STRESS TEST REQUIREMENT FOR IRB METHODS

• We are convinced that stress-testing techniques, although still in a developing stage in the area of credit risk, can play an important role in the future for assisting banks, and to some extent regulators, in the process of capital adequacy assessment.

• We doubt, however, that given its non-mature present stage, it should be included as a requirement to qualify for applying IRB methods.

• We also doubt that, for the same reason, could be an adequate instrument to mitigate the possible procyclical skew of the new regulatory framework. From our view the present proposals already contain enough mechanisms to mitigate such effects.

• Other credit risk management tools closely linked to stress-testing, like portfolio models (such as Riskmetrics' CreditManager or KMV's Portfolio Manager), have been excluded from BIS II. The Basel Committee considered, perhaps rightly, that the present state-of-the-art was not mature enough for using these methodologies to determine regulatory capital. The main difficulty seems the quantification of correlation factors between different portfolios and markets to capture adequately portfolio diversification and concentration effects.

• In our opinion, stress-testing methodologies for credit risk portfolios are still far from consolidated. Besides, the usual data problems on rating migration patterns, correlations or volatility of LGD are even more acute in some portfolios, like those in emerging markets, with severe data limitations and short economic cycles.

• Availability of sound stress-test processes for credit portfolios could be also an excessive requirement for medium/small banking institutions that, otherwise, could expect to qualify for the foundation IRB method.

• But our main concern is that this new requirement could be a hidden way of increasing the level of confidence behind the capital curve of Pillar I.

• The qualitative BIS II requirements for internal rating assignation processes (see par. 361-362-363) already prescribe the use of stress economic scenarios to assign internal ratings.

• When using stress-test scenarios, migration tables of internal ratings (skewed for a downturn cycle) would have to be used. To the extent that those migration patterns were built on point-in-time internal ratings or, due to data problems, external sources of rating migration were used, an overestimation of rating downgrades and therefore new capital requirements could be the
result. That would mean applying effectively a greater level of confidence than the 99.9% now supposedly behind Pillar I.

- The maturity adjustment applied in the advanced IRB method can already be considered as a conservative “looking forward” approach, taking into account future deterioration of present PD’s, since time horizon for PD estimation is supposedly one year.

- Besides the proposed treatment for internal rating assignation, there are in the BIS II proposals other risk factors, like LGD’s quantification or the use of conservative haircuts for collaterals, that already incorporate a skew conservative enough for calculating regulatory capital. The additional application of stress scenarios over these risk factors (PD’s, LGD’s), which already have been conservatively calculated, could result in an overestimation of capital requirements.

- If we consider the usefulness of stress-test exercises for assess the impact of assymetric or specific shocks, such as specific industry downturn or a country recession, which finally penalises risk concentrations, we have to consider also that BIS II has excluded geographical or industry diversification effects from capital requirements quantification. In this sense excessive credit risk concentrations would have to be addressed in Pillar II, with or without stress-testing.

- In relation to the pro-cyclicality effects of the New Accord, we believe that the stress-testing requirement does not guarantee solving that issue. On the contrary it could contribute to increase capital requirements at the bottom of the cycle.

- To some extent, it is unavoidable that a more risk sensitive framework like the one proposed in Basel II will have a certain pro-cyclical effect. In any case there are already different factors that mitigate that effect and that do not make necessary the use of stress-testing practices:

  - Most banks operate with capital levels well above regulatory minimums.
  - Assignment of internal ratings should be based on a “through the cycle” basis.
  - The new regulatory framework already incorporates many assumptions of conservative nature.
  - Treatment of insolvency provisions, as is the case in Spain with the so called “statistical provision”, could be a good tool to reduce cycle impact (provisioning expected losses, independently of real losses being well bellow in periods of high cycle).
- Through Pillar II supervisory review process, regulators will always have the possibility of asking for additional capital buffers over regulatory minimum if a bank risk profile, due to factors not considered in Pillar I – such as excessive risk concentrations or flaws in its internal rating system – merits so.

- Finally, we believe that the requirement of “having in place sound stress-testing processes” is premature and should not be included as a requirement for applying IRB methods. Stress Testing could be a useful reference in the process of assessing capital adequacy under Pillar II, but its present state-of-the-art does not advice to prescribe its general application for regulatory purposes. On the other hand the proposed BIS II framework already disposes of enough mechanisms to reduce its possible pro-cyclical effects.

- In the case of Basel Committee not removing this obligation, we should seek to see confirmed last announced conditions on stress-testing and, as suggested in the last meeting of our working group, public disclosure of the results of these exercises should be avoided (given difficulty of comparing bank specific own-design methodologies).