Regulatory Stress Tests

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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 one 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

Source: Federal Reserve estimates in the Supervisory Stress scenario.

Supervisory Stress Scenario

Total: $534 billion
Initial and Stressed Tier 1 Common Ratios

Note: Aggregate ratios for 19 participating bank holding companies. Post-stress estimates are supervisory estimates.
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.