

30 March 2010

Public hearing on CEBS draft revised Guidelines on stress testing

Note of the meeting

London, 10 March 2010

The Committee of European Banking Supervisors (CEBS) held a public hearing on 10 March 2010 to present its draft revised Guidelines on stress testing. The hearing was chaired by Piers Haben (Chair of the CEBS Stress Testing Task Force).

Around 50 representatives from individual institutions, industry associations, consultancy agencies and journalists attended the hearing, which facilitated a significant degree of constructive debate during the three hour session, which within the context of broad support, led to several constructive points being raised for consideration.

Background

On 14 December 2009 CEBS published for consultation its draft revised Guidelines on stress testing¹, which update the Guidelines on Technical Aspects of Stress Testing under the Supervisory Review Process that were published on 14 December 2006.

The revised guidelines draw on the experience that supervisors have obtained by reviewing institutions' stress tests in recent years, and take account of the revised principles for sound stress testing practices and supervision published by the Basel Committee of Banking Supervision (BCBS)².

The guidelines are designed to assist institutions and supervisors in achieving robust, methodologically sound outputs that are effective in identifying risks and their potential mitigants during stressed conditions and their overall impact on an institution.

The guidelines aim to assist institutions in designing and implementing stress testing programmes with a robust governance structure, meaningful senior management engagement and an effective infrastructure, including information technology, data handling and skilled human resources. The revised guidelines

¹ <http://www.c-eps.org/documents/Publications/Consultation-papers/2009/CP32/CP32.aspx>

² <http://www.bis.org/publ/bcbs155.htm>

also provide assistance to supervisors in their assessments of institutions' stress testing. It is intended that the guidelines be implemented by institutions proportionately, having regard to the nature, scale, and complexity of the activities of the institution concerned. The revised guidelines are designed to be as practical as possible and aim to identify the relevant "building blocks" in an effective stress testing programme.

General remarks

In general, the draft revised guidelines were welcomed by attendees as clarification of supervisory expectations that would incentivise them to strengthen their stress testing frameworks.

Industry representatives raised some important challenges, particularly regarding the level of detail and prescription in the guidelines. Whilst attendees agreed that further explanatory detail and examples are useful, they requested that some of the more detailed points be clearly identified as being as good practices which banks and supervisors should consider, but not necessarily limit themselves to. Similarly, attendees asked for further clarification about the application of proportionality against some of the guidelines.

Some attendees requested clarification regarding the role of the guidelines in light of proposed changes to the regulatory framework outlined in the recent BCBS publication³ and EU Commission consultation paper on CRD IV⁴, particularly in relation to the proposals for the new liquidity regulatory regime. CEBS is continually monitoring developments in the regulatory framework and will review if necessary, relevant aspects of the guidelines in order to make them consistent with any new regulatory regime, once proposals are finalised.

Industry representatives also raised questions about the proposed implementation date for the guidelines – 30 June 2010, suggesting that it would take time for institutions to implement the guidelines and make any necessary enhancements to their infrastructure and frameworks. It was clarified that CEBS proposes a phased implementation approach to the guidelines, where institutions will be expected to transition to more sophisticated approaches to stress testing over time and gradually improve their stress testing frameworks.

Governance aspects

There was agreement that an institution's management body and senior management engagement in the stress testing process is critical, including their review and challenge of stress test scenarios and outputs. It was explained that there should be slightly different roles for senior management and the management bodies of institutions, the latter taking more of a review and challenge role compared to senior management who may be involved in scenario selection and defining management actions. However, some industry representatives argued that in case of large and complex institutions the involvement of the management body in stress testing should be proportionate, whereby they take an oversight role of setting the overall framework and its

³ <http://www.bis.org/press/p091217.htm>

⁴ http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf

objectives, understanding and challenging stress testing outputs, rather than focus on technical modelling assumptions.

Attendees agreed that stress testing frameworks should be integrated into an institution's business operations and there should be convergence between modelling for risk management purposes including stress testing, and modelling for other business purposes, e.g. performance management, pricing etc. Attendees were also supportive of integration between stress testing infrastructures and business infrastructures.

Industry representatives asked that the text of the guidelines provide institutions with sufficient flexibility to design and implement their stress testing programmes and develop their infrastructure in accordance with their specific needs.

Stress testing methodologies

Attendees supported the view that institutions should adopt straightforward approaches to stress testing methodologies and models which lead to meaningful outcomes of stress testing programmes that are understood by management at all levels of an institution.

On the subject of better integrating stress testing with business operations, attendees asked how conservative assumptions in stress testing methodologies could be aligned with business operations.

There was constructive debate around the use of "severe but plausible" scenarios for stress testing, with some attendees suggesting that the financial crisis of 2008-2009 may have been considered by many as an implausible scenario prior to the crisis.

Reverse stress testing

There was a broad support for the introduction of reverse stress testing as a risk management tool to help institutions identify its vulnerabilities, internally challenge the severity of scenarios used for "normal" stress testing, and inform institutions' mitigating management actions. It was suggested that the text of the guidelines be clarified in terms of: the purpose of reverse stress testing as a risk management tool; supervisory assessment and expectations in relation to reverse stress testing; and the balance between quantitative and qualitative approaches.

Multi-layered approach to stress testing programmes

Attendees expressed support for the view that stress testing should cover the full range of a banks' business lines, should capture all risk types, and that a full range of scenario analyses, including reverse stress testing, were necessary and appropriate.

Some challenges were raised about conducting stress tests at a legal entity level for complex institutions, as some institutions are managed on a business line basis, and not necessarily through legal entities. It was explained that national supervisors' requirements to undertake stress tests at a legal entity level

originate from the CRD (as a forward-looking component of the ICAAP framework). However, attendees requested that supervisory colleges be recognised as important tools to coordinate supervisory stress testing activities and potentially play a bigger role in discussing stress testing results.

Stress testing outputs

Attendees suggested that mitigating management actions take two forms - reactive and proactive - which should be properly addressed in the guidelines.

Attendees supported the idea that mitigating management actions should be approved by appropriate levels of authority (e.g. the decision not to pay out dividends would need to be taken and approved by the management body).

Supervisory review and assessment

Attendees supported the inclusion of a section on supervisory review and assessment and viewed it as facilitating convergence of supervisory approaches.

Industry representatives emphasised that there should be coordination between supervisors with respect to individual and legal entity stress tests for cross-border banking groups, and in particular, with regard to prescribed scenarios. Some encouraged CEBS to engage in dialogue with third country supervisors to share experiences and practices with respect to stress testing and Pillar 2 in general.

Finally, attendees asked that this final section of the guidelines emphasise the importance of adequate supervisory resources to properly assess institutions' stress testing frameworks.

Attendees at the hearing were encouraged to provide their written comments to the draft revised guidelines by 31 March 2010. All comments received will be published on CEBS's website unless respondents request otherwise. The final version of the document taking into account the results of the public consultation is expected to be ready by end of Q2 2010 and will be published on the CEBS's website.