Stress Testing for Strategic Planning

OFR Conference on Evaluating Macroprudential Tools
January 30, 2015

Til Schuermann
Our clients’ industries are extremely competitive. The confidentiality of companies’ plans and data is obviously critical. Oliver Wyman will protect the confidentiality of all such client information.

Similarly, management consulting is a competitive business. We view our approaches and insights as proprietary and therefore look to our clients to protect Oliver Wyman's interests in our presentations, methodologies and analytical techniques. Under no circumstances should this material be shared with any third party without the written consent of Oliver Wyman.

Copyright © Oliver Wyman

This report is not intended for general circulation or publication, nor is it to be reproduced, quoted or distributed for any purpose without the prior written permission of Oliver Wyman. There are no third party beneficiaries with respect to this report, and Oliver Wyman does not accept any liability to any third party.

Information furnished by others, upon which all or portions of this report are based, is believed to be reliable but has not been independently verified, unless otherwise expressly indicated. Public information and industry and statistical data are from sources we deem to be reliable; however, we make no representation as to the accuracy or completeness of such information. The findings contained in this report may contain predictions based on current data and historical trends. Any such predictions are subject to inherent risks and uncertainties. Oliver Wyman accepts no responsibility for actual results or future events.

The opinions expressed in this report are valid only for the purpose stated herein and as of the date of this report. No obligation is assumed to revise this report to reflect changes, events or conditions, which occur subsequent to the date hereof.

This report does not represent investment advice nor does it provide an opinion regarding the fairness of any transaction to any and all parties.
What is stress testing?

**Scenario**
(e.g. a prolonged US recession)

**Forecasting machine**
(Analytical models)

**Results**
(Balance sheet, P&L, key regulatory ratios)
Practically, stress testing requires dynamic projections of revenue, income, expenses, balance sheet, and regulatory ratios – so you need a lot of models!

9-Quarter dynamic forecast

This poses many hard questions

- P&L link to balance sheet: how will components of P&L change?
- Volumes and margins: what will the impact on new volume and renewals be?
- Balance sheet evolution
  - How will the structure (term, mix, and availability) of liabilities evolve?
  - How can asset and liability changes be modeled?

Models are conditional on systematic risk factors, so stress testing is rooted in a desire to separate systematic from idiosyncratic risk.
It’s hard to overstate the impact that stress testing and formal capital planning (CCAR) is having on US banks

• “The frequency and quality of discussion with my CEO and the board is totally different from before the crisis”

• “The work-load is incredible – but it has forced interaction across groups that rarely did so before”

• “PPNR risk dynamics were poorly understood before CCAR”

• “We have much better quality models and risk awareness”

But there is a real risk that CCAR devolves into a compliance exercise

• Stakes are high, so focus is on outcome – “passing” – instead of process

• Process and workload intensity forces routinization

• “What do I need to do to keep the regulator happy”
  – Instead of: “What are my strengths and weaknesses – and how should that inform my strategy and the resources needed to support it”

So how can we use the CCAR machinery for “Business as Usual”? 
Banks comfortable with CCAR are actively applying it to strategic planning

High-level strategic planning process
Client example

- Exec. mgmt. / Strategy
  - Past perf.
  - Bank strategy
  - Bank perf. targets
  - Group targets

Group/BU mgmt.
- Tactical options
- Group/BU plans

- Review / challenge
  - Separate macro-env. contribution to plans

- Budget process
  - Challenge business plans

- Separate macro-env. contribution to plans
- Conduct what-if analysis on tactical plan options
Scenario-based planning
Using CCAR models for strategic planning

\[ Performance = \beta \times Macro + \alpha \]

What can I expect performance to be if:
- Macro environment is as expected
- Bank is managed same as in past

What remains after macro trends? Is this reasonable? Are there strategies to achieve this?

What is the sensitivity to macro environment?

Target | CCAR model: base | CCAR model: bear | CCAR model: bull | "Residual" performance needed
Stress Testing for Strategic Planning

OFR Conference on Evaluating Macroprudential Tools
January 30, 2015

Til Schuermann