

## **Lenders 'failed' to stress-test bad risks**

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BANKS failed to take into account the interconnected nature of risks when they "stress-tested" lending books, and boards failed to play a big enough role in reviewing exposures.

In an assessment of banking shortfalls, the Bank of International Settlements — known as the central bank to the world's central banks — revealed weaknesses in organisational aspects of stress-testing programs.

Global banks, particularly in Britain and the US, have been caught out by the extent of the financial crisis, with estimates putting potential losses at more than \$US1 trillion (\$A1.48 trillion) following the unwinding of debt instruments.

President-elect Barack Obama is expected to consider new efforts to tackle the US banking crisis, including the possibility of removing toxic assets from bank balance sheets.

The BIS called on banks to increase shock-testing across their operations. "Prior to the crisis, stress testing at some banks was performed mainly as an isolated exercise by the risk function with little interaction with business areas," it said.

"This meant that, amongst other things, business areas (of banks) often believed that the analysis was not credible.

"Moreover, at some banks, the stress-testing program was a mechanical exercise. While there is room for routinely operated stress tests within a comprehensive stress-testing program, they do not provide a complete picture."

Still, regulators, including the Reserve Bank of Australia, have said the nation's financial system remains sound and has coped better with the recent turmoil than many other financial systems.

"The banking system is soundly capitalised, it has only limited exposure to subprime-related assets and it continues to record strong profitability and has low levels of problem loans," the reserve said in a recent assessment of the nation's financial system.

In Australia, NAB had been most heavily burnt by the global financial crisis after it was forced to make \$1 billion in write-downs on asset-backed securities linked to the US housing market and sitting in off-balance sheet vehicles.

Elsewhere, ANZ was forced to sharply increase provisions and bad debt charges this year, partly as a result of its exposure to corporate bonds backed by troubled monoline insurers.

In a series of recommendations, the BIS said stress testing of a bank balance sheet should begin at board level. "Results from stress-testing analyses impact on decision-making at the appropriate management level, including strategic business decisions of the board and senior management," it said.

It should also be geared towards the most material business areas and towards events that might be particularly damaging for the firm.

"This could include not only events that inflict large losses but which subsequently cause damage to the bank's reputation," the BIS said.

Banks should also conduct "reverse stress testing", which involves theoretically breaching regulatory capital ratios or even insolvency, and then asking what events could lead to such an outcome for the bank.