European Banking Federation

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Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

CEBS Guidelines on Stress Testing

EBF Response to CEBS CP 32

GENERAL REMARKS

The EBF welcomes the work carried out by CEBS in preparing the guidelines for stress testing as long as they contribute to set common standards throughout the European Union. The EBF has long pursued the issuance of clear guidelines in all matters within the supervisory scope. We understand CEBS's desire to promote good industry practice among firms and found CEBS's draft principles and guidance useful and thought-provoking.

The EBF was invited to express the views of the banking industry at the CEBS seminar about ICAAP that took place on 22 October 2009 in Rome. On that occasion, we indicated that the industry would welcome some formal guidelines for the assistance of banks. In this vein, we appreciate the guidance put forward by CEBS. However we think there is need for more clarity in certain aspects as explained by this document.

Our Members generally welcome the approach that takes into account the nature, scale and complexity of firms, and emphasises a qualitative approach, and accepts that capital is not the only mitigating action.

We are of the opinion that stress testing does not necessarily mean more capital. Gaining a better understanding of the risk profile of the institution and enhancing the control of the governing body over the business are among the major benefits pursued.

The key messages that the EBF conveys to the CEBS are the following:

- Stress testing is meant to be an internal process in the banks and a further step towards the improvement of risk and capital management. To the extent possible, supervisors should refrain from imposing common scenarios on banks which would accommodate peer comparison, but would not take full account of firm specific issues. Also, insisting too much on 2008 scenarios could blind firms and supervisors alike to new market behaviours and future risk factors.

- As conveyed during the aforementioned CEBS seminar, the EBF reminds supervisors that they should review the stress testing exercises of banks following these steps and in this order: Understanding the bank's business and internal processes, promoting

European Banking Federation (a.i.s.b.l.)
10 Rue Montoyer B-1000 Brussels
T: 32 (0)2 508 37 11
http://www.ebf-fbe.eu

dialogue, challenging the internal views, trying to reach common ground and, only as last resort, taking corrective measures if need be. We congratulate CEBS for having reflected this view along the guidelines, especially in promoting dialogue between firms and their regulators and amongst senior management. Nevertheless, we think that more emphasis should be placed in the first stage – understanding – all the more due to the wide range of types of businesses and circumstances that may affect different banks. The better understanding the supervisor gains about the bank business, the easier is the review of its stress tests.

- However, there is a general concern about the available resources, not only at the banks' side to perform such comprehensive stress test exercises, but also at the supervisors' side who will need to dedicate plenty of resources if we want to make a sound review process in an atmosphere of common understanding. In large international banks with many legal entities in different jurisdictions and different activities, it will prove challenging to involve all risk managers and economists in the overall comprehensive stress testing exercise even though they already have responsibility for legal entity stress tests.

- As regards the supervisory review of stress test in the most complex groups, supervisors might make use of the internal validation teams, to the extent these perform or validate stress tests and stress testing processes. A mention of this possibility in the guidelines (perhaps in guideline 18) would be welcome.

- The principle of proportionality has been broadly respected. Nevertheless it is important to remind supervisors that sophisticated scenario-based stress tests lose their relevance when applied at solo levels and/or small to medium sized entities: in these cases we advocate for sensitivity analysis along dimensions to risk parameters and factors actually managed at this local or intermediate level. Consistency is a major concern, especially in the case of cross-border groups, for which subsidiaries might be compelled to prepare different versions of the stress tests in order to meet the expectations of different supervisors. Several different stress tests performed at local levels could then hardly be aggregated in a rational way.

- The EBF would suggest CEBS stating clearly that stress test in large groups should be conducted at group level and the assessment thereof coordinated by the home supervisor in the context of the college of supervisors.

- One of the industry's concerns relates to the lack of clarity about if and how the results of the stress tests may be interpreted as requiring additional capital. Needless to say, entities will deploy different scenarios and be more transparent with supervisors to the extent that a dialogue and understanding atmosphere is established. Clarity in the approach of supervisors and cooperation between them in the case of cross border institutions would build on that purpose.

- The EBF deems the implementation of these guidelines by 30-June-2010 to be too soon, although it's not clear whether this deadline applies to supervisors. Banks will need time to conduct gap analyses, adopt the principles and build the requisite IT environments. The EBF proposes that CEBS should schedule the implementation of these guidelines for January 2011 at the earliest. This is especially important given that many banks are still in the process of improving their internal risk management practices post-crisis and that most banks have to turn their existing group, risk type and portfolio stress testing into one all encompassing stress testing framework, and the time required to construct, validate and control this process is estimated to be rather long.

- As a concluding remark, we welcome the existence of guidelines, but we also state the need for flexibility in the supervisory process. Supervisors should refrain from becoming over-reliant on stress testing, since each stress testing only represents one possible course of events. Both stress tests based on historic events and more forward looking stress tests can never be fully accurate and therefore more important than assessing, and drawing conclusions on, actual stress test results in absolute amounts are the observed trends and perceived weaknesses in portfolios or risk management practices.

SPECIFIC COMMENTS

Guideline 1:

It is not clear how deep the management intervention should be. There has to be room for delegation. It also depends on the stress test to be conducted. Clearly, the principle of proportionality should work both ways, i.e. the management body of large international banks, even though playing an important role in the overall process, cannot be expected to deal with all details of scenario setting and checking of assumptions. This role should be delegated to senior managers in the business unit or legal entity involved.

As a statement, the guideline is fine. With regard to interpretation, there is a need for pragmatism. Stress testing as a means of informing management is fine in theory. In practice, it is a basis for discussions at management level and only one driver of strategy and forward planning.

Management by stress testing is not always a sensible means of identifying what the future holds. Stress testing should be seen as a pressure test of strategy. There is some recognition of this idea in paragraph 23.

Guideline 2:

This should be up to firms to interpret.

The terms used in paragraph 18 c require definition.

With regard to timetable, it is not clear whether firms need to conduct tests from bottom-up, top-down or both.

Paragraph 20 focuses on firm-wide testing and challenge. This will involve many supervisors and require building an infrastructure. It should be determined by the firm as to how it achieves this.

Stress testing is both an art and a science. Judgment has to be applied. A balance has to be struck between the qualitative and quantitative aspects.

Firms are struggling to build a system to cope with the requirements. The stress testing teams and management have limited time to conduct tests.

Supervisors need to have more direct discussions with senior management and issue clear guidance on regulatory expectations, and be aware that the new requirements will lead to an increase in expenditure and resources which are scarce.

Paragraph 29 emphasises benchmarking, both internal and external. As per the above paragraph, this will take time and consume resources.

Guideline 3:

With regard to paragraph 24, the programme is not actionable in isolation. Other issues have to be taken into account. Clarification as to how far action should be taken would be appreciated.

Guideline 5:

It should be left to firms to determine the frequency of review. It depends on the stress tests that the firm is conducting and the global policy governing the firm's approach.

We wonder how effectiveness of stress testing should be defined and measured. One can only really test the effectiveness when the next crisis emerges.

Paragraph 29 mentions that institutions should, where possible, benchmark their stress tests outside the institution. Contrary to operational risk, there are no external loss databases. As a result, we wonder how this can take shape if it is currently not possible.

Guideline 6:

In essence, capital requirement calculated for Pillar 1 represent a potential loss in an extreme scenario. As such, stressing capital requirement may seem irrelevant. It is the case for operational risk, for which the internal model (AMA) is based on potential incidents which impacts are measured on extreme frequency and severity. More specifically speaking on operational risk stress testing, the impact of potential losses consequently to processes or infrastructures' failures does not change whatever the economic situation is normal or stressed. Operational risk stress-testing are not relevant

Guideline 7:

With regard to paragraph 39, a range of scenarios can mean from severe to mild. As for paragraph 40, time horizons are to do with the underlying portfolio and the capital planning stress test.

Guideline 8:

Greater transparency is required if credit risk is to be brought into the process.

Paragraphs 42 and 46 are fine as statements and objectives, but are not necessarily doable. It looks quite difficult to translate economic scenario's to risk drivers. Some more guidance on how to do it would be welcome.

It's not clear from paragraph 44 (b) what is the aim pursued by excluding for example the diversification effects. Management should be allowed to exercise judgment.

We welcome paragraph 47's emphasis on streamlining and simplicity, but we think that this is more difficult in large and complex organisations.

Guideline 9:

We would welcome an explanation of what feedback effects mean in this context. Are they second order effects or a counter-balancing strategy (ie limits on lending, which have an impact on the real economy)? This is linked to macro-prudential regulation.

In any event, it should be clear that feedback effects have to do with behaviour of market participants which is not always easy to estimate before a particular event actually takes place. In this respect, stress testing is not science but merely art.

It is difficult to work out what action to take from simultaneous stress tests. Taking the recent crisis as an example, where interbank markets dried up and interbank interest rates increased around the start of the crisis, later crossing over to the real economy. Such a scenario would have been very hard to predict. As a result, one may be tempted to use the recent crisis as the basis for a scenario, but extending the period where interbank markets dry up. The question that this raises is whether the next crisis will have the same characteristics as the previous one. The analogy to operational risk where a lot of emphasis is placed on managing low probability high impact events comes to mind in this area. An example of the adverse feedback dynamics could be the lowering of interbank limits that was seen during the crisis.

Guideline 10:

There is a need for more guidance on the types of scenarios referred to. The question is what a plausible event should be. The actual observations during the crisis showed stress situations that were deemed impossible prior to the crisis. Is the idea to set up scenarios that nobody believes in? Should the scenario maybe look like '2008+'? What kind of scenarios would meet the requirements?

In paragraph 51 it is mentioned that stress tests and sensitivity analysis should have multiple degrees of severity. Therefore the expectation is to analyse various scenarios with differing severity of the stress values, ranging from moderate to extreme parameter values. Sensitivity analysis uses multiple degrees of severity while for firm wide stress tests it is of more importance to test different stress scenarios. Combining the two - multiple scenarios at multiple degrees of severity - makes stress testing a calculation exercise instead of an important risk management tool.

It would be helpful to expand on paragraph 52, non-linear interactions, and give examples.

Guideline 11:

We note the request for reverse stress tests and the assertion that such tests are not expected to result in capital planning and capital add-ons. We agree with this assertion, but wish to point out that, in the case of British banks, the FSA is inferring additional capital buffers in its Consultation Paper 09/30.

The requirements set around the second order effects are hard to meet in practice.

Guideline 13:

Does firm-wide refer to a legal entity?

It would make more sense for banks to group businesses according to their own internal structure and strategic organisation.

We urge supervisors to coordinate through the college of supervisors in order to ensure that there are no additional local requirements to repeat an exercise in the same bank with different assumptions.

Guideline 15:

Paragraph 77 details some actions to mitigate risk. It should be noted that some actions are not realistic and may take time to achieve the desired impact. Management action should be actionable now rather than when a severe downturn takes hold.

The trigger for and timing of action are key. Banks are putting early warning systems in place, if they have not already.

Firms operating in the United Kingdom, as per discussions with their supervisor, have found the regulator to be sceptical about mitigation. In addition, the UK regulator deems a much more explicit set of mitigating actions to be appropriate. The preference appears to be for high capital buffers. Supervisors should think about the need for so much stress testing if capital buffers will be set at a high level.

We believe that paragraphs 77 (e) and 78 to be a means of enforcing additional capital buffers by the back door. This is linked to, for example, the targeted planning buffer for liquidity following a stress test and irrespective of the existing buffer.

As a general point of attention, supervisors should hold stress testing results against accounting and other provisions, capital buffers and other mitigating factors already in place and not lose sight of already built in stresses in existing parameters and confidence intervals used.

Guideline 16:

It is not sufficiently clear what the severity, range and time are.

More clarity would be welcome also about how the capital planning stress tests under ICAAP are different from other stress tests. A capital planning exercise is complex in a global bank, especially the development of the base case up to board level and running more than two downturn scenarios. It consumes plenty of resources.

Guidelines 18 and 19:

Supervisors should be aware that each institution is different and recognise the diversity of firms and their business models.

Guideline 20:

We are concerned about the interpretation of point 100 in the CP32 and would suggest that it should be clarified that point 100 - and capital buffers - is concerning each individual bank's capital planning framework/capital targets, i.e. not concerning regulatory capital.

Guideline 21:

It would be useful to refer such matters to the firm’s college of supervisors. The home state supervisor should lead its peers towards common stress tests and fora for discussions. Supervisory coordination sounds good in theory, but in practice regulators have followed national interests for the time being. We would encourage CEBS to place more emphasis in the need for coordination and common understanding between supervisors.

Guideline 22:

Common scenarios affect banks in different ways. Firms have different sensitivities. They are not appropriate to inform capital planning decisions in isolation. Supervisors should take a measured view when developing a programme of tests. Banks are being approached to conduct more and more tests, both for internal and external consumption. It is difficult to obtain consistency between mandated stress tests and testing for the ICAAP. Regulators should avoid prescribing scenarios. If they do wish to prescribe scenarios, then account should be taken of business processes.

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