

Basel Committee on Banking Supervision
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19 March 2012

**Your Ref: Comment letter on Consultative Document
- Core Principles for Effective Banking Supervision**

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative document on Core Principles for Effective Banking Supervision. I generally support the changes as improvements to the 2006 proposals, which provide a more comprehensive and cohesive set of principles in order to strengthen the global financial system and develop a more effective supervisory regime for banks. I specifically support the proportionality concept, in that the application of the principles should allow for the size, nature and complexity of the business and risks being considered, and I agree with you that: "The proportionate approach also allows assessments of compliance with the Core Principles that are commensurate with the risk profile and systemic importance of a broad spectrum of banks"¹.

Principle 7: Major acquisitions

Principle 7 on major acquisitions states that among the objective criteria that the supervisor uses is that new acquisitions "do not expose the bank to undue risks". This is still quite subjective and I would recommend that "undue risks" should be measured under quantitative criteria that should consider two features: a "new risk" test would determine whether the acquisition exposes the bank to any new risk factor compared with current activities; and an "increased risk" test would determine whether the acquisition arbitrarily or artificially increases exposure to the existing risk factors within the current activities. This consideration of "new risk" and "increased risk" is a good starting point for determining whether a new acquisition would expose the bank to undue risks; however, I accept that this approach should be complemented by such qualitative assessment as deemed suitable by the supervisor.

¹ See § 4 of the consultative document.

Principle 15: Risk management process

Principle 15 on the risk management process refers to the importance of stress testing within banks. Naturally stress testing should allow for shocks and variations along the following lines:

- 1) changing individual assumptions and parameters (sensitivity testing);
- 2) changing several assumptions and parameters at the same time, where the assumptions and parameters could reasonably be expected to change together (scenario testing);
- 3) changing the dependencies assumed between assumptions and parameters.

The importance of point 3 above is often underestimated. I would recommend that you specifically emphasise the importance of considering dependencies and correlations under stress testing, particularly as typically observed and expected dependencies may not apply in the tail conditions and events that underlie many stress conditions and scenarios.

The reference document *Principles for sound stress testing practices and supervision*, May 2009, requires under Principle 4 that the stress testing process and analysis should be well documented. This is a minimum requirement. However, for clarity and completeness I would recommend that the documentation should be sufficient and complete enough to allow stress testing processes to be replicated by a third party.²

Yours faithfully

C.R. Barnard

Chris Barnard

² Results as well as processes should be robust and auditable.