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CEBS
via email: cp32@c-ebs.org
CC: Mr. Arnoud Vossen

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Reference BR1108

Subject: NVB reaction to CEBS Consultation on stress testing

Dear Sir, Madam,

The Netherlands Bankers' Association[1] (NVB) welcomes the opportunity to comment on CEBS Consultative paper 32 on Stress Testing. Stress testing is an area that receives a lot of attention from banks. It can be a very valuable tool to learn more about the specifics of an organisation and the possibilities for management to intervene in cases where adverse developments materialise. In that sense, stress testing prepares the bank to properly manage low probability high impact conditions, and ads to the stability of the individual bank and the financial system as a whole. Stress testing is an area that can be regarded both as an art and as a science; there are no straightforward ways for setting up good stress testing practices. As a result of the crisis, stress testing now receives a lot of additional attention. We appreciate that CEBS took this opportunity to formulate best practices in the area of stress testing. However, we also have a number of remarks.

Introduction timelines
Regarding the timing of the implementation of the guidelines; setting June 30th as the deadline leaves almost no room for banks to implement the guideline, if they do not already comply. Taking into account the expected throughput time that CEBS requires after the deadline for the submission of reactions, banks will only have one or two months to implement the guidelines after they have become final. This is a very short timeframe! We therefore suggest postponing the introduction until January 2011.

Stress testing and Sensitivity analysis
The document appears to cover two distinct areas that are related; stress testing and sensitivity analysis of risk drivers. We would like to point out that – although these items are related – they are different processes with different objectives.

[1] The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

Summary of existing practices
In general we feel that the consultative document is a summary of existing practices and requirements. It closely resembles the Basel Committee paper bcbs155 '*Principles for sound stress testing practices and supervision*'; although some of the existing requirements are made stricter.

On a more detailed level we have a number of comments and concerns. These will be discussed in the detailed observations.

In case you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,

Onno Steins
Advisor Risk Management

Appendix - Detailed Observations

In paragraph 16, CEBS mentions that:'*…However, the management body (or relevant designated committee) should actively participate in the design of the programme in particular scenario selection…*' We welcome the remark that the management body may delegate the responsibility to senior management, as this is in line with common business practices and the required level of expertise.

With regard to Guideline 5: '*The institution should regularly review its stress testing programme and assess its effectiveness and fitness for purpose.*' we are unsure how effectiveness is defined, as this can only really be tested when the next crisis emerges. How should the effectiveness be monitored? Does this mean that the beginning of 2008 will become a new stress testing scenario, like 'black Monday'?

Paragraph 29 '*The effectiveness and robustness of stress tests should be assessed regularly, qualitatively as well as quantitatively, in the light of changing external conditions to ensure that they are up-to-date. An independent control function such as internal audit should play a key role in the process. The quantitative processes should include benchmarking with other stress tests* ***within and, if possible, outside the institution****.*' mentions that institutions should, if possible, benchmark their stress tests outside the institution. Contrary to operational risk, there are no external databases for stress testing. Although we see the added value of an external benchmark, we wonder how this requirement can be satisfied in practice.

In Guideline 7, paragraph 39a, CEBS mentions that '*a. Address all the material risk types of an institution (e.g. credit risk, market risk, operational risk, interest rate risk and liquidity risk). No material risk type should be left unstressed or unconsidered.*' With regard to the material risk types we feel that these should be identified by the sensitivity analysis. After this identification step, the stress test should follow, uncovering the losses that would occur in a stress scenario that affects the banks' weakest points.

Guideline 8: '*An institution should identify appropriate and meaningful mechanisms for translating scenarios into relevant internal risk parameters that provide a firm-wide view of risks:*' Although we agree with this guideline, it will be very hard in practice to implement this guideline, as it requires an institution to translate economic scenario's into risk drivers.

Guideline 9 '*System-wide interactions and feedback effects should be incorporated within scenario stress testing.* ': this is tough to estimate in practice, as this guideline refers to second order effects. Second order effects are usually hard to estimate. Taking the recent crisis as an example, it was observed at the start of the crisis that interbank markets dried up and interbank interest rates increased. At a later stage, there was a cross over to the real economy, from what started out as a financial markets crisis. Such a scenario is very hard to predict. As a result, people may be tempted to use the recent crisis as the basis for a scenario, extending the period where interbank markets dry up. This raises the question whether the next crisis will have the same characteristics as the previous one. Observed examples of adverse feedback dynamics are the lowering of interbank limits that was seen during the crisis and the increase of interbank rates. It is not clear to us whether this guideline would include management actions as well. We request CEBS to clarify this point.

With regard to Guideline 10: '*Stress testing should be based on exceptional but plausible events. The stress testing programme should cover a range of scenarios with different severities including scenarios which reflect a severe economic downturn*': we wonder what is considered a plausible event. Looking at the actual events that were observed during the crisis, stress situations occurred that were previously deemed impossible. What kind of scenarios should institutions set up? What kind of scenarios would meet the requirements? In our view, it should be avoided to require scenarios that nobody believes, as this does not add credibility to stress testing.

In paragraph 51 it is mentioned that stress tests and sensitivity analysis should have multiple degrees of severity. Our expectation is that this means that there will be different scenarios that are performed on a Group-wide basis. Sensitivity analysis uses multiple degrees of severity, while for firm wide stress tests it is more important to test different stress scenarios. With regard to the sensitivities, a range of severities can be applied. It is not the intention to perform group-wide scenarios at multiple levels of severities; the power lies in performing many different scenarios. Combining the two - multiple scenarios at multiple degrees of severity – would make stress testing a calculation exercise instead of an important risk management tool.

Paragraph 57: '*Reverse stress testing consists of identifying a scenario or combination of scenarios that lead to an outcome in which the institution's business plan becomes unviable and the institution insolvent, i.e. stress events which threaten the viability of the whole institution, as well as assessing the probability of realisation of such scenarios*': in our view, performing this exercise will create interesting opportunities to learn about your company. However, the requirement also creates a problem, as one can think of a lot of scenarios. Should an institution shock its risk drivers by such an amount that your company can no longer sustain the losses, for instance? Using extreme values for each risk driver based on the sensitivity analysis may not result in insolvency of the institution as a result of diversification benefits. The same issue applies to paragraph 58, where no concrete guidance is given. We therefore ask CEBS to provide additional guidance on these two paragraphs.

With regard to the second order effects that are mentioned in paragraph 61: '*……Even in a qualitative sense, the impact of macro-economic shocks on an institution's solvency should consider first and second round effects*', we note that these effects are very hard to assess in practice.

Looking at Guideline 14: '*An institution should identify outputs in relation to its regulatory capital and resources, and also relevant balance sheet and P&L impacts, as a result of its stress testing programme.*' it is not clear to us how this guideline should be applied. We ask CEBS to provide additional guidance on this guideline. Does it only refer to scenarios, for instance?

We fully agree with Guideline 15: '*Institutions should identify credible management actions addressing the outputs of stress tests and aimed at ensuring their ongoing solvency through the stressed scenario*'; this is the most important reason why banks use stress tests.

Guideline 17: '*Capital planning stress tests should be consistent with an institution's risk appetite and strategy and contain credible mitigating management actions*' provides a very good instrument to test your risk appetite.

With regard to paragraph 15 in Credit risk 2: '*Stressed LGD rates should reflect downturn conditions; if observed LGD rates for a given obligor cohort are higher than those implied by the downturn LGD figures, then the stress tests should, at a minimum, be updated to include the observed conditions and perhaps should also include scenarios where LGD rates deteriorate even further*' we wonder if institutions are asked to apply an additional level of stress to the downturn LGD in a crisis situation, or if they should you use a different value for the stressed LGD altogether in such a situation?