination is essential to avoid duplication/ unnecessary tests. Members would urge CEBS to seek ways to enhance cooperation with third country supervisors.

**Limitations of stress testing:** Whilst useful in providing directional guidance for the impact of adverse conditions on the firm's performance, by its nature stress testing is a hypothetical forward-looking projection with a significant margin of error. Care should be taken to avoid over reliance on stress testing results and establishing direct links between stress testing results and capital requirements. Stress testing should be seen as one of many factors informing management decision-making.

**Reverse stress testing:** We agree with CEBS' broad description of reverse stress testing. We also agree that there is a place for extreme scenarios that explore the potential failure of a firm's business model. However, it should be up to the firm to decide on the extent to which reverse stress test results will influence strategic and business planning. Likewise, the emphasis of any reverse stress test requirement should be on a qualitative assessment of potential vulnerabilities in the firm's business model and for this reason reverse stress tests should be conducted at the consolidated group level.

**Double counting of risks:** We would like to remind CEBS that, for firms using internal models, the Pillar 1 framework already includes a number of stressed parameters (e.g. downturn LGD and the soon to be introduced stressed VAR). Therefore, for capital planning purposes, while it is important for stress tests to take into account all Pillar 1 risks and any relevant Pillar 2 risks,

the stress testing guidelines should not result in additional stress test procedures that lead to capital add-ons and double count risks.

**EU supervisory architecture:** CEBS will become the European Banking Authority (EBA) by the end of 2010. However, the legal status of CEBS guidance under the EBA is uncertain and there is a concern that these guidelines will become binding technical standards. We would like clarification of what the new supervisory arrangements will mean for CEBS proposed guidelines on stress testing and any other guidelines issued by CEBS before it becomes the EBA.

## **2 Overarching comments to the sections within CP 32**

In this section we have provided comments on each of the main parts of CP 32. A number of the comments made will refer to and elaborate some of the key messages already outlined in Section 1.

### **2.1 Governance**

The guidelines follow a building block approach that focuses on (i) governance structures, (ii) possible methodologies, (iii) the multi-layered approach to stress testing, (iv) the outputs of a stress testing programme and their linkage to management intervention/mitigating action (v) and supervisory review and assessment. On page 4 of CP 32, Figure 1 attempts to capture this approach visually.

While visual aids can be helpful, they need to be used with care. As it stands Figure 1 appears to isolate stress testing from other aspects of business processes, in particular strategic planning and risk-appetite setting. While we have no issue with CEBS using visual aids, we urge it to reconsider the inclusion of a visual representation that does not capture the interplay between all the dimensions of a stress testing programme. If such diagrams are to be used then it needs to be clear that this is a high level representation and not an exhaustive representation of the process.

#### ***Differentiating between the management body and senior management***

Defining the role of the management board and senior management is central to any stress testing programme, but the proposed guidelines do not sufficiently differentiate between their functions or responsibilities with regard to a firm's stress testing programme. While we agree that the management body will, on a proactive basis, be ultimately responsible for the firm's stress testing programme, the management body needs to be sufficiently removed from the day-to-day management of the programme so as to provide sufficient independent challenge of the tests being run, the assumptions and data underpinning the tests, and the outcomes being reported.

Moreover, a firm's individual governance processes will vary according to the jurisdictions it operates in, its size and complexity; so there needs to be scope for the management body to delegate some of its responsibility to senior management. It is senior management's responsibility to appropriately filter information to ensure the management body is not

overwhelmed by minute details and focuses on stress testing central to the firm's survival; be that from a capital, liquidity, business strategy, or product perspective.

Similarly we expect senior management to identify where the firm is most vulnerable (i.e. hot spots) and bring them to the board's attention even if stress testing was not used to identify them. Stress testing is a tool that the entire organisation uses to look at the risks of the firm, and essential to senior management in the delivery of information to the Board.

The proposed guidelines do not differentiate between the management body and senior management, nor do they emphasise the importance of the management body providing independent challenge, and the key role played by senior management. We suggest that they need to do so, allowing firms to ultimately decide on the organisational structure that is most appropriate for them.

## **2.2 Stress testing methodologies**

### ***Contagion***

We agree that firms should aim to achieve a more holistic risk assessment across their operations and key risk types, with a fuller examination of correlations between risks firms, their linkage to economic sectors, the wider macro economy and second order effects. However, this is an area of stress testing that is still evolving and firms continue to development of scenarios that are most relevant to them.

### ***Reverse stress testing***

#### ***Nature of Reverse Stress Test***

We agree with the broad description of reverse stress testing outlined in Section 3.4 of the guidelines. This is an evolving area of risk management and a view of what is good practice, let alone best practice, is still being developed. Nevertheless, a consensus has emerged that, in the first instance, reverse stress testing should rely more on qualitative than quantitative approaches, concentrating on the key vulnerabilities of the business model (i.e. the factors that might give rise to a loss of market confidence in the firm). For most firms, it is impractical to run a number of specific disaster scenarios. Instead they approach reverse stress testing by focusing on key vulnerabilities, identify risk drivers common to these vulnerabilities and work backwards by deriving a scenario, based on smaller number of examples of events, which might give rise to their failure. The likelihood of these events is then assessed mainly by qualitatively means and by allocating to broad ranges of probability (akin to a 'Low', 'Medium' and 'High' classification). We welcome guidelines that allow firms to adopt this approach.

#### ***Relationship of Reverse Stress Test to business planning***

We agree there is a place for examining extreme scenarios that explore the potential failure of a firm's business model. However, it should be left up to each institution to decide the extent to which these influence strategic and business planning. As reverse stress testing evolves, we expect further debate on the use of reverse stress testing in business planning.

#### ***Importance of a qualitative approach***

The emphasis of any reverse stress test requirement should be on a qualitative assessment of potential vulnerabilities of firms' business models and how these can be appropriately managed. Stress testing should help to inform the development of robust contingency plans. We believe that attempting to identify the point at which insolvency would begin in a reverse stress test scenario and any capital and liquidity implications depend heavily on qualitative assessments and careful judgements.

### *Group context*

In our view, reverse stress testing makes most sense if conducted at the consolidated group level. The costs involved of conducting additional reverse stress testing at a more granular level (business unit or solo regulated entity level) would be considerably higher. Moreover, the benefits of doing so are unclear and will depend upon the firm's organisational and legal structure. For firms operating internationally there are home/host issues around the interaction with non-EU parents. Our preference is for firms to take responsibility for deciding how much reverse stress testing is undertaken at the solo level, business level or group level.

### ***Scenario selection – how to identify an appropriate range***

We agree that it would be desirable to operate a range of scenarios of different types and severities, including the reverse stress test. Although it is difficult to identify an optimal number of scenarios, it is clear that the appropriate number will vary by firm. Given that an infinite number of scenarios that could be run, the total number should be limited. Firms need to balance: maximising the coverage of the scenarios; managing the costs of running the scenarios; and filtering results into a form that can be challenged by boards and be actionable. We would suggest that a sensible approach would be to allow firms to develop the scope of their programme of scenario testing over some years so that they can arrive naturally at the optimum level. Initially a small number of holistic group-wide scenarios should be acceptable to regulators in addition to the reverse stress tests. Care should be taken to avoid duplication of stress testing requirements, including firms' own stress testing, tests prescribed by local regulators, colleges of supervisors and international bodies.

We would encourage the authorities to strike the right balance between prescription and guidance when setting any industry wide common scenarios. It is important for scenarios to be appropriate and firm specific to ensure effective deployment of resources and efficient use of senior management time in their examination.

### ***2.3 Portfolio, individual and firm-wide testing***

Our members fully support firm-wide stress testing but would like to emphasize that it must reflect the organisation of the group. We support CEBS's view that it must also be proportionate to the firm and could include a range of stress tests.

### ***2.4 Outputs of stress testing and management intervention actions***

We support the view that, in terms of ensuring their continued viability, firms have a number of credible management actions available to them. We again underline, that increasing capital and/or liquidity buffers constitute only one possible response.

### ***2.5 Supervisory review and assessment***

### ***The supervisory review process***

Industry recognises that medium-term forecasts of the capital position of a firm under a range of scenarios provide valuable insight into the firm's risk profile as well as providing a view on the impact of possible mitigating actions. It is also recognised that additional capital is likely to be required where a best estimate forecast under a base case scenario reveals a capital shortfall developing.

Where a capital shortfall is revealed in more adverse but less probable scenarios, consideration of whether additional capital is required should be undertaken in the context of the perceived probability via an assessment of the plausibility of the scenario. This issue is directly related to the overall calibration underlying the regulatory capital requirement.

We are conscious that a combination of stress testing at solo level and a direct link between stress test results and capital requirements could lead to significant capital buffers being locked up in individual subsidiaries severely restricting a firm's ability to manage capital effectively. We understand that the purpose of these draft guidelines is to promote an understanding of stress testing requirements. The aim is not to determine the location or level of capitalisation within individual legal entities, but, as supervisors are aware, there can be inefficiencies to firms when excessive levels of capital are held in subsidiaries. There can also be consequent adverse effects on local economies if investment and competition is stifled.

### ***International dimension: consistency is essential***

As noted in the key messages section, we are concerned about the impact on firms of having to run multiple stress tests emanating from firm and supervisory requirements at both the consolidated and individual entity level. International cooperation between supervisors is essential for ensuring a coherent and consistent approach, minimising the burden on firms and supporting effective group-wide stress tests across jurisdictions. A disjointed approach to stress testing by supervisors is less likely to support the soundness of international financial markets and will give only a partial picture. Members strongly support cross-border initiatives, such as the proposed Basel Committee recommendations in the March 2010 consultation on *Good Practice Principles on Supervisory Colleges*, to achieve consistent principles and supervisory requirements. Appropriately constituted supervisory colleges, including host supervisors as appropriate, are important to ensure coherent approaches for internationally active financial institutions and will lead to more efficient use of resources..

We note that a number of supervisors have adopted stress test exercises based on common scenarios in order to inform them about the possible extent of any government support programmes that might be necessary. As we return to more normal conditions in the financial markets it would be helpful if supervisory colleges, led by the consolidating supervisor and in conjunction with the firm, developed common scenarios. Such an approach will minimise duplication of effort. Supervisors should also take into account any firm designed stress tests that involve complementary scenarios.

### **3 The Guidelines**

#### **Guideline 1**

We agree to guideline 1 in principle, but find the supporting text to be contradictory to the spirit of the guideline. The management body needs to be sufficiently independent from the process to challenge the tests, the assumptions and data underlying the tests and the reported outcomes. Of particular concern is paragraph 16 which states ‘the management body (or relevant designated committee) should actively participate in the design of the programme in particular scenario selection, business assumptions and the discussion of the results of firm-wide stress testing.’ We suggest this is a role for senior management not the management body. The management body needs to be sufficiently detached from the testing process to independently challenge the results and decide on the appropriate mitigating action.

We fully expect boards may instigate tests by asking questions such as ‘what happens if the economic condition of a country or region deteriorates or if a currency depreciates significantly’, but then the board, particularly in large complex firms, should be able to delegate the detail of analysing the impact of these questions to senior management. We also agree that the management body needs sufficient knowledge and experience to introduce such tests and evaluate the results, but the guidelines need to provide sufficient scope for delegation.

Paragraph 17 suggests the engagement of stress testing committees, , but the scope for delegation appears to be limited. Firms risk management frameworks can take a number of forms and it should be left to firms to determine how they organise themselves.

#### **Guideline 2**

Guideline 2 asks firms to build an effective infrastructure and embed it into its risk management processes. The guideline and paragraph 22 appear to demand that firms build a specific stress testing infrastructure. This ignores the fact that, in effect, what firms do is to build unified datasets on which they run stress tests. Financial services firms are not static entities. Business, accounting and risk systems change with new business lines being developed and new products being offered, so what is fundamental, from a risk management perspective, is the ability to draw relevant data from these systems in a timely manner so they can be meaningful deployed in any number of stress tests. Firms’ infrastructure needs to be appropriate to their business needs and be capable of producing the datasets required to develop meaningful risk management information, including stress testing results.

Paragraph 20 suggests that stress tests be subject to comprehensive discussion across the entire organisation. While our members agree that challenge is essential, stress tests can quickly become complex in particular if several parties in a number of departments are involved. In order to react quickly to requests and market circumstances and to remain actionable (as per Guideline 3), it might be appropriate for firms to curtail the number of internal feedback loops. .

#### **Guideline 3**

Our first comment concerns the drafting of the guideline. Currently, it states: ‘stress testing programmes should be actionable and impact decision making....’ We suggest that it should be

rephrased to say 'inform decision making'. This change would help to address our concerns about paragraph 24.

Paragraph 24 states that '[t]he management body and senior management have responsibility for taking appropriate actions based on the entire stress testing programme.' This language is confusing and duplicative. Moreover the notion that board and senior management action be based on the 'entire' programme appears impractical. We suggest this text be deleted. The next line could then be amended as follows: 'Measures and actions by the management board and senior management may vary depending on the circumstances, and examples of such actions, although not exhaustive are: ...'

Furthermore, the actions identified in paragraph 24 are too prescriptive. We suggest that in the case of (c) 'reducing exposures or business in specific sectors, countries, regions or portfolios', 'reducing' be replaced with 'revalue'. This would help to avoid prescribing a specific action. Similarly in the case of (h) 'implementing contingency plans' be replaced by 'review of contingency framework or the development of a framework where one does not exist'

Finally, in regard to guideline 3, paragraph 25 indicates that stress tests results should be used as one input in establishing an institution's risk appetite and its exposure limits'. We agree that it is only one of many inputs informing a firm's risk appetite and stress limits and ask that the paragraph be rephrased to emphasis this point.

#### **Guideline 4**

We agree with the guideline, but are concerned that element (d) of paragraph 27, in connection with a stress testing programme's policies and procedures, suggests that envisaged remedial actions be included in policies and procedures. Management needs to act on the results of the stress tests in a changing business environment. Such lists could potentially preclude actions that might not get considered because they are not on the list.

#### **Guideline 5**

We support the guideline but question aspects of the explanatory text. First, the final line of paragraph 29 refers to benchmarking within and, if possible, outside the institution. In regard to external benchmarking, it is not clear what benchmarks CEBS envisages. If the expectation is that firms should benchmark their stress tests against their peers, this is an aspect of stress testing we would expect supervisors to consider. We would remind CEBS that even when firms use the same or similar inputs in the broadly similar stress tests, the results will vary and this variance a normal aspect of stress testing. Moreover, external benchmarking gives rise to confidentiality and market sensitivity issues. Even internal benchmarking has its challenges. Consider that a firm's subsidiaries are dissimilar – markets and product offering vary – so even if the metrics produced by the stress tests are accurate, they will be reflective of different business environments. So we suggest that final line of paragraph be deleted.

Second, to avoid paragraph 30 being read by supervisors as a checklist, we ask that "should" be replaced with "suggest".

#### **Guideline 6**

We support the guideline but suggest that the first line of paragraph 32 be amended to identify sensitivity analysis as the 'simple stressing of the relevant risk driver or risk factor to assess the

sensitivity of the institution to that risk driver or risk factor as appropriate to the firm's business'. This would resolve the inconsistency presented in the current drafting of paragraphs 32 and 36 where paragraph 32 makes reference to 'one risk driver' while paragraph 36 refers to 'single factor analysis'. Risk drivers are not limited to a single factor, for example, a shift in the probability of default is not a shift in a risk driver. The probability of default is determined by a number of risk drivers.

### **Guideline 7**

We support guideline 7 but question items (e) and (f) under paragraph 39. In the case of item (e) it is unclear what CEBS is aiming to convey and we would like to suggest that in stress events risk drivers do always behave in ways we would expect. In regard to (f) we would suggest that 'developments in technology' could be removed. We also suggest that the list introduced under paragraph be positioned as a menu of ideas for consideration, rather than a prescriptive list and be modified to state 'Scenarios should, as appropriate to the institution:...'

### **Guideline 8**

No comment

### **Guideline 9**

We suggest guideline 9 be reworded to simply state: 'System-wide interactions should be reviewed as part of a firm's stress testing programme'. We understand 'feedback effects' to refer to second order economic impacts, but are of the view that the term 'system-wider interaction' already encompasses these effects. For similar reasons we suggest that the term 'feedback effects' should also be deleted from paragraph 49 or be replaced with 'second order economic effects'.

We also note system-wide interactions and second order effects are very difficult to assess in practice and that there is potential for a never ending loop of scenarios for firms to assess, so firms will need consider how and which effects are considered. It needs to be left up to the firm to determine the relevancy of these system-wide interactions to its business.

### **Guideline 10**

No comment

### **Guideline 11**

We support guideline 11 and generally support how it and the explanatory text are drafted. In particular we note and agree with the assertion that such tests are not expected to automatically result in capital planning and capital add-ons.

We do, however, highlight that 'insolvency' (as it is used in paragraph 58) potentially suggests a narrow view (i.e. a firm being wound down) of business model failure. So we propose that 'insolvency' be replaced with 'business model failure' so as to capture instances when, for example, a firm finds that counterparties no longer want to transact with it and/or experiences a loss of confidence and/or is having problems raising capital or additional funding.

### **Guideline 12**

We support the guideline, but suggest that it be modified so that the second sentence refers to 'changes in correlation between risks' rather than just 'correlations between risks'. Similarly in paragraph 65, the text should be modified to state 'taking into account changing correlations' rather than 'taking into account correlations'. This modification in the text would help to capture how changes in correlations can lead to significant losses.

### **Guideline 13**

We support the guideline but suggest that it be explicitly stated that firm-wide stress tests should be determined by the firm and guided by the principle of proportionality.

### **Guideline 14**

While our members support this guideline, their attention was drawn to paragraph 71 which refers to 'a specific configuration of macro-economic variables'. If this configuration is provided to firms by supervisors as a baseline or 'anchor scenario' firms should be able to adjust the scenario so that it properly aligns to its business model. Baseline scenarios, by their nature are very generic, so it is difficult to construct a scenario that affects firms operating in different sectors (e.g. retail versus investment banking) equally.

### **Guideline 15**

We support the guideline although there are aspects of the guideline and supporting text on which we offer comments. The guideline refers to 'solvency through the stressed scenario'. Similar to our remarks under guideline 11, we suggest that 'solvency' is too specific and be changed to 'business viability'.

We are also concerned that paragraph 77 element (e) and paragraph 78 introduce automatic capital add-ons. We appreciate that the items listed under paragraph 77 are identified as examples, but there is a concern that such add-ons might be considered without due consideration to existing buffers. So we recommend that (e) be removed from paragraph 77 and due recognition be given to existing buffers in paragraph 78.

Credible management action can take a number of forms and the validity of the action is a function of the problem being addressed. To fully reflect this, we also suggest that the list presented under paragraph 77 be introduced in the following way: 'There are a range of valid management interventions and mitigating actions, and these include, but are not limited to:'

### **Guideline 16**

We support guideline 16, however, we would like to remind CEBS that a capital planning exercise is complex exercise for firms, and in particular, global banks.

Members note that paragraph 81 indicates that all capital planning should cover a period of at least two years. While some supervisors require a 3 to 5 year forward ICAAP, firms are of the view that stress tests forecasts beyond two years are not valuable. We suggest that 'at least' be removed for the last line of paragraph 81.

### **Guideline 17**

No comment

### **Guideline 18**

We support the guideline, but note that the explanatory text makes no reference to how frequently supervisors should assess a firm's compliance with the guidelines. To take account of an environment where firms might be dealing with a number of supervisors, we suggest that the guideline be modified to state that such assessments be meaningfully sequenced and/or coordinated with other supervisors.

### **Guideline 19**

No comment

### **Guideline 20**

The guideline is reasonable. We are of the view that stress testing results should foster a fruitful dialogue between supervisors and firms. As part of this dialogue, however, firms need to have the right to both informally and formally challenge conclusions drawn by supervisors. Provision for these channels need to be included in this guideline.

Again, we reiterate that stress testing should not automatically result in increases in capital. Although paragraph 100 indicates that capital and/or liquidity buffers are part of a range of actions, the current drafting of this text appears to suggest that capital and /or liquidity buffers are inevitable. Capital buffers are usually determined by the management body and based on sources of information management relating to the capital plan, current and future risk appetite, and overall market and regulatory expectations. In setting capital buffers, stress tests and scenario analysis are only one consideration that might be taken into account by the management body.

### **Guideline 21**

We support the spirit of this guideline. We see the consolidated supervisor as taking the lead and working with the firm in determining the appropriate group wide stress tests to be run. The tests, and the results, would then be discussed and reviewed with the individual firm's college of supervisors, or core college, as appropriate. We suggest that paragraphs 101 and 102 should be clarified to reflect this. Currently paragraph 101 simply refers to home and host supervisors, and is silent on the need for host supervisors to coordinate with consolidating supervisors. This guideline needs to be clear on the importance for host supervisors to coordinate with consolidating supervisors so that multiple application of testing is avoided.

The individual firm's college of supervisors is one forum where supervisors can achieve consistency of approach and minimise duplication of effort. The majority of internationally active firms operate both within and beyond the European Union, therefore both EU and global colleges are important. However, in addition to co-operation within colleges, we encourage CEBS to seek other ways to promote consistency and efficiency in setting stress testing requirements globally, for example through engagement with third country supervisors.

Our concerns in regard to paragraph 103 are similar to paragraph 100. Paragraph 103 suggests that capital buffers are inevitable but we believe that they should not be the primary or sole focus.

### **Guideline 22**

We recognise the requirement for system-wide supervisory stress test exercises based on common scenarios for the purpose of assessing the overall health of the financial system. We would underline, however, that common scenarios will affect firms in different ways. For example, a scenario that focuses on a general downturn in the residential housing market will affect a retail firm differently than an investment firm. So we warn against stress tests being used inform capital planning in isolation of other considerations and/or enhancements.

We also ask supervisors to coordinate their testing programmes to manage the flow of information arising from these tests. It is essential that mandatory testing does not crowd out the development of in-house testing.

#### **4 Individual Risk Area Annexes**

The individual risk annexes are of particular concern to our members. First, all the annexes appear to be addressed to 'all institutions' when, in fact, in they are should probably be more appropriately addressed to IRB/ IMM/ AMA firms. Not to make this differentiation takes no account of variety of firms to which the guidelines and annexes will be applied and overlooks the concept of proportionality.

Furthermore, the individual risk Annexes are overly prescriptive and we question whether they properly consider the changes in the international regulatory framework currently being discussed and potentially double count risks. For example CRD 4 introduces two stressed liquidity requirements in the form of a liquidity coverage requirement (LCR) and a net stable funding requirement (NSFR) in the form of a Pillar 1 type charge. We suggest therefore that at this stage the Annexes be dropped to ensure the CEBS guidelines remain over-arching guidelines rather than a detailed, prescriptive list of 'checks' that may not in all instances be applicable to the firm. This will ensure alignment to the need for firms to develop the right stress scenarios for their specific business.

We have not provided detailed responses to the Annexes and request that the Annexes be dropped.

## 5 Conclusion

We hope that you will find our comments useful. Please contact me by way of email Anita Millar, (anita.millar@afme.eu), Irving Henry ([irving.henry@bba.org.uk](mailto:irving.henry@bba.org.uk)) or Antonio Corbi (acorbi@isda.org)

Yours sincerely,



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The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1<sup>st</sup> November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.