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Stress-testing scrutiny

How has the nature of stress testing within the banking and capital markets sector evolved as a result of the post-crisis financial regulatory reform agenda?

Brinda Bhattacharjee (BB), Senior director, Moody's Analytics: The losses suffered during the crisis highlighted the need for enhanced stress-testing approaches across all components of the balance sheet and income statement to assess an institution's capital sufficiency to withstand unforeseen market conditions and drive strategic risk management decisions. The financial reform agenda has further emphasised the significance of accurate stress testing as a key component of prudent risk management standards. As a result, banks are very keenly focused on recalibrating portfolio-level loss estimation techniques, enhancing financial forecast models to project sufficiently risk-sensitive income statement effects, developing platforms to integrate income and loss forecasting methodologies and establishing an enterprise-wide stress-testing function with executive-level representation from risk, finance and treasury to ensure comprehensive firm-wide cross-risk coverage and oversight.

What role have recent supervisory stress tests played in market perception of the safety and soundness of the global financial sector?

BB: Central banking authorities, local regulatory bodies and supervisory agencies have conducted numerous system-wide stress tests, both in the US and Europe. Since 2009, the 19 largest US bank holding companies have participated in annual stress tests, designed to assess whether these institutions could maintain prescribed regulatory capital standards when subject to adverse macro-economic conditions. Public disclosure of the results of the stress tests has markedly increased shareholder awareness and industry focus on the banking sector's capital adequacy and the institutions' eligibility for executing their planned capital actions. Some regulatory agencies had, early on, advocated that the disclosure of poor results might further destabilise an institution's market access to capital and liquidity The supervisors' disclosure of how these institutions would be expected to fare under stress has prompted significant public engagement on this issue.

What are some of the primary stress-testing-related challenges your clients have faced in recent months, particularly as they prepare for Comprehensive Capital Analysis and Review 2013 and the next round of European supervisory stress tests?

BB: Enterprise-wide stress testing continues to be a significantly manual process and most institutions are still challenged with developing an integrated stress-testing approach that adequately reflects their complexity, addresses regulatory requirements and supports strategic business growth decisions and capital planning processes.

With limited transparency into the supervisors' loss estimation techniques, banks are focused on enhancing their modelling precision and redeveloping their macro-economic factor-driven loss forecasting models. Limited data availability to develop sufficiently granular and risk-sensitive loss forecasting and financial modelling tools to generate stressed losses and stressed income statement effects that comprehensively reflect the risk sensitivities of an institution's activities has also presented challenges.

At larger institutions, designing customised scenarios that are sufficiently relevant to the bank's primary activities and risk profile, while applying scenario interpretations consistently across all risk and finance models and across all business lines, has proven to be challenging, particularly where stress-testing processes are fairly decentralised. At smaller institutions, considerable energy is being spent to ensure that scenario selection is sufficiently regionalised and caters to the specificity of their lending footprint and investment activities.

The enterprise-level aggregation of stress-testing results, incorporating balance-sheet impacts, income statement impacts and loss estimation across all risk types at the reporting granularity prescribed by the supervisors has also proven to be difficult for many institutions and surfaced a number of data integrity and consolidation-related issues.

What role does stress testing play in strategic business planning as a result of the regulatory reform agenda?

BB: As banks' post-crisis liquidity and capital positions began to stabilise, senior executives were faced with longer-term strategic decisions about how to meet increased capital and liquidity requirements, despite speculative sovereign exposure, market volatility and the need to remain relatively de-leveraged. These decisions highlighted the need for fully aligning capital management objectives with the firm's strategic management decisions. As a result of the financial regulatory reform agenda, most banks are in the process of fully institutionalising a risk-sensitive culture, as executives at these institutions attempt to fully align stress testing and risk management objectives with broader strategic business objectives. The role of an institution's board in risk management activities has transitioned from oversight to direct participation in strategic risk management decisions and banks have begun to place a premium on linking prudent risk management practices with business growth plans. The results of stress testing and stricter capital adequacy requirements have motivated banks to begin thinking about how to strategically rebalance their portfolios, reassess their legal entity structures and capital allocation across business units, evaluate capital-intensive lines of business, address inconsistencies in limits management practices, modify dividend policies and re-evaluate investments in complex illiquid instruments.

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To view and listen to the full proceedings of the *Risk* stress-testing interview with Brinda Bhattacharjee, visit *www.risk.net/2185830*