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The Deputy Director General

Paris, 27 September 2006

FBF response on the CP12

Dear Mrs Nouy,

The French Banking Federation (FBF) welcomes the opportunity to comment on the Consultation Paper on Stress Testing under the Supervisory Review Process–CP12 issued by the CEBS.

The response to this consultation, as far as liquidity risk is concerned, has been prepared with the help of the Association Française de Gestion Actif/Passif, the French association of assets and liabilities managers. Its contribution has been very valuable to highlight the position of the French banking industry.

French banks acknowledge that the text has been streamlined to reflect common understanding of stress testing. It gives a comprehensive description of the industry best practices in this field. They support the approach taken by the CEBS with its emphasis on a flexible, appropriate and proportionate approach under the responsibility of the institutions. Nevertheless, there are a few issues that, in our opinion, remain to be resolved or that may be improved by the CEBS to provide a better definition of stress testing.

Moreover, French banks are concerned by the fact that the consultation paper is mainly focused on credit and liquidity risk stress testing, but does not address in a consistent manner operational risk stress testing. French banks believe the draft could be improved to reach a better common understanding. Therefore, they provide the CEBS with a draft that could complement the CEBS proposal in this particular field.

The French Banking Federation is committed to building a level playing field that an adapted regulation can contribute to create. FBF is at CEBS' disposal for any further discussion on these issues.

Please find our detailed comments attached.

Yours sincerely.

Pierre de Lauzun

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RESPONSE TO CONSULTATION PAPER 12 (CP 12)
ON STRESS TESTING UNDER THE SUPERVISORY REVIEW PROCESS

1- General comments

The French Banking Federation (FBF) appreciates that the CEBS has devoted considerable effort to sum up its views on stress testing under the supervisory review process and to submit it to the industry for consultation.

The French Banking Federation welcomes much of the material included in the CP12 on stress testing with its emphasis on a flexible, appropriate and proportionate approach under the responsibility of the institutions. It wishes to highlight the significant progress made by the CEBS in this field giving banks a clear description of stress testing. The CP12 is a pedagogical work that will be useful for every bank especially those who are not familiar with stress testing.

French banks agree that stress testing is an important component of the risk management process and an input into the risk appetite assessment and the capital management.

French banks acknowledge that the text has been streamlined to reflect common understanding of stress testing. It gives a comprehensive description of the industry best practices in this field. But there are a small number of issues that, in our opinion, remain to be resolved or that may be improved by the CEBS to provide a better definition of stress testing.

2- Specific comments

French banks strongly support the proportionate approach described in ST1. They agree that the stress testing process should not be done according to a "tick box" approach but that stress tests should be defined by the bank itself according to its size and complexity. The list of stress tests given in the CP12 may not be relevant for every bank, especially the smallest ones. Even if it may sometimes look like a catalogue of prescriptions, the regulators should not expect banks to perform all the stress tests described in the document. French banks strongly support the ST2 wording "banks should conduct stress tests on all the risks they have identified as material".

Those of our members that operate in different EU countries are particularly concerned by the fact that stress testing should only be done at the top consolidated level and that the home regulator should be responsible for the stress testing of the whole group. They insist upon stress testing to be aligned with SREP and ICAAP as stated in ST6. They think that stress testing should be supervised by the home supervisor and this should be asserted in the final paper. "ST6: Stress testing should in principle be applied at the same level as the ICAAP under the responsibility of the lead (or consolidated) supervisor. EU countries must also reach an agreement with regulators outside EU because ICAAP and stress testing will be done at the top consolidated level.

The first line of defence in the case of stress testing should be the net income for the year or the capacity of the bank to withstand losses without impacting very significantly bank's income (beyond market expectations). Every institution should be free to define the level of loss it can bear. Before considering capital, which is deemed to cover unexpected losses, banks must rely on their recurring profitability to cover losses resulting from stress tests (§30).

To comply with ST 7 and §34, it will be helpful if the regulators could provide banks with time series of estimated parameters which could be used as a reference when data is scarce.

Stress testing gives a good opportunity for the management body of the bank to clarify its risk appetite and the remedial measures it should take when deemed appropriate. There should be no extra automatic increase in the capital required by the regulator but a range of actions or remedial measures taken by the management body. The building up of an additional capital buffer is only one of the last remedial measures to be taken as stated in ST14.

Regarding the annual assessment of the adequacy of the stress testing process (§48), French banks believe that the text should be streamlined. Although they agree that yearly review may be appropriate for scenarios and parameters, it is clearly unnecessary to require a reassessment of the whole process.

As far as ST20 and ST21 are concerned, French banks think these proposed guidelines relating to Large Exposures should not take place in the Stress Testing document because they relate to a very specific factor which could affect the value of collateral. In their opinion, these guidelines should take place in Pillar I or in the Large Exposures rules. Moreover, stress testing of the realisable value of financial collateral is burdensome.

3- Stress testing and operational risk

French Banks appreciate the CEBS work on stress testing and they have endeavoured to provide as much constructive input in their response as possible on one particular issue. Regarding operational risk stress testing, they believe the draft could be improved to reach a better common understanding.

They are concerned by the fact that the consultation paper is mainly focused on credit and liquidity risk stress testing, but does not address in a consistent manner operational risk stress testing. Operational risk is only mentioned in §89, stating that: *"... some risks are more qualitative in nature and therefore cannot be measured exactly. (...) Nevertheless, CEBS's guidelines on the application of the supervisory review process state that risks which are not precisely quantifiable should be included in the ICAAP if they are material. Stress test according to Section III of these guidelines could be a means to arrive at such an assessment. Examples of such "impossible to be modeled exactly" risks could be (...) some kinds of operational risk (e.g. legislative risk)...".*

Other major examples of risks of the same category are "major shocks": natural disasters (e.g. tsunami, catastrophic floods), terrorism, pandemia (e.g. avian flue). Consideration of such risks is, in their views, relevant for all institutions and can be approached only through stress testing techniques; these risks should then be assessed in a forward looking manner as part of the Pillar 2 ICAAP.

Operational risk stress testing for "major shocks" also raises the same type of questions, and is strongly inter-related with credit risk and liquidity risk stress testing (§87 underlines that operational risk may be a source of liquidity risk). Similarly, various scenarios considered for operational risk, especially "major shocks", would impact earnings through operational risk, credit risk, liquidity risk, and even market risk for some of them. Lack of guidance on such operational risk stress testing could affect negatively the institutions if:

- Some regulators consider that operational risk is not or less concerned by the guidelines, and issue consequently complementary guidelines or requirements that are not consistent between countries;
- Some regulators incline to consider that potential impacts on capital resulting from operational risk stress testing for "major shocks" are to be dealt with in Pillar 1 rather than in Pillar 2 – even though the related scenarios are similar by nature to Pillar 2 stress tests for credit and liquidity risks;
- Some institutions take advantage of operational risk stress testing not being addressed in the guidelines to minimize the work carried out on that subject, leading to a potential underestimation of some critical risks at the systemic level.

French banks thus consider that operational risk should be addressed with the same level of detail than credit and liquidity risk in the future Guidelines on Stress testing. This objective could be achieved through:

- Adding another sub-section in section IV: "Stress testing guidelines by risk categories", that could be: "4. Operational risk", whereas "Liquidity risk" would be assigned the rank of sub-section 5;
- Adding another annex on operational risk, similar to the one dedicated to Liquidity risk (Annex 1).

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With regards to the proposed sub-section "4. Operational risk", they suggest the following being addressed:

- Definition of operational risks types that are to be considered by all institutions through stress testing, especially "major shocks" as defined above;
- Proposed guidance, similar to some extent to those proposed for macro-economic stress tests in §52-53;
- As major shocks scenarios will impact an institution earnings through various types of risks (credit, operational, market, liquidity), the methodology should specifically address the risk of taking into account the potential consequences on capital through multiple (and duplicated) ways. Typically, scenario tests on major shocks encompassing all types of risks should be preferred to scenario tests specialized on each type of risk.

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With regards to the proposed new Annex ("Examples concerning Operational risk"), French banks suggest to consider the following as a possible content:

- Some elements to be considered for building scenarios on operational risks' "major shocks" (if specific operational risks scenarios are preferred), or for addressing operational risks issues as part of scenario tests on "major shocks" encompassing all types of risks;
- Examples of reasonable assumptions when assessing the impact of these scenarios on the institutions (e.g., impacts on clients, staff, suppliers and competitors; on assets; on markets' access; on earnings, etc.)
- Examples for elements of mitigating controls and organizations (e.g., business continuity planning, insurance policy, resilient organization)

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The proposed modifications should be reflected in the Executive Summary and Definitions sections as follows:

In §10, p. 3, second bullet: "In general terms, the stress testing of market risk is at a somewhat more advanced stage than those for other kinds of risk (e.g. credit***, operational*** or liquidity risk). In contrast, some small institutions have no stress testing arrangements at all. Given this and the new CRD requirements, the development of guidance, in particular for credit***, operational*** and liquidity risk and for group-wide tests is both necessary and desirable."

In §19, p. 6: "The guidelines for Pillar 2 stress testing set out in section III of this paper in principle also hold true for credit***, operational*** and market stress testing but do not override any specific provisions of the CRD."

In addition, introductory paragraph of section IV (§49, p. 14) should be completed as follows: "The following section details some of the stress test requirements of the CRD elaborating specific guidelines for macroeconomic stress testing and stress testing by risk categories (market risk, liquidity risk***, operational risk*** and credit risk) and, where necessary, considers the interaction between Pillar 1 and Pillar 2 stress testing.

4- Liquidity risk/funding

French banks welcome the fact that most of the guidance reflects industry's understanding of stress testing the liquidity risk. They fully agree with § 82, 83, 84, 85, 86 and 87.

§ 88 states that supervisors may perform their own stress tests for internal purposes only. On their side, banks perform liquidity stress tests. As the results of supervisor's tests give an external point of view on the liquidity situation of the bank, it could be appropriate to discuss them with the bank, as part of SREP.

French banks wish to emphasize their belief that the outcome of any liquidity tests should not result in capital add-ons, but rather be fully considered in the process defining the liquidity management and the funding policy, this process being part of the SREP dialogue.