Designing Macroeconomic Scenarios for Stress-Testing

Since the financial crisis broke, central banks around the world have taken unprecedented steps to revive the global economy. Ultra-low interest rates and ballooning central bank balance sheets have been the subject of much debate. Receiving much less attention, but arguably just as important, are the stress tests that financial regulators now require large institutions to take.

Stress-testing emerged in the U.S. and U.K. during the height of the financial crisis in early 2009. Financial systems had suffered a near-death experience: Major institutions failed, stock markets fell, and credit markets froze. While governments managed to prevent calamity with unprecedented fiscal and monetary policy steps, no one knew whether this would be a temporary fix or a lasting cure.

The U.S. Treasury and Federal Reserve designed stress tests for the nation’s major financial institutions to determine the amount of capital needed to restore their financial health. Banks were required to quantify what could happen to their mortgages, credit cards and other portfolios if the economy suffered a downturn as severe as the 1930s Great Depression.

Many viewed the stress tests skeptically. Some called them simply window dressing—a way to convince the public that banks were solid even if they were not. President Franklin Roosevelt had used a similar sleight of hand to restore confidence in the banks when he took office in 1933. Roosevelt declared a “bank holiday,” after which only “good” banks would reopen. There would thus be no reason to pull money out of good banks. The ruse worked; the bank runs ended. It later turned out that the administration was not sure the reopened banks were solid, and indeed knew that some were not. The president of the San Francisco Fed had insisted that Bank of America, the largest bank on the West Coast, was insolvent. But Roosevelt feared widespread panic if BofA did not reopen, so it did.

Bankers also protested that the stress tests were overly complicated, and would force them to go hat in hand to investors for more capital. Worse, if banks could not raise capital from private sources they would have to accept it on punitive terms from the government.

Regulators overruled the critics, imposing tests that were far from mere window dressing. Banks were required to consider what would happen if unemployment rose to double digits and house prices fell by more than 50%. What they found was stunning: Over two years the banks would suffer cumulative losses comparable with those in 1933 and 1934, the worst two years of the Depression. Financial institutions would need tens of billions of dollars in new capital to survive such a scenario.

The regulators were vindicated; the stress tests worked. The banks recapitalized, reassuring markets and themselves that the system was sound. Just a few months after the U.S. financial system had been at death’s door, it was up and running again.

Stress-testing has since become a standard part of global banking regulation, adopted by the International Monetary Fund for all its member countries. The largest financial institutions in the world test each year. Bankers no longer complain, viewing the process as critical for robust risk and capital management.

Stress-testing has also grown more sophisticated. In early 2009, only the very largest U.S. financial institutions were required to determine the loan losses they would suffer if U.S. GDP and house prices fell...
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Sharply and unemployment surged. By the middle of this decade, most institutions across the globe will be testing all aspects of their operations under a wide range of macroeconomic scenarios.

How these scenarios are constructed is key to ensuring that the stress tests promote a sound global financial system, which in turn can determine how much credit flows to the economy, what that credit costs, and what activities it funds.

Scenarios should be designed to account for the risks most threatening to the financial system. In 2009 and 2010, the largest threat stemmed from losses on U.S. mortgage loans. In 2010 and 2012 it was the potential for a breakup of the euro zone. More recently it has become the eventual exit of central banks from their zero-interest rate and aggressive bond-buying policies.

Each financial institution should also consider scenarios that stress its own idiosyncratic exposures and potential vulnerabilities. Some institutions have concentrated regional footprints, do more business in certain parts of the world, are focused on certain types of lending and investing, or rely on particular funding sources.

The severity of the scenarios financial institutions stress should reflect the macroeconomic, lending and funding conditions at the time a test is conducted. When leverage is high and rising and underwriting is easy, odds of a deeper downturn rise. If stress tests had been the norm a decade ago, they might have helped regulators curb the runaway mortgage lending that inflated the housing bubble in the U.S. and some European nations.

Conversely, overly stringent stress tests when leverage is low and falling and underwriting is tight could require financial institutions to hold too much capital and restrict credit, stunting economic growth. In today’s tough economic climate, this would hamper the global recovery. And it could also curtail investment in riskier but ultimately productive innovations, such as information technology and clean power that can improve living standards.

Poorly designed stress-testing scenarios could also stifle financial innovation. By definition, new financial products have no track record; thus the historical data needed for rigorous analysis are lacking. Macroeconomic scenarios should be designed so that financial institutions and regulators do not penalize new financial products that cannot easily be assessed quantitatively.

There is also a risk that stress-testing will foster financial protectionism. Most major banks maintain global operations, and the stress tests rightly consider global economic conditions. But regulators could force banks to hold more capital against overseas loans, prompting them to do less foreign lending, if they are stressing to a macroeconomic scenario in which the global economy is hit by an overly severe downturn.

Like any test, these encourage test-takers to focus simply on passing. This could mean that banks’ models and risk-management methods will grow to look alike, and that lending practices will become increasingly uniform. The problem will be worse if macroeconomic scenarios favor some types of lending over others. Banks could herd in the desired direction, threatening financial stability.

Financial institutions that undergo stress tests may avoid some risks, but those risks may simply move to another, less visible, part of the financial system where there are no stress tests and regulators have little influence. Macroeconomic scenarios must therefore also account for risks in the shadow banking system where there is no formal stress-testing.

Bank stress-testing helped save the global economy from a new depression, and it remains critical to a well-functioning financial system today. Well-designed macroeconomic scenarios can help ensure that stress-testing plays a positive role. This chapter considers the appropriate design of macroeconomic scenarios for stress tests and some tools and approaches available for this purpose.

Modeling approaches

While many approaches can be used to formulate macroeconomic scenarios for stress tests, the most common involves the use of structural macroeconomic models. While not perfect, structural models can capture the relationships among a wide range of variables across many global economies, a necessary requirement for robust stress-testing.

In the U.S., structural models are regularly used by the Federal Reserve Board and other regulators, as well as the Congressional Budget Office and the Council of Economic Advisers. Moody’s Analytics maintains structural models for the U.S. and 60 global economies. The model for the U.S. is particularly large, with 1,700 equations.

Structural models can adapt with relative ease to a shifting economic and policy environment. The Moody’s Analytics U.S. model, for example, was enhanced in the wake of the financial crisis to capture the impact of many new financial policies, most of them unprecedented and unconventional, including the capital raised by financial institutions to meet the requirements of the early-2009 stress tests.

This is captured via the equation for the spread between three-month Libor and three-month Treasury bills (the TED spread), which is modeled using two-stage least-squares techniques as a function of the delinquency rate on commercial bank loans and leases, the market value of equity lost in failing financial institutions during the financial crisis, the S&P 500 VIX index, and the amount of capital raised by the banking system via the Capital Purchase Program in TARP and the bank stress tests.

The rationales are straightforward: As the delinquency rate increases, banks demand higher interest to lend to other banks. The equity lost in failing institutions captures the growing panic that investors felt as the crisis intensified. The VIX is included to capture the impact of broad financial market volatility on credit spreads, and initial


unemployment insurance claims are used as an instrument for the VIX to account for any issue with endogeneity. The capital raised by banks either from the federal government or in the equity market captures the benefit of the stress tests in restoring stability to short-term funding markets. Based on this equation, the capital required by the stress tests reduced the TED spread by some 200 basis points.

Another recent model innovation, which should be identified given some of the criticism of structural models, is that monetary policy is endogenously determined in the model and does allow for quantitative easing. The federal funds rate equation is based on a so-called Federal Reserve reaction function, in which the real funds rate target is a function of the economy’s estimated real growth potential, the difference between the actual and target inflation rate, and the difference between the actual unemployment rate and the natural rate. This specification is augmented to include the difference between the presumed inflation target and inflation expectations, as measured by five-year, five-year-forward Treasury yields.

Because of the Federal Reserve’s extensive use of quantitative easing to respond to the financial crisis, the value of assets on the Federal Reserve’s balance sheet was added to the model. Fed assets are specified as a function of the federal funds rate target. When the funds rate implied by the equation falls below zero, the Fed’s balance sheet expands. And the more negative the implied funds rate, the greater the assumed balance sheet expansion.

Specifically, for every 100 basis points that the desired (but unachievable) funds rate becomes negative, the Fed is presumed to expand its balance sheet by $1.2 trillion. At present, the implied funds rate is negative 2.5%, which is consistent with the Fed’s holding close to $4 trillion in assets. Fed assets and the funds rate are in turn key determinants of 10-year Treasury yields in the model.

Another common criticism of structural models such as the Moody’s Analytics model is that they do not account for the important role expectations play in determining the economic impact of fiscal policy. In fact, the outlook for the federal debt-to-GDP ratio is a key variable in the model, affecting monetary policy and long-term interest rates via inflation expectations and real yields, and by extension current spending, saving and investment decisions.

It is perhaps telling that current inflation expectations and real long-term Treasury yields remain low despite large current budget deficits, ostensibly reflecting in part expectations that lawmakers will eventually address the nation’s fiscal problems.

### Baseline scenario

The design of macroeconomic scenarios for stress-testing begins with a baseline, most-likely scenario. This baseline is designed to fall in the middle of a distribution of possible economic outcomes. Since the chances of the economy precisely realizing any specific time path, no matter how reasonable, are small, the baseline is viewed as representing an outcome in which there is a 50% probability that economic conditions will be worse and a corresponding 50% probability that they will be better over the forecast horizon.

The Federal Reserve, in designing the baseline scenario for the annual Comprehensive Capital Assessment and Review, or CCAR, stress-testing process, relies on a consensus of macroeconomic forecasters who are surveyed each month. Consensus economic surveys generally provide forecasts for a handful of economic variables with a horizon of just a few years, and this varies considerably across countries. The Federal Reserve uses its structural model to produce forecasts for a broader range of economic variables and a longer horizon than is available from the consensus, but it is generally consistent with what consensus information is available.

Moody’s Analytics produces a baseline scenario for the U.S., individual states, metro areas and counties, and for 60 other countries each month. The assumptions underlying the forecasts are consistent across the globe. While the Moody’s Analytics baseline is not necessarily consistent with consensus forecasts to which Moody’s contributes, most times the differences are small.

### Federal Reserve’s CCAR scenarios

Most alternative macroeconomic scenarios used for stress-testing are more pessimistic than the baseline. The Federal Reserve, in its CCAR, produces two alternatives to the baseline, an adverse and a severely adverse scenario.

The severely adverse scenario envisions a sharp economic downturn, in which the economy descends quickly into a recession on par with that experienced from 2007 to 2009. Forecasts are provided for a dozen or so economic variables for the U.S., the U.K., Japan and emerging Asia.

The Fed does not provide an explicit narrative for its recession scenario, complicating the task of expanding it to other economic variables and other countries. However, Moody’s Analytics constructs a plausible narrative based on the forecasts provided by the Fed and an understanding of the key threats to the global economy. In the 2013 CCAR severely adverse scenario, for example, the key threats appeared to be a breakup of the euro zone, combined with a sharp slowdown in China and severe fiscal drag in the U.S. Moody’s Analytics uses this narrative to expand the Fed’s forecasts to a broader set of variables and countries.

The Fed’s adverse scenario stresses financial institutions under difficult conditions that may not be entirely realistic. That is, the odds of the specified adverse scenario occurring may be low, but anything like it could do significant damage to the financial system. In the 2013 CCAR, the adverse scenario included an immediate increase in inflation and interest rates and a flattening in the Treasury yield curve. It was not clear what would produce this outcome, but such a scenario would be very hard on the profitability and capital of financial institutions, especially after a long period of exceptionally low interest rates. If banks could weather this unlikely storm, they arguably could weather almost anything. Running the Fed’s adverse scenario through the Moody’s Analytics models was more challenging given the lack of a narrative.
Moody's Analytics alternative scenarios

Moody’s Analytics produces a number of alternative scenarios each month along with the baseline. The same hypothetical events drive four of the alternative scenarios, but they occur with varying intensity. The three downside scenarios have 1-in-four, 1-in-10, and 1-in-25 probabilities, while the one upside scenario has a 1-in-4 chance of occurring. In other words, the 1-in-4 probability downside scenario is constructed so that there is a 75% probability that the economy would perform better over the forecast horizon and a 25% probability that it would perform worse.

How well the economy performs in each scenario depends on the economy’s underlying condition at the time the scenario is constructed. For example, a 1-in-25 downside scenario would mean a higher peak unemployment rate when the economy was in the middle of the Great Recession, than it would today when the economy is growing. This differs from the Fed’s CCAR scenarios: The peak unemployment rate in the 2013 CCAR severe adverse scenario is similar to the peak unemployment rate in the 2009 scenario. The Fed is thus effectively requiring financial institutions to capitalize to a much less likely economic outlook today than it did in 2009.

A consistent economic narrative underpins the Moody’s Analytics alternative scenarios. Explicit hypothetical events push the economy away from the baseline outlook. Since many possible events could produce the same downside outcome for the economy, the events included in the scenarios are considered most likely at the time the scenario is constructed. For example, in the current context, the main events driving the downside scenarios include a U.S. political crisis around the federal government’s budget and Treasury debt limit, a revival of the euro zone debt crisis, higher gasoline prices, and a renewed decline in house prices.

Different scenarios are driven by the same events, but with varying degrees of severity. The 1-in-10 downside scenario, for example, is driven by the same events as the 1-in-4 downside scenario but with more significant changes from the baseline. Similarly, the contours of the 1-in-25 downside scenario are similar to those of the 1-in-10 downside scenario, but even more severe.

The events driving the scenarios are captured in the Moody’s Analytics structural model through many variables that are adjusted to produce the alternative scenarios. Some of the most commonly used are fiscal and monetary policy, global real GDP, the value of the U.S. dollar, oil and natural gas prices, stock prices, housing values, consumer confidence, banks’ lending standards, and inflation expectations. The variables are used parsimoniously, allowing the model to generate as much of the results as possible.

Most alternative scenarios assume that the economy’s long-term potential growth rate and full-employment unemployment rate are unchanged. That is, the economic downturn does not damage the economy’s ability to grow as fast as it did before the recession or impair the productive capacity of the economy. Real GDP and unemployment in the alternative scenarios ultimately return to their paths in the baseline. This also appears to be an underlying assumption in the Fed’s CCAR alternative scenarios.

It is important to note that if an economy’s potential growth rate is not affected by a recession, there must be a period of above-potential growth in the recovery for the economy to return to its prerecession full-employment level. The economy will grow strongly at some point in the recovery as underutilized labor and capital are put back to use. This may seem counterintuitive in a downside alternative scenario, but it is a regularity of past business cycles and must occur if economic activity is to ultimately return to its prerecession baseline level. Indeed, the deeper the recession, the stronger the subsequent economic growth, although the timing of when that outsize growth occurs is uncertain. This is clearly evident in the still-lackluster global economic recovery from the Great Recession.

There is a reasonable debate around this assumption, particularly now, as some argue that growth rates have weakened to a “new normal” because of the severity of the Great Recession. Economies suffering similar financial crises throughout history have taken many years to regain their footing. Indeed, the economy has been expanding at a lackluster pace since the recovery began, and there is compelling evidence that the economy’s full-employment unemployment rate is higher today, with long-term unemployment at unusually high levels. As such, Moody’s Analytics produces an alternative scenario characterized by economic growth that remains below its prerecession potential rate indefinitely. This scenario has 1-in-25 probability.

Also particular to current economic conditions is the concern that inflation will accelerate sharply. Those who worry about this point to the enormous increase in the Federal Reserve’s balance sheet in recent years, and the potential for energy and other commodity prices to rise because of strong demand from emerging economies and political tensions in commodity-producing countries. Much higher near-term inflation is thus the basis for another Moody’s Analytics alternative scenario, which has a 1-in-10 probability of occurring.

Determining scenario probabilities

The probabilities associated with each of the Moody’s Analytics alternative scenarios are derived based on the use of vector autoregression (VAR) models of the U.S. and global economies.

The use of VAR models in economic forecasting first began to expand in the early 1980s. A VAR model includes a relatively small set of equations specified so that the only explanatory variables for each equation are the lagged values of the dependent variable itself and the lagged values of all the other variables in the model. In other words, the explanatory variables are the same for each dependent variable. VAR models are completely agnostic about structural relationships in the economy. For example, economic theory says that there is a positive relationship between consumer spending...
and disposable income, but the relationship in a VAR model could be negative.

The U.S. VAR model used for the purpose of determining the probability of the Moody’s Analytics alternative scenarios includes all the major components of real GDP, allowing real GDP to be computed as an identity. Other variables included in the model are the unemployment rate, consumer price index, the three-month Treasury bill rate, and the 10-year Treasury bond rate.

Key exogenous variables in the U.S. VAR model include the output gap—measured as the difference between actual and potential real GDP—and the full-employment rate of unemployment—the unemployment rate consistent with stable inflation. Other exogenous variables include oil prices, global real GDP growth, and the trade-weighted value of the U.S. dollar.

VAR models are not very useful in constructing alternative scenarios for stress-testing, since they are generally too small and their results are difficult to explain. However, they are useful in determining the range of possible economic outcomes via Monte Carlo simulations. This involves running thousands of simulations accounting for the uncertainties involved in the VAR’s relationships. The VAR models are thus constructed to predict history accurately and, as important, to produce realistic Monte Carlo simulations.

Each simulation determines a new path for the economic outlook. Taken together, the simulations provide a distribution for possible outcomes for the economy. In a recent Monte Carlo simulation of the U.S. VAR model, the mean of the distribution of average annual real GDP growth rates was about 2.4% per year, which is consistent with the historical performance of the U.S. economy.

The distribution of possible economic outcomes provides the information needed to assign probabilities to the Moody’s Analytics alternative scenarios. More specifically, the distribution of the unemployment rate outlook, arguably the best overall barometer of an economy’s performance and an important variable in most stress tests, is used to calculate the probabilities. For example, if only 4% of the simulations have a peak unemployment rate that is greater than 12%, then a 12% peak unemployment rate would define a 1-in-25 alternative scenario.

The distribution of possible economic outcomes depends on the economy’s starting point. If the economy currently has a low unemployment rate, then the peak unemployment rate in the 1-in-10 scenario, for example, will also be lower.

Subnational, country and house price scenarios

Since most U.S. financial institutions have footprints that do not include the entire nation, Moody’s Analytics also produces baseline and alternative scenarios for U.S. states, metropolitan areas, and counties. Like with the national scenarios, those for subnational economies are based on structural models. The models account for the different industrial structures, demographic makeup, and business and living costs across the country. Events such as a financial crisis, government shutdown or surging energy prices will thus produce different regional economic consequences.

Different domestic and foreign migration patterns are also accounted for in the models, since they can have a large impact on the performance of subnational economies. Inflows of migrants looking for jobs in energy-producing regions such as Texas and North Dakota have fostered even faster growth in these areas. Conversely, migration out of industrial Midwest states such as Michigan and Ohio has exacerbated the downturn in these areas.

The Federal Reserve’s CCAR scenarios are silent with regard to regional economic performance. But Moody’s Analytics produces regional scenarios consistent with the Fed’s national CCAR scenarios. This requires Moody’s Analytics to construct narratives around the Fed’s scenarios. If the recession in the Fed’s severe adverse scenario is due to a euro zone crackup, for example, this will have a larger impact on the Northeast U.S. than on California. However, if the recession is due to a federal government shutdown, the Washington DC region and defense-dependent regional economies will be hit hard, but other regions much less so.

As an aside, a similar problem exists with the Fed’s CCAR scenarios for overseas economies. The Fed provides baseline and alternative scenarios for the euro zone, for example, but not the euro zone’s member nations. Yet a euro zone breakup would clearly affect these nations in very different ways, leaving Germany for instance in a very different place than, say, Greece. How different will depend on the narrative behind the hypothetical event. Moody’s Analytics constructs a plausible narrative consistent with the Fed’s forecasts and uses this to construct scenarios for each euro zone country.

Given the instrumental role of housing in the financial system and the economy in recent years, Moody’s Analytics has developed detailed house-price models for stress-testing. Metropolitan area repeat-sales house-price indexes are modeled using an error-correction specification that accounts for both the long-term trend in house prices, which depends on household incomes and rents, and factors that drive prices up and down around that trend, such as changing mortgage rates, credit availability and unemployment. The model specification allows for house prices to become significantly overvalued and also to correct quickly. Since housing markets are inherently regional, constructing reliable house-price scenarios depends on scenarios for regional economies.

Idiosyncratic scenarios

Increasingly, regulators are also requiring financial institutions to conduct idiosyncratic stress tests. Each institution has a unique set of exposures and vulnerabilities, and regulators want to make sure the institutions are prepared for possible stresses. This has become an important part of the Fed’s CCAR process.

An institution operating in the U.S. Midwest, for example, may concentrate on lending to vehicle manufacturers, dealers and suppliers. A southeastern institution may focus on commercial real estate lending in Florida. Another institution could rely more heavily on nondeposit funding or be a big player in providing custodial services to other financial institutions. Some institutions have
large securities holdings whose value is especially sensitive to rising interest rates.

In an idiosyncratic stress test, each institution must identify its own sources of vulnerability, assume events can expose these vulnerabilities, and determine what would happen then to the institution’s profitability, capital and liquidity. In the extreme, the institution could ask itself under what conditions it would exhaust its capital or liquidity, and thus fail. This is a reverse stress test.

Moody’s Analytics models can be used to construct idiosyncratic stress tests. This involves identifying institutions’ exposures, developing scenarios that would stress these exposures, and quantifying these scenarios with structural models of the economy. While the Federal Reserve is opaque with regard to the severity and length of the stresses institutions should consider, a reasonable approach is to assume a downturn that is at least on par with the Fed’s severely adverse scenario, but focused on the institution’s own vulnerabilities.

The Fed is also mum in these scenarios about the timing of the downturn. In its CCAR scenarios, the downturn begins immediately; that is, in the quarter in which institutions are testing. This is generally not very realistic, but simplifies the testing process since institutions can avoid making significant decisions about their future lending and funding practices. However, in an idiosyncratic test, institutions may want to assume that the downturn begins later, and after the institution takes on even more risk. This would create a higher bar, and provide confidence to regulators that the institution is on solid financial ground.

**Conclusions**

Stress-testing was instrumental in pulling the global financial system through the financial crisis. The tests forced financial institutions to recognize their problems and address them, not only to the regulators’ satisfaction but also to their own. Once bankers saw the tests were truly substantive, and realized that it meant they were capitalized well enough to withstand the flagging economy, they also knew their counterparties were equally solid. The financial turmoil immediately subsided, allowing an economic recovery to begin.

Stress-testing today is much more comprehensive and complex. Financial institutions are required to consider what will happen to their balance sheets, income statements, and their entire enterprises under a range of scenarios, some constructed by regulators and others constructed by the institutions themselves. This creates a wide range of questions regarding how to effectively and efficiently implement these tests.

One of the key questions is how to construct macroeconomic scenarios that realistically test the health of financial institutions and the financial system. This is difficult to answer given the limits of macroeconomic information, data and modeling techniques. But these limits are quickly becoming less binding as the data and modeling grow more refined.
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