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Critical Analysis and Challenges in Enhanced Risk Management and Capital Adequacy with respect to Dodd Frank Act

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Abstract: *This paper is about how regulatory stress testing is rapidly emerging as one of the most powerful tools for determining bank capital levels. While it provides the authorities with unique insights into the resilience of the banking industry, it also gives banks the ability to spot emerging risks, uncover weak spots and take preventive action. The Comprehensive Capital Analysis and Review (CCAR) in the US demonstrates that group-wide regulatory stress tests are complex, resource intensive exercises that require extensive senior management and Board engagement. The study has examined how banks carry out regulatory stress tests. To assess and manage "stress testing risk", banks need insights into their own stress testing capabilities and those of their peers. This paper provides valuable insights into the current state of play.*

Keywords: *CCAR, Stress Testing, Risk, Capital Adequacy, Board of Directors, Dodd-Frank Act, Front Office, Regulatory Expectations*

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I. Introduction

Comprehensive Capital Analysis and Review (CCAR) is a United States regulatory framework introduced by the Federal Reserve in order to assess, regulate, and supervise large banks and financial institutions - collectively referred to in the framework as Bank Holding Companies (BHCs). The assessment is conducted annually and consists of two related programs:

1. Comprehensive Capital Analysis and Review
2. Dodd-Frank Act supervisory stress testing

The core part of the program assesses whether:

1. BHCs possess adequate capital.
2. The capital structure is stable given various stress-test scenarios.
3. Planned capital distributions, such as dividends and share repurchases, are viable and acceptable in relation to regulatory minimum capital requirements.

The assessment is performed on both qualitative and quantitative bases. The Federal Reserve may order banks to suspend their planned capital distributions to shareholders until the target capital balance is restored.

The Comprehensive Capital Analysis and Review (CCAR) in the US demonstrates that group-wide regulatory stress tests are complex, resource intensive exercises that require extensive senior management and Board engagement. It is likely that regulatory stress tests in other jurisdictions will follow suit, with local variations on the theme, for example as part of the Comprehensive Assessment by the ECB/EBA.

How banks carry out regulatory stress tests is becoming more critical, simply because of their power to set capital buffer levels, determine management actions and restrict distributions (dividends and employee bonuses). Stress testing sits squarely on the agenda of CEOs.

To assess and manage "stress testing risk", banks need insights into their own stress testing capabilities and those of their peers. This paper provides valuable insights into the current state of play.

II. Literature Review

During this study, the following literatures were reviewed:

1. Basel Committee on Banking Supervision - Principles for Sound Stress Testing Practices and Supervision.
2. Supervisory Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework by OCC.
3. Regulatory Capital Rules - Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline

and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule by OCC.

4. Supervisory Guidance by OCC on Stress Testing for Banks with more than $10 Billion in Total Consolidated Assets.
5. Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance by Board of Governors of the Federal Reserve System.

III. Objectives of the Study

1. The need for banks to demonstrate strengthened risk management and to capital adequacy.
2. To demonstrate that to assess and manage "stress testing risk", banks need insights into their own stress testing capabilities and those of their peers. This industry survey provides valuable insights into the current state of play.
3. To demonstrate that in order to meet future regulatory demands, banks need to move regulatory stress testing from a standalone process to one that is more strongly integrated with other business activities.

IV. Population for the Research

The survey was conducted in person/over a call during November 2016 – June 2017 and includes 24 Senior Executives and Board Members of the 5 banks across geographies. We appreciate and value the time of all those respondents who contributed. The table below summarizes the questions and answers that contribute to respondents' position on the stress testing heat map. Each answer is mapped to a ranking scale from 1 (At risk) to 4 (Target). Ranking scores are averaged for all questions within each of the four categories.

Category	Questions	At risk (1)	Basic (2)	Sustainable(3)	Target (4)
Governance & engagement	Please indicate the level of involvement of the Board in each of the following stages of the regulatory stress testing process	1	2	3	4
	Please indicate the level of involvement of Executive Committee (ExCo) in each of the following stages of the regulatory stress testing process	1	2	3	4
	Please indicate the level of engagement with regulators at each of the following stages of the regulatory stress testing process	1	2	3	4
	Please indicate the efficacy of your regulatory stress testing process in each of the following areas: overarching framework; roles and responsibilities; documentation; and review and challenge by senior management and the Board	Poor	Moderate	Good	Excellent
Operating model	Please indicate the efficacy of your regulatory stress testing process in each of the following areas: integration/ engagement between risk, finance, treasury and dedicated stress testing functions; integration/engagement with front office business areas; integration/engagement between central and local teams (by geography)	Poor	Moderate	Good	Excellent
	To what extent is regulatory stress testing a separate exercise to: base case business planning; own/internal risk management; recovery/ contingency planning; resolution planning; reverse stress testing?	No overlap/ influence	Limited overlap/ influence	Fair degree of overlap/ influence	Significant overlap/ influence
Process	To what extent are you able to reconcile the base data used in regulatory stress testing to your audited financial results?	Viewed as independent dataset/ overarching reconciliation planned	Overarching reconciliation in place	Partial reconciliation with explained differences	Full reconciliation
	Which of the following best describes your current regulatory stress testing staff resources?	Significant shortage	Some Gaps	-	Sufficient/ excessive
	How long does the regulatory stress testing process take from start to finish?	More than 6 months	4-5 months	3-4 months	Less than one month
	What percentage of this time is spent modelling?	>75%	51-75%	33-50%	<33%
Results & Impacts	Have you ever revised your business plans in response to regulatory stress testing results?				
	Which of the following strategic actions have you changed in response to regulatory stress testing results?				
	What type of risk control actions have you taken in response to regulatory stress testing results?				

V. Findings and Analysis

While regulatory stress tests provide useful insights, banks have struggled to convert these to strategic change. It is clear that the increased regulatory stress testing requirements will absorb significant Board and senior management time. In some instances, banks might also be required to hire additional staff or invest in technology to make the step change required. As a result, regulatory stress testing can no longer be viewed as an independent process. Banks should aim to leverage the insights gained to inform other processes, including short and medium term planning. Our survey results suggest further scope exists for banks to integrate regulatory stress testing outputs more closely with other processes.

This section explores key insights into the impact of regulatory stress testing on banks -

Banks are not prepared for tougher regulatory stress tests

Overall, the participating banks seem confident that they meet current regulatory requirements (for example for ICAAP purposes) reasonably well. However, they seem to be significantly underestimating what they would need to do to meet the demands of a CCAR-like regime and the associated step change in regulatory expectations.

Inadequate people resources

Most respondents have fewer than 20 people dedicated to stress tests. The banks in my survey rely on small teams to carry out regulatory stress tests, with the majority of respondents revealing gaps in staff capabilities and numbers. In the US, banks have had to increase staff levels in response to ever-increasing demands imposed by the Federal Reserve.

More comprehensive Board engagement required

While Boards and senior management are heavily engaged in reviewing results of the stress tests, they are rarely involved in the end-to-end process of stress testing. This means they are likely to fall short of the increasing regulatory requirement for more comprehensive involvement.

More collaboration needed with the front office

Banks believe that they effectively integrate Finance, Treasury and Risk for stress testing. However, further scope exists for closer collaboration with front office (banks' front-line business and commercial activities). Almost three quarters of respondents feel collaboration with front office is non-functional or partially functional. While banks agree regulatory stress tests provide important insights, they struggle to find useful applications in running the business. 95% have never – or very rarely – revised business plans in response to stress test results. Regulatory stress test results are however, used by some banks to inform decisions relating to risk appetite and de-risking.

Data quality and modelling are top priorities

Banks believe that they are able to reconcile finance and risk data despite consistent and persistent concerns from regulators (and banks) over data quality. However, the majority of banks expect to enhance their stress testing frameworks over the medium term, with data quality and modelling capabilities as top priorities.

Evolving regulatory expectations

The regulatory focus on stress testing is driven by two main themes: the need for banks to demonstrate strengthened risk management and to capital adequacy. Regulatory stress testing expectations have increased significantly in a short period of time. As part of the introduction of Pillar 2 of Basel II from 2008 onwards, banks were first required to conduct capital stress tests as part of their Individual Capital Adequacy Assessment Process (ICAAP). The effectiveness of the implementation ICAAP stress tests has been mixed across different jurisdictions. During the global financial crisis and its aftermath, supervisors in several countries used their own stress models to perform their own assessment of bank capital needs. The financial crisis resulted in a step change in regulatory expectations of banks' stress testing capabilities – particularly in those countries where the crisis impacts were severe. A further transformation is coming, with the UK and EU authorities set to follow the US in introducing regular, comprehensive stress testing regimes. Other jurisdictions are likely to follow suit.

In the Eurozone, the ECB is undertaking its Comprehensive Assessment. The Comprehensive Assessment, which applies to all the major banks, has three legs: risk assessment, asset quality review, and stress testing.

Governance and engagement

Boards and senior management are predominantly engaged with the results of the stress tests and are, therefore, likely to fall short of regulatory expectations of more comprehensive engagement. Increased regulatory expectations for Board and senior management engagement re-emphasize the importance of stress testing as a risk management and supervisory tool. It is no longer sufficient for Boards and senior management to review and challenge the final results – more active engagement in scenario design, assumptions, understanding model limitations and formulation of management actions is expected.

Challenges and priorities

Most banks expect to develop their existing stress testing frameworks over the next few years and improving data and modelling capabilities are top priorities. Banks recognize that regulatory developments will place increasing demands on their stress testing capabilities but view the future as an evolution rather than a revolution.

Top challenges

- Data requirements
- Modelling approach
- Business unit/division approach
- Timing
- Governance
- Insufficient skilled resources
- Disclosures
- Managing regulators
- Scenarios
- Moving to business as usual

VI. Conclusion

The focus of this research has been on evaluating the processes each bank has in place to assess its capital needs and manage its capital resources, and how well the firm's policies and procedures are implemented and governed by senior management and the board of directors. More specifically, the analysis focused on the effectiveness of firm-wide risk management and measurement practices, governance over internal capital adequacy assessments, and the completeness and comprehensiveness of the capital plans and capital planning processes. The assessment of completeness focused on the extent to which the stress scenario analysis performed by the firms in support of their capital plans fully captured the firms' material risks. This assessment specifically considered:

- The extent to which the board of directors and senior management relied upon a robust analytical framework that weighed the appropriateness of proposed capital distributions against the inherent uncertainty in the economic outlook and the firm's financial performance.
- Whether the capital plan was supported by an effective process for translating firm-wide risk exposures into estimates of potential losses in an adverse environment.
- The extent to which the capital plans were supported by a stress scenario analysis framework that considered a range of economic, financial market, and operational events and outcomes.
- Whether this stress scenario analysis framework effectively brought together estimates of potential stressed losses, and earnings and other resources available to absorb those losses in an adverse environment, and consideration of the resulting impact on capital needs.

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