



21 February 2020

## TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS

### STRESS TESTING ASSESSMENT: FINDINGS AND FEEDBACK

Stress testing is an integral part of risk management. It helps improve the readiness of authorised deposit-taking institutions (ADIs) to withstand adversity by improving the understanding of risk, enhancing capital management, informing recovery planning and reducing the likelihood of failure and resolution.

Over 2018-19, APRA conducted a qualitative assessment of the internal stress testing capabilities across 28 ADIs. The scope of the assessment covered the ADIs' most recent enterprise-wide stress tests (EWSTs) and the most recent internal capital adequacy assessment process (ICAAP) reports. The focus areas were:

- governance;
- scenario development; and
- use of stress testing.

APRA's assessment was informed by the *Prudential Standard APS 110 on Capital Adequacy*, the *Prudential Practice Guide CPG 110 on ICAAP and Supervisory Review*, the 2018 Basel Committee on Banking Supervision Stress testing principles<sup>1</sup>, regulatory stress tests and expert judgement. To facilitate the assessment, participants were split into two peer groups to facilitate more meaningful comparisons: Group 1 consisted of larger diversified ADIs; and Group 2 consisted of other participants with total assets ranging from \$3 billion to \$25 billion.<sup>2</sup>

Individual ADIs that participated in the assessment have been provided with feedback on their practices. This letter sets out APRA's main findings and feedback on each focus area, enabling other ADIs to consider in improving their own stress testing capabilities.

### Governance

A sound governance framework is essential to the effectiveness of stress testing.

Most Group 1 ADIs had EWST frameworks with formalised governance structures, clear roles and accountabilities, and documentation to support most aspects of their stress testing process. The frameworks, however, were not always subject to regular independent reviews. Group 2 ADIs generally did not have specific frameworks for stress testing and instead relied in part on various risk-specific management frameworks and ICAAP documentation. When compared to Group 2, Group 1 entities typically had broader engagement across the organisation in their stress testing activities.

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<sup>1</sup> Basel Committee on Banking Supervision, [Stress testing principles](#), Oct 2018

<sup>2</sup> See Appendix A for the full list of participants.

#### Better practice examples include:

- Having a formalised EWST framework with clear line of oversight, objectives and requirements; structured roles and responsibilities; and policies and procedures to support the end-to-end stress testing process.
- The EWST framework is enacted in practice and subject to regular independent review. The scope of the review includes resourcing, data and IT infrastructure requirements.
- Stress testing processes adheres to a schedule and are integrated with broad engagement across the organisation. The Board and senior management, in particular, are formally engaged with their respective responsibilities for the review and challenge of the scenario design and stress test outputs.

### **Scenario Development**

Scenario design is critical to the value of stress testing in decision making, and ADIs should have a structured approach to scenario development to ensure they meet the objectives and requirements of stress testing.

Most Group 1 ADIs have structured and integrated scenario development processes that engage stakeholders across the organisation. Stress parameters and impacts were generally well considered, and scenarios typically covered all or most material risks identified by the entity. The process at most Group 2 ADIs tended to be less structured and integrated than those in Group 1, and their scenarios and stress parameters were typically designed with less sophisticated considerations. Participants in both groups would benefit from better coverage of non-financial and emerging risks. Many participants used previous APRA industry stress test scenarios either as a substitute for their own internal ICAAP scenarios, or as a reference to inform the macroeconomic settings of their own internal scenarios.

#### Better practice examples include:

- Having a structured, repeatable scenario development process with effective consultation, review, and challenge mechanisms. Inputs and challenges are sought from across the organisation, including from lines of business. Assumptions and limitations are appropriately justified and documented.
- Scenarios are designed with clear objectives using a range of approaches, and calibrated to be severe yet plausible. The stresses are tailored to target the entity's risk profile with consideration of their current business strategy, economic environment, emerging risks, and interactions between risk types.
- Each annual ICAAP is informed by a range of scenarios with varying degrees of severity (e.g. mild, severe, and extremely severe scenarios). The range of scenarios includes ones that cover the typical 3-year capital planning horizon, and ones that challenge the entity's internal capital targets and limits. Sensitivity testing of key stress parameters is also used to enhance the understanding of the drivers behind stress test results.

### **Use of Stress Testing**

ADIs are expected to use stress testing to inform their capital and risk management decisions. ADIs should ensure that insights from stress test results contribute to strategic decision-

making, and that stress testing is broadly recognised as a key forward-looking risk management tool.

Group 1 ADIs generally made better use of stress test results and used stress testing in a wider range of decision-making than those in Group 2. Their ICAAP reports included details of the stress tests undertaken and the implications the results had on their main capital management decisions. Group 1 ADIs typically used a set of capital adequacy criteria to express their risk appetite and assess their stress test results. The coverage and level of detail in the criteria, however, varied across the peer group. The role of stress testing appeared much less prominent in Group 2 ADIs, where ICAAP stress testing results were generally only used for the validation of their main internal capital targets. They typically did not have well-defined risk appetites around their capital adequacy.

Better practice examples include:

- Having a sound ICAAP process that recognises the importance of stress test results as key input for decision-making. This includes having a robust capital trigger and mitigating actions frameworks, and a comprehensive set of capital adequacy criteria.
- Details and discussion of the stress testing undertaken are presented in the ICAAP reports and are easily understandable. This includes information on the scenario narrative, scenario selection rationale, key assumptions and limitations, mitigating actions, and stress test results (before and after applicable mitigating actions).
- Stress testing are embedded into regular decision-making processes such as the processes for making strategic, business planning and recovery planning decisions.

### **Actions and next steps**

This assessment indicated that there are areas for ongoing improvement in stress testing for all entities. ADIs should review their internal stress testing framework in light of the findings above and consider ways to improve their capabilities. The results of this self-assessment and actions to improve capabilities should be incorporated in subsequent ICAAP reports.

The findings of this assessment will inform the further development of guidance on stress testing. APRA intends to publish a prudential practice guide on stress testing to promote industry better practice and consistency. APRA will consult with the industry in the second half of 2020.

To complement the ongoing improvement in stress testing capabilities and application, APRA is moving towards greater frequency and depth of stress testing for ADIs. This includes transitioning in 2020 to annual stress testing of large ADIs. APRA also plans to test resilience to broader scenarios, including the impacts from operational and climate change financial risks.

If you have any questions, please contact your APRA supervision team.

Yours sincerely,

John Lonsdale  
APRA Deputy Chair

## Appendix A: List of participants

Group 1 ADIs	Group 2 ADIs
AMP Bank Limited Australia and New Zealand Banking Group Limited Bank of Queensland Limited Bendigo and Adelaide Bank Limited Citigroup Pty Limited Commonwealth Bank of Australia HSBC Bank Australia Limited ING Bank (Australia) Limited Macquarie Bank Limited National Australia Bank Limited Rabobank Australia Limited Suncorp-Metway Limited Westpac Banking Corporation	Australian Central Credit Union Ltd Auswide Bank Ltd Bank Australia Limited Bank of China (Australia) Limited Beyond Bank Australia Limited Credit Union Australia Ltd Greater Bank Limited Heritage Bank Limited IMB Ltd Members Equity Bank Limited MyState Bank Limited Newcastle Permanent Building Society Limited Police & Nurses Limited Qudos Mutual Ltd Teachers Mutual Bank Limited