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Overall Stress Testing Framework Panel

FRB Stress Testing Model Symposium

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What type of scenarios should the FRB ("supervisory") and banks' internal ("company-run") stress tests consider? – 1

Supervisory and internal stress tests serve different, albeit complementary purposes

- Supervisory stress tests:
  - Assess/challenge sufficiency of banks' capital levels (and plans) in relation to their risk profiles [Pillar 2]
    - "Do you have enough capital?"
  - Identify/evaluate systemic vulnerabilities / risk exposures
    - Across financial institutions
- Company-run stress tests:
  - Assess/ensure sufficiency of our own capital levels (and plans) in relation to our risk profiles
    - "Do we have enough capital?"
  - Highlight/quantify firm-wide vulnerabilities / risk exposures
    - Across business units / risk categories

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What type of scenarios should the FRB (“supervisory”) and banks’ internal (“company-run”) stress tests consider? – 2

Different purposes suggest somewhat different design considerations

- Supervisory stress tests:
  - Ability to aggregate across institutions implies a single instrument calibrated to probe the vulnerabilities of the set of regulated firms and their diverse business mixes rather than any particular firm
  - Concern that “one size fits all” may not fit any one especially well
  - Should supervisory stress testing programs apply multiple, diverse scenarios?
  - Conversely, should multiple regulators adopt a single, consistent scenario?
- Company-run stress tests:
  - While firms have a genuine interest in applying a broad, systemic scenario such as a repeat of the 2008-09 financial crisis, their vulnerabilities and risk concentrations may be better probed through a collection of scenarios tailored to their business mixes
  - E.g., for an institution with a widely-diversified international portfolio, a set of regionally-centered scenarios (with potential contagion effects) may be even more informative and valuable:
    - Eurozone crisis
    - China slowdown / hard landing
    - U.S. fiscal cliff
    - Middle East crisis (Syria, Egypt, Iran… or a confluence thereof)
  - More granular stress tests
  - Idiosyncratic events

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How do you determine the severity?

Severity vs. Plausibility

- How do we know our (your) scenario is severe enough?
  - Scenarios of arbitrary severity can be designed, but…
  - Going concern perspective – extreme scenarios, e.g. financial system collapse, may be less relevant for supervisory / internal stress tests governing capital planning and more so for resolution planning
  - Importance of credibility (especially) for internal stress testing programs – senior management buy-in / connection to strategic planning / use test
- Benchmarking against historical events
  - Valuable in any case, but may become less relevant as the vulnerabilities of the last crisis are superseded by emerging sources of risk
  - How to benchmark scenarios without (recent) precedent?
- Importance of open-ended / what-if / "forward-looking" thinking process
  - Multiple sources of input; not confined to risk management departments
  - Avoiding derailment of the process by "that's unprecedented / impossible / unrealistic" criticisms observed before the recent crisis

And how do you ensure that the scenario is relevant each year?

Risk managing the last crash / crisis…

- Seemed a simple question in the couple of years immediately following
  - The same vulnerabilities and concentrations largely remained, leading to a focus on "double dip" concerns
  - Major challenge was tuning shocks due to very different levels of e.g. interest rates, or probing of different structural regions
- Current global macro environment is a good test case
  - While US-based vulnerabilities remain, this is perhaps not the brightest region on the global heat map
  - A European-triggered crisis with contagion to the US and other regions is arguably at least as likely and potentially just as damaging to many institutions
  - Perfect storm scenarios?