Financial Research Advisory Committee meeting
July 23, 2015

Discussion Topic 1: Stress Testing in the Financial System

Since the financial crisis of 2007-09, there has been substantial focus on strengthening the supervisory stress testing of banks. The OFR has a mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to evaluate and report on stress tests. The OFR has published several working papers and briefs on bank stress testing and is working actively with the Federal Reserve to obtain access to data from its Comprehensive Capital Analysis and Review exercise, consistent with prior recommendations from the Committee.

The OFR would like to seek feedback from the Committee on our research agenda on stress tests. Because much of the academic work on stress testing has focused on banks, we would like to focus this discussion on stress testing of nonbank financial institutions and system-wide stress testing, although we remain committed to evaluating and reporting on bank stress tests as well.

The Dodd Frank Act requires annual company-run stress tests for any financial firm with assets greater than $10 billion and whose primary regulator is a federal agency. The National Credit Union Administration has adopted rules for the stress testing of large credit unions. The Federal Housing Finance Agency has finalized rules implementing stress testing requirements for the government-sponsored enterprises (GSEs) and the federal home loan banks. The Securities and Exchange Commission (SEC) has adopted final rules requiring money market funds to conduct liquidity stress tests, in addition to evaluating the impact of certain specified hypothetical events. Draft rules covering other asset managers and swap dealers have not yet been issued but are expected from the SEC and Commodity Futures Trading Commission (CFTC), respectively.

The various federal regulators charged with oversight of central counterparties (CCPs) — the Federal Reserve Board, CFTC, and SEC — have either adopted final rules or proposed draft rules with respect to systemically important and securities-based clearing agencies under a separate requirement of the Dodd Frank Act. These rulemakings define "stress testing" for CCPs, but vary in their level of prescriptiveness with respect to CCP stress testing practices.

Large insurance companies are not subject to the Dodd Frank Act unless designated by the Financial Stability Oversight Council for heightened supervision. Since the financial crisis, the National Association of Insurance Commissioners has adopted a framework called Own Risk Solvency Assessment (ORSA), which is a principles-based approach to evaluating insurers' risk management framework and assessment of risk exposures, and which includes a forward-looking solvency assessment. Under ORSA, stress scenarios and firms' methodologies are not uniform and consider only the insurance legal entities as opposed to the consolidated firm.

These exercises, like the bank stress tests, are microprudential rather than macroprudential, in that they focus on the impact of stress on the solvency of individual firms rather than on the system as a whole. There may be a role for a broader stress test of the financial system to allow policymakers to identify which parts of the financial system have more risk and thus may require more Council attention, as well as to better discern which large firms are more likely to pose systemic risk if certain risks materialize.

Questions for discussion

1. Should stress testing requirements for nonbank entities be strengthened? If so, what types of non-bank entities does the Committee believe most are in need of strengthened stress testing requirements?

2. Are there best practices from bank stress testing that seem applicable to stress testing of non-banks? For example, are common scenarios useful?

3. How differentiated should stress tests be across institution types?

    a. What role, if any, should stress tests play in setting capital requirements for CCPs, GSEs, and designated and non-designated insurance companies, as is done in banking?
    b. How should stress testing influence supervision and regulation of parts of the financial system not subject to capital regulation, such as hedge funds? Should supervisory stress testing for these entities focus on liquidity or counterparty concentration risks or potential systemic spillovers?
    c. What, if any, features of stress tests for large, complex financial institutions are inappropriate for smaller, less complex institutions?

4. Does the Committee believe that a stress test of the U.S. financial system that subjected a range of financial firms to similar sets of shocks would be useful for purposes of evaluating risk? In what ways can microprudential stress tests be used to inform macroprudential assessments of risk?