Sent by email to stresstestingdp@bankofengland.co.uk

10 January 2014

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A framework for stress testing the UK banking system

Dear Mr Madouros

Enclosed please find our response to the discussion paper 'A framework for stress testing the UK banking system'.

Yours sincerely

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Discussion paper response

A framework for stress testing the UK banking system

10 January 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the Bank of England's (BoE's) discussion paper *A framework for stress testing the UK banking system*. AFME represents a broad array of European and global participants in the wholesale financial markets. Our members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA), a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

We provide below our over-arching response to the discussion paper, followed by comments on a number of other issues in the order they arise in the discussion paper.

Over-arching comments

We recognise the importance of a stress testing framework as a valuable tool in enhancing the robustness of the financial system and the resilience of individual financial institutions. We are pleased to provide our views to contribute towards the strengthening of the proposed framework, and welcome future opportunities to engage in this process.

We believe that the UK stress testing framework should be strongly coordinated with those of other supervisors in major jurisdictions, including the Fed's Comprehensive Capital Analysis and Review (CCAR) process in the US and the stress tests to be coordinated through the EBA. Coordination amongst supervisors would enhance the quality and credibility of stress test outcomes, and avoid contradictory capital adequacy assessments. While we recognise that certain divergences between processes to account for national specificities and objectives will be inevitable, we support a continued effort to enhance cross-border cooperation through colleges of supervisors and on a bilateral basis to remove areas of clear duplication and to align approaches where feasible.

A lack of coordination could promote imbalances in a group, including fragmentation in allocation of capital and liquidity, which would raise similar concerns to those expressed widely in response to the US Fed's proposals for foreign banking organisations under Section 165 of the Dodd-Frank Act. We believe that embracing strong coordination of stress testing frameworks would signal by supervisors a commitment to a global multilateral system of financial regulation.

For global systemically important banks (G-SIBs) with a presence in the UK coordination would allow institutions to leverage common controls and infrastructure across multiple exercises, which should reduce operational risk and facilitate the development of technology solutions, as

well as create a common 'language' to facilitate discussion both with and between global supervisors. This would benefit not only the UK subsidiaries of G-SIBs but also the overseas subsidiaries of UK banks.

Coordination should be considered in relation to many different dimensions of stress testing, including timing, stress severity, communication of disclosures (particularly for subsidiaries), capital planning, and remedial actions. Even if strong coordination across the entire framework is not achievable in the near term it is likely that at least some dimensions of the framework can be closely aligned relatively easily.

Disclosure of the outcomes of supervisors' different capital adequacy assessments applied variously to groups and subsidiaries should be coordinated. To the extent that methodologies, scope and timing of stress tests vary across different supervisors we should expect different outcomes. The reasons for these different outcomes will have to be explained to the market to maintain the credibility of the various stress testing frameworks and ensure that the markets are provided with information that presents a coherent view of the individual health of subsidiaries and groups. Firms may not be well placed to make such explanations in a fully comprehensive manner as they may not have the requisite information about the analysis carried out by each supervisor.

Coordination between supervisors will enhance the credibility of potential remedial actions, including where that includes the operation of cross-border recovery and resolution plans. Coordination among supervisors in stress testing could signal cooperation also in resolution – thus reinforcing the credibility of resolution regimes and enhancing market discipline.

Specific comments

Timelines

The timelines set out in the discussion paper will be challenging and will require a significant amount of resource within firms. To the extent frameworks are aligned between supervisors carrying out stress tests the timeframes could be aligned also, in order to avoid multiple duplicative processes. However, where frameworks are not aligned between supervisors harmonised timing could be problematic as it will stretch firms' limited resources over a peak period, which could detract from the quality of engagement in the process by firms. We recognise the value of having a single data date for all stress tests. However, given resource constraints and the need for engagement in the process by firms, achieving a single data date for stress tests across major jurisdictions should be predicated on achieving strong coordination between supervisors. Until strong coordination is achieved staggered processes would be desirable.

Starting stress testing analysis in January of each year (as set out in Box 3 of the discussion paper) will not be possible if 31 December data is required, as balance sheet data will not yet be available. We therefore suggest a later start for analysis. We also suggest that consideration be given to the impact of the intended timing on firms' ability to link regulatory stress tests with their internal processes, and thus achieve consistency between the inputs to management and supervisory decision-making.

Scenario design

We are concerned about what seems to be a requirement for bank-specific scenarios to result in higher losses than the common scenario. Page 19 of the discussion paper states that the set of bespoke stress scenarios should have "a degree of severity calibrated to match at least that of the common stress scenarios designed by the FPC". This is further elaborated on page 21 where it is said that the bank-specific scenarios are expected to result in higher losses than the common scenario. Where higher losses are not achieved the PRA may ask firms to redesign the bespoke scenarios.

We agree that bespoke scenarios should be expected to yield higher losses as they are targeted at the vulnerabilities of each firm. However, a firm cannot know in advance what the losses will be for each scenario; those loss figures are an output of the stress testing process. To impose an ex-ante requirement for greater losses when designing the bespoke scenario would effectively require firms to run the stress tests as part of the scenario design. We do not believe this makes sense and indeed we are not sure whether this is the intention. Instead, we believe the severity of the bespoke scenarios should be calibrated by aligning the likelihood of the outcome occurring with that of the common scenarios. In other words, the focus should be on the probability of a scenario occurring rather than the level of losses that will result. We recommend that BoE re-articulates the 'severity of losses' criterion for approval of bespoke scenarios into a criterion relating to the severity of scenario parameters. The objective of higher losses will naturally be achieved through the focus on a firm's vulnerabilities. For firms with UK-focussed exposures, and to the extent the common scenario will be focussed on the UK economy, the outcome of the common and bespoke scenarios will be broadly similar.

We caution that calibrating bespoke scenarios to higher levels of severity than the common scenario may result in firms managing their capital on a 'gone concern' basis, which would limit the value of stress testing as a meaningful risk identification and management tool. Instead, we believe the focus should be on scenario relevance to the idiosyncratic vulnerabilities of a firm's business model, and that this should be the driving consideration, together with a focus on the governance around scenario generation and the identification of vulnerabilities.

We note that the PRA Board must approve bespoke scenarios. It will be important that the process for approval is such that firms can still react to changing circumstances and adjust their bespoke scenarios appropriately in a timely way. Firms will often seek to update their scenarios to address emergent risks in periods of market stress, when the PRA Board may be more focussed on other issues surrounding the market conditions than on approving new scenarios.

The timeline for approval of bespoke scenarios by the PRA Board is not clear. For example, it is not clear whether PRA Board approval of bespoke scenarios should be expected during the second stage of the cycle ("banks' scenario design") set out in Box 3 of the discussion paper. We recommend that these timelines are clarified to allow firms to plan the commencement of stress testing analysis. Any delay in approving scenarios will decrease the amount of time available for analysis.

As a general rule we believe that scenarios should be consistent amongst themselves and plausible with regards to the current macro-economic environment and the most current expectations for the coming year(s). Addition of unlikely and inconsistent worst case scenarios for different segments would result in unrealistic, improbable and potentially misleading results, and would again damage the credibility of the framework.

Further, common scenarios should be defined in sufficient detail (including as to the geographical scope of application and prescription of both macroeconomic shocks and market shocks (as opposed to the "Pillar 2 Anchor scenario" that only prescribes macroeconomic shocks)) so as to allow firms to derive their consequences in a consistent way when using their own internal models. This is particularly important for mark-to-market firms. In the absence of prescribed percentage market shocks firms would need to exercise judgment to translate macroeconomic shocks into market shocks, and the potential inconsistency in the resulting percentages in each firm would hinder comparability of stress test results. Another example is credit risk, where quarterly data would be needed for some GDP components (consumption and investment). The Fed's SCAP/CCAR process has evolved in a similar way towards providing a high level of specification through detailed shock templates and provision of specific guidance through frequently updated FAQs, which has been welcomed by industry.

Data

We believe that the data requirements may be too ambitious, at least in the near term. The data required under the FDSF is very granular and in many instances could be challenging to provide. Much of the data will have to be created manually on relatively short timelines. A trade-off exists between the granularity, frequency and timing of data requirements and the level of control and validation that can be exercised. We are concerned that overly ambitious data requirements could take away from the integrity of the data. To partially mitigate this it would be beneficial for firms to have notice of ad-hoc data requests in order that they can be dealt with as expeditiously as possible.

We note that the data requested is much more granular and required more frequently and on shorter timelines than that used for equivalent frameworks like the Fed's well established CCAR process. Arguably the level of detail requested could be closer to that required for risk management than for stress testing. If the data is to be used for broader purposes other than stress testing (though it is not clear from the discussion paper that this is the case) those objectives could conceivably be met through other means.

We prefer an approach whereby the data requirements are less ambitious at the outset and the level of detail and granularity is built incrementally over time. Further, we suggest a materiality exemption be put in place so firms do not have to provide the data for small markets or for immaterial exposures. Both of these approaches would reduce the burden on firms of providing the data and increase the resources dedicated to (and therefore the quality of) remaining data being provided. They would also reduce the resources required by the BoE to process and analyse all of the data.

Further, we suggest that the BoE should provide to firms a description of the analysis carried out with the data they have provided and the results of that analysis. This will help firms to provide the most appropriate information for the analysis being carried out.

Models

We are concerned about the starting intention (expressed on page 25 of the discussion paper) not to disclose to firms the calibrations of the regulatory models used for stress testing. There should be, as part of the process, an opportunity for firms to make an informed comment on the outcome of regulatory models. This information will be crucial for understanding the outcomes of regulatory models and identifying what is driving the differences, and for making informed judgments about where the reasonable outcome lies.

We welcome the BoE's acknowledgement that the stress testing framework needs to involve "interpreting these [stress test] results, and reach[ing] a judgment around capital adequacy". The output of models that, by definition, do not capture all of the features and dynamics of the risks facing firms should always be interpreted by those with a clear understanding of the limitations and assumptions underpinning the model. We consider the interpretation of stress testing outputs an important and sensitive component of determining capital adequacy but are concerned about situations where material differences between a firm and the BoE are driven by differences in stress testing assumptions and methodology or subject to significant uncertainty due to known modelling limitations and the choice of model calibration. Model methodologies and assumptions will be key drivers of potentially material differences in projected trading book losses, where the differences between firms' and BoE's systems are likely to be significant. While we respect the need for the BoE to use its own judgment and reach its own conclusions we recommend that there is an opportunity for firms to understand the drivers of material differences between the BoE's and their own capital adequacy analysis and that firms be given the opportunity to respond to those differences.

While we recognise that BoE has a concern about 'managing models', we believe that the day-to-day imperative for models to accurately reflect risk, which is strongly in firms' interests, as well

as the governance around such models (both internal and external) would outweigh any incentive to tweak models for stress testing purposes. Firms have significantly advanced their approaches to stress testing over the past number of years, to the extent stress testing has become an integral part of risk management, capital planning and decision-making. Any risk of 'arbitraging' regulatory models and managing to a model has substantially reduced. If there are concerns about the integrity of a firm's models then we recommend that those concerns be addressed through the business as usual supervisory process rather than the during a stress testing exercise. Attempting to address that issue through decreased transparency about the calibration and methodology of regulatory models would be detrimental to the stress testing framework.

Further, an understanding of the calibrations and methodologies of regulatory models will allow firms to explain the outcome of stress testing processes to the market, especially where the regulatory model yields a different outcome to a firm's own model.

We do not believe that firms' models should be constrained by introducing floors or other constraints as part of the stress testing framework. Rather, the scenarios should be specified, the stress test run, and the outcomes assessed. Where there are differences between firms' internal models those differences will inform a discussion about a variation in outcome between firm and regulatory models. A capital adequacy review is not the appropriate forum for trying to force 'consistency' on internal models.

We agree with the distinction drawn in the discussion paper in Section 6 between asset quality reviews and stress testing. Any concerns about the value of an asset (e.g. a government bond) should be addressed in an asset quality review through credit risk adjustments or additional value adjustments for prudent valuation.

Remedial actions

We believe that there should be an opportunity for firms to discuss the range of possible remedial actions prior to a formal decision being taken. Indeed, firms should as part of their submission present the range of remedial actions they believe would bring the firm in line with supervisory expectations where the results of the stress tests indicate that these expectations are not met. Further, there will need to be an adjustment period in which to make feasible management action plans and pass them through internal governance processes, in order to minimise market disruption when a bank is required to take remedial action. This adjustment period should be explicitly built into the framework.

It is not clear from the discussion paper whether there will be a process for firms to appeal decisions by the PRA about remedial actions. Reading across to discussions above about the transparency of regulatory model calibrations: appeals would be less likely, and indeed firms would have more confidence in the framework generally, if firms understand the analysis and reasoning of the PRA in applying its supervisory judgment to stress testing results.

As mentioned in the 'over-arching comments' section above, decisions about remedial actions should be coordinated between regulatory authorities in order to avoid contradictory capital adequacy assessments. Contradictory assessments would damage the credibility of the stress tests and potentially lead to market disruption.

Disclosure

Disclosure is a key aspect of the stress testing framework that needs to be carefully considered and managed. We believe that disclosure of capital adequacy assessments for subsidiaries might need further specific consideration, particularly as this will be the first time capital adequacy assessments for subsidiaries will have been disclosed to the market. We expect that stress test outcomes for a subsidiary could potentially be (very) different than those for an entire group. Where those outcomes are disclosed to the market firms will have to be in a position to explain those differences to the market (despite the outcomes being 'owned' by

supervisors). This reads across again to discussions above about the need for firms to understand the calibrations and methodologies of regulatory models, as this will be one of the drivers of differences (along with different business mixes and exposures between groups and subsidiaries).

Furthermore, disclosure of outcomes for a subsidiary could mislead the market. Stress test results for a subsidiary would not include any intragroup support, whether in place ex-ante, which could be put in place, or which would be expected to be provided ex-post through a single point of entry resolution strategy. Thus, entity level results could understate the financial strength of a subsidiary and the group, and be misleading to counterparties and the market.

Given these concerns about the disclosure of outcomes for subsidiaries, but also relating to the outcomes for groups, there will be a strong onus on the BoE and on firms to explain the capital adequacy assessments coherently to the market. The messaging should be coordinated and allow for the BoE and each firm to make disclosures on the same day. Until the framework is more embedded there may be a greater need for 'education' about the disclosures, in order to limit the likelihood of unwarranted market disruption.

We have a general concern about the market's reactions to stress testing outcomes and their understanding of how assessments of capital adequacy are arrived at. Our two principal concerns are that 1) the importance of stress testing could be over-emphasised by the market and 2) that non-comparability of bespoke scenarios may raise unnecessary concerns about the capital adequacy of other firms. The reputation of the UK financial system could be put in doubt if a firm that publically 'passes' stress testing subsequently gets into trouble, as happened with a number of European banks following previous EBA stress tests. We recommend that it be made clear that assessments of capital adequacy are informed by stress testing, but not determined by stress testing, and be accompanied with information outlining the types of situation that would be expected to challenge the conclusions drawn from stress testing. Similarly, the use of bespoke scenarios in system wide capital adequacy analysis needs to be weighed against the market's expectation of a standardised analysis of capital adequacy. This is not to say that bespoke scenarios should not be used, but their formal use in assessment of capital adequacy should be carefully considered. We would be particularly concerned if conclusions about capital adequacy were driven solely by a bespoke scenario, developed by a firm itself, that in turn raised questions about the appropriateness of the scenarios applied to other firms. The disclosure around these findings and conclusions will have to be carefully considered.

We also encourage supervisors to consider limiting the publication of 'base case' results, where detail published could be used by market analysts to work backwards to deduce the firms' proprietary P&L projections. We suggest alignment with disclosure under the CCAR regime, which apart from facilitating comparison across jurisdictions would also leverage a tried and tested process that achieves a good balance between the provision of useful information and proprietary information.

Further, we are concerned about disclosure of qualitative assessments of firms' stress testing and capital planning processes and governance, in particular the risk of publishing proprietary information. In addition, the fact that such assessments are qualitative in nature will inherently require subjectivity in measurement across firms. Such assessments should be based on common, agreed standards made transparent to the firms under assessment and the market, and should focus on shortcomings found as part of the stress test review rather than a broader description of the specific internal frameworks adopted by individual firms. The disclosure of the outcome of assessments should then be presented in the context of comparing to this common standard. The messaging associated with such disclosures will have to be carefully considered to achieve objectivity and consistency, and avoid being misinterpreted or taken out of context by the market.