Society of Actuaries in Ireland

Bank Stress Testing

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Disclaimer

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Introduction

Focus of today's presentation:

- An overview of the challenges facing banks in the execution and delivery of the 2016 European stress testing exercise.
- What key lessons have been learnt from the 2016 exercise and how banks' are looking to apply these in the development of their stress testing frameworks.

Dr Monika Smatralova is a senior risk practitioner, currently a Head of 'Supervisory Review and Evaluation Process' function in Group Risk, Permanent tsb. Her academic background is in Financial Management. She has been working in risk functions of major high street and captive banks for a last decade focusing mainly on the credit and operational risk management and measurement and Enterprise risk management.

Monika is also actively involved in the senior leadership at PRMIA, successfully leading the Irish Chapter since 2013. In 2014 she was elected as the EMEA Regional Directors Committee Co Chair and the member of PRMIA Global Council. In 2015 Monika joined the PRMIA Educational Committee.

Susanne Hughes is a Director in Deloitte's Financial Services Risk Advisory Practice. Susanne specialises in providing regulatory risk advice across the Financial services industry, with a focus on Capital Risk Management, including ICAAPs, and Stress Testing. She has worked with numerous UK and European banks on a variety of engagements from defining target operating models for stress testing to supporting the execution and delivery of EU and PRA Stress Testing exercises.

Before joining Deloitte, Susanne headed the Stress Testing Team in Group Financial Risk at Lloyds Banking Group. During this time Susanne led on all Group-wide Capital Stress Tests, including PRA and EBA concurrent exercises, working with Risk, Finance and Treasury teams across the Group. Susanne has a degree in Mathematics from the University of Oxford

Comparing 2016 Banking & Insurance Concurrent Stress Tests

EBA EUROPEAN BANKING AUTHORITY

- Assesses a combination of macroeconomic and market risk shocks
- One adverse and one base macro-economic scenario with 2 additional market risk scenarios.
- 3-year time horizon 2015-2019
- 8.5 weeks to first submission, followed by 10 weeks of Quality Assurance review cycles and resubmissions.
- No pass / fail mark
- Results published for banks subject to EBA exercise in July 2016 on a bank by bank basis in some detail.
- Results fed into the SREP process.

eiopa EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

- Assesses the Insurance sectors' vulnerabilities to a combination of market risk adverse scenarios.
- One base and two stress scenarios – Double Hit and Low Yield.
- Point-in-time assessment of instantaneous shock
- 8.5 weeks from launch to firms' submissions.
- No pass / fail mark. No
- Results disclosed in December 2016 on an aggregated or anonymised way
- No capital requirements calculated, focus for EIOPA on financial stability.

Recap of 2016 EBA Stress Test

Participants. 51 banks subjected to the EBA exercise. ECB rolled out the same exercise to the remaining EU banks (c70) for inclusion in the annual SREP process.

Scenarios. One base line scenario plus one adverse macro scenario with two overlaid market shocks.

Data requirements. Material quantitative outputs required across balance sheet, NII, credit risk, market risk, operational & conduct risk (new in 2016) and capital. In addition qualitative requirements included supporting narrative documents.

Methodology. EBA applied restrictions to banks own stress testing methodology, including: (i) static balance sheet (ii) NII, RWA and Op Risk caps and floors (iii) non-recognition of income on defaulted assets.

Models. Banks were encouraged to use their own models however for credit risk PD and LGD benchmarks were provided.

Pass / Fail. No hurdle mark, unlike in 2014 exercise where hurdle was 5.5% CET1 ratio.

Results. 2 banks would have failed on the 2014 hurdle. Overall net reduction of CET1 capital in the adverse scenario was lower than in 2014 exercise.

Use of the EBA Stress Test Results

- The ECB use the stress test results as a key part of the Supervisory Review and Evaluation Process (SREP)*.
- The exercise provides two inputs into the SREP assessment:
  - A quantification of the impact of the adverse scenario on the capital of a bank.
  - The quality of the governance and control framework underpinning the stress testing, also used as an indicator for risk management across the bank.
- The ECB will set Capital Guidance for a firm based on these two aspects.
- Capital Guidance sits on top of the minimum and additionally capital requirements set for a firm on the back of their Pillar 1 and Pillar 2 assessment within the ICAAP.
- The Capital Guidance of a firm is also set on top of the CRDIV buffers which are phasing in through to 2019.
- Results provided to banks at the moment

*Further detail can be found in 'Information update on the 2016 EU-wide tress test' published by the EBA on 1st July 2016.
https://www.eba.europa.eu/documents/10180/1509035/Information+update+on+the+2016+EU-wide+stress+test.pdf

Key Lessons Learnt from 2016 EBA Exercise

Data quality is key and perceived weakness in controls around the process can directly lead to capital add-ons.

Models and associated assumptions need to be tailored to fit EBA methodology, robust and understood by senior management and Board.

EBA methodology can still leave areas of interpretation. Banks need a process to consistently interpret them across the group.

Strong communication to senior management and board to ensure ability to review and challenge appropriately.

Communication to the JST, via documentation and through face-to-face meetings.

Appropriate resource needs to be allocated to these exercises to run alongside BAU and to embed in the organisation.

How will banks prepare for future exercises?

- Plan to develop better data quality controls, often linking in with existing BCBS 239 programmes within their organisations. Key that this is not just a Risk problem.
- Bring stress testing models fully under internal model governance policies and ensure adequate second line validation and review.
- Ensure development of models addresses the requirements of the EBA methodology e.g. ability to manage the static balance sheet assumption.
- Ensure staff engaged in the process as well as Exec and Board are appropriately trained to understand their role and the purpose of stress testing.
- Get the house in order – documentation of processes, procedures and methodologies so that they are ‘off the shelf’ for the next exercise.

What does the future of banking stress testing look like?

- Expectation that the standards and requirements will continue to increase.
- Regulators will put more focus on what banks do as a results of the stress testing i.e. embedding in decision making and linkage to other key processes such as ICAAP, ILAAP, Recover Planning etc.
- Banks will have to manage the introduction of new accounting and regulatory rules, including IFRS9, Ring Fencing, MREL/TLAC, which to date have not formed part of the regulatory stress testing exercises.
- Potentially banks may be asked (i) to run more scenarios than just one base and one adverse and (ii) move to a dynamic balance sheet. CCAR has led the way with two stress scenarios and in the UK the PRA will introduce the Biennial Scenario on top of the Annual Cyclical Scenario in 2017 and both use a dynamic balance sheet.