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Dear Klaas

Principles for sound stress testing practices and supervision – a joint response by the trade associations

The International Banking Federation (IBFed), the International Swaps and Derivatives Association (ISDA) and the London Investment Banking Association (LIBA) are pleased to feedback on the Basel Committee on Banking Supervision's *Principles for sound stress testing practices and supervision – CP147*.

Our members are in general agreement that the proposed principles reflect current expectations about the role of stress testing as one of the key components in a firm's strategic, capital and liquidity planning arsenal.

Key messages

We welcome the principles

The experiences of the past eighteen months have plainly demonstrated the importance of stress testing practices that were sufficiently embedded, imaginative and comprehensive and thus able to cope with the financial tumult as it morphed

from an uncertainty about asset prices, to a liquidity crisis followed by rising concerns about counterparty risk with its consequent knock on impacts on firms' lending generally as wider economic conditions deteriorated.

Members have learned from these experiences and many of them have already significantly improved or developed their stress testing practices and have used them, as the paper notes, to plan their responses to the credit crunch as it unfolded.

But it is not proven that analysis of less likely and more severe scenarios would have made a material difference to the current crisis which is multifactorial in its origin. Stress testing is not a cure all. Rather it is one of a number of tools that firms and supervisors can use to plan responses to possible future scenarios - an internally consistent view of what the future might be and to provide a 'memory of the future'; which can be called upon if a scenario actually develops to improve organisational response.

However we are also conscious that within working memory the banking and investment banking industry has faced similar times of stress yet memory had faded as economic conditions remained favourable for an unprecedented period of time. So we support the principles and expect that they will be a valuable tool for firms as they benchmark their own stress testing practices against them, preserving the collective memory of the financial crisis as they do so.

The application of stress testing techniques to different types of risk are at different stages of development and the debate still continues about how amenable different risk types are to quantification. So the application of the stress testing principles to risk types must reflect the extent that the quantitative risk measurement of each risk type has evolved. Nevertheless, although the actual quantification can vary, members see value in using stress and scenario testing to enhance risk management.

Our members would welcome further guidance from the BCBS about its expectations of the effective date and transition period – without this there is a risk that different regulators will establish different standards, creating difficulties for our members that compete in a range of different countries.

Stress tests should be undertaken in Pillar 2

We support the BCBS's assertion that the general stress tests of the sort described in the Principles should take place as part of the preparation of a firm's ICAAP, although recognise that the objectives of a comprehensive stress testing programme range more widely than just managing capital. Basel II already contains a framework for general stress testing. We would expect regulators to integrate the BCBS's proposed principles into the Pillar 2 review process and evaluate their stress testing methodologies and governance in that context – not to require the development of a parallel set of stress tests.

The proposed principles are very helpful in providing a common language for firms and regulators alike to facilitate the dialogue about a firm's stress testing practices in

the Pillar 2 supervisory review and evaluation process. This is where that discussion should take place.

A proportionate, group wide approach matters

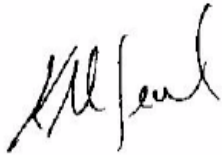
The paper highlights that its recommendations are based on discussions with larger, more complex banks. We agree with its assertion that the principles should be implemented proportionately. For the smaller firms, the costs of multi-factor stress testing will be high and the reliance on proportionality is therefore important. The boards and senior management of banks should determine for themselves the degree and depth to which their stress testing practices explore the impacts of different scenarios, although of course we would expect the supervisor to challenge those senior management decisions when appropriate. In the same way senior management should determine the frequency with which stress tests are updated although our underlying assumption is that each firm subject to the requirements of Basel II framework should perform an ICAAP containing an appropriate and proportionate range of stress tests annually.

The paper does not address the level at which stress tests should be performed. We believe that group-wide, holistic stress tests have the most relevance as only they can provide the aggregate view of a group's vulnerabilities. We expect that such group level stress tests would be led and coordinated by a centralised stress testing/risk management function that is independent of the firm's business units, according to an overarching governance process, which develops stress testing parameters to be applied in a uniform way to the entirety of a firm's business. We expect host state regulators to exercise flexibility regarding the levels at which stress testing takes place and any requirements they place on its local operations to reflect the way in which the firm is managed. To emphasise, our strong preference is that the stress testing principles should apply holistically at the group level, with the process being managed by a unit that is independent of individual business units, with a strong presumption that a key task for the stress testing team is robust challenge of business units' assumptions.

Capital is important but not the only answer

Firms apply stress testing in a wide ranging way so that senior management and the board can assess the results of the stress test in order to devise mitigating strategies. This is the real value of stress testing – it helps to elucidate the factors to which a firm is particularly vulnerable in order to determine what impact if any they might have on its capital and investment plan. If a capital weakness were identified we would expect this to be remedied but we would not expect senior managers, or regulators, to translate the results of stress tests into a need for more capital on an automatic basis. Similarly it would not be appropriate to establish a mechanical link between stress tests and economic capital, as it seems could be suggested by principle 19; they should be two independent and complementary components of the ICAAP.

We would be happy to discuss any of these comments further and or hear your views on our response. To arrange this please contact either Simon Hills at IBFed, Ed Duncan at ISDA, or Katharine Seal at LIBA.



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Recommendations to banks

Use of stress testing and integration in risk governance

- 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 processes should be embedded in the management of the bank and that this is best achieved by ensuring that the board and senior management are involved in the stress testing programme and must shoulder the ultimate responsibility for its efficacy.

In particular the senior management should review, challenge and approve the group-level scenarios that are subject to the stress testing process and subsequently identify any appropriate mitigating actions in relation to the group's strategy. The actual process of stress testing will likely be led and coordinated by an independent, specialist team, or confederation of risk teams¹ within group risk management that are responsible for the [co-ordination across risk types/divisions of group-wide scenario development \(ensuring consistency where appropriate\)](#).

We would expect this central risk team to report to a risk sub committee of the board, rather than to the board itself and it is this sub committee that should take operational responsibility for the stress testing process.

It should also be recognised that business specific scenarios will probably be employed at business unit level to aid decision taking and that the governance processes around such more localised exercises may be different given that they are being used for a different purpose than for the overall management of the group. These will be of less relevance to the supervisor as they only examine a subset of the group's activities.

- 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 this range of objectives for a firm's stress testing programme but note that, as principle two emphasises, stress testing is one of a range of complementary tools used in risk management. Although stress testing can be a powerful tool we see its greatest utility in providing a language and methodology for prompting more qualitative than quantitative discussion at a high level within a firm about the

¹ The process of stress testing is likely be carried out by a number of specialist central risk teams responsible for the particular risk type being stressed, and within that risk type (e.g. credit risk) the specialist analytics team responsible for e.g. retail vs. corporate. This more effectively facilitates discussion, buy-in and action with the senior risk and business management of that division.

scenarios that could put the successful implementation of a firm's business model at risk.

We agree that stress testing should be an aid to capital and liquidity management but do not believe that the identification of stress in either of these two areas should automatically lead to an increase in a firm's regulatory capital requirements. Other mitigating actions maybe even more appropriate. Alternatively management may make a positive decision to accept the risk as being within its risk appetite.

Although we note that the last sentence of the text elaborating on this principle, suggests firms may wish to voluntarily disclose the results of their stress tests we doubt that any of our members will do so. We see significant potential for misunderstanding if a firm reveals the intimacy of the range of the stresses it has subjected itself to without the opportunity for further extensive elaboration and a willingness by the market to delve behind the headlines.

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

This is a crucially important principle which we support. Those of our members that have found stress testing to be of most use have formed mixed groups of risk management specialists, economists and business line senior managers to debate and devise a range of adverse scenarios which can then be further elaborated upon by specialist team which will attempt to quantify their impact on the firm and its capital and liquidity. Experience shows that such groups can be of most use when led by a senior representative of a key business unit with the risk team providing challenge and constructive scepticism.

Whilst we agree that stress tests should be run at regular intervals the IT resource required to run a comprehensive stress test is not insignificant and we encourage regulators to temper their enthusiasm for quantitative outputs from a stress testing programme with an understanding of the demands this can make of an organisation. In essence we believe the value of a stress testing programme lies more in how scenarios are devised and potential mitigating actions debated than in how often it is run, although we would expect our members to at least align their main stress testing initiatives with the annual ICAAP preparation.

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

We agree with this principle and are sure that regulators recognise that it is more important that flexible ad hoc stress tests in response to emerging risk issues are performed expeditiously even though they may not be in total alignment with documented procedures designed for a more methodical stress testing programme. We are sure that regulators will not require firms to document the entire range of all possible remedial actions, but rather focus on a few most relevant ones.

- 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 twin goals of robustness and flexibility but have noted above that there will inevitably be trade offs in relation to one or the other that must be made. Our members are working towards creating systems that meet these two objectives. But stress testing is a risk management discipline relying as much on qualitative art as quantitative science. Developmental and sophistication variances do exist across risk types within individual institutions and recognition of this should be factored into expectations of what stress testing can deliver in the short, compared to the longer term.

- 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 stress testing frameworks should be independently reviewed by an independent control function but wonder how the results of stress tests could actually be benchmarked with stress tests carried out by other firms. There may be a role for industry/regulator joint working groups in this regard but doubt whether they will be able to delve very deeply into the mechanics of individual firms' frameworks given that there is no one size fits all approach and there is potentially a significant element of competitively sensitive information included, for instance, in the mitigating actions.

- 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.**

We agree that stress tests should cover a range of business risks and particularly that stress testing should take place at a firm-wide level, which we take to mean where relevant, a group wide level. So we view stress testing as holistic process, rather than a bottom up one requiring integration as this principle seems to imply.

However we do recognise the importance of having a strongly embedded and well developed stress testing framework which enables business units or particular subsidiaries or groups of subsidiaries to examine additional scenarios specific to their own risk profile, but *without being subject to the level of documentation or other supervisory expectations as for group-level stress testing.*

Risk concentrations may only become clear when a group wide approach is taken. Typically our members use centrally developed stress testing techniques and parameters which are then applied to business units or clusters of similar business units. This is necessary not only to ensure consistency but also as the IT resource consumed in running a comprehensive stress test is very significant.

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 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.

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.

The lessons of the past couple of years demonstrate the importance of taking into account systemic scenarios, not just idiosyncratic ones that include the consideration of an economic recession. We recognise it is important to involve senior management of business units in the generation of a range of forward looking scenarios and those of our members that have found most benefit from the stress testing process report that as much value is gained from the qualitative, discussion based aspects of this phase of the stress testing process as from the production and review of a quantitatively based outcome. However we do not think regulators should mandate stress testing at business or entity specific levels as the supporting text to Principle 8 tends to suggest. Stress testing at lower levels than the group is carried out for different reasons, for instance to test business plans, and in this context stress testing procedures may be more tailored than the group wide stress tests we advocate

The act of considering a range of scenarios is a valuable exercise in itself. However it is likely that a range of scenarios developed by an expert group including business unit leaders will subsequently be whittled down by the banks most senior executives for further quantitatively based exploration. This emphasises that not all scenarios that a bank develops as it iterates towards the most relevant stress tests for a firm at a particular time will be subject to quantitative analysis and we would expect regulators to recognise this as they review a firm's stress testing practices and procedures. Just because a scenario does not have a detailed supporting numbers based analysis does not mean that its consideration has not been a useful exercise.

We should recognise that comprehensive consideration of system wide-effects will always include the possibility of government intervention as a system wide stress caused the economy to deteriorate.

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.

We recognise the paramount importance of examining tail events and the possibility of them destroying the entire firm using reverse stress testing, but it should be recognised that at the group level, there is a difficulty in conducting a large number of quantitative reverse stress test scenarios, particularly in relation to the correlations between scenarios applicable to specific subparts of banks. The firm itself should take the decision about number of stressed scenarios it develops and justify it to their senior management and their supervisor.

Reverse stress tests should encourage management to explore a small range of extreme scenarios which could potentially result in a firm's business model failing. The key value of this type of testing is in influencing high level strategy, risk appetite and business planning and further enhancing existing contingency planning within the firm, not in assessing capital adequacy.

The point at which a bank becomes unviable is extremely challenging to define. The consultative document refers to the insolvency of the firm and is unclear as to whether this means breach of minimum capital ratios or complete depletion of capital resources. Our members assume that it is the former that regulators are concerned about.

We believe that the senior management focus should be directed to mitigating actions rather than quantitative evaluation of the most extreme events and that the supervisor should use reverse stress testing as a facilitator of dialogue rather than the determinant of a capital add-on to the minimum capital requirement.

So there must be full clarity on what are the regulatory expectations about how the results of the reverse stress test should to be used within the bank, and specifically, how the supervisors are intending to take the reverse stress test scenarios and outcomes into account in their Pillar 2 supervisory reviews.

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.

As night follows day a prolonged boom causing a run up in assets prices eventually and inevitably leads to a bust and it is the job of all industry participants to ensure that this lesson is not forgotten.

Given the experiences of the past two years we think it very likely that our members will indeed consider the impact of simultaneous liquidity and assets market shocks in their future stress tests, but regulators and industry participants alike must be determined in their identification of new and emerging threats to financial stability, being careful not to just re-run historical scenarios such as the credit crunch, an oil price shock or dot com market collapse. We are pleased that the BCBS principles recognise this and emphasise the importance of wide-ranging internal dialogue in constructing scenarios. It may be helpful too if such an open dialogue between regulators and industry participants generally were held to identify emerging points of tension in the global financial architecture in order that they could be incorporated, at the institution's discretion, into its stress testing programme.

However the BCBS will be as acutely aware as our members that the extreme and multi-faceted stresses which the financial services industry is currently being subject to is still in the process of being resolved. Whilst banks are playing their part in ensuring this happens quickly we must recognise that a successful resolution depends on the coordinated reactions of many different players, including central banks, finance ministries and regulators with input from accounting and auditing bodies too.

As firms review their responses to such system wide events it will be reasonable for them to make assumptions about how the authorities would react to the impact that a severe stress might have, particularly if they are a systemically important firm, and it would not be unreasonable for them to factor in these assumptions in to their damage limitation programme for discussion with the authorities.

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

Risk mitigation techniques are a key component in minimising exposures and are central to the smooth operation of our global financial system. For the most part over the past two years they have performed as expected, based as they are on well established legal principles and operational structures. We support this principle and agree that it is of course important to continue to challenge the efficacy of risk management techniques but we note that this challenge is being done all the time by infrastructure providers and the courts. Nonetheless, we have concerns that the statement of this principle may indicate that the BCBS has concerns that risk mitigation is routinely or systematically impaired. This view could tarnish the current wide acceptability and utilisation of these techniques and it would be helpful if the BCBS could demonstrate that this is not the case in the final iteration of the principle, e.g. “While recognising the welcome development of risk mitigation techniques, these techniques should remain subject to systematic challenge over time to ensure their continued effectiveness”.

Where risk mitigation techniques are less effective this has typically arisen because of conflicts between different legal approaches and these differences are already well understood and considered in the legal opinions that our member firms obtain before starting to use a particular risk mitigation technique, having balanced business needs with legal effectiveness.

We would prefer the replacement of the word ‘systematically’ with the word ‘robustly’ in this 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.

It is our overarching view that stress testing should be performed at a holistic, group wide level and given the experiences of a number of financial services firms that

have now disappeared from the financial horizon our members are fully aware that where a complex or bespoke product becomes, for instance, a dominant funding source its behaviour should be examined.

We would not advocate however that the behaviour of every complex or bespoke product should be examined in detail. It is important that any vulnerabilities a new product could pose for the group are considered at the design stage and during the new product approval process, but a proportionality test should be employed and we are pleased to that the BCBS principles recognise this.

Regulators should be aware of the difficulty in obtaining information for securitisations where all the risk has been transferred and none retained. Stress testing of these former assets will be difficult.

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.

This principle seems to be an adjunct to the previous principle with its focus on securitisation structures and in the interests of brevity these two principles could perhaps be combined along the lines of:

‘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 *and associated pipeline and warehousing risks*, 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.’

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 recognise that firms should take into account the likelihood of off balance sheet vehicles coming back onto their balance sheet and understand that at least one country has required this for sometime in the context of liquidity stress testing.

Whilst it is right for an individual firm to consider the possibility of a reputational spill over effects causing it to assume responsibility for an off-balance sheet vehicle’s activities it should be recognised that there is no meaningful approach to capital modelling of reputational risk available so its is impossible to apply quantitatively based stress tests to this form of risk. A better mitigant to reputational or strategic risk is perhaps having robust systems and controls in place to ensure that this issue is properly investigated, perhaps at the new product development and approval stage.

For this reason we prefer the deletion of the reference to reputational risk in the principle and suggest a change as follows:

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.

- 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.**

Members recognise that unexpectedly high levels of correlation have contributed significantly to the severity of the turmoil in the financial markets. The BCBS will appreciate that recent market performance has provided members with more data than they may have wished for on this issue, although it will take some while to perform the necessary quantitative analysis to identify how the modelling of the impact of wrong way risk on credit risk mitigation techniques used for highly leveraged counterparties could be improved.

Our members look forward to working with regulators on this important issue, which has its mirror in diversification benefits, in order to assimilate the informational content of recent events.

Recommendations to supervisors

- 16. Supervisors should make regular and comprehensive assessments of banks' stress testing programmes.**

We agree that the regulator should regularly engage with the senior management of a group to debate major macroeconomic and financial market vulnerabilities. As well as having this discussion at the level of an individual firm we believe there would be merit in regular meetings between systemically significant firms and the regulatory community about the sorts of stresses they are considering and the way in which vulnerabilities that may be building up could manifest themselves, in order to develop collective strategies to mitigate their impacts.

We think it is unlikely that a firm would review the process elements of its stress testing programme more than once a year although it is of course more than likely that key parameters and scenarios will be reviewed more frequently than that. Discussions at the level of the individual firm should be part of the supervisory review process (recommendation 19), which would include discussions on stress testing – these discussions would highlight macro and financial market vulnerabilities.

- 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 agree. There is benefit to the wider regulated community in ensuring that all firms that are systemically significant have adequate stress testing programmes in place as deficiencies can conceivably have a far reaching impact. Firms that do not have satisfactory stress testing programmes in place should be encouraged to improve them and take action. However the role of the supervisor should be to challenge the bank's solutions to ensure that there are no material deficiencies in the stress testing process and that its outputs have been adequately considered, for instance by triggering an in depth discussion where warranted, rather than to direct the bank's operations in the way suggested in principle 17.

Where firms are less systemically significant the principle of proportionality should again be used to judge whether a firm's stress testing programme is suitable using, we would expect, a less stringent set of requirements to determine whether a firm's procedures are deficient or not.

- 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).**

Whilst we recognise that regulators should be able to challenge the scope and severity of a group's scenarios we would expect this to be approached on a comply-or-explain basis as it is most likely that the firm itself will have a deeper understanding of its vulnerabilities than the regulator. The regulator will however be able to add value to the discussion by reflecting with the firm, non-specifically of course, on the sorts of scenarios that others in its peer group are using.

We think it is reasonable that from time to time, and with due notice, the supervisor may ask firms to use and evaluate particular scenarios but trust that this would not become a regular occurrence, given the resource intensiveness of the stress testing process, especially as regards reverse stress testing

- 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 fully agree with the assumption implicit in this principle, that the majority of a supervisor's interaction with a firm about its stress testing programme should take place in the context of its Pillar 2 review of a firm's group-wide ICAAP, which should provide a medium term view of its vulnerabilities. Where vulnerabilities are identified, of more importance to the regulator should be the quality of the risk mitigation plan

that the firm proposes to implement rather than recourse to extra capital - oftentimes improved systems and controls can result in a better outcome than a straightforward regulatory requirement for a firm to hold more capital.

Where extra capital is agreed to be an appropriate mitigant, we recommend that overall capital levels should be set in the context of group-wide regulatory capital rather than other balance sheet ratios although we recognise that there will be important debates and consultations to be had in the future on such concepts as leverage ratios or core tier 1 definition. Where such extra regulatory capital is deemed appropriate such ratios should be applied at a group, rather than legal entity level. Applying ratios at the group level supports the quality of overall group risk management and the understanding of the group of the balance of its needs.

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

We recognise that a number of regulators in individual countries have adopted such an approach 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.

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 this principle of inclusive dialogue about the emergence of systemic vulnerabilities involving relevant firms.

Our members stand ready to share their knowledge of stress testing in order to build capacity so that supervisors can understand the process and its outputs.

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