

Annex – Good Practices for Stress Testing

The following practices are adopted by AIs with more robust stress testing program.

- (a) Segregation of duties is maintained by confining the execution of stress-testing to units independent of the front office.
- (b) Perform comprehensive stress-testing covering both banking and trading books. This is a recommendation set out in Sections 2.2.4 and 2.2.5 of SPM IC-5 that stress-testing should cover both the trading and banking books with the adoption of an integrated approach and providing results on an institution wide basis.
- (c) Clearly document the major stress assumptions in the relevant stress-testing policy and / or reports.
- (d) Adopt a policy requiring management to review the relevance and appropriateness of stress scenarios and parameters at least once a year.
- (e) Perform stress-testing on movements in foreign exchange rates, parallel and non-parallel yield curve shifts and, where applicable, narrowing of Prime / HIBOR spread for designated management committee's regular review. In addition, perform stress-test showing the impact on net interest income as a result of a series of adverse stepwise interest rate movements.
- (f) Perform stress-testing scenarios that simulate previous major crisis situations, such as the 1997 Asian Crisis, the 1998 Russian Crisis and the 2001 U.S. Crisis. In addition, certain AIs perform stress-testing on a hypothetical oil crisis and a hypothetical crisis of major international currencies.
- (g) Generally perform stress-testing at least once a month, and more frequent stress-testings, such as on a daily or weekly basis, on more risk sensitive portfolios (e.g. more volatile or highly leveraged products) for risk management unit's review.
- (h) Define risk tolerance for stress-testing results with reference to impact on capital adequacy ratio. Excess of pre-set risk tolerance limit requires escalation to senior management for decision on remedial actions.
- (i) Assess the probability for each stress scenario and present both the gross and expected losses accordingly to management for their information and decision.
- (j) Present stress-testing results for designated management committees' review with trend analysis. Trend analysis with proper explanation on large variances improves management's understanding of an AI's risk exposures.