

Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee



SPI Project Methodological aspects of stress test for banks covering households and firms exposures

Project Strategy Meeting

December 7th, 2006

10-12:30 am

National Bank of Romania

MINUTES

Participants:

Project Working Group

Ion Dragulin, Director, Financial Stability Department, National Bank of Romania, Project Owner (PO) and Hosting Chairperson

Florian Neagu, Division Chief, Financial Stability Department, National Bank of Romania, Project Manager (PM)

Viorel Hodoiu, Deputy Director, CEC SA, Deputy Project Manager (DPM)

Mihai Stoica, Bancpost SA, project working group member

Romulus Mircea, Economist, Financial Stability Department, National Bank of Romania, project working group member

Velimir Sonje, Convergence Project Technical Anchor

Other participants:

Angela Margarit, Economist, Financial Stability Department, NBR

Bogdan Moinescu, Economist, Financial Stability Department, NBR

SPI Secretariat (Oana Nedelescu, SPI Director for Analytics and Policy)

I. General project setting

The discussion tried to clarify the goal and instrumentalities of the project and how a meaningful cooperation could be built among the central bank and the banking community in the area of stress testing, based on the public-private dialogue approach promoted by the SPI projects.

NBR outlined that the Financial Stability Department (FSD) has developed two types of stress-testing models:

1. a stress testing for the banking system: which is up and running; FSD is finishing the preparation of the working paper which will describe the model;
2. a direct stress testing for corporate and households which is currently being developed (the corporate component being more advanced) and where the corporates and households are stressed directly in order to determine their capability of sustaining shocks.

The central bank mentioned that while in the case of the first type of stress testing it can be envisaged a more intense cooperation between the NBR and banks (including, for example, a possible validation of the results of the NBR stress testing with individual banks, where the Supervision Department should be also involved), the stress testing for corporates and households has a stronger financial stability component and there is relatively less room for exchanging information between the two parties in calibrating the tests. However, in terms of corporates' stress testing, the results might be shared. And, in terms of households' stress testing, which is less advanced, potential for cooperation with banks is higher, but subject to further considerations.

The banks' representatives have highlighted that at the individual banks level stress testing is at its infancy and for this reason, in the area of stress testing the central bank will be the net exporter of knowledge for the benefit of the banking community. It was underlined that currently banks perform basic simulations of interest rate¹ and foreign exchange shocks in order to inform their market risk management. In the area of credit risk, it was stressed that there are some attempts to apply PD-based models, but the consistency of these exercises is questionable. In general, the level of development of credit risk modeling is low.

The central bank underlined that the banking community in general should have a greater understanding of the usefulness of stress testing and, implicitly, of the macroeconomic exogenous risks. In this respect, it was proposed that a survey is conducted with banks in order to determine the concrete areas where the central bank and the banking community could cooperate regarding stress testing. The SPI Secretariat will conduct the survey, in close cooperation with the Technical Anchor and PWG members from banks.

At the same time, the central bank representatives stressed that it is very important to start raising awareness within the banking community in respect to stress testing, as this could be a very useful exercise meant to inform banks on the potential risks that could occur. The central bank has also drafted a paper on the matter that could be disseminated with banks. The central bank appreciated that the SPI Project could constitute the right platform for initiating the cooperation with the banking community in the area of stress testing.

II. Discussion of specific technical issues

The NBR representatives outlined the main features of the stress testing, separately for corporates and households.

Stress testing for corporates

In this area, the NBR is more advanced. It uses a cross-sectional logistic regression with explanatory variables being financial ratios (such as profitability ratios, interest cover ratios, liquidity ratios, gearing ratios). Also, the NBR determines the total debt at risk for the banking sector using the probability of default implied from the existing model. The macroeconomic input parameters are the exchange rate and the domestic lending interest rate.

The main areas where the NBR needs specific technical advice are:

- the model stability and validation;

¹ Standard parallel shifts of the yield curve within income gap analysis are performed.

- the testing of the model under non-linear transmission of shocks through corporate balance sheets and P/Ls (currently only linear transmission of shocks is applied);
- how to integrate a potential shock derived from the avian flu pandemic;
- test the transition matrices.

It was agreed that SPI Secretariat/Technical Anchor will try to come up with the needed profile of a stress testing expert who would be able to answer the specific technical questions of the NBR. After agreement about the needed profile between SPI Secretariat and NBR, Convergence will propose the best solution to proceed with technical assistance.

Stress testing for households

In this area, the central bank is less advanced and could start building on the project together with the banking community.

In this area, the central bank could benefit from:

- other experiences in building up a model for the probability of default in case of households (i.e., the top-down approach used by the Bank of England;
- advise on possibly integrating the scoring performed by the credit bureau into the model;
- advise on the types of shocks used for stress testing households.

The banks have also underlined the particular benefits of cooperating with the central bank in this particular matter. However, data confidentiality issues were raised by the central bank. Limitations provided by data secrecy provisions shall have to be explored during the course of the project.

III. Further steps

The Technical Anchor will prepare a project document describing the main elements of the project methodology and will send it to PWG members on Monday, December 11, 2006. The PWG members are expected to provide a first input on the structure of the document by Tuesday, December 12, 2006. Final comment on the content of the document will be provided by NBR and banks by Friday, December 15, 2006. Upon receiving final comments, the SPI Secretariat will amend the document accordingly and will prepare a status report of the project for the SPI Committee meeting, to be held on December 20, 2006.

The SPI Secretariat / Technical Anchor will also draw the terms of reference for technical advice to the central bank and upon receiving approval on the proposed TORs, will propose the best solution for transfer of know-how.

SPI Secretariat will also start thinking about the content of the bank survey on stress testing that could be conducted in January 2007.