

# **Making the most of stress testing and risk metrics for the future**

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**Gary Styles**

**Strategy, Risk and Economics Director**

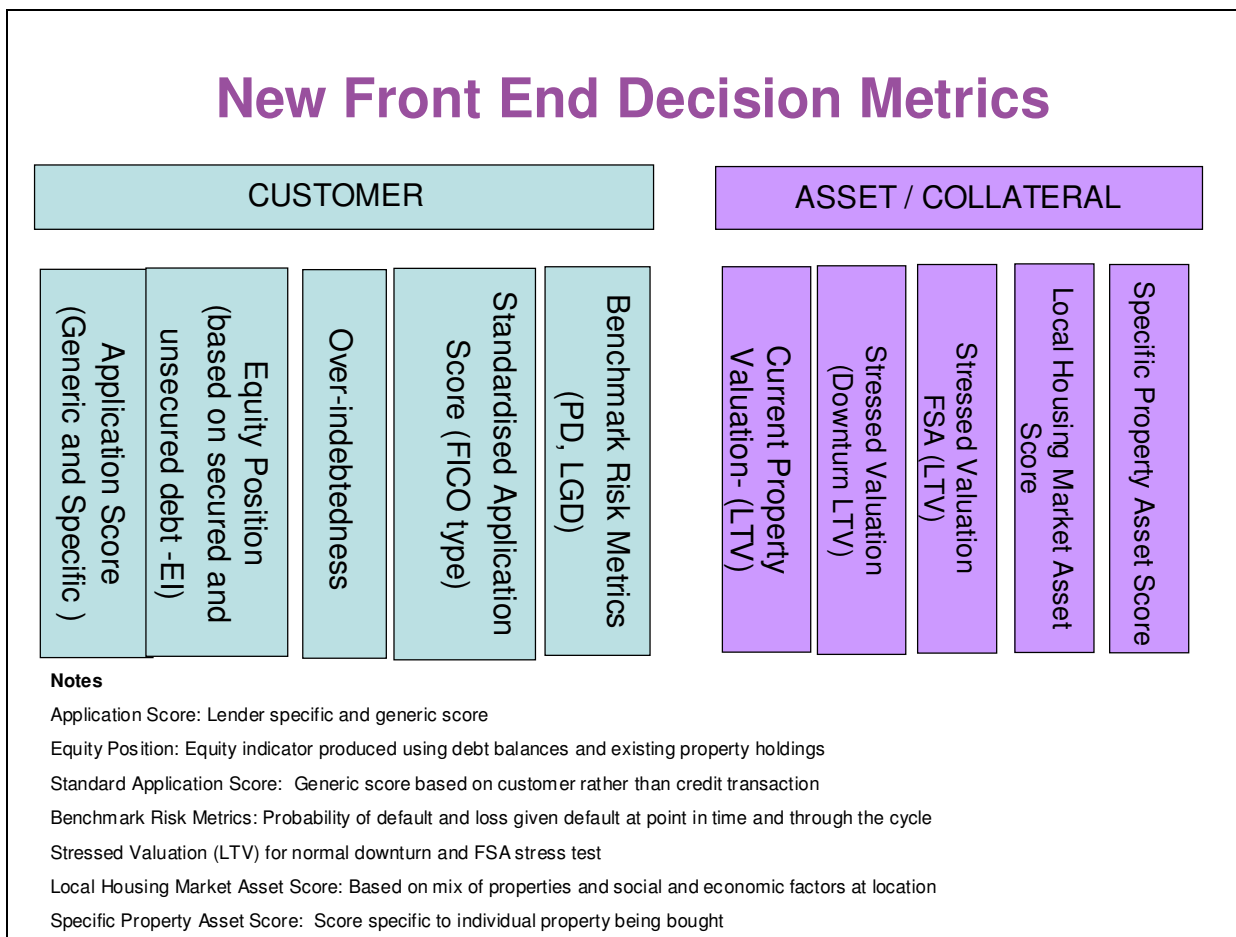
**Hometrack**

The increased emphasis on extreme stress testing and risk information has put many organisations in a spin. Keeping track of the latest stress tests and the base data used to produce the results is no easy feat and making the most of the results for your business is even harder. In many cases the process of stress testing and running of scenarios has become rather mechanical and somewhat distant from matters of direct importance to customers. Risk managers and economists really enjoy the process but what is it in for the customer and for the bank in the longer term.

I have argued for many years that stress testing and scenario planning should be at the heart of a financial organisation and should involve and be understood by all levels of staff across any business. The extreme events of recent years has made the process somewhat unreal and not easily directly linked back to new business levels or to customer decisions facing us today. The challenge is to make this process really work for the business.

Econometric model approaches are rarely stable in the face of such large changes in structure and policy regime, made worse by the variable quality and timeliness of the economic data underpinning these models. The need for more hands on involvement across a business could not be any greater. But to further embed the importance of this practice the results must directly affect decisions made today rather than address the decisions of the past.

What if we could place the results of the extreme stress tests and typical risk metrics for types of business back into the front end decision process. For example, we could produce a variety of stressed LTV's, the rate of default and loss experience for that type of loan and asset scores as part of the approval process. The chart below shows the type of existing and new data that could be made available at application stage or even the pre-application stage.



This list includes two types of stressed LTV, benchmark probability of default and loss given default, asset scores, two measures of existing equity and the more usual application scores and property values. This data can easily be provided for almost all addresses and customers in the UK.

By combining this data at the front end a more rounded decision can be made about customer's ability to pay and more importantly likelihood to pay when the environment becomes tough. Relying only on your own data and experience is highly risky in the current environment. Pooling some of this information and producing industry benchmarks must be the way forward to ensure a more uniform acceptance of lending practice. Using pooled risk metrics at the front end can only help to establish new norms and practices for

the future. Even more radical, why not ask all credit applications to be accompanied by a national insurance number or other unique customer number. This could then be quickly used to identify those customers who seem to want to take out multiple mortgages and credit agreements with no real ability or intention to actually pay.

We are gradually moving towards the US model of having a central data repository of all mortgages and it would seem only right that lenders take ownership of this opportunity to improve lending and credit decisions for the future. The UK mortgage industry has struggled for many years to produce the detailed mortgage and credit information the industry deserves. But we now have an opportunity to make any data repository work for the future rather than satisfy risk management and regulator thirst for historical data and validation. There are several global suppliers keen to manage the data repository in the UK and Europe, including Standard and Poors, MIAC and others but to be effective these suppliers must pass several key tests; Are they truly independent (not dependent on lenders for primary income), do they have real experience of managing and analysing loan by loan data, can they provide reassurance to lenders as to how the data will be protected, maintained and managed. Meeting these tests will be very difficult but essential to give reassurance to lenders, regulators and customers alike.

The time for sharing data and producing industry benchmarks has arrived. By combining the metrics and data we are already producing we can improve front end decisions and set any future growth in the mortgage market on a fully sustainable path. Maximising the use and application of the data should be on everyone's agenda otherwise we risk a return to another period of benign neglect and even more regulation and political interference.

G P Styles

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