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Consultation Paper 12 (CP 12) on Stress Testing Under the Supervisory Review Process

Dear Sir/Madam,

We welcome the opportunity to provide our comments on the CEBS consultation paper number 12 concerning stress testing under the supervisory review process. The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks with a consolidated balance sheet total of approximately EUR4.8 billion.

I. General

We welcome CEBS's intention that the scope of the forthcoming guidelines shall be confined to principles for the design of stress tests under the supervisory review process and under the IRBA. Contrary to earlier consultation papers or, moreover, guidelines, the provisions contained in the present paper feature less detail. In this context, we explicitly endorse the clarification contained in **No. 8** of the summary, pursuant to which merely those provisions shall be applied in a binding manner where the modal verb „should“ is being used. This approach allows credit institutions and national supervisory authorities the necessary discretion and furthers a better understanding of the paper. The ZKA generally welcomes this development. At this point, however, we would once more like to reiterate our fundamental concern, namely that an adequate reflection of national idiosyncrasies hinges on sufficient scope for discretion on the part of national supervisory authorities as regards the regulation of details. Uniform application of the directive and supervisory convergence within the EU must not incur an overspill of regulatory detail and - particularly for smaller banks - an inappropriately high cost encumbrance.

Apart from this, we naturally welcome CEBS's proposal to basically leave the choice of the measures to be adopted on the basis of the stress testing results to institutions (**ST14**). We also welcome the fact that the consultation paper sets forth that holding an additional capital buffer constitutes but one option (among others). Notwithstanding the foregoing endorsement, there are several points where the consultation paper establishes a direct link between stress testing and additional capital requirements (**No. 2, 18, 30, 43, 52, 57, 70, 77, 78**). We find this unacceptable. Stress testing results (both of an economic and also of a supervisory nature) shall and must not lead to any increase of regulatory minimum capital by default. Furthermore, we feel that supervisory authorities should base any assessment of potential differences between the actual capital and the stress test result on the specific peculiarities of the respective banks as well as on the specific features of the respective stress test. Minor differences, owed to the status of stress tests which are still under development (measurement errors) should not trigger any need for action. The adequacy of certain stress test is a subject of ongoing consideration.

In this context, we would once more like to underline our main point, i.e. that – for the purposes of addressing any shortcomings that may have emerged in the field of risk management – any individual capital surcharges under the SREP should merely be used as a means of last resort/*ultima ratio*. Such measures should merely be adopted if other troubleshooting approaches have proven unsuccessful.

We similarly endorse the view that the principle of proportionality shall also apply with regard to the methods used during stress testing. However, the requirements imposed on the individual institution should not hamper the creation of an EU-wide level playing field. In this context we would like to suggest rephrasing **No. 3** of the summary to include a wording that has proven successful during the German implementation of Basel II's pillar 2. For instance, it should be clarified that the formulated stress testing requirements depend on the size of the institution, the complexity of its business activities, its core business activities as well as its risk exposure. The terms: In this context, we feel that the expression „sophistication and diversification of their activities“ is ambiguous.

Concerning the paragraph “credit risk stress testing” we would suggest to pursue a broader approach enabling the bank to flexibly implement a stress test methodology covering the portfolio specific aspects of the respective bank. In our opinion there have been no significant changes in section stress testing credit risk (**IV.3**) in comparison to the previous version. We would welcome examples of possible scenarios for stress testing. However, these examples should only be suggestions and not obligatory. Furthermore we also think that the framework could be enhanced with examples of relevant risk parameters that are influenced by the stress scenarios. These examples should also be not obligatory.

Although not stated explicitly the guidelines seem to assume that there is a quantifiable functional relationship between risk factors and profit&loss. As implicitly stated in **no. 89** this is not always the case. In our view this should be incorporated into the general part of the guidelines (e.g. executive summary).

The stress tests concerning the concentration risk and the realisable value of the underlying securities that is covered under **IV.3**, should be regulated in the framework of CP 11. Furthermore, we would like to point out that in section **IV.3**, the Committee sets up requirements with regard to the treatment of (credit) concentration risks, that are highly detailed in some parts. In our view, in the absence of a portfolio model, implementation of these requirements is not feasible or, moreover, would take up an extremely high amount of resources. More likely than not, particularly smaller banks do not even stand the remotest chance of meeting these requirements. We take it that the principle of proportionality will be taken into account especially at this juncture. Otherwise, there will be a danger that the requirements with regard to stress tests might create a new and additional obstacle for the transition from the standard approach to the IRB approach.

Last but not least, at this juncture we would like to reaffirm that when we see a compelling need for a farreaching freedom of methods when shaping stress tests. This will lead to a diversification of stress test designs which does not only promote the competitive quest for better solutions, - it will also reduce the danger of a behavioral alignment amongst banks that could potentially endanger the stability of the European banking market. Standardised, homogenous stress tests fail to reflect banks' heterogenous business models.

Answers to the questions re. **No. 12**:

ad 1)

We agree to the approach and subscribe to the basic rationale behind the guidelines, yet we would appreciate it if our comments be taken into account.

ad 2)

In our view, it would a consolidation/streamlining of the guidelines would be more favorable. We feel that a leaner shape would make the regulatory content of the present consultation paper clearer. If needs be, details such as explanatory examples, may be further fleshed out in the annex.

II. Special Comments

No. 2 should clarify that the guidelines will not automatically result in capital surcharges. In our view, the language is unclear. It should therefore either be made more specific or it should be deleted. Under **ST14**, the choice of potentially necessary measures shall, on principle, be incumbent upon institutions (cf. also our general comments above). Here, the option of setting up an additional capital buffer is but one option (among others) for addressing potential shortcomings.

No. 15 and 16 distinguish between „sensitivity analysis“ and „scenario tests“. **No. 17** points out that this breakdown merely serves illustrative purposes. We feel that this is only relevant when it comes to the issue of proportionality within the meaning of **No. 21**. Hence, this differentiation is redundant; said numbers can be deleted.

No. 16 once more imputes use of the factor model; this was already the case in CP 11. In order to be able to carry out scenario tests in such a setting, the implicit working hypothesis is that the bank will be in possession of a model which is based on dependent risk factors. In order to deliver this, banks would have to use portfolio models.

Yet, to date, use of the latter has not been mandatory under the Pillar 2. Hence, there should be a clarification that especially smaller banks do not have to face any stress testing provisions that would require the use of portfolio models.

Furthermore, **No. 16** uses the example of a „Black Monday“. This may give rise to the impression that scenario tests may only be based on actual scenarios that have occurred in the past. This would be unhelpful. After all, as a matter of principle, stress testing scenarios need to be geared towards latest economic framework conditions.

No. 18 requires that institution should assess the effects of stress situation on their earnings in the context of their ICAAP. In this context we would like to point out that the risk profile of a bank is generally not only determined by the risk - return relation. Besides return components there are other capital components of capital, that can be as well and equivalently used to cover the risks of an institution. It is therefore not clear, why CEBS requires the comparison of stress testing results with earnings, accepting at the same time (see **No. 4**) that stress testing is mainly an internal instrument of the institution. We therefore suggest that the decision as to which capital components shall be included in the stress tests be left to institutions' discretion.

The statement "Stress testing helps form a view where paucity of historical data limits the predictive power of such [internal capital] models" is generally not correct. The sensitivity analyses and historical scenarios, which are addressed within CP12, do hardly provide information about the risk situation in future. A complete integration of (in general non-probabilistic) stress tests within formal probabilistic internal capital models (e.g. VAR models) can be methodically very difficult. We would therefore appreciate a replacement of the expression „should be used“ contained in the last bullet under **No. 18** by „could be used“.

In our view, at the beginning of section **III**, there should be an explicit note that the infrastructure set up for implementation of stress tests should be geared towards the risk category under review. After all, the various risks are associated with different methods.

According to **no. 21** sophisticated institutions should use a combination of both scenario tests *and* sensitivity analyses. In our opinion, it should be left to the institution, which kind of stress testing it prefers.

In our view, it is not possible as required in **ST2** to conduct stress tests on all material risk. Stress tests are special procedures for the quantification of risks. Yet, this does not mean that they can be deployed when and wherever VAR models either fail or where they have not yet been incorporated. For some material risk types like reputational risk it is not meaningful to develop a stress testing on top of a stress test based capital model. The guidelines should emphasize that there may be risks that do not lend themselves to quantification (pursuant to Pillar 2) and that such risks cannot be subjected to a stress test, or, moreover, where the scope of stress testing is only possible to an extremely simplified extent. We suggest to replace „*should conduct*“ by „*should consider conducting*“.

Furthermore, we ask for a clarification that - in line with the requirements set forth under **No. 22** - the risks identified under ICAAP shall form the starting point for establishing banks' material risks which may become subject to stress testing

In **No. 25**, the Committee requests institutions to identify the volatility of profit/loss or solvability that may result from risk factors. In our view, such an approach prejudices a test for these variables. Generally, institutions will stress or, moreover, stress test limits (including but not limited to relative or absolute risk limits). Hence, at this point we feel that the list should also include „other limits“.

In **No. 27** the Committee requests institutions to stress all material sensitivities. Given environmental changes, sensitivities will never be constant. This means, that any list of „material sensitivities“ identified by individual institutions will not be constant, either. Hence, the implementation of any stress tests would always presuppose a renewed review of the materiality. This review would then have to be evidenced/documentated. After careful consideration of the corresponding cost-benefit analysis, we suggest deleting the last sentence of **No. 27**.

In our view, the presentations under **No. 29** relate to back testing and not stress testing. Yet, regulation of back testing is not covered by the regulatory scope of the present guidelines. This point should therefore be removed.

No. 30, first bullet point, implicitly suggests that internal capital is derived by stress testing which is not true for most risk types and most institutions. We therefore ask for an amendment of the respective language.

Pursuant to **No. 30**, fourth bullet point, institutions holding a capital buffer which is not in line with the requisite exceptional but plausible stress scenario may explain to supervisory authorities how they plan to cope with an equivalent stress situation. First of all, we should like to point out that this provision is misplaced under **ST5**, since **ST5** seeks to provide a definition of the term „exceptional but plausible events. Furthermore, the language implicitly suggests that holding a capital buffer was mandatory and that institutions shall merely be free to decide upon its exact amount. In our view, however, and in line with our foregoing remarks, holding a capital buffer merely constitutes one way of acting upon the stress testing results. This should, therefore, be clarified accordingly.

For the sake of greater clarity and in order to remedy **No. 18**'s inherent contradiction, we suggest deleting the word „may“ contained in the first sentence of **No. 31**.

As far as larger legal entities are concerned, the presentations under **No. 33** implicitly suggest the need to apply legal entity stress testing. This requirement would cause a massive implementation burden and is in contrast to statements made in the CEBS expert meeting on the issue. We suggest a replacement by the FSA's intended regulation that centralised stress testing at group level is fully acceptable.

The presentations under **No. 34**, fourth bullet point should be specified in greater detail: There should be a clarification that an institution may replace sophisticated stress test scenarios (involving e.g. extensive data requirements, high IT effort) by less sophisticated scenarios, one prerequisite for such a substitution being that under the principle of proportionality the latter scenarios shall be more appropriate for the corresponding institution. On principle, stress tests should be carried out in the framework of those IT systems which are used by the bank for the calculation of the corresponding risks. There must not be any major extra costs concerning IT implementation.

What is more, pursuant to **No. 34**, bullet number four, the lack of availability of external data required to conduct the stress tests must not be seen as a sufficient reason to delay stress tests. We would therefore appreciate a clarification as to how, in such cases, stress tests should be carried out in the absence of a sufficient data base; alternatively, we suggest deleting **bullet number 4**.

No. 35 stipulates that, when determining the time horizon, institutes should take into account whether changes in the underlying portfolio take a long time to implement or not. Yet, we feel that it is not the holding period which is relevant in this context. Instead, rathermore, this requirement should be predicated on the period of time which is necessary in order to reduce or remove the risk (e.g. hHedging). For the sake of clarity, we therefore suggest using the term „risk defeasance period“.

No. 36, bullet point number three stipulates that supervisory authorities can request institutions to implement so-called ad hoc stress tests. These stress tests shall be implemented in addition to the regular stress tests. Their goal is to assess the impact of identical stress tests across a range of institutions. This authorisation should be deleted. Particularly in view of the considerable implementation effort incurred by the forthcoming capital adequacy rules, the requirement to implement stress tests for this purpose appears inappropriate.

If and when stress tests do not capture the entire portfolio, **No. 37** calls for a representative database which embraces all factors which are going to be stressed. In our view, it is problematic to draw conclusions with regard to the entire portfolio (i.e. the underlying overall entity) merely by means of random sample stress testing results. Furthermore, it is unclear how the representativeness of the sample can be secured. We therefore advocate deleting this requirement.

ST12 stipulates that the management body shall have the ultimate responsibility for the entire stress testing framework. Although we agree to this view, we feel it is inappropriate that the senior management is dutybound to authorise and control the conception of the methods employed during sensitivity analyses or scenario tests which, after all, tend to be of a rather technical nature. Here, especially larger banks should be allowed to delegate these tasks further. In this context, we suggest that the requirements concerning the internal documentation and control obligations be not made more stringent than the guidelines' rules on the implementation, validation and assessment of AMA and IRB (formerly CP 10). What is more, the provision reads that it must be ensured that senior management has a clear understanding of the implications of stress testing results. We are not clear as to how the supervisory authority would ensure and monitor this.

No. 43 stipulates that, on principle, the choice of the measures which potentially have to be adopted in the wake of stress testing is left to the discretion of institutions. As has already been pointed out in the general comments above: This provision is to be welcomed. In our view, no set of predefined remedial actions needs to be defined. Business strategies and risk exposures are constantly changing so that a one-size-fits-all approach cannot be taken, especially in what would by definition be extremely unusual situations. Situations of risk taking whose potential outcomes exceed predefined stress scenarios that usually include many subjective parameter assessments need to be evaluated on a case-by-case basis and corrective

measures taken accordingly. The main risks taken are already covered by other types of limits such as position and/or Value-at-Risk limits.

Furthermore, however, there should be a clarification that holding an additional capital buffer (cf. **bullet point number 5**), shall merely constitute an *ultima ratio*, aimed at addressing identified shortcomings where other troubleshooting approaches have failed. What is more, we suggest that bullet point number five should not refer to a „holding of an additional capital buffer“should not refer to the leading up of an additional capital buffer but instead to a review of the capital adequacy.

Bullet point number six could be construed to mean that the institution shall have to provide a contingency plan for each and every scenario. The resulting effort for institutions would be disproportionately high. We therefore request a corresponding clarification.

Under **No. 46**, the Committee sets up documentation requirements concerning the remedial measures adopted on the basis of stress tests. In our view, this requirement could replace the fifth bullet point of **No. 47**. Furthermore, as regards bullet point number five, we would like to point out that the measures which may have to be adopted depend to a great extent on the specific situation. It therefore appears inappropriate to seek an *ex ante* definition of each and any measures that may become necessary. *In lieu* of this, the documentation should lay down principles and competencies for deciding these forthcoming measures.

ST 15 and **No. 47** contain requirements with regard to the documentation of stress tests. Yet, this list is anyway not exhaustive and merely serves illustration purposes. We therefore feel that the bullet points contained in **No. 47** could be summarised in one sentence. During the national implementation in Germany, this has proven successful. One possible wording could read as follows: “As far as the stress testing process is concerned, all material information (e.g. scope of exposure, underlying assumptions, responsibilities, reporting lines and remedial measures and actions) should be appropriately documented.”

No. 47 stipulates that the documentation of the items mentioned under the various bullet points requires approval by the management body. In our view, since the documentation requirements feature a high degree of detail, there should be a clarification that the approval of the documentation within the meaning of **ST12** may also be delegated.

We would appreciate it if **No. 48** were to clarify that the scope of the mandatory annual assessment shall only extend to scenarios and parameters. We see no need for an annual review of the entire stress testing process. E.g., the Basel II framework will also not be reviewed & revised annually.

Under the provisions of **No. 52**, stress tests shall also take account of future business plans. In our view, the future business plans (for instance the formulation of the growth strategy) are part of institutions’ budget planning process. Yet, this process does not fall under the scope of stress tests. Hence, we suggest deleting this requirement. In addition to this, we feel that also the regulatory content of **sentences 4 and 5, No. 52** is already sufficiently described in CP 03’s ICAAP 8. The two sentences should be deleted. Furthermore, we would like to add that we feel that sentence five is unclear as far as its content is concerned. The capital needed for a growth strategy may be immaterial when compared to the total capital.

According to **No. 56**, tail events beyond the 10day VAR 99% confidence level have to be considered. This requirement contradicts the earlier statement of requesting only "exceptional but plausible" events. We therefore request a leaner, less stringent language for this provision.

No. 56, third bullet point should see a replacement of the expression „most severe“ with the expression „exceptional but plausible“. Furthermore, the fourth bullet point of **No. 56** should be deleted.

A general comprehensive stress test limit approach as required in **No. 56** is not in line with effective and meaningful risk management in an ever-evolving trading environment. Not every trading business should be limited by extreme and unlikely stress testing results, albeit they might be reasonable. Hence, a full set of limits for every trading and risk area is not meaningful and will only add to the bureaucratic burden of checking another set of limits regularly that are very far removed from the day-to-day realities of most risk-takers lives. Stress test limits for certain trading areas, like emerging market country exposures and for some activities are useful (i.e., where the institution believes that VaR measures are not very meaningful and/or position and VaR limits alone are not sufficient because the real risk is really only deep tail risk. We therefore request deletion of the final bullet point.

The requirement in ST21 and in the second sentence of **No. 60** would imply a specific LGD calibration for LE reporting (based on stressed collateral value). This would trigger a double counting with down-turn LGD and a huge process effort which is not justified on name-by name basis. We therefore suggest that, alternatively, it shall be possible to apply appropriate collateral hair-cuts. From our point of view, the **third sentence of No. 60** should be deleted: At any rate, it merely serves illustrative purposes; what is more, it also curtails institution's methodological freedom when it comes to choosing their measures for compliance with limits.

From our point of view, **No. 66** (and thus, section **IV.3.b**) can be deleted entirely, the reason being that this section does not offer any additional information which is not already given under **No. 51**. What is more, there are strong doubts that – in terms of their resources – smaller banks will be able to cope with macro-economic stress testing in the field of credit risks.

Pursuant to Annex VII, Part 4, *Nr. 40* Directive 2006/48/EC, during stress testing, there shall also be an assessment of the credit institution's capacity to withstand the negative scenarios under investigation within the framework of stress tests. The provision contained under **No. 70** should be specified in greater detail so as to clarify that the capital resources available to the Institution need to allow a complete coverage of the credit risk of the scenario that is being reviewed. As a result, institutions would be obligated to provide capital backing for the credit exposure emerging from a stress test. On the grounds that have already been mentioned above, we categorically oppose this requirement. Furthermore, it also contradicts the provisions under **No. 2** and **43** and **77**. We suggest deleting **No. 70** completely or at least clarifying that the capacity of a credit institution to withstand a negative scenario may also be achieved by other measures (for instance by way of the merger mentioned under **No. 43**).

Contrary to this, the language “by contrast“ employed under **No. 71** gives rise to the impression that the stress test mentioned in Annex VII, Part 4, No. 40 and 41 represents two entirely different procedures. We feel, that this is not in line with the regulator's intended *ratio legis*. Hence, we suggest a corresponding amendment of this provision to reflect the

actual *ratio legis*. Should, however, CEBS see a clear difference between the two procedures then it should be clarified where these differences lie. In such an event, there should also be a clarification that the wording „capital requirements could change dependent on the stage in the economic cycle“ shall also apply to the stress tests pursuant to Annex VII, part 4, No. 40.

No. 77 is to be welcomed, since it clarifies that stress testing results shall not have any immediate impact on an institution's minimum capital adequacy requirements. This, however, is unfortunately put into a different perspective, because it is being pointed out (albeit merely by way of example) that for additional capital adequacy requirements to apply, certain prerequisites need to be in place. Hence, the word „necessarily“ should be deleted; the same goes for the examples that have been listed under **No. 77**. Otherwise, we suggest deleting **No. 77** altogether.

According to the example given in **paragraph 87**, useful information for liquidity scenarios may be obtained from stress tests on credit risk. In our opinion, no meaningful conclusions can be drawn about liquidity risk on the basis of the small set of data on expected cash flows provided by LGD estimates. We therefore suggest deleting this example in **paragraph 87**.

No. 87 furthermore begs the question whether the separation of the liquidity risks from the other risk types (operational risks or reputational risks) is at all meaningful and whether it will be possible to implement this in a way that is methodologically fit for purpose. We feel that the model risks thus incurred do not live up to a cost-benefit-analysis, i.e. they incur no meaningful in terms of any additional insight.

The language in **ST26** appears to contradict the presentations contained in **No. 88**. Under the provisions of **ST26**, supervisory authorities may implement their own stress tests for an assessment of the liquidity situation of institutions. However, **No. 88** merely says that scenarios shall be given by the supervisory authority. There should be an explicit clarification that implementation of these stress tests shall not incur any additional costs for institutions. Furthermore, we generally feel that the value of such tests is tenuous.

No. 89 points out that, pursuant to the „Guidelines on the Application of the Supervisory Review Process under Pillar 2“ (CP03 revised) risks which cannot be quantified shall be included in the ICAAP if these risks are material. In order to clarify that CP 12 does not seek to change CP03 revised, ICAAP lit. g should point out that application of this requirement may become more flexible if the institute can prove that it possesses an appropriate strategy for risk mitigation or, moreover, management.

Although the examples concerning liquidity risk are only listed in the **Annex 1** it would be desirable to have explicitly stated, that institutions are not required to cover all listed points, but are free to choose from this list according to their needs and the peculiarities of their business.

Annexes

We welcome the list of illustrative examples (for the possible conception) of stress scenarios given in Annex 1 and we suggest to adopt this approach also as regards market price advice and credit exposures. For instance, this would relate to **No. 55** and **No. 56** for market price risks and as far as credit exposure is concerned, this would affect **No. 61** and **63**. This would make a lasting contribution to the document's user friendliness and would lead to a stronger clarification that the lists are given for illustrative purposes.

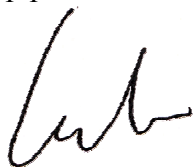
Yours sincerely,

for

ZENTRALEN KREDITAUSSCHUSS

Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V.

p.p.

A handwritten signature in black ink, appearing to be 'BK', written in a cursive style.

(Bernhard Krob)