
Key Aspects of Stress Testing for Financial Institutions

Looking beyond 2022

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Focal Points

- Risk Identification and Horizon Scanning
 - Cross-risk relationships, e.g. Credit – Interest Rates – Inflation, Country Risk – Inflation, Climate Risk – Country Risk - Inflation
- Scenario Design & Construction
 - Clarify Narratives
 - Tie Risk Identification strategies to Amplifiers
 - Likelihood and Severity of Outcomes
- Model Risks
 - Fit-for-purpose; what does that mean in practice?
 - Climate risks; what are the forward looking challenges?
- Integration:
 - Capital vs Liquidity
 - Risk Appetite Frameworks
 - Reverse Stress Testing & Recovery Plans

Examples

	Physical Climate / Zambia	Transition Climate Risk / Nigeria
Narrative	Drought	Carbon taxes implemented across a range of international markets.
Amplifier	Complete reliance on hydro-electric energy for copper mines that drive government revenues.	Oil producer, but importer of nearly all refined products.
Outcome	Economy impacted by local food price inflation, and deterioration in government finances sees capital outflows and depreciation in currency.	Local economy impacted by widening, local 'crack spread'.
Risk Identification Feedback	How good are we at seeing through the real GDP, inflation, rates and currency impact to both Credit Risk and Interest Income projections?	How good are we at seeing through the direct and second order effects if our models are just geared to the "oil price"?

Outlook and Future Challenges

- Climate Risk “vectors” not present in banks’ historical data. By 2025-7, those vectors will be increasingly present in the Base Case forecasts. How will provision models adapt? How will stress models adapt? Are those models able to risk longer-dated balance sheet commitments our clients will look for to help with the transition?
- Co-relationship between Real GDP, Interest Rates, Inflation, and their impact on Credit and Customer Behaviours increasingly challenging as we forecast high inflation. What historical precedence do we have – 1974??
- The ability of firms to navigate uncertain outlooks will depend on their agility to produce alternative forecasts that challenge the status quo. Firms need to revisit how they get comfortable with models being “fit for purpose”, particularly as clients look to make significant business model change in response to climate, business and political risks.
- Firms need to do more to understand the points of non-viability for their business models, and relate those back to levels of capital and adequacy of liquidity.
- Integrate the learning from these lines of inquiry into the Risk Appetite Frameworks.