



HONG KONG MONETARY AUTHORITY

香港金融管理局

Our Ref.: B1/15C
B1/21C

9 May 2012

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Supervisory Policy Manual (SPM) – IC-5 “Stress-testing” (Revised)

I am writing to inform you that, following consultation with the two industry associations, the Monetary Authority is issuing today the above revised SPM module as a non-statutory guidance note (revised IC-5).

The global financial crisis has demonstrated the need for, and utility of, comprehensive and robust stress-testing programmes as an integral part of banks' risk management frameworks and decision-making processes. The revised IC-5 has incorporated the *Principles for sound stress testing practices and supervision* issued by the Basel Committee on Banking Supervision in May 2009 (BCBS Principles); the HKMA's relevant supervisory practices and experience; as well as recommendations and observations made by international organizations and industry groups to address weaknesses in banks' stress-testing practices in the wake of the global financial crisis.

Major requirements of revised IC-5

The revised IC-5 provides more detailed and elaborate guidance on the following aspects of a stress-testing programme:-

- (a) **Process, policies and procedures** – Guidance is provided on the process for developing and implementing a stress-testing programme to assist authorised institutions (AIs) in their risk identification and control, capital and liquidity planning, and decision-making; and on the establishment of clearly-defined and well-documented stress-testing policies and procedures;

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- (b) **Governance and infrastructure** – Guidance is provided on the roles and responsibilities of the Board and senior management in respect of AIs' stress-testing programmes. Stress-testing is expected to form an integral part of AIs' overall governance and risk management frameworks, and should be actionable in the sense that stress-testing results should feed into their decision-making processes at the appropriate management levels. AIs should also ensure that there are adequate and robust information systems and infrastructure to support their stress-testing programmes;
- (c) **Stress-testing approach, methodologies and techniques** – There are a variety of approaches, methodologies and techniques for conducting stress-testing. AIs should adopt those approaches, methodologies and techniques that are most appropriate to the nature, scale and complexity of their business activities and the risks associated with those activities. The importance of using an integrated and firm-wide approach to stress-testing, and the need to consider a spectrum of perspectives, possible correlations among risk types and feedback effects in stress-testing, are also emphasised;
- (d) **Design and setting of stress scenarios** - Guidance is provided on the major principles underlying the design of stress scenarios and the measurement of stress impacts. In particular, AIs are expected to devise a range of severe but plausible stress scenarios along a spectrum of events and severity levels for all relevant risk factors, taking into account the interaction between these risk factors. The stress scenarios employed should be forward-looking and capable of providing a firm-wide assessment of emerging risks and vulnerabilities. Examples of risk factors or stress scenarios that are commonly adopted in the stress-testing of banks are also provided for AIs' reference;
- (e) **Use of stress-testing results and risk-mitigating strategies** - Guidance is provided on the reporting of stress-testing results to the Board and senior management of AIs and, where appropriate, to AIs' supervisors; and on the formulation and determination of risk-mitigating strategies in response to stress-testing results (this however does not preclude a conscious and well-justified management decision not to take action on the results);

- (f) **Interpretation and communication of stress-testing results** - AIs should be aware of the limitations of stress tests when interpreting the results generated from those tests, which are usually sensitive to the design of, and inputs to, the stress-testing programme and indicate only the estimated impacts, but not the probability, of the stress events occurring. Emphasis is also placed on the appropriate communication of stress-testing results within an AI, and with external parties such as supervisor(s), market participants and other stakeholders of the AI; and
- (g) **Independent review of stress-testing programme** – Guidance is provided on the need for regular and independent reviews of an AI's stress-testing programme, and on the major aspects of the programme to be covered in such reviews.

The HKMA is mindful of the challenges posed to the industry in implementing the stress-testing requirements in the revised IC-5, particularly those relating to reverse stress-testing. Therefore, the HKMA has indicated that it will adopt a “proportionate approach” when assessing AIs’ stress-testing programmes, having regard to the nature, scale and complexity of their business activities and the risks associated with those activities. In addition, the HKMA has laid down more detailed guidance and elaboration on reverse stress-testing requirements, the application of which is confined to local banks initially.

The revised module also describes the HKMA’s supervisory approach for assessing AIs’ stress-testing practices, which is consistent with the BCBS Principles applicable to supervisors.

Implementation

With the issue of the revised IC-5, AIs are expected to take all necessary steps to bring their stress-testing programmes into line with the guidance set out in the module no later than six months from the date of this circular. In view of the technical challenges associated with the reverse stress-testing requirements, the HKMA allows local banks to implement those requirements within a period of 12 months. In exceptional circumstances, individual AIs may seek an extension of the 6-month implementation period (12-month in the case of reverse stress-testing) from the HKMA.

The HKMA will monitor AIs' progress in incorporating the relevant guidance set out in the revised IC-5 into their stress-testing programmes during the implementation period. Hence, AIs should be ready to provide their enhanced stress-testing programmes for the HKMA's review six months after the date of this circular. The HKMA may also request local banks to provide updates on their progress in developing their reverse stress-testing plans (including any draft scenarios under consideration) to the HKMA nine months to one year after the date of this circular.

On-line access to the module is available under the icon for "Supervisory Policy Manual" on the HKMA's public (<http://www.info.gov.hk/hkma>) and private (<http://www.stet.finnet.hk>) websites.

Should you have any questions regarding the revised IC-5, please feel free to contact the undersigned on 2878-1388 or Ms Echo Chan on 2878-1558.

Yours faithfully,

Rita Yeung
Acting Executive Director (Banking Policy)

c.c. The Chairman, The Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn. Mr Jackie Liu)