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European Banking Federation
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NF/GM
N°0653

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Subject: FBE response to Consultation Paper CP12: Stress Testing under the Supervisory Review Process.

Dear Mrs Nouy,

The European Banking Federation (FBE) is pleased to comment on CEBS' consultation on Stress Testing and appreciates the progress made by the removal of overly prescriptive elements from the draft guidelines.

We fully support CEBS' proportionate attitude vis-à-vis the elaboration of the guidelines, which should be implemented within a long-term perspective, through substantial on-going dialogues between the supervisors and the financial institutions.

In view of the complexity of the issue and the variety of institutions' practices, we wish to underline that supervisors' expectations should be pragmatic. Institutions should be allowed to perform stress tests at the consolidated level, when and where they consider it useful.

Our detailed comments are enclosed. For any questions, please don't hesitate to contact either myself or my colleague Noémie Francheterre (n.francheterre@fbe.be).

Yours sincerely,

Guido Ravoet

Enclosure: 1



FBE comments on the Consultation Paper on Stress testing under the Supervisory Review Process (CP12)

The CP12 guidelines give a comprehensive description of the industry best practices and will be a useful forward-looking tool for banks to determine action plans and to set their risk appetite.

We fully endorse CEBS' flexible and proportionate approach vis-à-vis the guidelines' implementation under the responsibility of the institution. However, given the complexity and particularity of the issue, we wish to emphasise that supervisors should not expect banks to use, or comply with, every guideline of the CP, but rather engage in an ongoing dialogue with one another with a view to gradually establish a common understanding of the different practices related to stress testing.

General comments:

1. The FBE **welcomes CEBS' application of the proportionality principle** to its guidelines on stress testing. Institutions use stress testing with different degrees of intensity, depending on the nature, scale and complexity of their activities within an evolving concern environment and not for purely hypothetical 'tail events'. The supervisors' expectations should therefore be realistic and commensurate not only with the size of institutions or entities within a group, but also with their business lines and risk profile.
2. We are pleased to note CEBS' acknowledgement that "institutions are on different points of a continuum" (§5) and that industry practices as regards stress testing are still in a developing process (§6). Accordingly, a significant part of institutions within the EU would not, at this stage, be able to comply with the requirements of CP12. We recommend explicitly mentioning in the executive summary that **the guidelines' implementation should be seen as a long-term process.**
3. CP12 IT requirements seem very strict and it would be difficult for financial institutions to meet them all. **Specifications related to IT infrastructure should be considered with leniency** as implementing an adequate IT infrastructure can take many years. Moreover, certain tools may be interesting to develop from a risk management perspective, but may come at a cost that exceeds the economic added value. In the meantime, we would request CEBS to take into account the current tools available to institutions to perform a stress test.
4. Accordingly, we strongly **encourage supervisors to apply these guidelines within a flexible and evolutionary approach.** It will be important for supervisors to have an ongoing dialogue with the industry in the coming years so as to reach a common understanding of the different approaches to, and applications of, stress testing. It could also be necessary to introduce a review clause of the proposed guidelines.
5. Stress testing is a main component of the ICAAP and a useful exercise to complete it; we welcome that CEBS recognises this (§§ 4 & 5). As such, we wish to underline that, as for the ICAAP, **institutions own the stress testing process, and conduct it at the consolidated level.** This means institutions should determine in which cases stress tests could offer any added value and then define how to manage any risks resulting thereof. We are therefore pleased that "supervisors would discuss with institutions the feasibility of conducting ad hoc supervisory stress tests" (ST9). It is essential that the guidelines prescribed in CP12 do not turn into a prudential obligation to develop a stress test as an end in itself.

6. We agree with CEBS that holding additional capital is merely one option that institutions can use to compensate for their vulnerability to exceptional events. We wish to add that, within the ICAAP, specific **capital add-ons should even be a last resort technique only**, once other risk mitigation measures have failed.
7. Even though the examples regarding liquidity risk are annexed to this paper (Annex 1), we urge CEBS to **explicitly state it does not expect institutions to cover them all, but rather that the latter may freely choose from the list** according to their needs and the particularities of their business.
8. As regards the structure of the CP we feel that a part of the paper is overlapping with other papers. In order to avoid the risk of creating similar yet different regulatory guidelines, we would propose that each CP as much as possible concentrates on a specific topic. In this respect, we would propose to **move ST20 and ST21 to future work on the large exposures/concentration risk rules**.

Specific remarks

ST1: the guidelines on stress testing will be applied to all institutions taking into account their size, sophistication and diversification.

9. We support the proportionate application of the guidelines by CEBS. Given the complexity of the topic, we particularly expect that small institutions will fully benefit thereof. To be consistent with the principle that stress tests should be decided and defined by the institutions themselves, we suggest amending the first sentence of paragraph 21 as follows: “As a general rule, sophisticated institutions should use scenario tests *and/or* sensitivity analysis...”

ST2: In line with one of the principles listed in the CEBS Guidelines on the Supervisory Review Process (ICAAP 7) institutions should identify their material risks. In general, institutions should conduct stress tests on all the risks they have identified as material.

10. We think it would be impractical to conduct stress tests on all material risks. While stress testing is a special procedure for quantifying risks, it is not necessarily an appropriate response to all the risks an institution faces, even if they are material. For instance, where a capital model is stress-based, such as the calculation of operational risk/reputational risk, it would be ill-advised to further stress testing it. ST2 guidelines should highlight that non-quantifiable risks may exist (in accordance with Pillar II), which either cannot be subject to stress tests or only in an extremely simplified procedure. Consequently, we recommend replacing “should conduct” in ST2 by “should consider conducting”.

ST3: Based upon the identification of material risks, institutions should derive material risk factors that should be subject to stress testing.

11. We agree that “the number of risk factors to be stressed should depend on the complexity of the portfolio” (§27) but observe that more complex portfolios do not automatically require a significantly higher number of risk factors than a less complex one to ensure that a robust stress test is performed.
12. Paragraph 27 seems to imply that institutions should stress all material sensitivities. However, sensitivities are volatile (as CEBS itself acknowledges it in § 34), which makes it impossible for the institutions to have a stable ‘set’ of sensitivities defined as being ‘material’. This would mean that, before stress tests can be conducted on material sensitivities, the extent to which the latter can still be qualified as ‘material’ would have to be reviewed. In addition, evidence of this review process would have to be provided. For cost-benefit reasons, we therefore recommend deleting the final sentence of paragraph 27.

13. To underline that stress testing is the responsibility of the institution, we would suggest replacing “justify” by “explain” in paragraph 28.

ST4. Depending on their situation, institutions should consider historical and/or hypothetical scenarios.

14. Hypothetical scenarios are usually based on emerging threats and opportunities. In this respect, historical scenarios mainly provide broad volatility and correlation estimates. Thus, historical scenarios are based on different circumstances which happen to come together at a period in time but which may never come into alignment again. Consequently supervisors should not feel concerned if an institution does not apply historical events to its current and prospective portfolio in its stress testing programme.

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

15. We agree with this statement. We believe the institution’s role is to make its own assessment of exceptional but plausible risk drivers and to derive relevant stress tests. We call upon CEBS to leave the institutions enough room for manoeuvre to define these events, and to abstain from providing prescriptive indications of probability and frequency of such events’ occurrence.

16. Paragraph 30, first bullet point is unclear. It seems to suggest that internal capital is derived from stress testing’s results. However, this is not the case for most types of risks and most institutions. We invite the supervisors to clarify and/or amend this point.

17. We believe it is burdensome to request institutions to motivate the measures taken, or not taken, with regards to specific stress tests’ results, as stated in the last bullet point.

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

18. The FBE agrees with this principle. As institutions have a centralised approach to risk management, it is relevant for them to prepare their ICAAP at the group level. Cross-border institutions have a consolidated approach to stress testing. Centrally developed stress testing parameters would be applied to business units and the results of these tests would be calibrated at group level and incorporated into the overall ICAAP.

19. In addition, we acknowledge that there may be incentives to conduct stress tests at a lower level within a group structure or even for a specific pool of exposures. However, it is essential that the decision to do so be made by the institution itself and not be imposed by the supervisor.

ST7. The frequency of stress testing should be determined in accordance with the nature of the risks to which the institution is exposed and the types of tests performed.

20. We agree with this principle. However, we would like CEBS to clarify what it means when stating that a lack of the external data required to conduct a stress test “may not be seen as a sufficient reason to delay stress tests or not perform them at the right frequency” (§ 34, last bullet point). It is indeed not evident how a stress test can be conducted without such data.

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

21. In our view, this seems too far-reaching. When conducting global stress tests several hypotheses have to be taken into account in order to correlate the different time spans upon which the individual stress tests are based. Moreover, stress tests of some risk types (e.g. strategic risk, business risk) are not based on the maturity and liquidity of the positions stressed. The frequency and time horizon of stress testing should be consistent with institutions’ practices. Consequently, we

propose to amend this guideline as follows: “ST8. Institutions should determine the time horizon of stress testing *by risk type and the positions stressed when applicable*”.

As regards the determination of the time horizon, we agree with the current 10-day requirement. However, we recommend making a reference to the consideration of the risk defeasance period (i.e. when the risk has been defeated).

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

22. The FBE would, in principle, agree with this guideline. However, in view of the implementation burden imposed by the new capital adequacy rules, and given that ad hoc stress tests cannot, by definition, be performed ‘at the push of a button’, we expect supervisors to make reasonable requests and to effectively discuss their feasibility with institutions.
23. As far as large cross-border institutions are concerned, ad hoc stress tests should be coordinated by the consolidated supervisor.
24. As regards the third bullet point, we wish to highlight that each institution uses specific parameters and methodologies, which are designed for its own portfolio. As a result, the outcome of stress tests across a range of institutions may not lead to comparable or even meaningful results. Given this drawback, we believe that supervisors should analyse differently the results of stress tests of an individual institution (possible meaningful results) and that of stress tests across a range of institutions (leading at best to mere indications to be further explored in 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.

25. The FBE supports this principle. However, in view of the significant technical obstacles to overcome, we advocate that institutions’ compliance with this principle be assessed in a flexible and realistic way.
26. Furthermore, requiring that representative data has to embrace all the factors that can be stressed (paragraph 37) seems inappropriate. Drawing conclusions from the outcome of stress tests performed on a representative sample for the whole portfolio seems indeed inappropriate. We suggest deleting this requirement and allowing stress tests to be conducted on sub-portfolios as an alternative.

ST11 is missing.

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.

27. While we agree with the management body being the ultimate responsible for the entire stress testing framework, there is no need for the senior management to approve the design of the largely technical processes involved in sensitivity analyses or scenario tests. In addition, we have doubts as to how it could be assured, and how supervisors could verify, that senior management has a clear understanding of the implications of the stress tests’ results.
28. We appreciate the possibility for delegation of certain aspects of the stress testing framework to specific risk committees or senior management. However, we would propose extending this possibility to the whole stress testing framework, and particularly within large banks. Decisions made by the management body usually are high level decisions. They involve strategic and overall policy matters concerning, among others, risk management and capital assessment (partly based on

the ICAAP results), of which stress tests' results are an element. In our view, these results lead to senior management decisions from which general policies stem.

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.

29. An institution's risk management framework is built upon clear reporting lines and based on clear communication channels. In that respect, we consider that ST13 presents a more accurate and complete picture of the decision-making process within an institution than ST12. We therefore think that ST12 is redundant and invite CEBS to delete it.

ST14. Where deemed appropriate by the institution, it should take remedial measures or actions considering the level of risk exposure as revealed by stress tests and the objectives and risk tolerances defined by the management body.

30. In accordance with our opinion that institutions are responsible for managing the risks revealed by stress testing, we welcome this principle. We also support the recognition in paragraph 43 that senior management's adjustment of risk levels as a result of stress testing may vary according to circumstances and that, implicitly, no action can be a valid response.
31. We would ask CEBS to provide clarification concerning the sixth bullet point in paragraph 43 as it could be interpreted as meaning that institutions must have a contingency plan available for each scenario, which would impose a considerable burden on institutions.

ST15. Appropriate documentation should be in place to facilitate the adequate implementation of the whole stress testing framework.

32. In view of the level of detail of the documentation required, we believe it should be allowed to delegate the approval of that documentation, as provided for in ST12. Moreover, we do not think that the list should be treated as an exhaustive list by supervisors. Institutions should be free to decide how to approach the documentation of its objectives, risk strategies and policies.
33. As regards the last bullet point, the remedial measures which may have to be taken strongly depend on the specific circumstances of each case. It therefore appears unrealistic to determine all these measures in advance. The necessary documentation should rather merely set out rules and responsibilities for remedial measures or actions that have to be taken.

ST16. Institutions should consider periodically whether stress tests are still adequate. In particular, institutions should ensure that assumptions regarding the risk profile and the external environment are still valid over time.

34. In our view, a yearly review of the entire stress testing framework is unneeded. It should be clearly stated that only scenarios and parameters need to be reviewed every year. In addition, while we agree with the internal assessment adequacy checking procedures listed, we would not want it to be interpreted as a checklist that all institutions should follow. Consequently, we suggest changing "should" in the last sentence of § 48 to "could".

IV.1. Macroeconomic stress tests

35. On paragraph 51: stress testing based upon changes in the macro-economic environment will be adequate for many institutions that are active in the retail sector. However, some institutions' activities do not cover this area; these institutions hold only highly collateralised customer portfolios of highly rated professional counterparties. In such case, stress testing based upon changes in the macro-economic environment seems unnecessary. In this respect, and as a forward-looking remark, we would find it appropriate, as part of the review of the CRD, to amend Annex V

Paragraph 2 as follows: “Under Annex V Paragraph 2 of the CRD, institutions *may* manage, monitor and mitigate the risks...”

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

36. We are pleased to note that CEBS does not consider it necessary to change the current supervisory requirements for stress testing for institutions using internal models for the calculation of market risk requirements. These are embedded in institutions’ internal processes.
37. We agree with paragraph 56, which states that ‘tail events’ beyond the 10-day VaR 99% confidence level have to be considered as this represents an “exceptional but plausible” event (ST5).
38. CEBS seems to assume that financial institutions use (or should use) limits for their products, which should be stressed (paragraph 56, last indent). In practice, however, it is not always necessary to use limits. Since it is the institutions’ responsibility to establish the structure of limits, we believe that stress tests should be conducted on existing banking limits.
39. A general, comprehensive stress test’s limit approach is at odds with effective and meaningful risk management in an ever-evolving trading environment. Not all trading activities should be limited by extreme and unlikely stress testing results, even when they might be justifiable.

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.

40. We are uncomfortable with the catch-all phrase “or any other event which may affect the realization of the collateral’s estimated value...” as stated in paragraph 61 and would prefer its removal.
41. As expressed in general comment n°9 above, we think that ST20 & ST21 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.

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.

42. In view of the requirement set in ST21 and of the significant technical and time consuming barriers that need to be surmounted in general with respect to CP12 requirements, we reiterate our recommendation (see comments n° 4 and 26 above) that these principles be assessed within an evolutionary perspective.
43. In requiring over-collateralization in all circumstances, paragraph 65 does not appear to match the flexible approach we advocate as regards the application of these guidelines. We therefore suggest the deletion of ST21 and the accompanying paragraph 65 and their merger with ST20, which would then read:

“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 aggregate realisable value of their financial collateral, which should be adjusted accordingly*”.

IV.3.c. Stress testing for IRB institutions

44. Paragraph 69, line 3, implies that stress testing is the only tool to be used to meet the Annex VII part 4 test. It should be changed to: “A tool *that could* be applied is stress testing”.
45. We disagree with the assertion in paragraph 70 that the institution’s available capital resources should “fully cover credit risks...” as we think it is in conflict with CEBS’ acknowledgment that there will be no automatic add-ons as a result of Pillar 2. Rather, an institution is expected to be able to explain how it would react, should an adverse scenario materialise, to ensure that at this future point capital would be sufficient. For this reason we recommend the deletion of paragraph 78.

ST22. Institutions should regularly project cash flows under alternative scenarios of various degrees taking into account both market liquidity (external factors) and funding liquidity (internal factors).

46. We agree with the statement that the design of liquidity stress scenarios is “the responsibility of each institution”. We furthermore believe that the scenarios presented in Annex 1 are helpful pointers as to how these could be developed.

ST25. To come up with a complete view of various risk positions, stress testing of other risk types may be usefully considered to design “alternative liquidity scenarios”.

47. According to the example provided in paragraph 87, useful information for liquidity scenarios may be obtained from stress tests on credit risk. We do not think, however, that any meaningful conclusions could be drawn on liquidity risk from a small set of data on expected cash flows provided by LGD estimates. Consequently, we suggest deleting this example from paragraph 87.

ST26. Supervisors may perform their own stress tests based on available data in their assessment of liquidity risk under SREP.

48. We believe it is reasonable and prudent for supervisors to carry out their own stress testing in addition to those performed by institutions to examine the impact of a liquidity crisis on specific institutions, or the market more generally. As the results of supervisors’ stress tests give an external viewpoint on an institution’s liquidity situation, it would be appropriate to discuss these results with the institution concerned, as part of the SREP.