OFFICE OF FINANCIAL RESEARCH

Financial Research Advisory Committee Meeting
July 28, 2016

Discussion Topic: Research Agenda of the OFR's Stress Testing Program

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandates the Office of Financial Research (OFR) to evaluate and report on stress tests (Sec. 154(c)(1)(E)). The OFR's stress testing program is designed to satisfy this mandate. It looks at banks, nonbanks, and the U.S. financial system as a whole. The OFR's website details research completed to date that relates to this program.

The stress testing program has three components:

1. **Compile supervisory data needed to evaluate stress testing methodologies.**
   The OFR will need a wide range of supervisory data to carry out its work under this program. Some of the data the OFR already has. Some it will need to obtain. For example, the OFR has recently begun to on-board the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) datasets.
2. **Develop coherent stress scenarios beyond those currently used.**
   Stress tests assess the resilience of financial institutions under various adverse scenarios. Evaluating existing stress tests and contemplating approaches to stress testing financial institutions not currently subject to stress tests requires developing alternative scenarios. Those scenarios should come from an internally consistent economic model.
3. **Assess methodologies for stress testing individual firms and the U.S. financial sector as a whole.**
   Evaluating stress tests involves not just analyzing test results but also assessing the underlying methodology. For financial firms not currently subject to stress testing and for the financial system as a whole, this assessment involves exploring potential methodologies for stress testing.

Research under the program encompasses banks, insurance, money market funds, central clearing, broker dealers, mortgage finance, and asset management (particularly hedge funds and real estate investment trusts). Work is organized by financial sector. Financial institutions subject to capital regulation are given priority, followed by sectors that have received public support in the past or that may be subject to run risk.

Among the types of financial institutions, OFR research will address the following questions:

- **Strengthening approaches to supervisors' microprudential stress tests**
  - Should supervisory scenarios be tailored to the business models of particular companies or types of financial institutions, or be standardized? How far should supervisory stress tests go in capturing a financial firm's idiosyncratic business activity or exposures?

  - What can be learned from international experience to date with supervisory stress tests of nonbanks, such as insurance, CCPs, and asset management?
  - How can approaches to estimating a financial firm's revenue under stress be improved?
  - How can approaches to estimating changes in a firm's balance sheet under stress be strengthened?
  - How can stress tests incorporate liquidity risks?
  - When should regulators rely on firm-supplied results as opposed to obtaining data and running their own models?
  - Where do supervisory stress tests need to evaluate consolidated risk and legal entity risk more closely?

- **Integrating feedback effects more fully into microprudential stress tests**
  - How can stress tests incorporate systemic effects, such as contagion channels and feedback effects, from institutions' responses to stress?
  - How can stress tests of bank and nonbank financial firms consider potential feedback effects on the macroeconomy from a credit contraction?

- **Assessing emerging risks**
  - What kinds of stress scenarios — credit, market, funding, and liquidity — are different types of financial institutions most exposed to?
  - What can be learned about emerging risks from evaluating firms' own stress test scenarios shared with supervisors?
  - How can stress test results inform microprudential supervision and use of macroprudential tools, such as capital buffers?

- **System-wide stress tests**
  - How can a system-wide stress test be made both tractable in terms of granularity of data but credible to policymakers in its output?
  - What are appropriate risk measures for a system-wide stress test?
  - How would data need to be improved to enable system-wide stress tests?

Questions for Discussion

1. What are your thoughts on the scope of the OFR's multiyear stress testing research agenda?
2. Are we missing any important research areas?
3. What data might best contribute to this program? What data gaps are there that most need to be filled?