

Robust Stress Tests for Banks & Investment firms



Stress tests defined

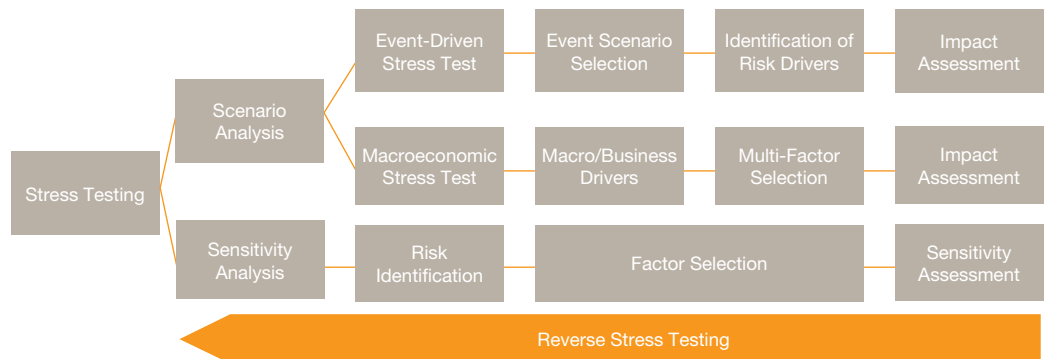
On 11 March 2011 the CSSF published the Circular 11/506 (amending the Circular 07/301 on the ICAAP) which defines its requirements in terms of stress testing practices. While stress testing has been expected of banks and investment firms at least since the advent of the ICAAP in early 2007, the new Circular 11/506 now makes it a formal obligation for all institutions to establish a stress testing framework.

Identifying and addressing vulnerabilities throughout your organisation

May 2011

What are stress tests?

Stress tests are basically “what-if” analyses whose goal is, according to Circular 11/506, to “assess the extent to which adverse events could jeopardise the adequacy of the business model with the risk profile and with the real capacity to manage and support risk”¹.



This chart illustrates some of the key themes to consider when implementing such “what if” analyses. Bearing in mind the institution’s existing ICAAP and the proportionality principle, the initial step is to decide how to stress test potentially material risks. A series of methods exist and have their own specific pros and cons:

Scenario analysis

Examines the effect of changing multiple variables at one time, either based deterministic scenario or with reference to historical events and to risk databases.

Sensitivity analysis

Examines the effect of changing one or few variables rather than considering a full alternative scenario.

Reverse stress testing

Starts from an assumption of business failure and identifies how this might occur.

¹ CSSF Circular 11/506.

What is expected of banks & investment firms?

Based on the 2010 CEBS² Guidelines on Stress Testing (GL32³), the Circular requires all credit institutions and investment firms to implement a robust stress testing programme, not only in terms of capital management, as it was the case with the initial version of Basel II, but also, and perhaps most importantly, in terms of liquidity requirements, as it will be one of the focus points of the upcoming Basel III.

Your challenges

While stress testing is a notion that has been around for several years, it must now be at the forefront of Executive Committees and Risk Managers' agenda alike. The challenge however is that while most actors acknowledge the need for upgrading their stress testing capacities, few actually master the process. This is particularly the case of smaller organisations.

Implementing a thorough yet proportionate stress testing programme can be a daunting challenge for many actors, as it cannot be done overnight and some guidance and experience is required if it is to be a value-adding exercise.

How we can help

We can help you answer the following initial questions:

- Who should be responsible for designing, running and assessing the results of the stress testing programme and how often should that be carried out?
- Who should be responsible for designing the sensitivity analyses and scenarios?
- How should the bank perform stress tests at a group level? Conversely, can I use locally the stress tests performed by my group?
- Who should determine which remedial actions the bank should take to alleviate the effects of exceptional yet plausible events?
- Should the results of stress tests be available to external stakeholders?
- Are the answers to the above questions documented in writing (policy/procedures)?

² The EBA (European Banking authority) has officially come into being as of 1 January 2011 and has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS).

³ Based on the Principles for sound stress testing practices and supervision of the Basel Committee (2009).

Our pragmatic approach

1

Diagnostic:

- A diagnostic of your current stress testing set-up will be performed through interviews and reviews of all relevant documents.

Output => Clear summary of the gaps identified between your current set-up and Circular 11/506 and CEBS Guidelines GL32.

2

Recommendations:

- Recommendations will be proposed to align your processes to regulatory requirements, including a clear description of best practices and the related formalisation that need to be implemented, always bearing in mind the proportionality principle.

Output => Detailed description of processes to put in place in order to satisfy the regulatory requirements.

3

Action plan:

- An action plan will be elaborated to address the identified gaps.

Output => Definition and implementation of stress testing processes and methods, selection of adequate tools if required, identification of required data and resources.

4

Assistance:

- Our team can assist you in the definition and the implementation of the recommendations.

Output => Implementation/assistance in the drafting of a stress testing policy, creation of dedicated tools, drafting of operational procedures & training sessions.

Selected stress test credentials:

- **Major private bank:** design of a stress testing framework in the context of an ICAAP upgrade.
- **Multiple private banks:** liquidity stress testing, assisted clients in designing stress tests appropriate to their respective business models.
- **Medium-size commercial bank:** capital contingency plan resulting from stress testing.
- **Major custodian bank:** quantitative liquidity stress testing, linking the asset management and banking worlds.
- **North-American broker/dealer:** review of a stress testing governance framework.

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