CAFRAL
CENTRE FOR ADVANCED FINANCIAL RESEARCH AND LEARNING
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Takeaways from Program on Stress Testing, Risk Management and Capital Planning

Stress Tests are being used for several purposes such as for macroprudential surveillance (by identifying the build-up of systemic risk and vulnerabilities in the financial system); as a crisis management tool (e.g., in the US and the European Union); to assess an individual bank's health (Supervisory or Microprudential Stress Tests) and as a part of the regulatory capital framework by prescribing the minimum level of capital that a bank must maintain even under stress situations. In addition, banks carry out their own internal stress tests from risk management and strategic perspectives.

The Program focused on practical implementation of frameworks for Stress Testing, risk management and capital planning. Experts from abroad and India made presentations in the Program in which senior officers of banks and financial institutions participated.

The key takeaways from the Program are given below.

Key takeaways:

1. Internationally, some of the key developments in stress testing relate to the following:

- There is an increasing trend towards more disclosure of the stress test results. The disclosures are watched keenly and the stress test results could have implications for the share prices of banks.
- Some banks are in the process of integrating the capital and liquidity stress tests. This throws up interesting challenges. Capital deals with the liability side of the balance sheet and liquidity inflows are more about managing the assets. This is like trying to manage two opposing ends.
- Stress Test results are increasingly having implications for business strategy. If a particular business does not look good during a severe stress scenario, then the management undertakes a close review of those businesses.
- For the Global Systemically Important Banks, the stress tests are very resource intensive.
- The stress tests are increasingly getting aligned to the budgeting exercise of the bank.
- A single view of the organisation is developing due to the stress tests and there is an attempt to get rid of all silos. This is not easy and can be a costly and painful exercise.
- Recovery plans vs. stress tests – Recovery plans focus more on the recovery aspects and resilience- what actions would be taken for recovery, how quickly can it be taken, how

these actions are implemented, etc. Recovery planning is not so much about scenarios, these are extreme scenarios anyway.

- Pillar 2 ICAAP stress tests are based on mild scenarios because their objective is to estimate capital requirements for a bank on an ongoing basis. The other stress tests (not under Pillar 2) could consider extreme scenarios, with severe implications for banks. These could form the basis for strategy – where businesses could be shed or volumes increased depending on how the business portfolio behaves under stress. Pillar 2 ICAAP stress tests normally would not determine strategy, they take the strategy as given and compute capital for a going-concern firm.

2. In the Indian context, banks are implementing frameworks for stress testing primarily under Pillar 2. The stress-testing exercise is yet to gain sophistication.

3. The Reserve Bank of India's analysis of the performance of the financial sector on functional aspects and its resilience (as assessed through stress tests) is gaining in sophistication.

Compiled by CAFRAL Team