

Stress Testing Conference

27 September 2005

- **Need for a holistic approach**
 - Design depends on implementation and use
 - Range of time horizons: “bad week” vs “1-100 years event”
- **Blurring of boundaries between hypothetical and historical scenarios**
 - Inform hypothetical scenarios with historical experience
 - Scenarios need to be forward looking
- **Senior management involvement**
 - Strong evidence that “senior management takes an active part in identifying potential stress testing scenarios” (point 2 of ‘comprehensive approach’)
- **Modelling market liquidity risk remains a challenge**
 - Firms are aware of need to factor in liquidity risk, but methodological difficulties persist

Credit Risk discussion feedback

Uses of stress testing:

- Heads of business to understand the key risk drivers and feedback into the setting of risk appetite.

Status quo:

- Practice varies between firms

Key challenges:

- Availability of accurate data in stress period and stress tests need to be complemented by qualitative discussions
- For Risk Managers to make scenarios credible and comprehensible for Senior Management/Board

CEO discussion feedback

- **FSA role: support for proactive role**
 - Giving feedback on Firms' choice of stresses (but not prescribing stresses)
 - With supervisors well-informed to illustrate best practice industry-wide
- **Board's focus: should be on**
 - Firm failure (including contingency planning and wider business consequences)
 - Part in assessing new business
- **Business**
 - Important not to over-emphasise role in capital setting
 - Important in managing liquidity as well
- **Context**
 - Stress testing is one important risk management tool – but only one

Insurance:

- **ICAS has prompted beneficial internal debate about construction of scenarios, and led firms to add to set of views taken of their overall business risks.**

Obstacles to aggregation:

- **Are not only limited to technological issues. Difficulties arise from potentially different time frames for crystallisation of market risk (quick!) and credit risk (slow!).**
- **Firms lack credible internal data, so to come up with reasonable picture of potential losses arising from operational risk, are pushed to examine judicious combinations of (stressed) loss distribution analyses and (stressed) judgmental scenarios.**

Governance:

- **Value added from stress testing comes at least as much from discussion and debate that it engenders as from number(s) produced by process.**