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Consultation paper "CEBS Guidelines on Stress Testing" (CP 32)

Dear Sir or Madam,

On 14 December 2009, CEBS published a consultation paper entitled "Guidelines on Stress Testing". We have pleasure in taking this opportunity to comment.

General observations – Section 1

Fundamentally, we consider it appropriate to derive principles-oriented recommendations from the experience gained with regard to the efficiency of stress testing, which is definitely in need of improvement. Moreover, we share the rationale of the paper to integrate stress testing to a greater extent in risk governance and risk management and to develop stress testing models further. In general, however, we consider that too strong a focus on the financial crisis should be avoided (e.g. points 48, 67) so as not to narrow the perspective unnecessarily.

On the other hand, we see a particularly urgent need for adaptation concerning the following points, since the requirements are disproportionate:

1) Participation of the management or the supervisory board in the stress testing programme

It is true that the board will define scenarios and have key results reported to it, but for large and complex institutions full involvement of the management body in the design and implementation of a stress testing programme is not practicable. The involvement of the board should be inversely proportional to the size of the institution: the larger the institution, the more extensive the delegation of the stress testing programme to the senior management and committees will be. The definition of “management body” should therefore also include the stress testing committees.

2) Capital buffer derived from stress testing results

The results of the stress tests may not be used to establish binding capital buffers in order to guard against wrong incentives in scenario selection. Capital buffers and potential capital add-ons are important aspects in the capital planning process, but it should not be mandatory for them to be determined on the basis of the results of a stress test. Only where other measures (e.g. portfolio restructuring) are no longer effective could the stress test results be used for the formation of capital buffers.

3) Stress testing at individual and group levels

From control and resources points of view, we reject the carrying out of separate stress testing programmes at the level of groups and individual institutions. It must be possible for the institution to determine the granularity of the stress tests individually and flexibly, depending on its business model. In general, when assessing the need for stress tests at subsidiary level, consideration must be given to the possibility of capital transfer within a group.

In our estimation, the fundamental orientation of a bank in the context of the capital and liquidity planning process must as hitherto be based on the respective regular risk measurement procedure. This includes, in particular, the definition of the risk profile and the configuration of the limit system. Stress tests serve to assess from a different perspective the fundamental orientation of the bank formed on the basis of the traditional risk measurement procedure. Unfortunately, no substantial comments are made on the relationship between traditional risk measurement procedures and stress test analyses.

In our opinion, the quantitative results of the stress tests should under no circumstances be used for the capital requirements in Pillar I or Pillar II, as otherwise there is an incentive to carry out only moderate stress tests. To this extent, we reject the ideas expressed in point 11, inter alia, concerning the capital buffer as a function of the stress test results. Capital buffers and capital add-ons are a risk management tool for banks which they should use individually and independently.

In principle we caution against the belief that stress tests would be able to ensure absolute security. Excessive confidence in stress tests ensures only apparent security, since future market discontinuities and disruptions can never be entirely anticipated.

The required calculations of bank-wide stress scenarios in general and the call for flexible platforms, as formulated in concrete terms in Guideline 2, lead to very substantial capital outlay and permanent high costs for IT systems, which in our view are not matched by any corresponding benefit. In addition, the requirements will greatly increase the complexity of the IT through a data warehouse covering the institution as a whole. Moreover, its realisation will presumably take several years. We therefore ask for these requirements to be abandoned and to build on existing IT systems.

Depending on the risk profile and business model, consideration of most of the principles should be entirely relevant and necessary for smaller institutions too. All the same, we welcome the direct mention of the principle of “proportionality” (point 9). However, this should relate not only to the size of the institutions and their risk profile, but also to the respective risk types. Furthermore, the principle of proportionality applies equally to the selected methodology and to the frequency and level of detail of the stress tests: these should be proportionate to the existing and possible future risks.

For smaller institutions, it should therefore be possible, with due regard for proportionality, to satisfy the stress test requirements using simplified methodological approaches – e.g. sensitivity analyses. This is also conceded by CEBS (point 9). The recommended extension to consideration of interactions between individual risks is however inappropriate for small institutions and therefore deleted. In general, it should be borne in mind that full consideration of interactions between individual risks is not possible on account of the large number of risk factors and the complexity of the markets.

The statement in point 8 that these CEBS Guidelines do not introduce new Pillar I or Pillar 2 guidance is not comprehensible for us. We ask for clarification.

The proposed amendments in some cases entail a comprehensive need for adaptation in the institutions. This is particularly true with regard to the above-mentioned IT conversion. Since the Guidelines have not yet been finalised and represent a clear extension compared to the existing regulations, the deadline for implementation is far too short. We call for application of the innovations not before the end of 2010. It should at least be clarified whether the deadline mentioned of 30.06.2010 refers to the strived-for time of transposition in the respective national legislation or implementation of the new rules in the respective banks.

For the final version of the Guidelines, we recommend striving for a shorter, more concise and less repetitive presentation.

Specific observations

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

Point 16

According to point 16, the management body is to be included in the discussion of modelling assumptions and scenario selection. Moreover, it is to be involved in the assessment of the assumptions about correlations in a stressed environment. We consider that these specifications clearly go too far, especially as suitable benchmark assumptions are currently still controversial even among experts. It is true that the management body will specify scenarios and have key results reported to it, but for large and complex institutions, full inclusion of the management body in the design and implementation of a stress testing programme is not practicable. Admittedly, the chief risk officer (CRO) of an institution has a more detailed understanding of the stress testing procedure compared to the rest of the management body. However, even for the CRO detailed knowledge within the meaning of the CEBS specifications cannot be expected.

The involvement of the management body should be inversely proportional to the size of the institution: the bigger the institution, the more components of the stress testing programme could be delegated to senior management and committees. Since stress tests are to identify weaknesses specific to each institution, inter alia, it is appropriate to divide the responsibility for the stress testing programme between different levels. The responsibility for the stress testing programme should lie with the management body, the management responsible for risk control and where appropriate stress testing bodies and committees. Notwithstanding these restrictions, the chief risk officer of an institution is in a position to comply with the specifications mentioned.

Point 24

We consider the responsibility of the management body/senior management for taking all decisions for the entire stress testing programme to be unrealistic. First and foremost, decisions of the corresponding level of management must be influenced by stress tests. An escalation to higher levels of management should occur in cases where the consequences of the outcome are greater.

In principle, we consider an internal review of capital and liquidity requirements left to the decision of the bank to be appropriate. We do not consider it appropriate for it to be mandatory to derive a capital requirement from stress tests (point 24 e). Each institution should be able to decide for itself the extent to which the outcome of stress testing is reflected in its risk architecture. A capital buffer based on stress tests would give rise to wrong incentives in scenario selection and implementation.

In addition, stress tests are the wrong tool for mandatory capital planning since the probabilities of occurrence of stress situations as a rule cannot be quantified. Complex macroeconomic relationships can never be modelled completely and in every possible configuration and so interactions of individual risks cannot be covered to the full extent by stress tests. The call so far to improve capital adequacy, for example with the help of the VaR model plus stressed VaR, should be quite sufficient and provide sufficient cover for tail risks, for example.

Furthermore, it should be formulated more clearly that implementing contingency plans is only one of many possible actions. The current formulation could give the impression that contingency plans must be introduced for all risk types. This would not be appropriate.

Conceptually, the idea that the institution should take possible management actions is reasonable. However, this could lead to automatic behaviour not adapted to the special circumstances in situations of extreme stress. If various institutions have developed the same ideas and concepts beforehand, this may lead to reinforcing and accelerating a crisis. It is precisely getting a contingency toolbox ready which psychologically leads to the blind application of the tools it contains. For this reason, concrete fixing should not be obligatory. Furthermore, consideration of the actions of other institutions cannot be guaranteed sufficiently on account of the resulting complexity. These aspects should be revised and tightened up accordingly.

Point 29
For the review of the quantitative processes, use is to be made of benchmarking with other stress tests within and if possible outside the institution. Stress tests provide additional insight especially if they are tailored to the respective portfolio. In our opinion, external benchmarking of the stress testing programme is not feasible or only appropriate in part. The requirement should be deleted for this reason.

The department of a credit institution competent for methods and processes, e.g. risk control, is responsible for the design of the stress test and its ongoing review (assumptions, effectiveness, methods, etc.). Separate from this, the task of the internal audit is to examine and evaluate all activities and processes of a credit institution independently of the process on the basis of a risk-oriented procedure. On account of the growing importance of stress tests, this subject is given due consideration by the internal audit with regard to depth, scope and frequency of examination. However, the impression should be avoided that the internal audit of a credit institution is made responsible for the regular review of the stress testing concept. Validation and review take place primarily in risk control.

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

Guideline 6 (Sensitivity analysis) and point 34
The additional benefits of the introduction of (too many) stress tests with varying degrees of severity are questionable. Sensitivity analyses which relate to only one or a small number of risk drivers are by definition simpler to carry out and present. But here too it seems far more important for basic stress tests to deepen the analysis and to concentrate on the interpretation of the results than to tie up resources by increasing the number of stress tests.

Depending on the specific risk situation and the concrete portfolio, the institutions should for example be able to decide themselves whether additional sensitivity analyses are necessary, if scenario analyses are already carried out. This is particularly applicable regarding the need for analyses at portfolio level.

Point 39
As in the case of sensitivity analyses, the additional benefit from multiple scenarios is questionable. The additional expenditure is justifiable only if there is a clear benefit in the risk management context. In contrast to sensitivity analyses, scenario analyses are complex and involve considerably higher expenditure on technology and human resources (also see comments on point 34). In this respect, the scenarios mentioned should be inter-

preted only as examples. Besides, it should be left to the institution which scenarios it considers to be appropriate and necessary.

Point 39(c)

In our opinion, depending on the complexity of the internal capital model, concentration risks are already considered by corresponding risk allocation procedures within the individual risk types. We consider inter-risk-types concentration measurement to be hard to implement, since no standard has been established so far in practice. The implementation will in many cases relate to individual cases.

Point 39(d)

We request an explanation of the concept “narrative scenario”.

Point 39(f)

According to point 39(f), it is a task of the stress testing to identify valuation interactions between newly developed and established products. We consider this not to be a task of stress testing, but a task which must be carried out in the context of the new product process and not on the basis of stress test analysis. Point 39(f) should therefore be deleted.

Point 47

According to point 47, the stress tests should be “streamlined” in the case of complex institutions too. We consider this specification to be unrealistic. The complexity of larger institutions must be reflected appropriately in the stress tests. Complex institutions generally speaking also need complex stress testing programmes. This point should be deleted.

Points 48 and 49

It is understandable that stress testing programmes should contain future-oriented scenarios including the effects of a recession. Nevertheless, the requirement to consider system-wide interactions and feedback effects is unrealistic. Even if only qualitative assessments are required for these interactions, this requirement far exceeds the possibilities of stress tests.

The difference between “adverse feedback dynamics” (must be analysed quantitatively) and “second order effects” (qualitative analysis is sufficient) is not sufficiently clear. On account of the different specifications for the two types of effects, clarification based on an example would be desirable.

Points 51 and 54

The explicit demand is made for the capital requirement to be based on a "more severe stress scenario". Whether establishing a capital requirement is to be based on a scenario analysis essentially depends on the institution's internal procedures. Decisions within the institution (e.g. portfolio restructuring) as a rule result in the stress case not occurring in the first place. Should these measures no longer be effective, the effects of a severe scenario can be cushioned by a capital buffer.

Points 57-61

In our opinion, the use of reverse stress testing is impossible in practice. In view of the high complexity and cost of implementation which should not be underestimated, the additional findings from this stress testing are marginal. We therefore advocate the deletion of these points.

Irrespective of this position of principle, it should be examined to what extent risks which in general are not to be underpinned with capital (such as the liquidity risk, for example) are to be considered. We expressly welcome the explicit mention that no capital add-ons are to result from reverse stress testing. Regularly should be interpreted to mean a maximum of once a year.

Section 4 – Portfolio, individual risk and firm-wide stress testing (Guidelines 12-13)

Points 66 and 68

The definition of "firm-wide" cannot be inferred from the statements of the consultation paper. In its broadest definition, it could refer to legal entities, which means that no distinction is made between a banking group or its parent company and the subsidiaries of foreign banks. It is expected that requirements for a parent company of a group generally differ from those for subsidiaries. In particular, the requirements for group subsidiaries should be considered to be satisfied by corresponding processes at the level of the parent company. For complexity reasons, general application of a full stress testing programme at group subsidiary level is feasible only if uniform stress tests are carried out for all entities of the group. However, this yields no additional benefit compared to the stress test at consolidated level. Generally speaking, compulsory carrying out of stress tests at different levels is to be rejected and left to the choice of the institutions in relation to their business model.

Point 70

An expected loss estimated under the various scenarios is to be an essential output from the stress testing. It remains unclear why the main focus should be on the expected loss at

this point. As we understand it, the expected loss acts at most as a reference value, but is not an essential output from stress testing. We request clarification.

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

Guideline 15 (Management actions)

According to Guideline 15, the institution is to ensure its ongoing solvency through a stress scenario. We consider this to be a dangerous requirement which should be deleted as in this case only moderate tests will still be carried out that with the current capital endowment do not lead to insolvency. Cases are quite conceivable in which stress events may occur which do not necessarily have to be underpinned by capital (e.g. high costs for hedging the event, unlikelihood of the occurrence of the event).

In addition, the effectiveness of management actions and risk mitigation techniques can never be represented in full. Also having to consider the management actions of other institutions in the stressed environment likewise cannot be modelled. This means that there is not much point in considering stress test results on both gross and net bases.

Guideline 16 (capital planning stress tests under ICAAP), points 80-82

A few scenarios such as “severe economic downturn” and “system-wide shock to liquidity” are explicitly mentioned and are to be considered in the capital planning. Irrespective of these scenario examples, we reject this requirement because it postulates automatism between stress testing results and the capital cover for these results. Moreover, in complex organisations, capital planning is already a major challenge and is usually not based on stressed situations. A scenario analysis based on capital planning would further increase the complexity of the analysis. We therefore consider these regulatory requirements to be inappropriate.

With regard to the stress test results, risk management measures to be strived for should be active rather than passive like capital cover. Considering the stress tests in the context of capital adequacy (ICAAP) may not lead to additional capital requirements being derived from stress test results.

Moreover, extreme stress scenarios cannot be underpinned with capital because otherwise a strong curb would be placed on further business activity of the institutions, the credit supply would be made unduly scarce and achieving appropriate profitability in the credit industry would be systematically impeded. However, even in the case of somewhat less extreme scenarios, it must be possible, as a management decision, not to hedge against the

occurrence of the scenario and not to insure the associated probability of insolvency, but to accept it. According to point 25 (last sentence), this should also be possible. The primary management vision based on going-concern considerations must have priority here over the supervision point of view.

According to point 40, institutions should determine the time horizon of the stress testing in accordance with the characteristics of the portfolio, such as the maturity and liquidity of the stressed positions, where applicable, as well as the risk profile and purposes of the particular exercise. In contrast to this qualitative specification, a period of at least two years is now demanded for all capital planning stress tests. Detailed planning with a time horizon of two years, depending on the business field, must be strongly based on assumptions. The validity of stress tests of these plans consequently remains very limited. This provision should be deleted.

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

Guideline 18 (regular reviews of stress testing programmes)
The “regular basis” for the information on firm-wide stress tests should be specified as annually at most. Regular meetings with the supervisors to discuss the stress testing should take place outside official examinations to promote open dialogue.

Point 91
It must be ensured that stress testing does not lead to higher capital requirements under either pillar I or pillar II. Any automatic link between possible stress test results and a potential capital buffer is counterproductive.

Point 97
The supervisors are to assess the feasibility of the proposed management actions in stressed conditions (in connection with Principle 15). In our view, an assessment is possible only with difficulty, since there is no automatism between a specific stress test result and a corrective action to be inferred from it. Which management action is in fact taken in the end in real stressed conditions depends on a number of factors not ascertainable by stress tests and can often not be determined ex ante.

Point 100
Point 100 provides supervisors with the possibility to impose institution-specific capital and/or liquidity buffers on the basis of their own models. We consider it not to be the task of supervisors to set the results of their own models as standards for capital requirements. Implementation and results analysis should be for the institutions to carry out (bank-

driven process) as part of the pillar II processes. The specification of buffers based on own models, on the other hand, changes this approach and is therefore totally unacceptable.

Point 102
For data confidentiality reasons, the stress test results should be disclosed only in the core college and not in the general college. This restriction applies at least for the quantitative part. Qualitative aspects can also be discussed by the general college.

Annex 2 - Securitisation

Securitisation 1
Stress tests in relation to securitisation positions should consider all relevant information regarding the asset pool, contractual arrangements and structural elements. In this connection, we interpret the requirement to focus on the properties of the securitised loans portfolio to mean that it is not required to focus exclusively and in all cases on loan-by-loan data. This is not necessary especially in the case of granular and homogeneous portfolios and not possible especially in the case of loan portfolios with high transfer frequency. There is no discernable additional insight to be obtained from carrying out stress scenarios on the basis of individual loans in these cases on account of their low share in the portfolio and their homogeneity. Accordingly, it must be possible for the purposes of stress tests and on the lines of a look-through, to have recourse to top-down parameters/statistics of the securitised loans portfolios and to analyse their dependence on macroeconomic changes/stresses.

Annex 3 – Credit risk and counterparty risk

Point 5
For the sake of clarity, it should be stated that this does not refer to implementation of a migration mode in a simulation model (e.g. multi-State mode in CreditMetrics).

Annex 4 - Operational Risk

Point 2
The requirement that stress tests must be based on external events is very far-reaching. The causal link that a stock exchange crash causes an increase in litigation cannot be considered to be universally valid. We request deletion or replacement by more plausible reasons.

Point 3

The actual stress test is to account for material changes within the institution, such as new products, systems, areas of business und outsourced activities, and especially in areas with a lack of loss data history be based on scenario analyses. We assume that considering point 3, it is still possible to categorise stress tests according to events and request corresponding clarification.

Operational risk 2, points 5-7

The requirements described in our view in fact refer to the implementation of AMA components (in particular scenario analyses) in non-AMA institutions. We consider the requirements to be problematic in this respect, as the systematic expenditure would increase considerably for these institutions. This is inconsistent with the idea of using a simplified approach according to pillar I. We recommend a reduction in the requirements in respect of stress tests for non-AMA institutions.

The direct correlation between macroeconomic factors and the increase in operational risks is not obvious. We doubt whether a statistically demonstrable correlation exists between an economic downturn and the increase in cases of fraud, and request deletion.

Points 8-12

Stress tests are to be applied to all four AMA elements (internal and external data, scenario analysis, and business environment and internal control factors), which correspond to their specific model. Sometimes the influence of individual components in the supervision model is limited however, such as, for example, the influence of the business environment and internal control factors (BEICF) on the adjustment of the AMA capital. Consequently, the AMA capital cannot be stressed with the business environment and internal control factors. In the United States, the banks are in turn advised not to use the scenarios directly in the model, which likewise leads to problems.

Concrete examples to carry out stress tests are cited especially on loss data and scenario analysis. The listing of concrete examples valid for all institutions is problematic, since not every example can be used in the models of each institution. The recommended actions are too specific, since models used sector-wide react with varying sensitivity to this. “Real” stress assumptions are therefore to be defined specific to the model. Otherwise the requirement is not practicable and should be deleted.

The institution should stress their BEICF taking account of the macroeconomic trends. The validity of the macroeconomic stress tests of the BEICF seems questionable, since

there is no perceivable causal link between the two. The requirement should therefore be deleted.

Annex 5 – Liquidity Risk

Points 3-7

The full loss of funding facilities on the interbank or capital market as an institution-specific scenario is too conservative and not risk-based. The business model in combination with the credit standing of the respective bank should be taken into account.

Points 7-12

There is no perceivable added value from calculating additional indicators on the basis of a stress test. Most of the statutory indicators already include certain rollover assumptions (i.e. they already consider a certain level of stress). This means that the superimposition of the additional stress assumptions do not lead to a valid result. The effects of stress on the liquidity buffer of a bank are already an integral component of the detailed stress test analysis as described in the CEBS framework recommendations on liquidity buffers and the survival period.

Annex 6 – Interest rate risk in the banking book

Point 2

We request clarification of the extent to which the requirements are linked to the Basel interest risk coefficients.

For further questions we are always prepared to support you with detailed information.

Yours faithfully,

On behalf of

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