The background of the slide is a dark blue collage of various Australian banknotes. Visible elements include the portrait of Queen Elizabeth II on a \$50 note, a \$10 note, a \$20 note, and a \$100 note. The word 'AUSTRALIA' is visible on the \$50 note, and 'DOLLARS' is visible on the \$100 note. The text is overlaid in a bright yellow color.

Stress testing Approaches to Systemic Risk: *Reasonable Expectations*

Keith Hall

Reserve Bank of Australia
IMF Conference on Operationalizing
Systemic Risk Monitoring

Washington DC
May 26-28 2010

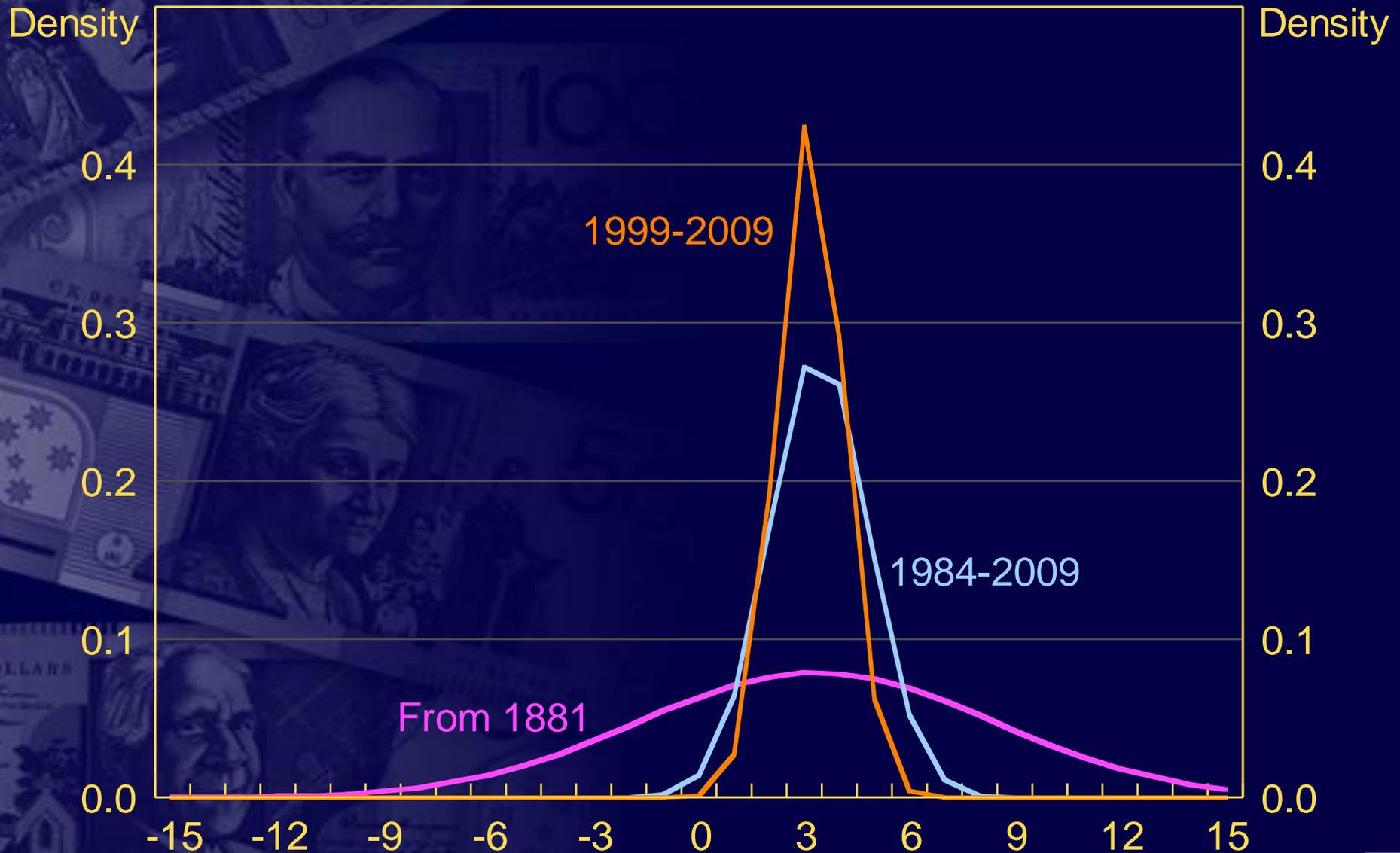


Reasonable expectations?

1. While we all recognise the significant limitations around the models commonly used for stress testing purposes, we would like to believe that they still generate meaningful results.
2. While we don't expect our chosen scenarios to be the harbinger of the next financial crisis we would like them to be reasonably aligned with the most prominent risks in the system.
3. While we want to travel as far into the 'tail' as we can we don't want to sacrifice 'plausibility' completely.



Probability Densities of Australian GDP Growth

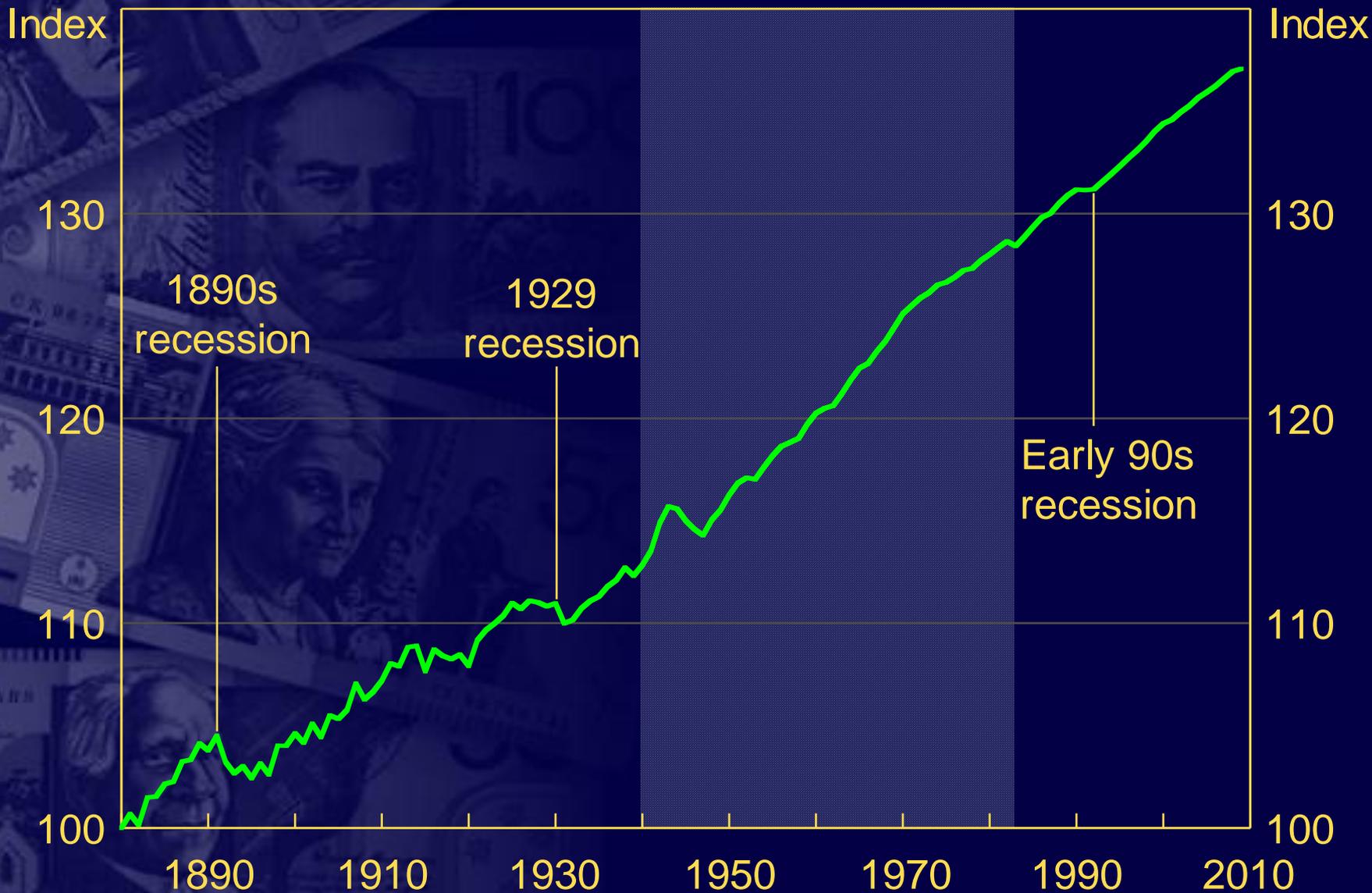


Sources: ABS; RBA



Real GDP

Log level, 1880 = 100



Sources: Butlin RDP7701; Fisher and Kent RDP9906; ABS National Accounts



Australian Real GDP Growth



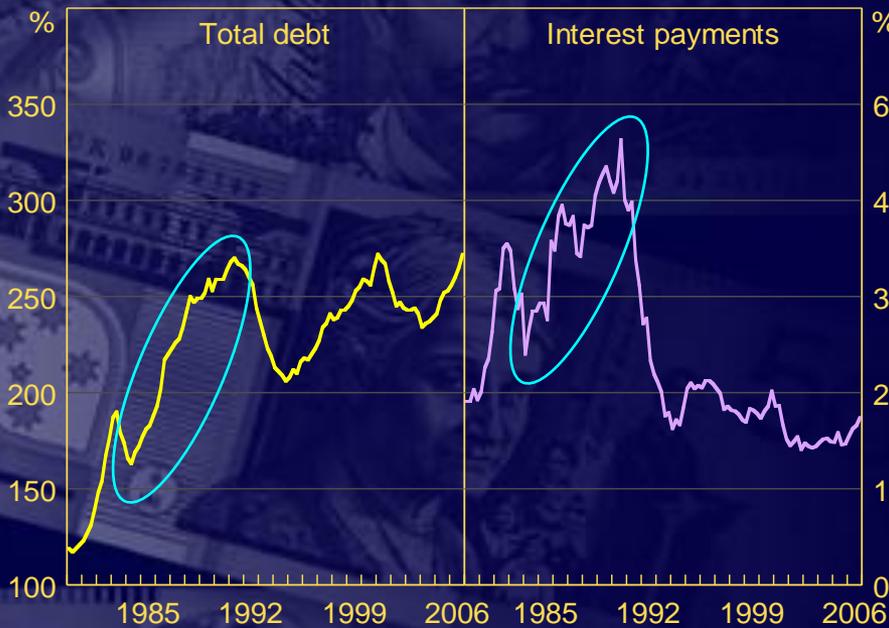
Sources: ABS National Accounts; Butlin RDP7701; Fisher and Kent RDP9906



Corporate sector risks in the early 1990s

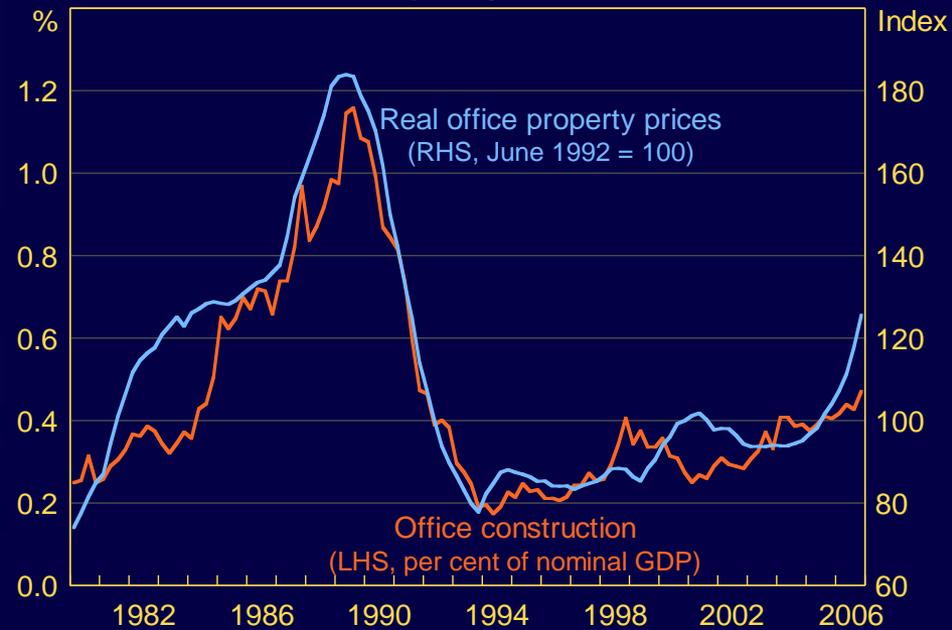
Business Sector Finances

Per cent of profits



Sources: ABS; RBA

Office Property Indicators



Sources: ABS; Jones Lang LaSalle; RBA



... and the implications for Australian banks

Major Banks' Profits before Tax

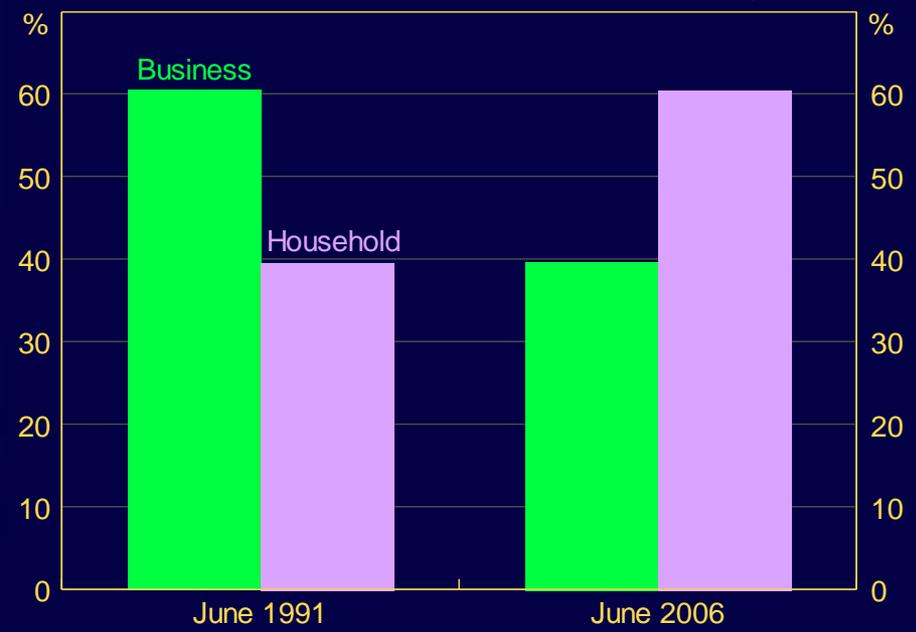
Return on shareholders' equity



Sources: Banks' annual and interim reports

Bank Lending by Type

Per cent of total on-balance sheet bank lending



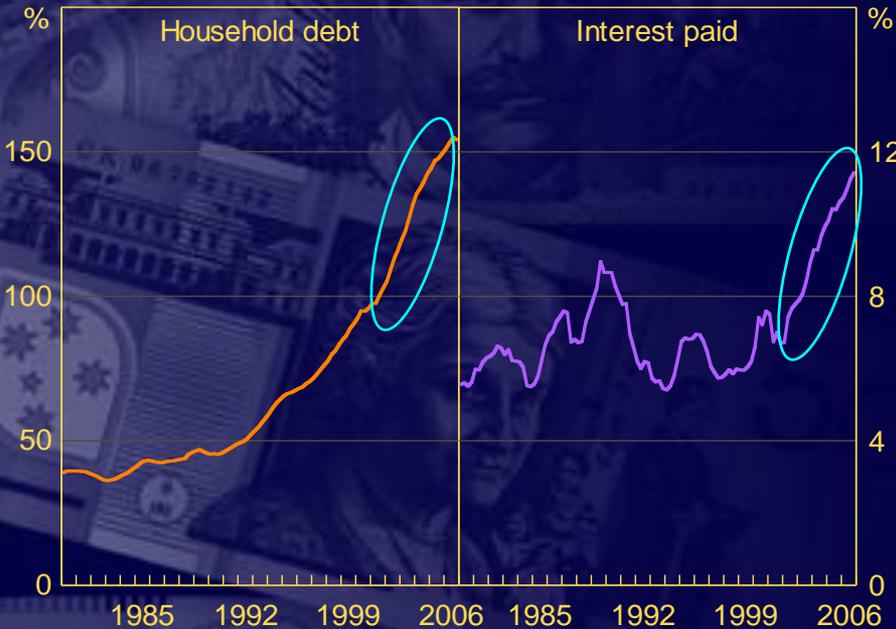
Sources: APRA; RBA



Household sector risks in the 2000s'

Household Indebtedness

Per cent of household disposable income



Sources: ABS; RBA

House Prices

1995 = 100



Sources: ABS; APM; REIA



Some observations

- Its not the size of the tail, but what's inside that counts.
- What's inside the tail is likely to be significant amount of structural change in the economy and in both borrower and lender behaviour.
- No single model is going to generate a full set of meaningful loss estimates. You need to be 'eclectic', blending the best of the available macro and micro-prudential methodologies. At the institutional level, the injection of 'expert judgement' helps enormously.
- The dialogue you generate in the attempt to measure tail outcomes is as at least as important as the results themselves.

