Strengths and Weaknesses of using the same estimation approaches for BAU and stress testing

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Points for Discussion

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• Range of Practice Observed (Trading & Counterparty):
  Types of models that are often leveraged from BAU for stress testing purposes are,
  – Valuation models (For Pricing and CVA)
  – Capital models (From IMM and IRC) that include simulation of market environment

• Questions to ask when BAU models are used for stress testing
  – Type and results of additional testings done on BAU models, and additional validation activity done to ensure usage under stress testing is appropriate
  – How to extend ongoing performance monitoring tests for BAU models to stress models

• Questions when different set of models are developed for stress testing purposes, despite existence of BAU models that could be leveraged
  – Why the firm/bank decided to not use BAU models, and how stress testing models are different from BAU models and the level of difference of measure-able
  – Tests and validation activity done to ensure the developed stress testing models are adequate

• Observed weaknesses
  – BAU models not being validated explicitly for stress testing usage
  – Lack of support that simulated environment is consistent with the intended scenario