Regulatory Stress Tests

Presented at:

The Annual Conference on Bank Structure and Competition

May 11, 2012

Lisa H. Ryu

Federal Reserve Board

Disclaimer

The views expressed in this presentation are those of the presenter and do not necessarily represent the views of the Federal Reserve Board or of the Federal Reserve System.

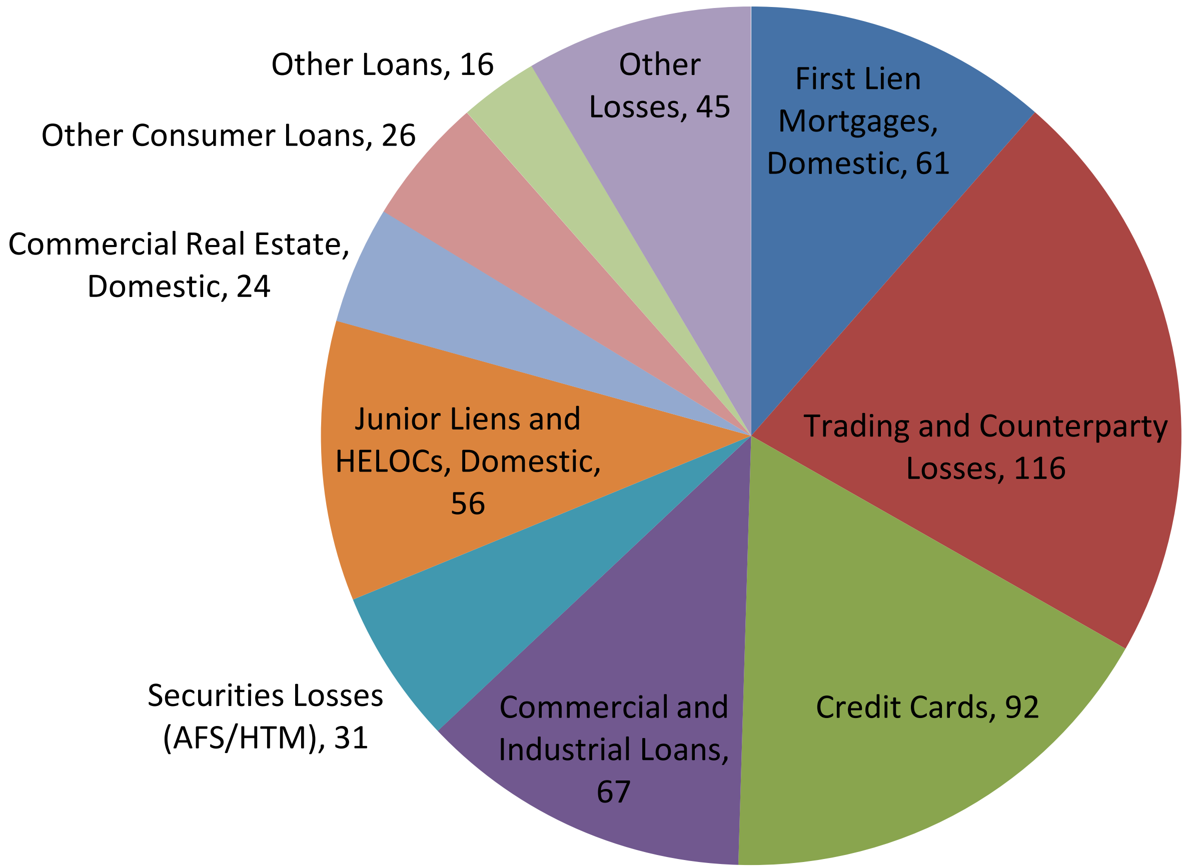
Regulatory Stress Tests: Brief History

- Supervisory Capital Assessment Program (SCAP) (2009) – the first time the Federal Reserve ran a supervisory stress test
- Comprehensive Capital Analysis and Review (CCAR) (2011) – Supervisory stress test models used primarily for sensitivity analysis
- CCAR (2012) – Supervisory stress test model estimates used as <u>one</u> of the key inputs in decision making and disclosed publicly

CCAR and Stress Tests

- CCAR links the forward-looking quantitative assessment of capital adequacy (stress tests) and qualitative assessment of firms' capital planning processes to capital actions.
- Key components for CCAR – assessment of firms' capital plan, risk measurement, and management.
- Aims for cultural change in capital planning – forward-looking assessments of risk and capital

Projected Aggregate Losses: CCAR

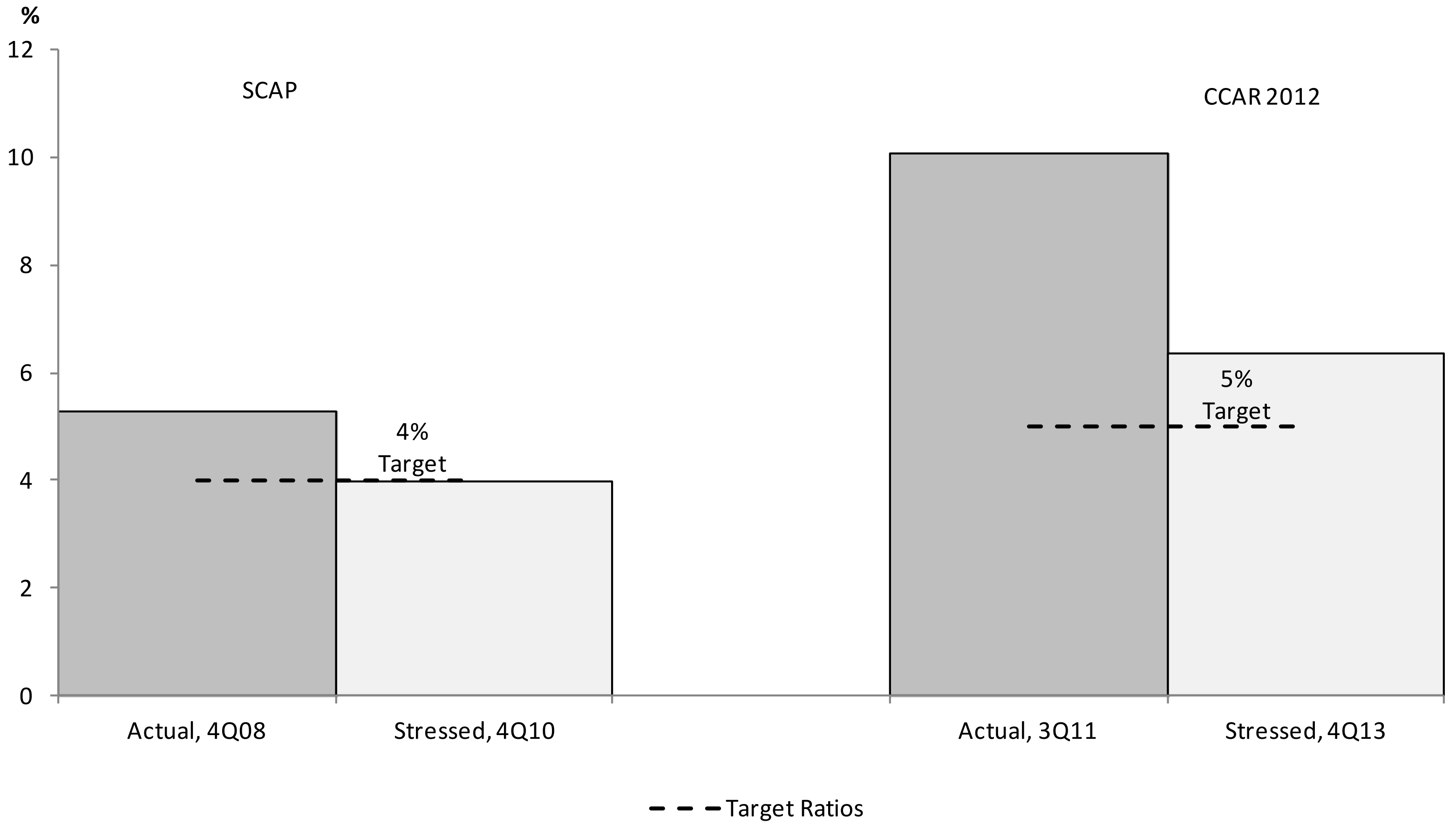


<u>Supervisory Stress Scenario</u>

Total: $534 billion

Source: Federal Reserve estimates in the Supervisory Stress scenario.

Initial and Stressed Tier 1 Common Ratios



Note: Aggregate ratios for 19 participating bank holding companies. Post-stress estimates are supervisory estimates.
Source: Federal Reserve. "The Supervisory Capital Assessment Program: Overview of Results," May 7, 2009.

Dodd-Frank Act (DFA) Stress Tests

- Mandates annual supervisory stress tests on SIFIs (>=$50 billion)

- Also, mandates company-run stress tests for all BHCs and banks >=$10 billion

- Specifies three scenarios – baseline, adverse, and severely adverse

- Requires the public disclosure of supervisory stress tests by the Federal Reserve and company-run stress tests by BHCs and banks

Supervisory Stress Tests: Key Topics

- Stress Scenarios
- Data & Methodologies
- Model Validation & Governance
- Transparency and Disclosure

Stress Scenarios

- Balance between the consistent framework and flexibility to account for salient or specific risk factors

- Supervisory stress scenario for CCAR – Hypothetical scenario of severely adverse economic environment, characterized by: a deep global recession, and sharp falls in asset prices and increases in risk premia

- Critical for firms to consider idiosyncratic stress scenarios most relevant to their own portfolio for capital planning purposes

  - Increasing supervisory focus going forward

- DFA stress tests require both adverse and severely adverse scenarios.

Data & Methodologies

- Expansion of regulatory data collection to capture key risk drivers at a more granular level
- Data availability affect modeling choices; Robust modeling requires a robust set of data
- Supervisory models will continue to evolve as the data collection matures and new products and risk characteristics are identified.
- Firms' ability to provide reliable data generally improved since SCAP
- Improvement noted in firms' methodologies; still a long way to go for many firms

Model Validation and Governance

- For CCAR, an independent model validation group assessed the Federal Reserve's supervisory modeling techniques, primarily focusing on conceptual frameworks

- Expect to maintain a high standard for model validation for all supervisory models, similar to supervisory expectation for firms

  - Expect robust backtesting, solid documentation, and independent validation of models, combined with an appropriate governance structure

- Formed the Model Validation Council to provide independent advice on the Federal Reserve's model validation process

Transparency and Disclosure

- Publicly disclosed the summary of supervisory methodologies and firm-level results
- Disclosure to the market – do we need more or better information for enhanced market discipline?
- Disclosure to the firms – how can we promote a robust stress testing framework tailored to the firms' ongoing needs?
- Modeling symposium planned for later this year to discuss best practices

Closing Thoughts

- Considerably more capital cushions in the banking industry now than before the crisis.

- A forward-looking assessment of capital adequacy is critical and is here to stay.

- While focusing on individual firms, CCAR and stress tests meet macro-prudential regulatory objectives.