

COVID-19: stress testing

Challenges faced in the stress testing and planning process

May 2020

Introduction

Once again, stress testing has become a key tool for banks and regulators to inform how best to navigate through the coming months and years. Immediate COVID-19 challenges will be addressed by creating new or adjusting existing scenarios. As well as this, overlays and understanding will be developed of how different portfolios or sectors will react to the evolving impact of COVID-19.

Market context

- ▶ After a number of years of benign economic conditions, stress testing models and infrastructure are being used and tested by banks as a tool beyond regulatory exercises - with a particular focus on portfolio management, capital adequacy and International Financial Reporting Standard (IFRS) 9
- ▶ Both banks and regulators are testing stress testing tools and frameworks during this unprecedented crisis, which brings an uncertain path to recovery. Models have not built to react to such severe and instantaneous shocks
- ▶ Whilst financial institutions run regular stress tests, in the run up to the crisis, an epidemic scenario was generally not considered or identified as material risk and likely
- ▶ Most Q1 reporters combined stress testing outputs with other forecasts from IFRS 9/Current Expected Credit Losses (CECL) provisioning models and conducted sensitivities against financial plans to determine potential downside ranges
- ▶ Regulators in Europe and the UK have relieved the industry from completing regulator concurrent stress tests and allowed banks to draw down on capital buffers - however, banks should expect regulators to ask for updates on capital and stress views on an ongoing basis

Immediate observed challenges

- 1** Resource-intensive processes are not agile enough to provide timely analysis to support decisioning. They are further hindered by operational challenges from the Government imposed lockdown.
- 2** Conflicting conclusions might be produced by multiple teams on a siloed and inconsistent basis.
- 3** Traditional macroeconomic models were not designed to capture the complexity of the COVID-19 crisis.
- 4** Scenario design has become a huge area of contention, given the wide variation in consensus forecasts - as observed in Q1 disclosures.

Considerations for coming months

- 1** Continue to develop and refresh scenarios based on new information, using Q1 reporting as a key benchmark.
- 2** Challenge modelled outputs, and adjust to capture the impact of sectoral sensitivities, including expected government/supervisory actions.
- 3** Targeted enhancement of key analytic areas leveraging broader data sources (e.g., supply chain analytics).
- 4** Create working forums with representation from provisioning, strategy, Financial Planning and Analysis (FP&A) and stress testing, to align consistent messages and implication.

Next and beyond

How can learnings from this crisis create a more responsive analytics framework and operating model, to align stress testing and planning to steer the business?

	Next	Beyond
Scenarios	<ul style="list-style-type: none"> Establish monitoring of sector specific leading indicators, (e.g., air traffic volumes, high street foot-fall) and leverage a broader range of economic data Targeted enhancement of key analytical capabilities including supply chain analytics Establish a more agile scenario refresh operating model and associated governance process 	<ul style="list-style-type: none"> Strengthen the scenario design framework, to include wider professionals beyond traditional economists (e.g., portfolio managers, data scientists), who will consider more wide ranging scenarios including climate epidemic and cyber related scenarios Establish a robust process by developing a range of scenario severities and maintain wider-ranging scenario library
Estimating impacts	<ul style="list-style-type: none"> Improve Management Information (MI) to explain results, including reconciliation between accounting, stress testing and financial planning sensitivities, where forecasts are not aligned Establish challenger methodologies and additional benchmarking processes 	<ul style="list-style-type: none"> Rationalise and integrate forecasting model landscape and centralise execution platform/capability Develop advanced on demand analytics capability for agile exploration of vulnerable groups and bottom up rules based impact / sensitivity analysis
Enhancing process and controls	<ul style="list-style-type: none"> Strengthen level of engagement from portfolio management teams and front office, to ensure robust challenge Enhance workflow management and communication channels to ensure rapid ongoing response and timely engagement from front office and businesses Establish clear channel of approval to avoid cycles of iteration of results 	<ul style="list-style-type: none"> Redefine and simplify roles and responsibilities to strengthen overall engagement and accountability Embed audit controls, lineage, time-stamping, version management, e.t.c., as part of the forecasting platform Design playbooks for different scenarios (e.g., epidemic, cyber), defining key working group and processes to rapidly estimate impacts
Agility through technology	<ul style="list-style-type: none"> Stocktake of limitations and direct/indirect costs of existing systems including support/licencing and manual workarounds Peer analysis around areas of technology investments and associated design choices Consider investment options and associated costs/benefits 	<ul style="list-style-type: none"> Maximise the use of technology to create flexible execution capacity and reduce production cycles Enhance data visualisation to enhance analytics and insights capabilities Transition to workflow integrated in the execution process
Alignment and embedding	<ul style="list-style-type: none"> Integrate and leverage COVID-19 stress testing outputs into replanning and budgeting exercise to understand: key risk to "new plans", monitor planning assumptions and corrective actions Establish virtual forecasting centres of excellence drawing upon diverse expertise from stress testing, financial planning, strategy and provisioning 	<ul style="list-style-type: none"> Align and consolidate stress testing, financial/strategic planning and provisions capabilities, to create consistency, transparency and efficiency Embed outputs of stress testing in business Key Performance Indicators (KPIs), including multiple scenario based metrics

Addressing the "next" challenges will prepare for the upcoming wave of regulatory scrutiny, and support closing regulatory findings.

Investments in enhancing capabilities can be leveraged to meet-sustainability requirements (including climate risk) and embedded into planning and decision making.

How EY can support

- Benchmarking of methods and tools deployed to respond to COVID-19
- Scenario design and understanding of relevant potential sector specific impacts, from EY economist and industry professionals
- Rapid visualisation, supply chain insights and rapid top down assessments from EY analytics tools
- In-depth experience across the US, UK and EMEIA market to supplement your response teams from EY's global stress testing network
- Change management expertise, supporting the implementation of new operating models for planning and stress testing

Key contacts

For further information, please contact the Financial Services Advisory team



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