



EUROPEAN SAVINGS BANKS GROUP
GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
EUROPÄISCHE SPARKASSENVEREINIGUNG

■

DOC 0888/06

Brussels, 29 September 2006

JEA

European Savings Banks Group (ESBG)

Response to CEBS Consultation Paper 12 (CP12) on
Stress testing under the Supervisory Review Process

■



Profile European Savings Banks Group

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of €4,716 billion (1 January 2005). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



General comments

The European Savings Banks Group (ESBG) welcomes the interest shown by the Committee of European Banking Supervisors (CEBS) for the area of stress testing and its willingness to engage in an exchange of views with the industry on this question. The ESBG is convinced that an in-depth dialogue between competent authorities and market participants is the only way to deliver guidelines, which can bring value for both sides. In this context, we would like to highlight our view that the guidelines have benefited from the ongoing dialogue with the consultative panel. We appreciate the fact that the guidelines are now more “principles-based” and less detailed than previous versions of the document.

There is no question that stress testing is a valuable instrument for risk management and capital assessment. By its character, stress testing is in principle apt to capture all kinds of risks and their interferences. As such, delivering general guidelines on this topic can be considered a useful exercise. This being said, we would like to highlight a number of issues of concern as regards the scope of application of these guidelines and in turn about the CEBS’ expectations from market participants:

- Stress testing is a complex and extensive exercise. Actually, the calculation of a limited number of scenarios already requires substantial resources from credit institutions. We would therefore like to point out that the supervisors should be realistic in relation to the number and magnitude of stress tests they expect banks to run.
- Likewise, the ESBG is of the opinion that Europe’s supervisors should have realistic expectations about stress testing and about the virtues of such an exercise. It should be reminded here that stress testing will never provide a full picture, but should rather be considered as delivering valuable complementary insight as regards the risk profile of the activities of an institution.
- Along the same lines, while we support the ambition of the paper and consider the proposed guidelines as useful, we believe that CEBS should acknowledge that the huge majority of European banks are at this stage not in a state to comply with its guidelines. Stress testing is still a relatively new area, in which the experience of many credit institutions is still limited.

In addition, we would like to raise a number of concerns of a general nature as regards the approach followed in the paper:

- Sections I, II and III of the Consultation Paper deal with stress testing in general and are therefore not assigned to a single risk category. However, some of the concepts covered, such as “economic cycles”, are relevant only for some risk categories and not for others. We believe that this should be clarified in the document.
- The ESBG considers that the guidelines concerning credit risk (in particular the sections IV.3.a and IV.3.b) are excessively detailed. More concretely, these requirements are only applicable to credit institutions with a portfolio model, or which are willing to invest huge resources to comply with them. Most of these requirements are not applicable to Europe’s smaller credit institutions. Section IV.3.c (“stress testing for IRB institutions”) is also of concern as it is yet another hurdle for credit institutions to move from the Standardized Approach to the IRB Approach.



- We also believe that obliging credit institutions to perform certain types of stress tests could endanger the stability of the European banking system, by increasing the level of systemic risk. The fact that credit institutions use different methodologies on the other hand has a positive effect from a systemic risk perspective.

In the next section with more specific comments, we will point out to a number of areas where we identified redundancies, which we believe should be removed. Likewise, we are of the opinion that in a number of cases, the proposed guidelines contain examples, which should rather be included in the annexes.

Specific comments

Paragraph 20: we appreciate the freedom granted to the credit institutions as regards the scenarios and methodologies to be implemented. This is particularly important in the context of stress testing. Specifically, some banks will choose to implement very severe scenarios, while others will opt for milder, but however stressed ones. The banks' choices will be made internally, on the basis of the situation of the bank. On the other hand, this freedom granted to banks could possibly lead to a non-level playing field, should stress tests lead to additional capital requirements. Against this background, we believe that the supervisors should develop a common understanding on the definition of an acceptable stress test.

Paragraph 21: the ESBG appreciates the reference to the principles of materiality and of proportionality. In fact, given that stress testing is a rather expensive exercise, we consider that the proportionality and materiality principles should also grant banks the freedom to weigh the value of additional risk management information against additional costs.

Paragraph 25: this section, as it currently stands, limits the room for manoeuvre of credit institutions, by prejudging how the relevant risk factors should be assessed. In order to avoid prejudging the behaviour of banks, we would suggest indicating that the institutions should stress the relevant risk factors that “may affect their earning/profitability, solvency or other limits”.

Paragraph 26: in paragraph 26, CEBS notes that past losses should be taken into account because they could recur. We believe that especially as regards operational risk, historical scenarios are already contained in the time series used for risk modelling. Repeating them would not add new insight, but rather would overbalance past losses. In our opinion, a better solution would be to review the results of the qualitative analysis (i.e. risk assessments) and incorporate them. This would be a good management check done by the experts of the institution who have an overall insight of their units and are in a good position to make assumptions for potential future hazards. With such an approach, realistic but plausible scenarios would be obtained.

Paragraph 27: according to paragraph 27, credit institutions should stress “all material sensitivities”. This wording raises a number of questions. First, it should be noted that the degree of a sensitivity is not constant, implying that the list of “material sensitivities” is not constant either. Second, this would require checking and documenting the materiality of all material sensitivities. We consider that the costs of these requirements would be high and would in fact outweigh the potential benefits for the banks. We would therefore recommend deleting the last sentence of paragraph 27. As an alternative, CEBS' guidelines could make it



clear that stress testing should apply to *identified* material sensitivities (“All *identified* material sensitivities should be stressed”).

Paragraph 30: in the second bullet point of this section, CEBS indicates that the institutions should “run stress tests of different degrees of severity and likelihood”. We are of the opinion that this requirement is not completely clear. Specifically, is it CEBS’ understanding that the institutions should demonstrate with qualitative arguments that severity and likelihood vary, or rather is it expected from banks that they assess quantitatively the severity and likelihood of a scenario? We assume that the first option would be the correct interpretation, as assessing quantitatively the severity and likelihood of a scenario would be almost impossible. We would like to indicate also that the requirements contained in this section do not apply to operational risk, as for this category of risk there is no link between the events leading to a loss and the point in time within an economic cycle.

Paragraph 31: to us, there is a conflict between the wording of paragraph 31 and paragraph 18. We would therefore suggest deleting the word “may” in the first sentence of paragraph 31, as in practice “the way the ICAAP is structured influences the level at which stress tests are performed”.

Paragraph 33: In this section, CEBS notes that “for smaller entities within large banking groups, stress testing can be performed by a specialized function at the parent level, (...)”. In this section, it should be clarified that if stress testing is adequately capturing the exposure at group level, there should be no additional testing for the smaller entities.

Paragraph 36: the ESBG considers that a supervisor should use its power to require ad hoc stress tests only in exceptional circumstances. Instead, the right approach should be that the supervisor and the bank engage in an ongoing dialogue.

Paragraph 41: the ESBG supports the view that the management body and the senior management of an institution should be able to assess the results of a stress test. However, it is neither necessary nor realistic to require the management body or the senior management to be aware of all the technical details of these exercises.

Paragraph 46: we believe that this paragraph should be included in paragraph 47, in replacement of the fifth indent.

Paragraph 47: we support the view that providing appropriate documentation on the objectives and procedures of stress testing is important. However, we believe that it is unrealistic to assess all possible remedial measures of all possible outcomes beforehand. Against this background, we would suggest replacing the current version of paragraph 47 by a general documentation clause, which has proven useful in the area of market risk. A possible wording could be: “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.”

Paragraph 52: we note that the fourth and fifth sentences of paragraph 52 (“Such strategies may also have a substantial impact on the institution's future levels of capital. For instance, a growth strategy requires an institution to hold more capital whether by retaining profits or by raising more capital externally”) are in fact also included in CEBS’ guidelines on the



v

Supervisory Review Process under Pillar 2 (CP 03 Revised), in ICAAP 8. We would therefore suggest deleting these two sentences.

Paragraph 56: we share CEBS' view that stress testing tail events above the regulatory confidence levels can provide valuable information for risk management purposes. This exercise should however not result in additional capital requirements, apart from very exceptional circumstances.

Paragraph 60: the second sentence of this paragraph is redundant with ST 21, and could accordingly be removed. The third sentence should also be removed, as it only provides an example.

Paragraph 66: the ESBG is of the opinion that the section IV.3.b should be removed, as it does not add information as compared to paragraph 51. In addition, we would like to reiterate our view that performing macro-economic stress tests could prove a particularly burdensome exercise for the smaller credit institutions.

Annexes: we welcome the examples provided in Annex I. We believe that these examples should also be used in the areas of market risk (paragraphs 55 and 56) and of credit risk (paragraphs 61 to 63). This could improve the quality of the document by making it clearer and more readable.

v