

MORE STRESS TESTING IS INEVITABLE: MAKE IT ABOUT MORE THAN COMPLIANCE

Proactive banks can make stress testing a timely tool

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As we approach the first anniversary of the Dodd-Frank Act, much uncertainty remains. Regulators continue their implementation while the industry awaits concrete answers about specifics and the path forward.

One thing grows clear: An intensified focus on identifying, managing, and documenting risk--and the use of regular stress tests as an assessment and enforcement tool--will define life for banks. New mandates will result in higher capital reserves and more stringent liquidity ratios.

Indeed, increasingly, stress testing must be baked into a bank's standard operating procedures. Banks must be equipped with a unified analytics infrastructure that enables new levels of agility in setting up, analyzing, and reporting on risk scenarios--and modifying them rapidly when warranted--whether driven by regulatory demand, by crisis, or by top management request.

How can banks begin preparing, even as regulators continue their rulemaking? Think proactively.

A new landscape for liquidity and capital adequacy

Stringent liquidity and capital adequacy requirements are Dodd-Frank fundamentals. Like Basel III in Europe, the Act seeks to transform the industry's approach to liquidity risk. With the rules-based approach as set forth in Dodd-Frank and Basel III, regulators are expected to establish well-defined rules, as well as ratios based on specific investment and lending conditions.

Many in the industry expect Dodd-Frank requirements for liquidity risk will align with those under Basel III, which require banks to set minimum liquidity based on a stress test using standardized calculations. Basel III will introduce a "liquidity coverage ratio" that requires banks to maintain high-quality liquid assets sufficient to cover net cash outflows for a 30-day period under a stress scenario. In addition, Basel III establishes a net stable funding ratio test, which will measure the level of liquid assets to the level of liabilities that mature in a year or less.

Moving forward, banks will be required to have a comprehensive liquidity risk management program. They will need to be able to facilitate compliance and promote sound operations by clearly identifying and assessing enterprise-wide liquidity risk under normal and extreme conditions. They will need to develop strategies to effectively bridge liquidity gaps.

In addition, the Act will literally invert thinking about capital adequacy. Federal banking agencies will increase capital requirements in times of economic expansion and decrease them in times of economic contraction. In addition, the Act sets current risk-based capital and leverage standards for insured depository institutions as a floor for future standards for bank holding companies and systemically important nonbanks. And there will be increased focus on managing counterparty credit risk and maintaining countercyclical capital buffers.

New capital requirements will somewhat limit the amount of capital that financial institutions can put to work. Expanded analytical capabilities and enterprise visibility will be essential to achieving this objective while still managing for risk.

De rigueur stress tests

Under Dodd-Frank, stress testing of both liquidity and capital adequacy will become the norm, not a crisis-inspired measure. And that stress testing will go far beyond what happened in the wake of the financial crisis. Instead, the industry will see stress testing ordered as a follow-up to regularly scheduled periodic reports.

Regulators increasingly will see vulnerabilities in reports and request stress tests based on those vulnerabilities. The stress test scenarios will thus be very specific to each bank. Further, regulators will expect the results of the tests quickly--often in just a few days. They will assume that banks will organize their risk data in a fashion enabling rapid response.

The value of proactively getting ready for this eventuality goes beyond making the regulators happy. Stress testing represents a tool for managing enterprise performance. Global events, whether related to economic developments, disasters, or conflicts, can have a profound--and sometimes immediate--impact on bank's performance. The ability to run stress tests "on-demand" enables an institution to tune response--for example, contingency funding strategies--as events unfold. Tests may help management gain a better understanding of the potential impact of global events.

In addition, this same approach can support organizations as they seek to more proactively manage their business, enabling a timely view of costs and profitability, as well as the performance of specific products.

Getting ready for stress testing as norm

Adopting a proactive stance today can give banks an important advantage in preparing to meet new regulations and requirements with confidence, while remaining focused on their core business. Where should banks start?

• Acceptance is key. We have entered a new era of financial services oversight, and change is inevitable. Earlier this year, Federal Reserve Chairman Ben Bernanke, during the Annual Conference on Bank Structure and Competition, spoke of initiatives on both sides of the Atlantic to implement a macroprudential approach to supervision and regulation. The Financial Stability Oversight Council and Office of Financial Research--formed by Dodd-Frank--have sweeping powers. They can not only ask systemically important banks for new and detailed data on operations, but can also designate non-financial players as systemically important and in need of regulation. In short, no financial institution will escape the impact of Dodd-Frank.

• Begin to realign. Risk and profitability are two sides of the same coin. Over the past few years, banks have been reminded painfully of this fundamental and non-severable link. A recent study, *Transforming the CFO Role in Financial Institutions: Towards Better Alignment of Risk, Finance and Performance Management*, found that financial institutions scoring themselves highly on their ability to align risk and finance functions appear to be doing better financially than their peers.

In some cases, organizations realign so risk and finance executives report to the same top-level executive. Cross-functional teams will also be increasingly important, especially as stress tests become more complex and comprehensive. For example, regulators may ask a bank to assess the impact of a particular scenario not just on risk-weighted assets but also on liquidity risk and profitability.

In many organizations, the resources needed to fulfill regulatory requirements might reside in separate teams that do not regularly collaborate. Moving forward, some organizations may want to task some individuals to span both the risk and finance teams to facilitate better communication and collaboration.

• Focus on analytical transformation. An important early step in preparing for compliance is considering unifying the infrastructure for analytics, covering risk management and performance management--and even financial crime and compliance.

Doing so can provide visibility across the entire enterprise and deliver insight when and where it is needed. As the financial downturn demonstrated, the ability to connect developments and indicators in one part of the business with those in other parts of the business proves essential to determining an organization's true strengths and vulnerabilities.

Financial institutions will have to supply significantly more data to an expanded universe of regulatory authorities, and more frequently. That's inevitable. While regulators continue with rulemaking, banks have an invaluable window of opportunity to bolster their risk management environment. Those that take advantage of this time stand to benefit greatly from a smooth transition when the dust finally settles.

About S. Ramakrishnan

A 25-year finance and technology veteran, S. Ramakrishnan is currently group vice-president and general manager of Oracle's Financial Services Analytical Applications business. As a part of Oracle's Financial Services Global Business unit, he is responsible for the full portfolio of the unit's analytical applications for enterprise risk management, enterprise performance management, governance risk and compliance and customer insight. Prior to joining Oracle, Ramakrishnan held leadership positions at Citibank where he achieved recognition as an early innovator in the field of Data Warehousing.