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31 March 2009

Re: Consultation Paper 08/24: Stress and scenario testing

Dear Rory,

The joint associations (BBA, ISDA and LIBA) welcome the opportunity to comment on the FSA's consultation paper entitled "Stress and scenario testing" (CP08/24), and we are happy to participate in and contribute to on going discussions with the Bank of England and the FSA.

The paper has resulted in a useful interchange among our respective members. We found the FSA's observations on stress testing helpful and thought-provoking, but we believe that there is scope for providing further clarity and to develop an enhanced regulatory framework that balances the need for better industry practices with a sensible, pragmatic approach to regulation. We also believe important improvements to the draft guidelines will help achieve the shared objectives of the both the industry and the regulator.

Stress testing is an important tool for firms and is an evolving area with current significant challenges in firm's stress testing methodologies, scenario selection and governance processes. We understand the FSA's desire to promote good industry practice among firms and encourage UK firms to amend identified shortcomings both in their stress testing frameworks and those identified by the stress test. We welcome a regulatory approach that takes into account the nature, scale and complexity of firms.

We discuss a number of issues that have been raised by the consultation in this cover letter but the three key messages we most wish to draw to your attention are:

Reverse Stress Testing: We seek further clarity from the FSA on their intent in this area. Broadly we understand the general principles underlying the FSA's proposals, but in practical terms firms have reached very different interpretations of the FSA's requirements. Consequently there is not yet sufficient understanding of the FSA's requirements for firms to gauge whether the firm's interpretation of what is reasonable and achievable would match the FSA's expectations. Many of our members suggest that a fruitful way forward would be to identify the key assumptions underpinning a firm's business model and stressing these factors. We look forward to continuing to work with the FSA on this subject. We do not believe a regulatory requirement to run a reverse stress test should result in a hugely quantitative process focussed on attempting to predict the future.

International Dimension: London is a global financial centre, home to very many globally active firms. We continue to place a central priority on the importance of the FSA maintaining an approach that is broadly consistent with the international regulatory treatment on stress testing. This will strengthen global risk management practice and support firms in improving their group risk management practices. We note in particular that the application of detailed stress testing to a solo UK entity may not always be meaningful and we suggest that primary stress testing should be applied at the consolidated group level. The CP has raised some concerns that the FSA proposals go beyond what other countries will require. Therefore, there is a danger that, instead of strengthening global risk management practice and providing support to firms in improving their group risk management practices, the disparity of requirements will have the opposite effect

Promoting dialogue: The FSA's proposals provide a useful framework for promoting dialogue between firms and the regulator, and amongst senior management. We believe that this is an important objective for the FSA. Industry shares this aim and believes that this will support strategic planning and capital management. In our comments below there are repeated references to the importance of engagement and dialogue between the FSA and the firm. This reflects our members' strong view that stress testing should be seen as an enabler for further regulatory discussions along the comply or explain basis.

Our response below draws out our discussion more fully on these key points and identifies other important areas. The Annexes to our letter contain our formal responses to the questions posed in the CP and further specific observations and questions arising from the CP.

Discussion of main comments

Reverse stress testing proposal – *what is the FSA's intent?*

Nature of Reverse Stress Test

As the FSA is aware from meetings that have taken place during the consultation period, the Reverse Stress Test (RST) is a concept that has provoked considerable debate amongst our members and it is not clear that we have understood the FSA's intentions. Although we understand that the FSA is keen to promote greater breadth of analysis in firms' stress testing, we do not have clarity on how it is expected that it should be undertaken and used, and depending on the requirement that the FSA intends, there would be significant challenges in implementing the RST.

As industry discussions have evolved a consensus has emerged that that the reverse stress test should rely more on qualitative than quantitative approaches, concentrating on the key vulnerabilities of the business model (i.e. the factors that might give rise to a loss of market confidence in the firm).

Industry perceives that there is potentially a large range of specific events that might give rise to business failure although ultimately failure is likely to be manifest through impacts in a small number of areas of key vulnerability (e.g. insufficient cash (inadequate funding and liquidity), depletion of capital through losses, business attrition through loss of reputation). It is clearly impractical to run a large number of specific disaster scenarios so instead it would be more practical if firms were to focus upon the key vulnerabilities and work backwards by identifying a small number of examples of the events that might give rise to their failure. The likelihood of these events could thus be assessed mainly by qualitative means and by allocating to broad ranges of probability (akin to a 'Low', 'Medium' and 'High' classification).

Or, in other words (and as outlined at the March meeting with the FSA) pending further clarification from the FSA, it is, for example not clear whether the FSA wishes firms to identify a range of disaster scenarios that could destroy the firm, or to identify the assumptions on which the business model is based and stress these factors to the point where the business model is no longer viable and the firm would lose the confidence of its counterparties. Clarification from the FSA would be welcome on whether an approach along the lines sketched out in the previous paragraph would be consistent with their intentions.

Industry would like the FSA to set out what it is looking to achieve from changing the stress testing regime. A clear explanation of the FSA's regulatory objectives for the overall stress testing regime would help banks to build compliant stress testing approaches.

Relationship to capital

One concern has been that the Reverse Stress Test would lead to an increase in a firm's minimum capital requirement as set by the FSA – in other words that the RST would lead inevitably to a capital add-on. At the discussion between the trade association representatives and the FSA on 22 January, the FSA confirmed that there was no automatic link. We would suggest instead that firms should assess whether capital is required, whether other mitigants are needed, or whether no action should be taken. The outcome of this exercise should be open to discussion with the firm's regulator. We recommend that the final guidelines include an explicit statement to this effect.

Relationship of RST to business planning

We agree that there is a place for examining extreme scenarios which explore the potential failure of a firm's business model, but firms will make individual decisions with respect to the extent to which these scenarios will influence strategic and business planning. So there remains a need for an important discussion with the FSA on the role and involvement of senior management and business planning in the light of RST results.

Importance of qualitative approach

The emphasis of any reverse stress test requirement should be on a qualitative assessment of potential vulnerabilities in business models and how these could be appropriately managed and help the development of robust contingency plans. We believe that attempting to identify the point at which market confidence is lost in a reverse stress test scenario and any capital and liquidity implications would depend

heavily on qualitative assessments and careful judgements. Our members feel that, although quantitative methods will be required to be employed to assess the impact, and results of stress testing will be presented quantitatively, qualitative inputs are often required to assess scenarios that are being projected.

Group context

In our view reverse stress testing makes most sense if conducted holistically at consolidated group level. The costs involved in conducting additional reverse stress testing at a more granular level (business unit or solo regulated entity level) would be considerably higher and the benefits of doing so are unclear and will depend upon the firm's organisational and legal structure. For firms operating internationally there are home/host issues around the interaction with non-UK parents. Our preference would be for firms to be able to decide for themselves, on a discretionary basis, how much reverse stress testing is undertaken at the solo level, business level or group level. Otherwise the Handbook text should be very clear about the minimum standards that apply.

We elaborate further on the reverse stress test requirement in our response to Question 3 in Annex I.

International dimension – essential to ensure consistency

Stress testing is one of the many dimensions in which there is a need for effective cooperation amongst regulators. Cross-border supervisory co-operation and engagement is essential to ensure that group-wide stress tests are recognised across the jurisdictions, so that they are meaningful and unnecessary duplication of effort is avoided. Disjointed approaches to stress testing by supervisors are unlikely to support the soundness of international financial markets where counterparties are interdependent. Members strongly support joint cross-border efforts such as the proposed Basel Committee recommendations to achieve consistent principles and supervisory requirements. In particular, supervisory colleges should be used to align approaches that are appropriate for internationally active financial institutions. This will ensure more effective use of resources, lower costs and more pragmatic regulation of internationally-active groups including overseas subsidiaries of UK regulated groups. Therefore, we encourage FSA involvement in the review of parent companies' stress tests through the college of supervisors.

With regard to the organisation of firms from overseas in the United Kingdom, firms welcome the Turner Review's recommendation that regulatory and supervisory coverage should follow the principle of economic substance not legal form.

We recognise that a number of regulators in individual countries have adopted stress test exercises based on common scenarios in order to inform them about the possible extent of any government support programmes that might be necessary.

As we return to more normal conditions in the financial markets it would be helpful if, to the extent that it is determined that a banking group should be subject to a stress test, the common scenarios were developed in the supervisory college, under the leadership of the consolidating regulator, in cooperation with the bank itself to avoid a duplication of effort, although the firm itself would likely be running a range of complementary scenarios that the firm itself would define and assess.

Scenario selection – how to identify an appropriate range

We have always supported the FSA's proportionate and pragmatic approach. We agree that it would be desirable to operate a range of scenarios of different types and severities, including the Reverse Stress Test. Although it is hard to identify an optimal number of scenarios, there will clearly be a limited number appropriate to firms and the appropriate range of scenarios will differ on a case by case basis. There are, as noted above, an infinite number of scenarios that could be run by firms all with the same outcomes. A balance is required, therefore, between maximising coverage, the costs involved and the capacity for senior management to integrate the resulting information into high level decision making. We would suggest that a sensible approach would be to allow firms to develop the scope of their programme of scenario testing over some years so that they can arrive naturally at the optimum level. Initially a small number of holistic group-wide scenarios should be acceptable to regulators in addition to the Reverse Stress Tests.

We believe that Pillar 2 stress testing should focus upon realistic and plausible scenarios which are likely to resonate with senior management. These could be supplemented by a limited amount of testing based upon low probability scenarios, including reverse stress testing.

We would encourage the authorities to strike the right balance between prescription and guidance when setting any industry wide common scenarios. It is important that scenarios are appropriate. Scenarios generally need to be firm specific to ensure effective deployment of resources and appropriate use of senior management time in their examination.

Careful consideration needs to be given to the requirements being proposed in other FSA papers currently under consultation (e.g. CP08/22). Parallel, perhaps overlapping, requirements may make it difficult for firms to react if they cannot take a holistic view, especially with regard to the changes in systems often required as a consequence. For example, the third scenario of the Individual Liquidity Adequacy Standards under the liquidity consultation is similar, in our view, to the reverse stress test. We also recognise new requirements are likely feeding down from Basel requiring firms to incorporate extreme scenarios in the market risk capital calculations for trading book positions.

Individual Capital Guidance (ICG) and the supervisory review process

Firms are unclear as to how the proposed changes to the stress testing requirements will fit into the supervisory review process, including cooperation with other regulators on home / host aspects, and how the results will be used in setting ICG, particularly this year when many firms are required to prepare ICAAP submissions.

Given that a number of firms have not received any feedback on their ICAAP submissions or had a SREP visit, it would be useful for the FSA to clarify the interaction of Pillar 1 and Pillar 2, and how the original ICAAP stress testing and the proposed reverse stress testing are expected to operate together. It is important for firms to understand the regulatory expectations for this, especially during an economic downturn of deteriorating capital ratios, and how any potential capital add-ons would be derived in the setting of Individual Capital Guidance. Again, firms wish to refer to the meeting held on 22 January 2009 where the FSA advised representatives from trade associations that adverse results from stress tests in general will not automatically lead to capital add-ons.

The industry recognises that medium term forecasts of the capital position of the firm under a range of scenarios provide valuable insight, including the impact of possible mitigating actions. It is also recognised that additional capital is likely to be required where a best estimate forecast under a base case scenario reveals a capital shortfall developing.

Where a capital shortfall is revealed in other more adverse but less probable scenarios, consideration of whether additional capital is required should be undertaken in the context of the perceived probability via an assessment of how plausible the scenario is. This issue is directly related to the overall calibration, or level of confidence, underlying the regulatory capital requirement. We welcome the fact that the FSA has not proposed any direct link between stress testing and ICG as this would effectively increase the confidence level beyond that inherent within Pillar 2.

We are conscious that were there to be a combination of stress testing at solo level and a direct link between stress test results and capital requirements this might lead to possibly significant capital buffers being locked up in individual subsidiaries severely restricting a firm's ability to manage capital effectively. We, of course, understand that the purpose of this CP is to discuss stress testing and not the location or level of capitalisation within individual legal entities, but as the FSA is aware, there can be inefficiencies to firms when excessive levels of capital are held in subsidiaries. There can also be consequent adverse effects on local economies if investment and competition is stifled. We recognise that in the context of the debate launched in the Turner Review, there are significant discussions to be had about groups and subsidiaries notwithstanding the fact that firms manage capital resources, including buffers, across their groups. It is important that groups are encouraged to maintain a holistic view of the risks and operations, and to continue to manage their capital resources in an efficient manner for the risks being assumed. Stress testing at individual regulated entity level is likely to produce far more extreme results because of the lack of portfolio effects.

With respect to branches, we would expect that the FSA would liaise with fellow supervisors through colleges of supervisors, given that branches do not have a separate legal personality and do not have separate capitalisation.

IRB Quantification

Firms are already required to use a downturn LGD, a through-the-cycle PD, and for modelled derivative and securities funding transactions a non reducing exposure measure. Furthermore, IRB firms are required to carry out a downturn scenario on their credit portfolio calibrated to a 1/25 year recession. No firm surveyed by the joint associations uses stress testing in the calibration of IRB parameters. As set out more fully in Annex I this reflects the fact that setting IRB parameters and stress testing are essentially complementary activities.

Hence we would appreciate greater clarity on what the FSA is seeking. For example, the reference to using the results of Pillar 1 stress tests to improve accuracy or conservatism is unclear and possibly contradictory in that it is by no means clear that the most conservative estimate is necessarily the most accurate. We do not believe that there is a need to build in further stress test procedures into the IRB framework in Pillar 1.

Firms would like FSA to clarify how they see stress testing being used for the validation of IRB models, particularly as robust validation processes are already required. It is also unclear how firms would meet the use test if obliged to stress test the IRB parameters. We would be glad to discuss with the FSA what is intended.

Contagion

We agree that firms should aim to achieve a more holistic risk assessment across their operations and key risk types, with a fuller examination of correlations between risks. This will take time to achieve, and is an area the FSA can help to share best practice across the industry as this evolves. It is important that firms remain motivated to seek diversification opportunities, so it is important that the impact of contagion, particularly in times of stress, is better understood.

Role of management

The role of the board of directors and senior management within stress testing is very important. Boards have ultimate responsibility for approval of firms ICAAPs, ILAAs and stress tests. However these will be implemented by different institutions based on their individual governance processes. There needs to be recognition that while the board has responsibility for oversight of the risk management function, they must be enabled to delegate some of that responsibility to the relevant senior management.


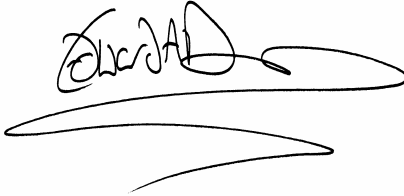
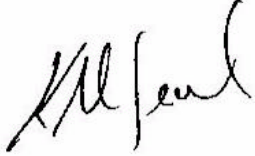
Risk managers recognise the opportunity arising from this consultation to obtain greater senior management buy-in, increase the visibility of risk management and promote a more risk-aware culture across their firms. Conversely, industry is keen for supervisors to understand firms' business models better and hope that there will be an enhanced dialogue moving forward with greater depth of relevant experience in the supervisory community in order to discuss and challenge business models and mitigation processes that might be appropriate.

Implementation timescales

We would suggest that any significant changes in the regulatory interaction (e.g. in the review of the ICAAP) should be phased in over a 2-3 year transition period given the complexity and scale of the regulatory requirements.

We would be happy to discuss our response. We look forward to continued constructive discussions in forthcoming meetings and to arrange this please contact Irving Henry at the BBA (020 7216 8862), or Ed Duncan at ISDA (020 3088 3574), or Katharine Seal at LIBA (020 7796 3606). Our Members look forward to working with the FSA further on these proposals.

Yours sincerely,

 <p>Irving Henry Director BBA</p>	 <p>Edward Duncan Head of Risk and Reporting ISDA</p>	 <p>Katharine Seal Director LIBA</p>
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Annex I: Responses to CP Questions

Chapter 2 – Market failure analysis, summary CBA and context for proposed changes

Q1: What is your view of our analysis of the market failures?

Industry is in agreement that stress testing should be integrated into management's decision-making process, especially as business models evolve, and risks become more complex and develop more quickly.

It is important to ensure that any new requirements are pragmatic and take a measured view of the unprecedented events witnessed recently. New requirements should be proportionate to the risks being assessed and mitigated.

Q2: What is your view of our cost-benefit analysis?

When the FSA surveyed the costs of stress testing in 2008, some firms made the cost assessment based on a one-off, qualitatively assessed, reverse stress test, which has possibly resulted in underestimated costs. The proposed changes outlined in the CP would require firms to comply with additional requirements including a reverse stress test (at least annually), use of stress tests in the calibration and validation of IRB parameters, regular stress testing in relation to securitisation and off-balance sheet exposures, and additional senior management engagement and governance. All this involves more substantial costs than those surveyed.

We do support implementation of more robust stress testing processes, and in recognition of both the new requirements, and increased supervisory focus on stress and scenario testing [1.8, 3.20], accept that there will be an increased cost of risk management, but it must be proportionate to the benefits.

Chapter 3 – Proposed changes to Handbook rules and guidance for stress and scenario testing

Q3: Do you consider our reverse-stress testing proposal reasonable?

We believe the single most important objective of a regulatory requirement for firms to conduct RSTs should be to promote a dialogue about stress and scenario testing between senior firm management and their lead supervisor. We agree that if appropriately constructed, reverse-stress testing potentially encourages senior management to identify vulnerabilities through the consideration of severe/extreme scenarios, which enables review of strategy and risk appetite and the development as appropriate of mitigating actions, and further enhances existing contingency planning within the organisation.

We support supervisory direction towards less reliance on historical data, which would also complement an increased confidence around use of expert judgment, and to some extent address the quantitative burden of proof that banks have faced when supervisors have challenged a bank's assumptions.

The FSA will need to have a good understanding of a firm's business model to effectively review the appropriateness of the stress scenarios run, the results and impact of mitigating actions taken, as well as to challenge the views of the firm. We would like to obtain further clarification on steps the FSA would take if it disagreed

with the conclusions and positions taken by the firm on potential vulnerabilities in the firm's business model.

The point at which a bank's operations become unviable is extremely challenging to define. In addition to the capital position measures, the bank's business plans may become unviable due to liquidity constraints; either when wholesale funding sources dry up, or when the retail depositors lose confidence promoting a run on the bank. The reputational aspect is practically impossible to quantify with any degree of accuracy. Reputational risk becomes a particularly pressing issue due to the transparency of dealings with central banks. We therefore believe that in order to be meaningful, reverse stress testing should be done on a qualitative, rather than quantitative basis.

The CP reinforces the message in a number of sections (s18, Annex 4) that the reverse stress test is not expected to lead to additional capital costs for firms, but also notes that 'results are considered alongside the ICAAP and ARROW frameworks' (s22 Annex 4). The unintended consequence of the ICG expression (which includes stress capital) may conflict with the principle in the CP that firms more fully explore tail risks. There must be full clarity on how the results of the reverse stress test will be used in setting a firm's ICG.

We are uncertain as to the merits of reverse stress testing at solo entity level. For entities whose activities, particularly hedging and booking practices, are inextricably intertwined with the remainder of the group, a reverse stress test requirement makes little sense.

Further, the FSA's suggestion that a firm might be prepared to let a subsidiary fail and carry on as an on-going concern is questionable. We are unable to think of a situation where a group has allowed a subsidiary in a major market to fail.

With regard to specific points of rule drafting, we have the following comments:

- * We note that draft BIPRU text SYSC 19.1.5(1) requires a firm to "assess the likelihood that such events could crystallise". We are concerned that some supervisors might interpret this as requiring a specific probability or range of probabilities to be assigned to each destruction scenario. The nature of such destruction scenarios is such that often their probability cannot be estimated.
- * The requirement to quantify the impact on financial resources that would place a firm in situation of business failure (SYSC 19.1.8(2)) is unlikely to be possible or meaningful for a subsidiary. In respect of capital resources, it is not clear what level would constitute business failure as counterparties generally look to the level of capitalisation of the group rather than the individual subsidiary. This is particularly the case where the entity benefits from a parental guarantee.

Q4: To what extent are firms already undertaking reverse-stress tests? What is the involvement of senior management in the design and review of these tests? What further steps would firms need to undertake to carry out a reverse-stress test as outlined in these proposals?

A small number of our members already undertake reverse stress tests, although it is not clear whether these are in accordance with the FSA's current detailed proposals.

The FSA requires the test to be signed off by the Board [3.27]. In our view this would make the Board involved in operational management of the bank, which is not in line with typical governance structures, hence we do not support this. We believe stress testing processes and scenarios should be reviewed by appropriate executives appointed by senior management, with scenario approval by a Board delegated committee.

Implementation of additional stress testing requirements will require additional investments by banks, especially in systems and processes. Any new requirements must therefore be implemented to a realistic timetable and in a phased manner given the potential implications this may have on a firm's ICAAP process. The timelines for implementing change or enhancements to current processes need to be clarified as the FSA has clearly stated in the CP that it expects individual firms to review existing practices in advance of new or amended regulatory requirements being implemented.

Q5: Is it appropriate to exclude BIPRU 50K investment firms from the reverse-stress testing requirements if wind-down scenarios are an important part of their risk analysis? Given that our expectations would be based on a proportionate approach by smaller firms, would reverse-stress testing be resource intensive for BIPRU 50K investment firms?

The exclusion in respect of BIPRU 50K investment firms is very narrow. For firms which are not systemically important, which could include some foreign branch operations which are not major participants in retail markets for example, a waiver system could be implemented without unduly affecting the outcome sought by the FSA.

Q6: Do you agree with our proposed clarification of the use of stress testing in IRB quantification?

Estimating IRB parameters and stress testing are two distinct risk management processes. Trying to bring the one activity to bear on the other gives rise to basic conflicts and does not result in a workable outcome, as explained below. First we review the relevant definitions:

- * The key Basel II requirements for IRB parameters are that they should be grounded in historical experience and empirical evidence (BIPRU 4.3.74), and be accurate long run averages (BIPRU 4.3.76). It is also generally acknowledged that parameters should be appropriate for foreseeable circumstances. We believe these requirements remain reasonable and appropriate.
- * The Accord and BIPRU do not strictly define stress tests, but the requirement (Accord Para 4.3.39) that "stress testing must involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a firm's credit exposures and assessment of the firm's ability to withstand such changes" in our opinion, reflects the common understanding of what stress tests comprise.

Were the above stress test requirements to be brought to bear on the parameter estimation requirements, there would be three conflicts, as follows:

- * The requirement for parameters to reflect long term averages (that is, to reflect a realistic mix of good and bad times) conflicts with the requirement for stress tests to be reflective of adverse conditions. For example, a plausible quantitative stress

test (though not one usually performed separately because it is well represented by the IRB capital requirement itself), would reflect a scenario where default rates are at their 95% worst case values. However the resulting PDs clearly cannot be used as IRB parameters or in place of the usual PDs in internal risk management.

- * The essentially judgmental nature of stress tests conflicts with the requirement that parameters should not be based purely on judgmental considerations. For example, application to PD estimation of a stress test scenario in which non-investment grade PDs are 20% would simply result in non-investment grade PDs of 20%, independent of historical data and contrary to the non-judgmental requirement.
- * The notion of "foreseeable conditions" in the parameter requirements is essentially different from the notion of "possible events or future changes" in stress testing. Where "foreseeable conditions" refers broadly to ranges of conditions that are known to be developing or expected to develop (such as the currently developing recessionary environment), "possible events or future changes" refers to severe adverse situations that are not expected at present, and whose likelihood of occurring cannot usually be estimated, but merely can be envisaged.

The concepts of stress testing as set out in the Accord are complementary to those of parameter estimation, and this is indeed reflected in many of the FSA's recommendations in the present consultation paper. The above examples show, further, that bringing the concepts of stress testing to bear on parameter estimation in a literal way results in dysfunctional outcomes, and as stated above no firms actually do use stress testing in this way.

Q7: Do you agree with our proposed clarification of the use of stress testing for credit risk mitigation purposes?

We believe that such stress testing should only be necessary if the risks arising from credit risk mitigation are considered by the firm to be material and are not already covered by other assessments. The main stress testing rule GENPRU 1.2.42 already requires stress testing of residual risk where that risk is considered to be a "major" risk. Further clarification would be helpful if FSA now intend that firms should go further than this.

Q8: Do you agree with our perception of the role of stress testing in operational risk and our proposal not to prescribe any additional stress testing requirements specifically for operational risk?

Industry is in accordance with the FSA's intentions.

Firms agree with the perception that the use of stress testing within operational risk primarily supports the management of operational risks (as per paragraph 3.38) and for use in AMA Models (as per paragraph 3.37). We would suggest that the FSA re-orders these paragraphs as the use of scenarios to support good operational risk management applies to all BIPRU firms (not just the AMA firms) and should be prioritised ahead of their use in modelling.

We would like the FSA to acknowledge the challenge in operational risk quantification, and to reinforce the greater imperative of banks focusing on risk

management via timely mitigation actions; ensuring that the risks are identified early and managed in a timely and effective manner.

The current crisis has demonstrated that risks tend to change from one risk type to another (i.e. from cause to effect). What becomes critical for all risk types is to ensure that events (and losses) are properly assigned to risk types based on clear guidance and principles.

We would welcome guidance on boundary events, (i.e. operational risk and credit risk, operational risk and market risk, operational risk and other risk types). Basic guidance has been provided via BIPRU through the Basel II framework document and more recently through a CEBS consultation paper. A clearer perspective on boundary events from the FSA is encouraged, at least in terms of high level principles that drive the assignment of events (and related losses) to risk types. This assignment may vary from the accounting treatment and that should be explicitly recognised.

The CP notes that the FSA does not want to prescribe scenarios, although a review of scenarios considered by individual firms for different risk types (and then within specific risk types), could enable identification of key common external dependencies on market participants (i.e. SWIFT, CLS, etc.). The FSA, trade associations and participants can then ensure that adequate focus and attention is given to specific scenarios that could cripple the market and pose systemic risk. This could be driven through the high level industry forum being proposed by the FSA in the CP.

Handbook changes to clarify our expectations

Higher level requirements

Q9: Do you have any comments on the proposed changes to the general stress and scenario testing rule and additional guidance for firms?

We are concerned that the 'range' of scenarios required should be reasonable and pragmatic given the time and resources needed to conduct these tests and the risk of losing senior management focus if they are provided with too much information.

In the formation of a scenario it is important to consider adverse events that may occur in the future and that are not just a re-run of the current financial stress conditions.

In the new draft of GENPRU 1.2.63 it is not clear why operational and legal risks have been singled out in the final sentence as usually legal risk is thought of as being included within the definition of operational risk. Can an example be given as to what other risk might have an economic impact, but which is not a financial or operational risk? It might be less confusing simply to delete this final sentence or alternatively amend it to "these events can be financial or operational".

A waiver procedure may be appropriate for those firms which are not of systemic significance. Consideration should be given to the extra-territorial impact on differentials with home country regulators.

Q10: Do you have any comments on our requirements that in general firms should hold capital now against the overall financial adequacy rule, including in a stress scenario after allowing for realistic management actions?

Clarification in the CP on changes to ICG to would be welcomed.

The identification and execution of realistic management action by banks when faced with sudden and severe events is likely to face significant supervisory challenge given recent industry experience. This will likely limit any potential deductions from the gross impact arising from a combination of sudden and severe event and one in 25 severity test.

Questions 9 and 10 can also be addressed together. This issue is linked to stress testing of Value at Risk modelling put forward by the Basel Committee. There is concern regarding secondary risk factors. There is potential duplication, and a need for regulatory clarification, regarding the need to hold capital against the overall financial adequacy rule, including in a stress scenario after allowing for mitigation.

In general, we favour the view of stress tests presented in 3.64 and 3.65 of the consultation paper: "Stress testing should be used by senior management to set and monitor policies and limits for the firm, who should then take appropriate action based on the results of the stress tests. Appropriate action could include reassessing whether the firm continues to operate within its risk appetite, changing the firm's strategy and taking mitigating actions." and "These stress testing requirements are not intended to affect a firm's capital requirements directly. However, a firm should consider the results of this stress testing in its Pillar 2 capital assessment."

This view of stress tests is inconsistent with that set out in draft rule BIPRU 2.2.16, which specifies an automatic requirement for a firm to hold capital not only against a 1 in 25 year economic downturn but also against an unquantified "sudden and severe" shock (incidentally, with no mention of mitigating management actions). We do not support such a broad brush requirement for additional capital, particularly where the quantum and nature of this "sudden and severe" shock has not been specified. Clearly there is a range of possible sudden shocks. Some firms – and some supervisors - may take a more conservative view than others as to what is included in an "appropriate range of adverse circumstances". On an extreme view, this "range" could include the "test-to-destruction" scenario envisaged in reverse stress-testing. We do not believe it appropriate to require banks to hold sufficient capital such that they can sustain all conceivable loss scenarios.

Thus the FSA should be more specific as to the severity of stress for which the overall financial adequacy rule needs to be met. In setting such a level of severity consideration should be given to the impact on the implied overall level of confidence to which regulatory capital would then be calibrated.

With regard to 3.48, firms would like clarification of what is envisaged by the requirement to "rehearse" actions.

Industry would also like the FSA to reconsider its position over statement 3.57. In terms of legal certainty it is important to understand whether a parent bank located outside the UK can "guarantee" a branch entity. In respect of branch operations the FSA may wish to consider how undertakings may have legal certainty in discussion with home country regulators. The FSA states that where a firm would place reliance on a capital injection from an overseas parent as a mitigant when assessing management actions under a hypothetical stress scenario then it would look for clear legal certainty that such transfers would occur. Similar requirements also seem to exist under CP22 for firms wishing to gain an intra-group waiver (*vide* point 1 under CP 22). This seems to be a significant "step up" in requirements from previous experience. We understand that the debate on group structure, parental support,

branch and subsidiarisation is raised in the Turner Review and that it is important to read the FSA's new requirements in that context. Nevertheless, a move towards requirements being applied at legal entity level does not accord with how international groups manage their risks and operations in practice and we are encouraged to see that Lord Turner also states that he supports the need to supervise by economic function rather than legal form.

We note, in the context of parental guarantee, that the requirement to have "legal certainty" is not a prerequisite for such arrangements to work successfully. For example, during the recent financial market turbulence, many international groups have provided additional funding to their subsidiaries despite the absence of a legal requirement to do so. Ignoring the ability of groups to provide funding to their subsidiaries is likely to result in stress tests that do not achieve the required level of management buy in. A better alternative in such cases would be for the FSA to review whether the group as a whole would have sufficient funds to support its subsidiaries under the same scenario. Firms would also like the FSA to modify its requirements to that it "may" seek such requirements and to provide a timetable for smaller firms whereby they will be given sufficient time to put legal arrangements in place (if required).

GENPRU 1.2.42 R makes no reference to management action taken in mitigation. The FSA should clarify what is meant by a "sudden and severe" event.

Firms would like the FSA to clarify what is meant by "calibration" in GENPRU 1.2.75 G, paragraphs 2 and 4.

Q11: Do you agree with our proposed clarification of the use of stress testing for market risk purposes?

Clarification is required in relation to stress testing of the trading book.

We agree with the principles set out in the CP, though we have some concern on the application of some of the proposals. We would welcome clarity on the time period envisaged with respect to "longer term" stress scenarios.

Relevant reliable history does not generally exist for more than 10 years history on most market data series.

The FSA expects firms with Value at Risk model approval to conduct "frequent" stress tests of their trading book positions (BIPRU 7.10.72). We believe that this is an appropriate requirement for Pillar 1 purposes. However, some firms might use standardised rules for Pillar 1 purposes and use VaR and other models for risk management and Pillar 2 purposes. We are concerned that supervisors might be tempted to read across from BIPRU 7.10.72 to require all firms to conduct "frequent" stress tests at the level of individual regulated subsidiaries regardless of their pillar 1 approach. It is our view that a firm's stress testing programme should be aligned with the manner in which it has organised its business. For many firms, stresses are run by the various lines of business in an integrated and co-ordinated manner, but results of such stresses for individual subsidiaries may be difficult to extract and not immediately relevant for day-to-day management if the firm has not applied for Value at Risk model approval for Pillar 1 purposes for that entity. Running frequent stress tests at the level of individual subsidiaries in such circumstances would fundamentally fail the use test, as the results are not used for internal risk management purposes.

Q12: Do you agree with our proposed amendment to our stress testing guidance for interest rate risk in the banking book?

Industry has no issue with the proposed changes themselves, although the wording of BIPRU 2.3.9 needs to be tidied up. It mentions "option risk" where we believe it specifically refers to "embedded" as opposed to "explicit" option risk. It also refers to "repayment risk" whereas we believe that it means "prepayment risk". So we would suggest the following changes to the wording:

“the ability to measure the exposure and sensitivity of the *firm’s* activities, if material, to repricing risk, yield curve risk, basis risk and risks arising from embedded optionality (for example, pipeline risk, prepayment risk) as well as changes in assumptions (for example, those about customer behaviour);”

Q13: Do you agree with our proposed amendment to our stress testing guidance for securitisation?

These proposals should be cross-referenced to the Basel Committee proposals and article 122 of the Capital Requirements Directive, especially the grandfathering clause.

We accept the rationale behind the proposed amendments and support the proposal in its attempt to focus attention on the need to consider the wider risks and implications of securitisation activities. Securitisation activities where a firm retains an economic interest should be included in appropriate stress tests, as should assets in pre-securitisation warehouses. However, the recommendation in the Group Risk section regarding taking back assets where true sale has been achieved is less realistic due to the difficulty in obtaining information for securitisations where all of the risk has been transferred and none retained. Please see the Group Risk section for further comments.

Q14: Is our explanation of how estimates of pension obligation risk are impacted by other stress tests sufficiently clear?

Pension risk is taken into account for ICAAP purposes.

Q15: Do you have any comments on our clarification of the Handbook text for BIPRU firms whose activities are simple?

This addresses contagion risk. Many BIPRU firms are branches and subsidiaries of foreign banks. Therefore, there is an extra-territorial element and the FSA should consider reciprocity with other supervisors, including the release of information between regulators. Such cooperation will ease the requirements for less complex institutions that are more risk averse and systemically insignificant compared to larger firms. This annex is ideally split between UK firms, and the branches and subsidiaries of overseas firms.

Group risk systems and controls requirements – Handbook changes proposed in the CP

Q16: Do you have any comments on the proposed amendments to our Group risk Handbook text?

There is an international dimension to this issue, including the Capital Requirements Directive. There are different layers of regulators which has an impact on management of such risks. Regulatory cohesion is key, ideally by means of colleges of supervisors. As such issues can be addressed on a bilateral basis where the FSA is home regulator and on a global basis where the FSA is a host regulator.

The requirement in GENPRU 1.2.90 needs to be clarified. Although we agree with the recommendation that firms should consider whether certain assets or liabilities of off-balance sheet vehicles could be brought back on balance sheet for reputational or other reasons, this should be analysed in a targeted fashion rather than across the board. The likelihood of such transfers taking place will depend on the particular circumstances of each firm, type of vehicle and the particular scenario being analysed. As such, it may be appropriate to transfer some types of assets and liabilities, but not others. The GENPRU text should make it clear that firms should have the discretion to make such judgments as long as they can be justified. Therefore, we recommend that the following text be appended to GENPRU 1.2.90:

“This analysis should be performed on a case-by-case basis taking the relevant circumstances into account.”

With regard to evidence that the board has considered an extreme scenario and mitigation, the FSA should not see stress testing as a single metric or an optimal solution. Test results should inform decision-making, but the outputs should be used thoughtfully and not automatically. As we note in our cover letter, qualitative judgment is at least as important as quantitative mitigating action if not more so.

Annex II: Other Observations and Questions

1.7 Firms welcome further guidance and the emphasis on corporate governance.

1.22 We look forward to the Q1 2009 DP and clarification from the FSA on new minimum capital ratios.

1.23 Industry is responding to the Basel Committee's stress testing consultation separately and is pleased to hear that the FSA will be informed by this paper.

2.6 We agree broadly with the FSA's assessment. However, we are of the opinion that stress testing is only a tool and an art rather than a science. Qualitative judgment and measures form part of the response to stress test results, not just quantitative actions, for example additional capital.

2.8 Regulators should understand business models, including their impact on peers and the systemic risks posed by models. In addition, regulators should understand mitigating action taken by firms. These may be appropriate even if they don't correspond to what the regulators expect.

2.9 Business models, including their effect on the relevant firm's peer group and the systemic risks posed by models, should be the focus of supervisory review.

2.10 Firms agree with the FSA's conclusions. The regulator should clarify the stress testing requirements in an ICAAP context.

2.11 Industry agrees with the statement. Firms would like supervisors to gain greater insight into business models and appreciate the effect of models on the competition and wider financial system.

2.13 The FSA accepts that reverse stress test requirements will lead to an increase in costs. At a time when firms are reviewing their activities and firefighting, these costs will cause further strain. In addition, they may not be appropriate for firms that are not of systemic importance.

2.14 Firms agree with the intent and urge the FSA to understand mitigating action taken in response to test results.

2.15 Industry welcomes the clarification intended by the FSA.

2.16 This is a fair assessment of the crisis and perceived shortcomings.

2.28 The findings regarding governance are sensible.

2.29 Industry concurs with the need to consider plausible scenarios.

2.34 - 6 Firms welcome the emphasis on a holistic approach, including to liquidity.

2.37 Industry welcomes international supervisory coordination. This is a global issue and requires a global solution, ideally within the framework of colleges of supervisors. In addition, the approach reflects the organization of banks, i.e. in terms of function rather than jurisdiction. Firms would like the FSA to pay greater attention to structure when drafting proposals.

2.46 The incorporation of and support for industry-led initiatives, such as the Institute for International Finance's recommendations, are encouraging. We second the final paragraph of 2.46.

Annex 4.12 Firms agree with the FSA that the oversight of remuneration should be effected at board level, and that bonus calculations are better regulated by taking into account capital and risk.

Annex 4.15 Industry agrees with the FSA's contention that scenarios must be plausible.

Annex 4.19 Supervisory understanding of business models and what impact models have is also necessary.

Annex 4.20 The regulator should get the balance right as, at the moment, any increase in costs could be detrimental to economic recovery.

Annex 4. 20 - 3 Firms welcome such intentions and the need for high quality framing of scenarios.

Annex 4.27 Industry welcomes the reduction in unanticipated costs.

Appendix 1: Draft Handbook text

Annex B, 19.1.3 G: The word "review" is acceptable. However, the word "approve" is not appropriate for the circumstances. It's not clear what is to be approved, the scenario, the severity of the scenario and the mitigating action. The "governing body" may not be appropriate for the task. A more relevant body would be the Risk Committee. The section should be cross-referenced with sections addressing management structure.

Annex B, 19.1.3 G; 2nd line: Suggest, deletion of the word "the" prior to "events and circumstances" in order to avoid the suggestion that the firm has to identify the entire universe (rather than just a selection) of events and circumstances which would give rise to the failure of the business plan

Annex B, 19.1.5 R: It is not possible to assign a numerical probability in general to estimate likelihoods as it would be impossible to validate the probability generated. In addition, there is confusion over the organisation of firms, either as part of a group or solo, and how reverse stress tests work based on operating structures.

It would be helpful to have guidance on what is envisaged by the word "range".

Annex B, 19.1.6 G: We suggest that the firm should decide the amount and scope of reverse stress testing on a 'solo basis' and, therefore, that the second sentence should be amended to reflect this. Otherwise this guidance should be expanded to clarify precisely what is meant by 'on a solo basis', specifically addressing international aspects and where the group's operating structure is not aligned with its legal structure.

Annex B, 19.1.9 G: It is not clear how a reverse stress test might reveal that a firm's risk of business failure exceeds its risk appetite. Can this be clarified?

Annex B, 19.1.10 G: We suggest this is amended to "...a firm should consider a scenario based upon the failure of one or more of its major counterparties as well as"

Annex C, 1.2.42 R (2): It would be helpful to have guidance on what is envisaged by the word "range", bearing in mind the need to remain pragmatic, the time and resources involved in stress testing and the danger of overwhelming senior management with too much information.

Annex C, 1.2.63 G; 5th line: We suggest that the word "extreme" is replaced with "adverse". Otherwise there is a contradiction with the following sentence "They are based on the analysis of the impact of a range of events of varying ... severity".

It is not clear why operational and legal risks have been singled out in the final sentence and usually legal risk is thought of as being included within the definition of operational risk. Can an example be given as to what other risk might have an economic impact but which is not a financial or operational risk? It might be less confusing simply to delete this final sentence or alternatively amend it to "These events can be financial or operational."

Annex C, 1.2.73A G (6): We suggest that this is amended to "A firm should document its stress test projections and policies which should be approved by the firm's senior management or governing body. Stress testing should be included within the firm's ICAAP or ICA submission document." Requiring a 'stress testing management plan' is overly prescriptive and if retained would require greater clarification.

Annex C, 1.2.75 G (2): We would request further clarification on the meaning of "calibration of the stress and scenario analyses".

Annex D, 2.2.16 G: There is no reference to mitigation.

Annex D, 2.2.16 G: The underlined new text implies that the ICG should be such amount as to enable the firm to meet the overall financial adequacy rule in the face of every adverse scenario that it analyses, irrespective of the severity of those scenarios. This is unreasonable as it has the potential to raise overall capital levels to a point where banks will have insufficient ability to lend and would, therefore, not achieve the FSA's objectives.

Annex D, 2.2.25 G (4); 5th line: We would like clarification of regulatory expectations when the existing economic conditions are already equivalent or more severe than "such as might be experienced once in 25 years".

Annex D, 2.3.9 G: "pipeline risk" and "repayment" risk should be defined.

Annex D 5.2.9 R: The main stress testing rule GENPRU 1.2.42 already requires stress testing to be conducted for each of the material risks identified (specifically including, if relevant, residual risk. The new text in BIPRU 5.2.9 seems to duplicate that and adds to it by requiring stress testing of credit risk mitigation risk, irrespective of whether that risk is material or "major". We suggest the new text is unnecessary and should be deleted. If considered necessary 5.2.9 R could be clarified with regard to stress testing through the addition of a guidance comment.

Annex D 7.1.18 R: We question whether it makes sense to require the stress testing of the trading book to have to automatically take into account all other stress testing carried out under any other provision of the Handbook. We suggest that the

relevance of stress test carried out in other risk disciplines should be assessed by firms when carrying out trading book stress testing. If it is deemed relevant, these other stress tests should be taken into account in trading book stress testing.