



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

24 March 2009

Our ref: ICAEW Rep 24/09

Rory Vaughan
Capital Adequacy Policy
Financial Services Authority
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London E14 5HS

By email: cp08_24@fsa.gov.uk

Dear Sirs

CP 08/24: Stress and Scenario Testing

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on CP 08/24: Stress and Scenario Testing.

The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

Please contact me or Iain Coke, Head of the Financial Services Faculty, should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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**THE INSTITUTE
OF CHARTERED
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ICAEW Representation

ICAEW REP 24/09

FSA CONSULTATION PAPER 08/24: STRESS AND SCENARIO TESTING

Memorandum of comment submitted in February by The Institute of Chartered Accountants in England and Wales, in response to FSA Consultation Paper CP 08/24: Stress and Scenario Testing published December 2009.

Contents	Paragraph
Introduction	- 1
Who we are	2 - 4
Major points	5 - 6
Responses to specific questions	7 - 25

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the consultation paper *CP 08/24: Stress and Scenario Testing* published by the FSA.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

MAJOR POINTS

Support for the initiative

5. We generally support the recommendations made within the CP. The reverse stress testing requirement will encourage firms to further understand the key sensitivities to their business model and help to enhance capital and risk management processes.
6. However, the institute would stress two points to the FSA. Firstly, the FSA must be cognisant of the burden placed on finance and risk functions already – particularly given the recent far-reaching liquidity proposals. Any additional regulatory burden must not be done at the expense of other risks. Secondly, the institute would welcome further clarity in a number of areas from the FSA. Whilst we accept the responsibility lies with senior management and the FSA can not produce a 'one size fits all' model some guidance around regulatory expectations of parameters and reasonable management actions would be welcomed.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

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

7. We support your overarching view, and that of the various international and industry groups, that improved stress and scenario testing arrangements at firms will help to address the market failures that resulted in firms' business models becoming unviable as the market and economic conditions changed and firms needing to raise additional capital at a time of low market confidence. We regard stress and scenario testing as being a key management tool to assess and understand the firm's risks and contribute to effective capital planning.

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

8. No comment

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

9. We would support any proposal requiring firms to explore more fully the vulnerabilities of their current business plan and then make decisions that better integrate business and capital planning.
10. We welcome your statements in respect of proportionality – particularly bearing in mind the additional burden the reverse stress testing requirements will place on firms. In rolling out this requirement, we recommend that the FSA be fully cognisant of the resource pressures on finance and risk functions bearing in mind that this is additional to the proposed requirements for liquidity and the ongoing requirement to update the ICAAP. Implementation of these stress tests should not be at the expense of other fundamental risk management functions.
11. The CP states that the reverse stress test should be carried out at a solo as well as group basis. We would recommend that the FSA provides further guidance on its expectations in this respect particularly bearing in mind that for many firms, stress testing and capital planning is carried out on a group-wide basis. Any proposals to require the reverse stress test at solo and group level could create a significant burden upon certain firms which may be unduly burdensome and not reflective of the how the firm's manage their risks on a day to day basis.
12. Firms may look to the FSA to provide some further guidance on what sort of reverse stress scenarios the FSA would expect firms to consider depending on their size, activities and group structure for example.

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

13. No comment

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

14. No comment

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

15. We agree that stress testing of the IRB model parameters is fundamental bearing in mind the inherent model risk and the limitations of relying on models using historic data.

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

16. No comment

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

17. No comment

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

18. No comment

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

19. We support the principle that capital should be held now to enable the firm to hold adequate financial resources in a stress scenario after the consideration of appropriate management actions. However, the FSA should consider giving further guidance on what it believes to be realistic management actions as this proved to be an area of confusion during the ICAAP process. The FSA will also need to remain cognisant of other EU and international supervisory developments and expectations to ensure that the UK financial markets are not placed at a competitive disadvantage due to onerous capital buffer requirements relative to overseas peers.

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

20. No comment

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

21. We consider it is reasonable to explicitly refer to the types of interest rate risks that firms should be considering in BIPRU 2.3.9G(1).

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

22. No comment

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

23. We agree with the statement that there is some confusion among firms about the FSA's expectations as regards pension obligation risk – in particular any Pillar 2 add-on that the FSA would expect a firm to hold. The proposed additional guidance states that firms should include in their estimate of financial resources both the expected obligations to the pension scheme and an increase in obligation that may arise in a stressed scenario. We would recommend that the FSA clarifies its expectations in respect of mitigating management actions that it would deem acceptable to reduce the estimate of financial resources the firm should hold to meet its obligations in both stressed and unstressed scenarios.

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

24. No comment

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

25. No comment

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