



MAKING LEMONADE FROM STRESS TESTING LEMONS

THE BRIGHTER SIDE OF THE BANKS' COMPREHENSIVE CAPITAL ASSESSMENT AND REVIEW PROGRAM

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Executive dining rooms and cafeterias at banks across the United States are all abuzz with talk about the cost and burden of post-crisis regulatory demands. But few regulations have left a more sour taste than the Federal Reserve's demanding Comprehensive Capital Assessment and Review (CCAR) program – or stress testing, as it's more commonly called.

JPMorgan Chase's Chief Executive Officer Jamie Dimon, in his 2014 letter to shareholders, noted more than 500 bank professionals (and thousands of additional contributors) were dedicated to the 2014 submission, which was more than 5,000 pages long. The following year, those numbers ballooned to more than 950 people, and the submission exceeded 20,000 pages. Citigroup, in its third quarter 2014 earnings call, informed investors that it was spending an incremental \$150 million to \$175 million on improving its capital planning capabilities in 2014 alone.

Is this money spent just for regulatory compliance? Yes, satisfying the regulations is necessary, but surely one can make good economic and profitable use of the machinery and processes that have been laboriously built up. How can banks use stress testing for offense rather than just for defense and compliance?

To make progress in thinking creatively about the stress testing and the CCAR machine, a very short overview is in order. Each year, the largest banks have to go through a capital planning exercise. Will the proposed capital plan, which is closely tied to the firm's strategic plan (more on that later), survive some really stressful economic and market conditions? If yes, and if the Federal Reserve feels comfortable with the associated risk and capital management, as well as many other processes, then the bank passes the test – and the capital plan, which may contain dividend increases, share-repurchase programs, and even the possibility of inorganic growth, as for

example through an acquisition, is approved, or in the tortured language of the Federal Reserve, “not objected to.”

To pull this off, banks have built modeling machinery, which allows them to forecast bank financials – balance sheet and income statement, regulatory ratios – under a range of stressful economic environments. No small feat!

RIGOROUS BUDGETING

The careful reader will likely have noticed that, if you can forecast bank financials under stressful conditions, then surely you can forecast them in expected or baseline conditions. Indeed, banks do just that because they are required also to submit baseline projections to their supervisors – in other words, what the banks actually expect to happen.

Indeed, this is not a new exercise, and it is something corporations have done throughout their existence: It's called a budget, but it is unlike any budget ever generated in the past. It is far more rigorous, supported with empirical analysis, and, importantly, helps separate the return that comes from the economy and the market, and the return that is delivered by the bank's management. Any asset manager of course will recognize this exercise immediately: It is the process of separating “beta” (what the market gives you) from “alpha” (what you can deliver above and beyond the market).

Banks should and can use stress testing for offense rather than just for defense



Banks are abandoning their old budgeting process and are using the baseline CCAR projection by adapting it to their budget for the next year. However, one shouldn't slavishly adopt the model output; in fact, there may be very good reasons to deviate, deliberately, from a model's best estimate of, say, revenue growth, given expected economic and market conditions. Senior management may wish to set some stretch goals to encourage prudent growth relative to what would happen organically. This is not wishful thinking. As a senior client told us recently, CCAR-based budgeting "simply works better."

DECONSTRUCTING ALPHA

An actual client experience brings home this idea. As part of vetting CCAR results, one business unit was proposing, for its budget, 5 percent growth over the coming year. But the CCAR model's baseline projection was just 3 percent. This raised some questions among the executives, including the chief executive officer: How was the business proposing to

generate the additional 2 percent, the "alpha", that the economy was not projected to deliver for the company? Would it be through more aggressive pricing, stronger sales (achieved perhaps by lowering risk limits), or more effective customer retention?

This question triggered a rather spirited debate. After the meeting, members of the team told us that such a robust and disciplined discussion on growth targets would not have been possible even a year earlier.

Come year-end performance evaluation, and compensation discussions, a natural question to ask is: How did you do relative to budget, relative to those stretch goals? One of the hardest problems in performance evaluation is in separating skill from luck. In our client example, if the business unit delivered 7 percent instead of the promised 5 percent growth, was that because of creativity, ingenuity, and grit – or did the economy just turn out better than what had been expected at the time the budget was generated? The CCAR machine can help to answer this question.

STRATEGIC PLANNING

If CCAR can help with budgeting and performance, it's not a big leap to consider how it can improve strategic planning. In which areas should the bank seek growth, where should it shrink, and where might inorganic growth be called for? Moreover, how do these ideas play out in the firm's financials – earnings and balance sheet – and what are the economic conditions that would need to transpire for the strategic plan to work well, just squeak by, or actually fail?

In fact, the real benefit of stress testing and CCAR – although still untapped and unrecognized – arguably may lie in its potential for facilitating a more rigorous, robust, and credible strategic planning process.

The regulator has a narrow interest: Is there sufficient capital and capital generation capacity to support this strategic plan, even if the economy were to go south? Senior

management, the board, and shareholders, on the other hand, have much broader interests: They care about the upside along with the downside. The CCAR machine can help with both: It can warn about the downside risks and inform about the upside potential.

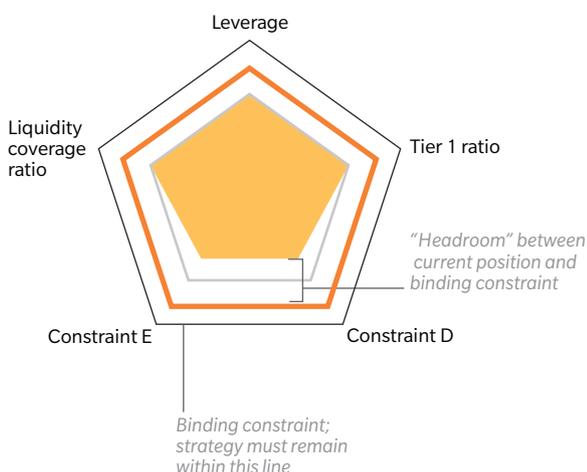
Thanks to CCAR, that strategic planning machinery has now been built! And it can be put to good use answering a number of strategic questions. As an example, consider the following: where should the bank invest its next marginal dollar of assets? As constraints on a bank – imposed both internally by, for example, the firm's risk appetite, and by supervisors – increase in both number and complexity, this question becomes more difficult to answer.

Take the stylized example in Exhibit 1: A bank has a number of constraints intended to measure its financial strength that it must respect – leverage, a risk-based Tier 1 capital ratio (capital over risk-weighted as opposed to unweighted assets like the leverage ratio),

EXHIBIT 1: STRESS TESTING STRATEGIES

BANK'S COMPREHENSIVE CAPITAL ASSESSMENT AND REVIEWS HELP SET STRATEGIES BY STRESS TESTING ALTERNATIVES

CURRENT POSITION



STRATEGY ALTERNATIVES



QUESTION 1 QUESTION 2: RISK/RETURN FEATURES

QUESTION 1 In bounds?	QUESTION 2: RISK/RETURN FEATURES Return on equity	Profits	Return on capital
✓	✓	—	✓
✗	NA – strategy violates Leverage Ratio		
✓	✓	—	—

Source: Oliver Wyman analysis

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liquidity – but it has some headroom with which to maneuver. The bank may consider several strategies to take advantage of this headroom, but one strategy may push against one constraint, say leverage, while another may get the bank close to a different constraint, say liquidity. The first question to answer is whether the bank can stay within its constraints, by passing CCAR, for example, while remaining within its own risk tolerances, across each of the possible strategies.

Here, the ability of the CCAR/strategic planning machine to capture downside risks is key. Strategy II fails this test (via a leverage ratio breach) and must be discarded. For strategies

that pass this first test, the next question is one of classic risk/return optimization. Here, the ability of the CCAR machine to capture baseline expectations and upside potential is highlighted. Among the remaining strategies, the CCAR machine can be used to pick the strategy offering the best return: Strategy I.

This is just one of the lemonade recipes we have been exploring with our clients. There are many more, equally promising, recipes. They are moving from the test kitchen to the main dining room, and the taste is getting sweeter by the day.

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