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Mrs Danielle Nouy  
Chair  
Committee of European Banking Supervisors  
CEBS  
Floor 18, Tower 42  
25 Old Broad Street  
GB- London EC2N 1HQ

Brussels, 27 September 2006

BY EMAIL: [CP12@c-eps.org](mailto:CP12@c-eps.org)

Dear Madam,

## **CP 12 - Stress-testing under the Supervisory Review Process**

Febelfin, i.e. the Federation which regroups four trade associations from the Belgian financial industry<sup>1</sup>, welcomes the opportunity to express its views on the consultation paper mentioned above. We highly appreciate the work done by CEBS in this matter and in particular the improvements which have already been made to the original draft document. Nevertheless, we would like to draw your attention on a number of important points.

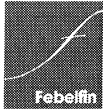
Our views fully concur with those expressed by the European Banking Federation.

Stress-testing is one of the building blocks of the ICAAP process, i.e. a process in which the institution itself takes care of laying down its internal/economic capital requirements. Since institutions work with a centralised risk management, we consider it appropriate to calculate the ICAAP at the highest consolidated level. The same goes for the decision whether or not to do stress-testing. Although we recognise that, in specific circumstances, there may be a need to develop stress tests at a lower level in a group structure, this decision should be left up to the institution itself and must not be imposed by the regulator. Stress-testing should also be used only in a 'going concern' environment and not for 'tail-events'. As such, stress-testing should be seen as a way to achieve a result instead of an aim in itself.

As stress-testing is a highly technical matter, it would be unrealistic and physically impossible to take it for granted that the top-level decision-making bodies of an institution are fully acquainted with this matter. For this reason, we would like to propose to extend the possibilities for

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<sup>1</sup> The following trade associations are part of Febelfin: the Belgian Bankers' and Stockbroking Firms' Association (ABB/BVB); the Professional Union of Credit Providers (UPC/BVK); the Belgian Association of Asset Managers (BEAMA); the Belgian Leasing Association (BLA).



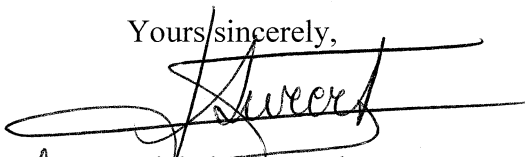
delegation to the senior management of an institution. Furthermore, we are of the opinion that regulators should take into account the principle of proportionality when applying this framework to smaller institutions.

Last but not least, we plead for realism in the implementation of this stress-testing framework. One should take into account the gap between academic developments in a specific field on the one hand and their application in the 'real world' on the other hand. Filling this gap implies huge IT-investments and creating (and linking) large databases in order to derive reliable parameters from these. These developments, especially at the consolidated level in large international groups, are very time (and effort) consuming.

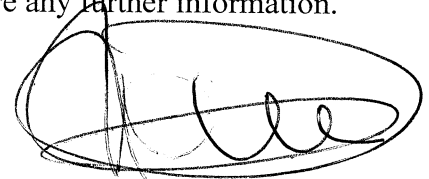
Consequently, we fully endorse the CEBS acknowledgement that industry practices are still developing and we encourage supervisors to assess these developments with due flexibility, in a principles-based way and from an evolutionary point of view.

Our detailed comments can be found in the enclosure to this letter. Please do not hesitate to contact our services and our working group should you require any further information.

Yours sincerely,

  
Michel Vermaerke  
Chief Executive Officer

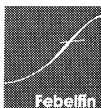
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Daniel Mareels  
Head of the Taxation, Accounting Standards  
and Prudential Regulations Department

Enc.

cc: Mr. E. Wymeersch, Chairman of the Banking, Finance and Insurance Commission



## **CP12, Stress-testing under the Supervisory Review Process, general and detailed comment of Febelfin**

### **1. Main comment**

1. Need for a realistic approach of the implementation. We highly appreciate CEBS's acknowledgement that institutions currently find themselves on different points of a continuum (§ 5 of the CP) and that industry practices in the field of stress-testing are still evolving (§ 6 of the CP). We feel that, for different reasons mentioned below, it is currently impossible to meet every requirement of the proposed guidelines. Although some hurdles can be taken in the near future, we would like to draw the attention of CEBS more particularly on the technical hurdles in this specialised matter.

One should take into account the gap between academical developments in a specific field on the one hand and their application in the 'real world' on the other hand. Filling such gaps implies huge IT-investments and creating (and linking) large databases in order to derive reliable parameters from them. These developments, especially on the consolidated level in large international groups, are very time (and effort) consuming.

For these reasons, we fully endorse CEBS's acknowledgement that industry practices are still developing and we encourage supervisors to assess these developments with due flexibility and from an evolutionary point of view.

More specifically, we would like to draw the attention on the aggregation of stress tests. One may think of putting together the results of the various stress tests on different risk components when it comes to fixing the capital requirements for all risk components taken as a whole.

However, this kind of aggregation would not be adequate. Indeed, each of the risk components is assessed according to its proper timespan [the market risk for example will be assessed over a short timespan (i.e. on a day-to-day basis or over a period of 10 days more or less), whereas the credit risk will be assessed over a bigger timespan (a couple of years)]. Numerous hypotheses however lie at the basis of the assessment of the appropriate correlations between those timespans and this affects the exactness of the result. Furthermore, the parameters used for credit stress-testing at present are not stable enough for them to be considered as reliable.

Consequently, the best thing to do at this stage is to rely on less complicated methods of stress-testing, such as sensitivity analyses.

2. Involving the decision-making bodies. Stress-testing is a highly technical matter. It would be unrealistic and physically impossible to take it for granted that the

top-level decision-making bodies of an institution are fully acquainted with this matter. Since stress-testing is one of the building blocks of the ICAAP process, it should be sufficient if the top-level decision-making body takes its decisions on the basis of the results of the ICAAP process as a whole instead of each building block taken separately.

Although we appreciate the possibility of delegating some aspects of the stress-testing framework to specific risk committees or senior management as provided in ST12, we would like to propose to extend this possibility to the stress-testing framework as a whole. The reason for this is the level of decisions taken by the management body. In general, these decisions will involve strategic and overall policy matters concerning, among other things, risk management and capital assessment (based upon the results of the ICAAP-process among other things). The results of stress tests are part of this (as one of the building blocks of ICAAP) but, in our opinion, they lead to senior management decisions which provide the basis for general policies.

This decision framework rests upon reporting lines and clear communication channels. We clearly prefer principle ST13, which, in our view, gives an accurate and complete description of the decision process within an institution. So, we are of the opinion that principle ST12 is redundant.

3. Stress-testing as a way to achieve a result instead of an aim in itself. Stress-testing is one of the building blocks of the ICAAP process, i.e. a process in which the institution itself takes care of laying down its internal/economic capital requirements.

We appreciate that CEBS recognises this in §§ 4 and 5 of the CP. We also highly appreciate the fact that supervisors would discuss with institutions the feasibility of conducting ad hoc supervisory stress tests (ST9, § 36, last sentence).

However, reading through the document, we are afraid that some regulators may impose stress-testing in situations which are not considered to be meaningful by the institution. Here are some examples:

- Stress-testing asked for by host regulators for activities of local entities;
- Stress-testing across a number of institutions based upon incommensurable individual hypotheses;
- Stress-testing disregarding the ‘gap’ between academical developments and the implementation process within institutions;
- Stress-testing for hypothetical events;.....

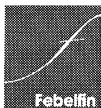
For these reasons, we strongly advocate that it should be left up to the institution to determine in which cases stress tests can offer added value. Under no condition

must the CP12 guidelines lead to a prudential obligation of developing a stress test as an aim in itself.

4. Taking into account IT. The IT infrastructure of an institution is evolving constantly. The supervisors should be aware not only of the conceptual problems mentioned above, but also of the preparation and time (between 3 and 5 years) needed for developing an adequate IT infrastructure (certainly at the consolidated level).
5. Stress-testing is useful only in an ‘going concern’ environment, but not for purely hypothetical ‘tail-events’. Stress-testing is based on exceptional yet plausible events. Stress-testing is used for identifying risks, for detecting ‘early warning’ signals and for testing capital buffers. It also serves to identify the point at which the institution will start suffering from capital destruction.

Beyond that point however, the use of individual stress tests for each institution becomes more restricted. It seems that in those utterly hypothetical cases, i.e. a general liquidity crisis, there would be a task for the ECB, as this kind of crisis affects the sector as a whole.

6. Concern about proportionality: given the technical intricacies of these requirements, one may wonder how small institutions will cope with this implementation.
7. No excessive regulation: although we endorse the principles laid down in the consultation paper for the major part, there is still some concern about the extent to which the national supervisors will impose a detailed implementation of these principles. As already mentioned above, it should be pointed out that stress-testing, being one of the building blocks of the ICAAP process, is a process proper to the institution, which is responsible for its implementation.
8. Implementation level: although stress-testing can take place at the same level of the ICAAP (highest level of consolidation), one is afraid that (host) supervisors will impose specific stress tests for each legal entity.
9. Stress tests are no sector-level instrument: one may doubt whether stress tests imposed by the supervisors on all institutions (or on a group of them) can lead to significant results. Each institution indeed uses its own methods and hypotheses and this inevitably makes it impossible to compare the results one another.
10. Structure of the CP, introduction of references to other CPs: We feel that a large part of the consultation document is overlapping with other papers. In order to avoid the risk of creating similar yet different regulatory guidelines, we propose to work with references to other CPs. Each CP could concentrate on a specific topic without overlapping with other topics. As for this CP, we propose to delete § 49 ‘*Stress testing guidelines by risk categories*’ and at the same time to connect this



document with clear references to other CEBS-guidelines or the CRD on specific topics.

## **2. Detailed comment on specific guidelines**

### **ST1. The guidelines on stress-testing will be applied to all institutions taking into account their size, sophistication and diversification.**

Although we agree with the principle as such, we plead for – given the complexity of the topic – allowing small institutions to fully benefit from the proportionality principle.

### **ST5. Stress-testing should be based on exceptional but plausible events.**

Referring to our main comment No 7, we consider stress-testing to be one of the building blocks of the ICAAP-proces, i.e. the process used by the institution itself for assessing its internal capital adequacy. The institution itself knows best what are the risk drivers and what is the need for developing stress tests. We call upon the regulators to leave institutions sufficient freedom for their own assessment of the need for stress-testing. We strongly feel it would be inappropriate to implement CP12 on a too prescriptive basis defining when and under which conditions stress-testing will be necessary.

### **ST6. Stress-testing should in principle be applied at the same level as the ICAAP.**

We agree with this principle.

Since institutions work with a centralised risk management, we consider it appropriate to calculate the ICAAP at the highest consolidated level. The same goes for the decision whether or not to do stress-testing. We recognise that there may be a need to develop stress tests at a lower level in a group structure or even for a specific pool of exposures. However, this decision should be left up to the institution itself and must not be imposed by the regulator.

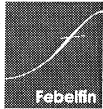
### **ST8. Institutions should determine the time horizon of stress-testing in accordance with the maturity and liquidity of the positions stressed.**

Referring to our main comment No 1, we think this principle is inappropriate for the following reasons :

First, within the framework of overall stress tests (aggregated stress tests on individual risks), numerous hypotheses have to be taken into account in order to correlate the different timespans upon which the individual stress tests are based.

Secondly, stress-testing for some risk types (eg. strategic risk, business risk) is not based upon the maturity and liquidity of the positions stressed.

For these reasons, we propose to rephrase the principle as follows: *‘ST8. Institutions should determine the time horizon of stress testing for each kind of risk and position stressed, when applicable.’*



**ST9. Under specific circumstances, supervisors may require institutions to perform ad hoc stress tests at a specific point in time.**

We agree with this principle, but referring to our main comment No 9, we draw the attention on the fact that every institution uses specific parameters and methodologies which are appropriate for its own portfolios. Consequently, the outcome of stress tests across a number of institutions may not lead to comparable or even meaningful results.

Regulators should pay attention to this aspect when assessing the results of stress tests across a range of institutions. In fact, we feel that given this drawback, there should be a difference in analyzing the results of the stress tests of an individual institution (meaningful results are possible) and the results of stress tests across a range of institutions (leading at best to mere indications to be explored further into detail).

**ST10. Institutions should use accurate, complete, appropriate and representative data when performing stress tests and the IT resources should be commensurate with the complexity of the techniques and the coverage of stress tests performed by institutions.**

We agree with this principle, but referring to our main comment No 4, we ask for flexibility when it comes to judging to which extent the institution complies with this principle. Given the important technical and time consuming hurdles to be taken, we plead for this principle to be assessed from an evolutionary point of view.

**ST12. The management body has the ultimate responsibility for the overall stress-testing framework. Where appropriate the management body can delegate certain aspects of this framework to specific risk committees or senior management, keeping the effective oversight.**

**ST13. The stress-testing process should be an integral part of an institution's risk management framework, with clear reporting lines and communication in an understandable format.**

When reading those two principles together, we think that principle ST12 is redundant. Referring to our main comment No 2, we propose to delete principle ST12.

**Paragraph IV.1 Macro-economic stress tests**

**§ 51. Under Annex V Paragraph 2 of the CRD, institutions should manage, monitor and mitigate the risks they are or might be exposed to, including those posed by the macro-economic environment in which they operate in relation to the position in the business cycle.**

Stress-testing based upon changes in the macro-economic environment will be adequate for a lot of institutions active in the retail segment. However, some settlement institutions (having a legal status of credit institution) are not active in this field and hold only highly collateralised customer portfolios of highly rated professional counterparties. In

those cases, stress-testing based upon changes in the macro-economic environment seems unnecessary. So, we propose to rephrase § 51 as follows:

*‘Under Annex V Paragraph 2 of the CRD, institutions may manage, ... .’*

**§ 55. ....Depending on the nature of the portfolio the stress tests could factor in (where applicable):**

- **Illiquidity/gapping of prices (including interest rates and exchange rates);**
- **Concentrated positions (in relation to market turnover);**
- **One-way markets;**
- **Non-linear products/deep out-of-the-money positions;**
- **Events and jumps-to-default, and**
- **Significant shifts in correlations and volatility.**

§ 8 of the document explicitly states that *‘In cases where the terms “could”, “may”, etc. are used, the guidelines simply provide illustrative examples, meaning that institutions are free to use other solutions.’*, but we know from experience that listed examples are used by some regulators as a ‘tick box’ for assessing the extent to which an institution complies with regulated matters. Consequently, we propose to delete the examples mentioned throughout the consultation document and more particularly in § 55.

**ST19. For those institutions using internal models for the calculation of capital requirements for market risks, supervisory requirements for stress-testing remain unchanged. Their on-going fulfilment will be considered under the SREP.**

We propose the rephrase this principle as follows:

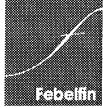
*‘For those institutions using internal models for the calculation of regulatory capital requirements for market risks, ... .’*

**ST20. Institutions under the large exposures provisions using the comprehensive method for calculating the effects of financial collateral, or permitted to use their own estimates of LGDs and conversion factors, should identify conditions which would adversely affect the realisable value of their financial collateral.**

**ST21. According to Article 114 (3) of the CRD, where the results of the stress-testing indicate a lower realisable value of collateral, the value of collateral taken into account for the purpose of determining an institution’s LE limits should be adjusted accordingly.**

We ask for flexibility when it comes to assessing the extent to which the institution complies with these principles. Given the important technical and time consuming hurdles





to be taken, we plead for these principles to be assessed from an evolutionary point of view.

However, our general remark is that these principles do not belong in a paper on stress-testing and should rather be put forward within the framework of future work on concentration risk and/or large exposures.

Finally, we would like to point out that principle 11 is missing in the document.