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March 13, 2009

By electronic delivery

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel, Switzerland

RE: Consultative Document, "Principles for Sound Stress Testing Practices and Supervision," January 2009

Dear Madam or Sir:

The American Bankers Association¹ welcomes the opportunity to comment on the Basel Committee's Consultative Document on "Principles for Sound Stress Testing Practices and Supervision." In preparing to respond to the Consultative Document, we consulted with a range of banking firms with significant stress testing programs.

Stress testing has become a core management tool and essential element of the risk control regime for banks. However, developments over the past year have highlighted important ways in which the stress testing programs of major financial institutions' can be improved, leading them to review and strengthen their practices. Therefore, banks welcome the proposed principles as a basis for discussion of what supervisors can expect from financial institutions.

Before commenting on the 21 proposed principles, we offer the following general observations, which are explained below:

- The principles should distinguish between expectations for institution-wide and portfolio-specific stress testing.
- Stress testing programs should fit the institution.
- Supervisory expectations for stress testing should be principles-based.
- Stress test results should not be used to determine capital requirements.
- Supervisors and institutions benefit from coordination within colleges of supervisors.

¹ The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$14 trillion in assets and employ over 2 million men and women.

➤ **The principles should distinguish between expectations for firm-wide and portfolio-specific stress testing.**

We fully support the importance of stress testing and understand the need for review of institution-wide scenarios. While a stress test on a particular business line or portfolio can identify risk sensitivities in a particular area that a model of aggregate capital may not capture, an institution-wide process is necessary in order to assess the impact of concentrations and natural offsets that occur during times of stress.

However, we are concerned about the potential burden that the proposed principles could impose on banking firms. No institution has the infrastructure to do holistic stress runs as frequently as appears to be proposed. Significant investments would be required to do regular “top-of-the-house” runs coordinated across all risk types and business lines. Even if an institution could do the comprehensive stress tests as often as proposed, it would be disruptive to implement follow-on actions that regularly. It is more effective for an institution to undertake a few institution-wide stress tests thoroughly and credibly than to conduct many at a lower level of quality.

On the other hand, smaller units within an institution may recurrently run scenarios for their portfolios or business lines. Supervisors must recognize that institution-wide and portfolio-specific stress testing have different functions and time horizons. Institution-wide tests consider major capital adequacy and liquidity issues, and therefore are conducted once or twice a year with a concerted effort at coordinating all risks and looking forward over a considerable period of time. In contrast, portfolio-specific stress tests generally have a near-term outlook and focus on earnings effects, with some consideration of capital and liquidity effects. Due to the more limited purpose and time horizon of stress testing at the business line or product level, there must be more flexibility in supervisory expectations.

Accordingly, the principles should be adjusted to make a clear distinction between requirements for:

- stress tests “to address existing or potential firm-wide risk concentrations” (page 14), versus
- ad hoc, portfolio-specific stress tests.

➤ **Stress testing programs should fit the institution.**

The magnitude and sophistication of an institution’s stress testing program should be commensurate with the firm’s scale and complexity. What may be appropriate for a large multinational banking firm is not necessarily appropriate for a trans-regional or narrower-function institution. Stress testing programs are very expensive to develop and run. If supervisory expectations are based on the needs of the largest, most complex institutions, then the costs to smaller or more focused institutions of performing intricate stress runs can easily outweigh the benefits. The boards of directors and senior management of institutions should determine the institution’s time and money commitment to stress testing based on its needs, subject to supervisor review.

Similarly, the board and senior management should determine how frequently the stress test program is reevaluated and stress tests are run. To be most effective, institution-wide stress runs should be limited to a modest number of scenarios that are most relevant to the institution. Moreover, the range of scenarios and techniques employed should fit the needs of stress tests; supervisors should not form preset expectations for the numbers of either. Committing resources to modeling conceivable yet highly unlikely events that are unrelated to any experience can prove to be little more than an expensive intellectual exercise. Again, the supervisor’s role is to challenge senior management to demonstrate that the scale, frequency, and overview of its stress testing is appropriate to its operations. A stress testing program should be judged based on how well it is run, not how often or how many bells and whistles it uses.

➤ **Supervisory expectations for stress testing should be principles-based.**

The art of stress testing is continually being advanced, and new ideas are developing. Supervisors should not have set expectations for the exact way that stress testing is to be conducted, as such bias could impede progress in risk management. Instead, the role of supervisors is to challenge senior management to defend the stress testing program and verify that the program is capable of being defended.

The details in the Consultative Document could potentially lead regulators to become overly prescriptive in specifying a stress testing regime and expecting too much from it. The principles present a useful outline for discourse between institutions and supervisors; they should not become a supervisory checklist.

An example is the documentation requirements proposed in Principle 4. If extensive records are required for every stress test that an institution runs, then this will impede management’s ability to evaluate spur-of-the-moment scenarios in reaction to a changing environment.

We believe that general stress tests are part of an institution’s Internal Capital Adequacy Assessment Process (ICAAP) and should therefore be evaluated by supervisors as part of the Pillar 2 supervisory review. Pillar 2 supervision is appropriately more principles based, which fits the need for creativity in stress testing. Moreover, institution-wide stress testing, like Pillar 2 in general, involves longer-term planning – unlike the shorter-term Pillar 1 regulatory capital calculations.

➤ **Stress test results should not be used to determine capital requirements.**

The Consultative Document gives the impression that regulators are inclined to regard stress testing as the panacea to all risk management challenges. However, stress testing is but one tool in the suite of risk management tools; it should be combined with other forms of risk analysis, such as value-at-risk (VaR), credit limits, factor sensitivity, and risk rating profile.

Like all the other tools, stress testing has shortcomings. Stress runs across an institution provide information on aggregate risk concentrations and risk mitigation activities. However, even a well-designed stress test presumes a scenario that will not play out exactly as modeled. Since institution-

wide stress scenarios normally extend past a year, the uncertainty of the results is great. After all, the point of a stress run is not to achieve the impossible, prediction of what will happen, but instead to aid in planning against contingencies that *could* develop. Thus, stress test results cannot, by themselves, define a level of need for capital; they should not therefore become a measure of additional required capital. In most cases, planning and adopting of risk mitigations are more effective in dealing with a stress than additional capital.

➤ **Supervisors and institutions benefit from coordination within colleges of supervisors.**

For multinational institutions, engagement and cooperation across jurisdictions enhances the supervisory review of stress testing and avoids needless duplication of effort. Recognizing international linkages of institutions, markets and stresses, coordination among an institution’s national supervisors can lead to stress testing that best reflects its organization-wide risk exposures. Cooperation lessens time-consuming and unproductive redundancy in supervisory review, allowing the institution to commit more resources to productive stress exercises. We therefore support the Basel Committee’s aim to achieve consistent principles and requirements for stress testing across borders, and recommend that colleges of supervisors should work to harmonize stress test exercises for international institutions.

Comments on the Proposed Principles

Principle 1. Stress testing should form an integral part of the overall governance and risk management culture of the bank. Stress testing should be actionable, with the results from stress testing analyses impacting decision making at the appropriate management level, including strategic business decisions of the board and senior management. Board and senior management involvement in the stress testing programme is essential for its effective operation.

We agree that stress testing is a key management tool. However, stress tests should not be regarded as a stand-alone or even primary device for decision-making. Stress runs need to be carefully designed and executed for results to be meaningful. Even so, the results require careful interpretation and should not be overly or exclusively relied on as representing objectively quantified “truth.” By definition, a stress test explores what *might* happen to an institution under certain specific conditions. In reality, the specific conditions will never play out exactly as assumed, and the institution’s reaction will differ along with its environment. The point of any stress test is not to predict what will happen to the institution, it is to help it prepare for stress circumstances. Its greatest utility is in providing a language and methodology for prompting more qualitative than quantitative discussion at a high level about scenarios that could put the institution at risk.

Therefore the principle should recognize that not all forms of stress testing are “actionable.” Analysis of trends over time in output from a particular scenario provides valuable insight into the risk profile of a particular business line or even the overall institution. This sort of information can inform management about levels and changes in risk exposure, but is not necessarily “actionable.”

More “actionable” stress test results involve risk concentrations or stresses for a specific business or portfolio, but these are not the only forms of stress testing.

As an example, the Consultative Document states that “stress tests should be used for setting the risk appetite of the firm or setting exposure limits” (page 13). We believe that risk appetite and exposure limits should be informed, but not dictated, by the results of stress tests.

We also agree with the principle that senior management and the board of directors should be involved in the stress testing process, as they are ultimately responsible for its success. Senior management should be deeply involved in the identification of institution-wide stress scenarios and risk management strategies, as proposed. However, there must be reasonable limits to supervisory expectations for involvement of the board of directors in the stress testing process. With a myriad of details for the board to consider, it is unreasonable to expect all board members to have the expertise or spend the time to understand the nuances and procedures of all stress tests. Key stress test information should be reported to board members but it is unrealistic to expect them to be involved with the choice of methodology or other technical decisions related to stress testing. The actual institution-wide stress testing will likely be conducted by a specialized risk team. The head of the risk team will likely report to a risk subcommittee of the board, not the entire board. While it may be appropriate for a board risk committee to be more involved with the stress testing program, we recommend that the supervisory principle should not expect the entire board to be involved in the details of the stress testing policy or other aspects of stress testing other than receiving reports and explanations of major changes.

Moreover, the principle should distinguish between holistic, institution-wide stress runs and those aimed at specific business or portfolio operations. Board and senior management should not be held responsible for stress runs focused on decision making and governance for particular business lines.

Principle 2. A bank should operate a stress testing programme that: promotes risk identification and control; provides a complementary risk perspective to other risk management tools; improves capital and liquidity management; and enhances internal and external communication.

We agree with the range of objectives for a stress testing program and that stress testing is a useful tool to supplement other risk metrics. As this principle emphasizes, stress testing is only one risk management tool; to support good quality decisions, stress test results relating to the risk profile of the institution should be combined with other forms of risk reports, such as value-at-risk (VaR), credit limits, factor sensitivity, and risk rating profile. We feel that the Consultative Document does not give due consideration to other risk tools, which are equally as valuable as stress tests.

We also agree that stress testing can aid capital and liquidity management. However, stress testing of liquidity management is a separate discipline from stress testing of risk-to-capital exposure. While the assumptions surrounding liquidity stress testing and risk exposure stress testing should be compatible, the methods used, timetables, and outcomes are very different. For example, liquidity management almost by definition relates to more severe macroeconomic scenarios. We feel that the liquidity stress testing regime is well covered in the Basel Committee’s “Principles for Sound

Liquidity Risk Management and Supervision”² so that the reference here should simply be a note that the assumptions of both should be compatible.

Importantly, we do not believe that the identification of stress in either of these areas should necessarily call for higher regulatory capital. Clearly, contingency planning and other mitigating actions can be more effective.

The principle proposes that “stress tests should also play an important role in external communication... A bank may also want to voluntarily disclose its stress test results more broadly to enable the market to better understand its risk profile and management.” None of our members is prepared to disclose stress results publicly, and none should be pressured by regulators to do so. We see significant potential for market misunderstanding of such data, which extensive explanation of the tests and their results may be unable to resolve. The uncertainties surrounding these results, assumptions, and the potential for misunderstanding are such that there should not be any external communication recommendation.

Principle 3. Stress testing programmes should take account of views from across the organisation and should cover a range of perspectives and techniques

We support broad collaboration across the institution for stress tests designed “to address existing or potential firm-wide risk concentrations” (page 14). However, such involvement would not be appropriate for more localized stress runs. Moreover, the range of perspectives and techniques employed should fit the needs of the stress test; supervisors should not insist on specified numbers of scenarios or methodologies simply as an intellectual exercise. To be most effective, institution-wide stress runs should be limited to a modest number of scenarios that are most relevant to the institution. The stresses considered at a consolidated level should be those most likely to have a severe impact on the capital of the institution – not a wide variety of tests, some of which are likely to have minimal impact.

While we agree that stress tests should be conducted at regular intervals, regulators must understand the demands that comprehensive stress testing places on an institution. The time and resources required to devise, run, evaluate and act upon a comprehensive stress test are not insignificant. A stress testing program should be judged based on how well it is run, not how often.

² Basel Committee, “Principles for Sound Liquidity Risk Management and Supervision,” September 2008.

Principle 4. A bank should have written policies and procedures governing the stress testing programme. The operation of the programme should be appropriately documented.

Requirements for too much and too detailed documentation will hinder flexible and expeditious execution of *ad hoc* stress tests in response to emerging situations. While the methodology should be documented, the need to extend this to reasons, judgments, every component, and the range of actions will result in a constrained, bureaucratic process and hinder valuable and timely stress testing.

Clearly, documentation is needed for a structured set of stress tests, but supervisors should not look for a full set of paperwork for all experiments. In most institutions, management frequently plays through scenarios to test how recent events may affect particular portfolios or business lines. Most of these stress tests are neither structured workshops nor thoroughly documented. Forcing documentation strictures on such *ad hoc* runs would absolutely undermine management’s ability to manage.

Principle 5. A bank should have a suitably robust infrastructure in place, which is sufficiently flexible to accommodate different and possibly changing stress tests at an appropriate level of granularity.

We support the dual objectives of robustness and flexibility for stress testing. However, as noted, a robust programmatic approach to stress testing conflicts with quick-response flexibility. Banking firms are working to enhance both, but stress testing is a developing art. Regulators must take care not to constrain progress with fixed views on flexibility and robustness.

We have a broad concern over scope creep. A banking firm should have latitude to determine its own infrastructure needs consistent with its governance and organization structure (e.g., centralized versus decentralized). Flexibility in implementing systems is a function of designing the specifics in advance of development. Risk infrastructure is not necessarily something that should be or improved to suit a stress testing regime. That is simply good management, and as such should be out of scope for stress testing. Risk infrastructure enhancements should not be a specific goal of developing and implementing a stress testing regime. They go hand in hand, but stress testing should be a part of an institution’s risk or management infrastructure, not the other way around.

We see institution-wide stress testing as a top-down process, whereby the firm considers a set of reasonable and relevant comprehensive stress scenarios and examines the interrelated effects across the range of its operations. An institution-wide stress test can identify particular areas where it would be advisable to drill down into specific business lines (or groups thereof) and carry out stress tests that are most relevant to those lines. These localized stress runs can appropriately be more detailed and specific to that business line than the institution-wide stresses. As a result, aggregation of results of these business or product stresses may be meaningless. Moreover, an aggregation can miss the portfolio effects where interrelationships among risks and business activities can be identified.

Principle 6. A bank should regularly maintain and update its stress testing framework. The effectiveness of the stress testing programme, as well as the robustness of major individual components, should be assessed regularly and independently.

We agree that, like every model that can potentially have a material effect on earnings or soundness, stress test models should be subject to thorough and independent model validation. In most institutions, the internal audit function plays a role in model validation along with the model validation function, but in others the model validation function covers all of the responsibilities without involving internal audit. Similarly, we concur that an institution’s stress testing program should involve experiments on the parameters and workings of the material models. This role is carried out by model operators, validators or operational risk units in different organizations. In evaluating the independence of the control function, supervisors should focus on whether there is effective challenge without preconceived expectations for institution structure.

It is problematic to suggest that institutions would benchmark stress test results against one another. Due to the idiosyncrasies of individual institutions and their stress tests, the results would not be comparable without thorough analysis of individual institutions’ systems. It is unlikely that institutions would be willing to share such proprietary information, and it would be inappropriate for regulators to expect such sharing.

Principle 7. Stress tests should cover a range of risks and business areas, including at the firm-wide level. A bank should be able to integrate effectively across the range of its stress testing activities to deliver a complete picture of firm-wide risk.

As noted above, we agree that a primary objective of a stress testing program is to identify concentrations of risk exposure, and that to do so an institution should examine the effects of a range of types of shock and their effects broadly across the organization. Risk concentrations may only become clear based on institution-wide analysis. We caution that gauging interrelationship between different categories of risk is an art; there are significant differences in techniques employed, and none has been confirmed as the accepted form.

We also believe that supervisors should be open to demonstration of an interrelationship occurring during a stress environment that is beneficial in that it provides migrating offsets to potential losses elsewhere in the firm. As an example, in the current extended economic downturn, credit losses are likely to rise and interest rates are likely to fall with slowing economic activity. If an institution has a “long” interest-rate risk position in its banking book, then increases in value of this position can naturally offset rising credit losses.

This principle appears to suggest that firm-wide shocks should be evaluated on a bottom-up basis, building from portfolio or business line stress tests aggregated to organization level, factoring in interrelationships. We believe instead that firm-wide stress testing is a top-down process, whereby the effects of a few comprehensive stress scenarios and remedial actions are considered across the range of operations. As noted above, an institution-wide stress test can identify areas where the firm may want to examine more deeply the effects of certain stresses on individual business lines. However, since these localized experiments can be more tailored to the characteristics of the separate business lines, aggregation of their results can lack meaning and miss risk offsets.

Principle 8. Stress testing programmes should cover a range of scenarios, including forward-looking scenarios, and aim to take into account system-wide interactions and feedback effects.

Recent experience has painfully demonstrated the consequences of “failure of imagination” and has emphasized the importance of using potential forward-looking exposures that may not follow historical patterns. Indeed, discussions within an institution of the relevance of a range of possible stresses suggested by decision-makers within the firm have proven to be useful exercises.

Nonetheless, an institution has to drill down from a limitless array of possible egregious scenarios to a set that is both credible and relevant. In life, a severe situation usually presents itself only after a stress event unfolds. Lacking precedent, it stretches the imagination to believe that an institution can anticipate how a novel event might play out. Committing resources to modeling conceivable yet highly unlikely events that are unrelated to any experience can prove to be little more than an intellectual exercise. Care is needed to avoid modeling results that are purely imaginary. In fact, a broad interpretation of this principle appears to conflict with the intent of Principle 1, that stress runs be “actionable.”

Regulators need to recognize that stress testing on an institution-wide basis is complex and time consuming. It is impractical to perform a full analysis for a large number of detailed scenarios. Rather, an institution will gain more from concentrating its resources on doing a thorough analysis over a limited set of scenarios, considering their implications for concentrations, and evaluating mitigation actions.

Principle 9. Stress tests should be geared towards the events capable of generating most damage whether through size of loss or through loss of reputation. A stress testing programme should also determine what scenarios could challenge the viability of the bank (reverse stress tests) and thereby uncover hidden risks and interactions among risks.

While recognizing the need to think beyond harsh circumstances seen in the past, as Principle 8 endorses, we are concerned that the intent of Principle 9 can be open-ended. There are infinitely many ways to assess values for parameters that could lead to catastrophic outcomes, but most of these have no relevance to the institution.

Circumstances that are likely to damage an institution severely are those involving major losses arising from concentrated positions, rather than assumptions such as ever more severe recessions or extreme market price movements. Modeling more dramatic recession scenarios or market price changes without basis undermines the credibility of the tests and their results.

Assumptions in stress analyses unavoidably have an element of subjectivity; thus expert judgment is required to cull the scenarios of relevance. “Reverse” stress tests not grounded in judgment or realistic assumptions are by definition meaningless.

If the goal of supervisors and bank management is the viability of the institution, requiring capital to cover *all* risks will destroy the institution as surely as taking too much risk. Financial institutions are in business to create returns for shareholders by taking measured and controlled amounts of risk. Inability to produce adequate returns on capital will make investment in the firms unattractive and impair their ability to raise capital when needed. Therefore, results from reverse stress tests should not be used to set capital levels.

Thus this principle should be revised towards testing the potential from losses arising from a combination of large losses due to a combination of concentrations with plausible but severe other stresses. If there is any role for reverse stress tests, it is to broaden management understanding – not to mandate fully compensating capital or other protections.

Principle 10. As part of an overall stress testing programme, a bank should aim to take account of simultaneous pressures in funding and asset markets, and the impact of a reduction in market liquidity on exposure valuation.

Given recent experience, financial institutions have sorely learned and will not easily forget the impact of simultaneous liquidity and assets market shocks. This lesson has been incorporated into institution-wide stress tests. Going forward, institutions and regulators need to prepare for not just scenarios seen in the past, such as joint liquidity and asset market shocks; as espoused under Principle 8, the more likely major risks in the future will be other than the mistakes of the past.

Principle 11. The effectiveness of risk mitigation techniques should be systematically challenged.

As noted above, a primary function of stress testing is to detect risk concentrations and develop contra risk mitigations. We concur that assessing these mitigations will necessarily be part of the stress testing program. Nonetheless, as noted under Principle 10, stress scenarios need to consider what may reasonably occur, even in a troubled period. Before entering into contracts for risk mitigation devices, institutions carefully evaluate the robustness of their legal and operational structures. Where risk mitigation structures have failed, the markets have learned and effected corrections. Going forward, institutions and regulators need to prepare not just for problems faced in the past but for those that could develop in the future.

Principle 12. The stress testing programme should explicitly cover complex and bespoke products such as securitised exposures. Stress tests for securitised assets should consider the underlying assets, their exposure to systematic market factors, relevant contractual arrangements and embedded triggers, and the impact of leverage, particularly as it relates to the subordination level in the issue structure.

We certainly agree that an institution “should include in its stress tests all relevant information related to the underlying asset pools, their dependence on market conditions, complicated contractual arrangements as well as effects related to the subordination level of the specific tranches.” And we recognize the importance of special attention to new products, especially their unproven qualities. We caution regulators about bias against innovative market solutions, which bias can stifle financial progress.

Principle 13. The stress testing programme should cover pipeline and warehousing risks. A bank should include such exposures in its stress tests regardless of their probability of being securitised.

We agree with this principle but feel that it may be some time before this becomes an issue again.

Principle 14. A bank should enhance its stress testing methodologies to capture the effect of reputational risk. The bank should integrate risks arising from off-balance-sheet vehicles and other related entities in its stress testing programme.

We recognize that an institution should consider the chance that it may assume responsibility for off-balance-sheet vehicles and the effects on its liquidity. However, we question the statement that “A bank should enhance its stress testing methodologies to capture the effect of reputational risk” (emphasis added). Institutions are looking for the best way to estimate reputational risk, but there is no generally accepted approach. Anecdotally, we understand some institutions have simply taken the approach of using a buffer to cover such non-modeled risks. We believe that robust systems and controls to ensure that this issue is properly investigated, especially at the new product or business line development stage, can provide more protection against reputational or strategic risk than additional capital. Therefore, we recommend that specific reference to quantification of reputational risk should be removed from this principle.

Principle 15. A bank should enhance its stress testing approaches for highly leveraged counterparties in considering its vulnerability to specific asset categories or market movements and in assessing potential wrong-way risk related to risk mitigating techniques.

We recognize that “correlated tail risks” for highly leveraged counterparties have increased “wrong-way risk” and contributed significantly to the severity of the current financial turmoil. These events are providing previously unavailable data on correlations during severe stress events, which institutions are incorporating into their stress models.

Principle 16. Supervisors should make regular and comprehensive assessments of banks’ stress testing programmes.

In the United States, we expect that the provisions of this principle will be carried out as part of the Pillar 2 supervisory review process. To give due time and effort to the exercise, institutions are unlikely to review the processing elements of their stress testing program more often than once a year, although key parameters and scenarios may be reviewed more frequently.

We agree that supervisors should regularly engage senior management from a set of financial institutions to discuss major macroeconomic and financial market vulnerabilities. This sharing of views on potential systemic economic and financial stress points, and ways that these may be handled, is useful for all involved.

Principle 17. Supervisors should require management to take corrective action if material deficiencies in the stress testing programme are identified or if the results of stress tests are not adequately taken into consideration in the decision-making process.

We generally support the provisions of this principle. The key point is that “supervisors should challenge banks on how stress testing is used and the way it impacts upon decision-making.” The art of stress testing is continually being advanced, and new ideas are developing. Therefore, supervisors should not examine an institution’s stress testing program with prior expectations for the exact way that it should operate. Instead, the role of supervisors is to challenge senior management to defend its stress testing program. We take issue with the statement that “supervisors should review the key assumptions driving stress testing results and verify their continuing relevance in view of existing and potentially changing market conditions” (emphasis added). It is the responsibility of management to support the assumptions used in its stress tests against effective challenge by supervisors and not supervisors’ role to “verify” anything in the tests.

Principle 18. Supervisors should assess and if necessary challenge the scope and severity of firm-wide scenarios. Supervisors may ask banks to use specific scenarios or to evaluate scenarios under which their viability is threatened (reverse stress testing scenarios).

We generally support the provisions of this principle. Supervisors have the authority to challenge the scope and severity of scenarios, but the point should be to challenge senior management to defend its stress tests. While supervisors may occasionally specify scenarios for institutions to run, such as the U.S. Treasury and banking agencies are currently doing for some very large U.S.-based banking firms, this practice should be rare. As outlined in Principle 1, senior management, not supervisors, are responsible for devising the stresses of greatest import to their institution. As above, we question the value of “reverse stress testing scenarios.”

We also caution supervisors against taking a “cookie cutter” approach when reviewing an institution’s stress-testing scenarios – that is, requiring one institution to use a particular scenario just because it has been used in another. It is incumbent upon the supervisors to understand each firm’s unique business model and how the stress scenarios were developed to test that unique model and its potential risks.

Principle 19. Under Pillar 2, supervisors should examine a bank’s stress testing results as part of a supervisory review of both the bank’s internal capital assessment and its liquidity risk management. In particular, supervisors should consider the results of forward-looking stress testing for assessing the adequacy of capital and liquidity.

We agree that stress testing is an input to the ICAAP and that supervisory consideration of an institution’s stress testing program should primarily be part of the Pillar 2 review. If supervisors identify vulnerabilities, they should look first for a risk management and mitigation plan – not additional capital. In many cases, more capital would be an ineffective or irrelevant solution.

Principle 20. Supervisors should consider implementing stress test exercises based on common scenarios.

We are not necessarily opposed to the concept of a common scenario as a means of “horizontal review” of banking organizations. However, supervisors must recognize that a “one size fits all” approach does not fit any institution well. More relevant are the institution-specific scenarios that keep senior management awake at night. The time and resources required to run generic scenarios detract from attention that could otherwise be devoted to consideration of the circumstances of greatest relevance to individual institutions. In general we feel that, if an institution uses comprehensive and effective scenarios based on the stresses to which it is most vulnerable, then benchmarking against an externally imposed scenario is redundant and of no value.

Generally, no two financial institutions are alike. To be meaningful, the stress testing regime should be customized by each institution based on assessment of its unique situation. Benchmarking is a commendable goal, but in practice it would be very difficult to achieve comparability across institutions due to differences in design and execution. Further, the relevance of a common benchmark can vary tremendously by institution; a scenario that is plausible and realistic for one firm may be completely inappropriate for another.

When supervisors impose a common scenario, it should be carefully designed and implemented to minimize the challenges to producing credible and meaningful results. Supervisors should seek industry input on the design, execution and interpretation of any universal stress test. One method would be to arrive at a common scenario based on a “horizontal review” of the scenarios institutions are using. Prescribed scenarios should further be less prescriptive in specifying parameters and instead be based on a specified economic/financial environment, allowing institutions to estimate their own parameters.

We suggest further that, before finalizing the stress testing principles, the Basel Committee should review recent “common scenario” exercises in the United Kingdom and United States. These can provide good opportunities to learn from actual experience.

What is especially to be avoided are circumstances where a poorly designed and executed generic stress test produces dramatic but meaningless results that are then made public or used in the

development of regulation or policy. It would be especially problematic for the results from individual institutions to become public. If regulators control all aspects of design, execution and interpretation of the analysis, then they are obliged to be fully transparent about data and methodology, lest results would be very difficult to critique effectively and constructively. The interpretation of “QIS4” results by various agencies is a case in point.

Principle 21. Supervisors should engage in a constructive dialogue with other public authorities and the industry to identify systemic vulnerabilities. Supervisors should also ensure that they have the capacity and the skills to assess banks’ stress testing programmes.

We fully support regular dialogue between bankers and regulators concerning developing stresses and interactions in the economy and financial markets. Supervisors should not only be able to assess the scope and severity of stress scenarios, but should demonstrate flexibility to assess the relevance and applicability of institutions’ stress testing programs.

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Thank you for the opportunity to comment on the Consultative Document. If you seek additional clarification on our points, please contact the undersigned at 202.663.5350 or rstrand@aba.com.

Sincerely,

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