HONG KONG MONETARY AUTHORITY
香港金融管理局

Circulars

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# Principles for sound stress testing practices and supervision

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The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

## Principles for sound stress testing practices and supervision

The Basel Committee on Banking Supervision (BCBS) has recently issued a set of Principles for Sound Stress Testing Practices and Supervision, a copy of which is available on the Bank for International Settlements' website at http://www.bis.org/publ/bcbs155.htm. I am writing to draw your attention to these principles and the need for authorized institutions to review their stress-testing practices in the light of them.

Obviously, stress-testing is an important tool used by banks for internal risk management and capital planning and it is also a key component of the supervisory assessment process for evaluating the capital adequacy of banks and identifying their vulnerabilities. Summarised in the BCBS paper are various weaknesses in banks' stress-testing practices revealed from the current financial crisis, including -

- inadequate board and senior management oversight of the stress-testing process;
- underestimation of the potential severity and duration of stress events;
- inadequate account of system-wide interactions and feedback effects caused by market reactions to stressed conditions;
- insufficient identification and aggregation of risks on a firm-wide basis;
- various problems associated with stress-testing models and methodologies; and
- inadequate coverage of risks arising from complex structured products, pipeline or securitization risk, counterparty credit risk, contingent risks and funding liquidity risk.

To address the above weaknesses, the BCBS guidance provides a comprehensive set of principles for the sound governance, design and implementation of stress-testing programmes at banks and sets out expectations for the role and responsibilities of supervisors in reviewing banks' stress-testing practices. Some key elements of the principles applicable to banks are highlighted below:-

- Stress-testing should form an integral part of the overall governance and risk management culture of a bank. It should be actionable and impact on decision-making at the appropriate management levels;
- Stress-testing programmes should promote risk identification and control, provide a complementary risk perspective, improve capital and liquidity management, and enhance internal and external communication. Such programmes should also cover a range of perspectives and techniques;
- Written policies and procedures, proper documentation, and robust and flexible infrastructure in respect of stress-testing should be in place;
- The stress-testing framework should be regularly maintained and updated, with its effectiveness and robustness regularly and independently assessed;
- Stress tests should cover a range of risks and business areas, including at the firm-wide level, and be able to deliver a complete picture of firm-wide risk;
- Stress-testing programmes should comprise scenarios along a spectrum of events and severity levels, including forward-looking scenarios, and aim to incorporate system-wide interactions and feedback effects;
- The interaction of funding and asset markets as well as the impact of a reduction in market liquidity should be taken into account. The effectiveness of hedges and other risk mitigation techniques should also be systematically challenged; and
- Stress-testing programmes should cover complex and bespoke products such as securitized exposures, pipeline and warehousing risks, reputation risk, risks arising from off-balance sheet vehicles and related entities, and counterparty credit risk.

We support the principles set out in the BCBS paper, and believe that their implementation in Hong Kong will help in further enhancing the resilience of individual authorized institutions and the banking system as a whole. While the existing guideline issued by the HKMA (re: IC-5 "Stress-testing") broadly covers the major aspects of stress-testing, there is scope for updating the stress-testing standards to align them with the BCBS principles and address the lessons drawn from the current crisis. We will aim to enhance the guideline as soon as practicable and will consult the industry on the proposed changes. In the meantime, authorized institutions should review and strengthen, where necessary, their stress-testing practices, taking into account the principles contained in the BCBS guidance. The principles should be applied to individual institutions on a proportionate basis, having regard to their size, complexity and risk profile.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

c.c. Chairman, Hong Kong Association of Banks
Chairman, DTC Association

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