POSITION PAPER

ESBG Response to

CEBS Consultation paper on draft revised guidelines on stress testing

(CP 32)

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The European Savings Banks Group (ESBG) welcomes the opportunity to comment on CEBS' Consultation Paper on draft revised Guidelines on stress testing (CP 32).

General approach

ESBG generally welcomes CEBS initiative to update the 2006 Guidelines on stress testing by incorporating lessons from the crisis, with a view to improving the effectiveness of stress testing procedures. ESBG also supports the objective of the revised guidelines to better integrate stress testing in banks' risk governance and risk management, as well as to further develop stress testing models.

However, ESBG would like to highlight that a too strong emphasis on the financial crisis (as apparent in § 48, 67) should be avoided as it is likely to bias unnecessarily the final guidelines.

Also, ESBG would like to stress the importance of maintaining a principles-based approach to stress testing. Too prescriptive rules would not bring any added value and risk standardising an area where this would be only detrimental.

Also, it should be made clear from the outset that stress tests do not have the capacity to provide for absolute safety. Too much reliance on stress testing creates only the appearance of safety, as stress testing will never be able to completely anticipate discontinuities in the markets.

Implementation

CEBS requires that the guidelines be implemented by 30 June 2010, although it admits that some aspects might require important changes and would therefore need to be phased. ESBG would like to highlight that such tight implementation deadline might be problematic for many banks, especially for small retail banks that lack resources. Therefore, ESBG calls for such deadline not to be mandatory, but merely an indicative timeline for the transposition of CEBS guidelines in national regulatory frameworks. For their actual application it would be much more realistic to consider the end of 2010.

ESBG also particularly welcomes the requirement in § 12 that national supervisors should provide the supervised institutions with sufficient flexibility as regards the implementation of specific aspects of the guidelines.

Proportionality principle (§ 9)

It appears that the guidelines on stress testing are becoming ever more relevant also for smaller institutions, depending on the individual risk profile and the business model. In this sense, ESBG welcomes the enshrinement of the proportionality principle in § 9. However, proportionality should not only apply by reference to the size and risk profile of institutions, but also to the relevant risk types. Furthermore, it should be clear that the proportionality principle applies as regards the methodology, as well as the frequency and the degree of detail of the stress tests: these should be adequately proportionate to the existing and possible future risks.

Consequently, under the proportionality principle, it should be possible for smaller institutions to comply with the requirements for stress tests by using simple methodological approaches – such as sensitivity analysis. ESBG welcomes that CEBS recognises this explicitly. However, ESBG invites CEBS to delete the additional proposed requirement that small banks should still consider interactions between individual risks, as this would be completely incommensurate.

No capital requirements to be derived from stress testing results (§ 11)

In order to avoid the wrong incentives in the choice of stress scenarios, it is necessary that the results of stress tests are not binding for determining capital requirements. Capital requirements, as well as the potential additional capital needs are important aspects in the process of capital planning and risk management and banks should be able to decide upon them individually and independently. Capital requirements and capital resources should not be mandatorily determined on the basis of stress test results.

ESBG therefore invites CEBS to delete in § 11 any idea of a dependence of capital requirements from stress testing results. It should be clear that the results of stress tests should not be mandatorily used for determining the capital requirements under Pillar 1 and Pillar 2. This would avoid creating wrong incentives to conduct moderate stress tests.

Specific remarks

Section 2 – Governance aspects of stress testing and use (Guidelines 1-5)

§ 24: In ESBG's view it is reasonable that capital and liquidity requirements are reviewed internally, upon the bank's decision. Yet, as already indicated, we don't think it is reasonable to derive capital requirements from stress tests, as suggested in § 24. Each institution should be capable of deciding for itself to what extent it will integrate the results of stress tests into its risk architecture. As already highlighted, imposing a mandatory link between capital requirements and stress tests would create wrong incentives as regards the choice and translation of stress scenarios.

§ 29: CEBS requires that the quantitative review of the stress testing programme should include benchmarking with other stress tests within and, if possible, outside the institution. However, stress tests are effective especially if they are tailored to a specific portfolio. An external benchmarking would be of no use. Therefore, we suggest that this requirement be deleted.

Section 3 – Stress testing methodologies (Guidelines 6-11)

§ 34: ESBG questions the added value of introducing (too many) stress tests with different degrees of severity. Sensitivity analyses, which concern only one or a few risk drivers, are by definition easier to conduct and to conceive. What really matters is to deepen the analysis undertaken through the basic stress tests and to concentrate on the interpretation of results. The absence of such in-depth analysis could not be compensated by increasing the number of stress tests.

For example, institutions should be able – depending on the specific risk situation and the concrete portfolio – to decide themselves, whether there is need for additional sensitivity analysis, once all scenario analysis have been undertaken. This is particularly important for determining the necessity of analysis at portfolio level.

§ 39: Similar to the case of sensitivity analysis, ESBG questions the added value of a multitude of scenarios. The additional costs would be justified only if such multiple stress scenarios could demonstrate a clear usefulness in the risk management framework. Contrary to sensitivity analysis, scenario analysis is much more complex and would involve significantly higher technical and personal resources. Therefore, ESBG calls for the listed scenarios to be seen only as examples. It should be left to the institutions to determine which scenarios are the most relevant and necessary for them.

§ 51 and 54: CEBS explicitly requires institutions to consider "a more severe stress scenario" for their capital requirements and resources over a plausible macro-economic base case. However, in practice, whether the determination of the capital needs of an institution depend or not on a scenario analysis, is established essentially in the internal procedures of the institutions. Internal decisions of an institution (e.g. portfolio structuring) do not entail, as a rule, the consideration of stress situations.

§ 57-61: ESBG takes the view that reverse stress tests are very hard to apply in practice, especially for smaller and less complex institutions. Because such reverse tests are particularly sophisticated they entail an additional burden and costs that should not be underestimated, and may not be justified through the marginal additional findings they might produce. Therefore, ESBG calls for the deletion of the relevant paragraphs.

Section 5 – Outputs of stress testing programmes and management intervention actions (Guidelines 14-17)

§ 97: CEBS requires that supervisors assess the feasibility of proposed management actions in stressed conditions. ESBG considers that such assessment is hardly possible, as there is no automatism between a certain stress test result and the derived corrective measure. The concrete management measure that will be taken under real stress conditions ultimately depends on a multitude of factors that cannot be caught in stress tests and often cannot be established in advance.

Section 6 – Supervisory review and assessment (Guidelines 18-22)

§ 104-106 (Guideline 22): The indication of general scenarios for the conduct of stress tests by the supervisors can, from our point of view, constitute a good basis for deriving institution-specific stress tests. It would be particularly helpful especially for smaller institutions to build on the scenarios proposed by the supervisory authorities, provided that – following individual reviews – these are considering comprehensively the material risks of the institution. In addition, further institution-specific scenarios should be admissible.

About ESBG (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 € 6061 billion (1 January 2008). It represents the interest 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 organized in decentralized 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.

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