Are banks' stress tests really stressful enough?

As lenders prepare for another round of Bank of England examinations, *Iain Withers* analyses whether they are covering all bases

The Bank of England's stress tests are akin to the alien invasions players of *SimCity 2000*, above, used to face

Fans of the blockbuster Nineties PC title *SimCity 2000* will remember it as a fiendishly addictive city management game. Players built roads, homes, offices, shops, factories and utilities in what proved a surprisingly popular simulation of life as a city mayor.

Sometimes the game would suddenly trash your city with an alien invasion, to test your mettle. A massive black metal spider-like creature would pop up on the screen and start razing parts of your lovingly crafted metropolis with laser beams. There was little you could do other than hunker down, wait for the alien to leave, put out the fires and rebuild.

This, in a sense, is what the Bank of England's stress tests are like. They are a simulation of a big, scary shock – albeit to the financial system, not a virtual city. Regulators want to test how Britain's seven largest lenders would cope in a crisis. Memories of the 2008 financial crisis and the all-too-real state bailouts of RBS and Lloyds loom large in the process.

This year, the scenario looks suitably frightening. The Bank is simulating UK GDP crashing 4.7pc, world GDP down 2.4pc, unemployment hitting 9.5pc, house prices diving a third and interest rates climbing to 4pc. As the Bank is all too keen to say, it's the toughest set of stress tests ever devised. On many of the measures, it is modelling a worse crash than 2008. The results on how the banks fared will be released before markets open tomorrow morning.

Despite the gloomy scenario analysts expect most of the industry to pass. The biggest question mark hangs once again over taxpayer-controlled RBS, the only lender to fail last year. The spotlight could also fall on those lenders planning to increase or restart dividend payments – Barclays, Lloyds and Standard Chartered – if regulators ask for them to set aside more capital, Goldman Sachs analysts said last week. The other three lenders being tested are HSBC, Santander and Nationwide.

Yet before the results even come out the debate has restarted about how useful the stress tests really are. The biggest real world potential stress the banks face, the challenge of a potential Brexit cliff-edge, is conspicuously absent from the simulation.

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Meanwhile, the lenders privately suggest the scenario that has been dreamt up is as fanciful as the aforementioned alien invasion, although they admit the stress tests are a useful tool for promoting financial stability.

"They're super strong. Each time, they're proper doomsday scenarios," says one bank insider. "I think they're quite harsh in terms of what they're testing. The chances of them happening are very, very slim. Yet there's no doubt they make the system stronger," says another.

Others claim the stress tests are not nearly strong enough, however. Kevin Dowd, an economist at the University of Durham and long-time critic of the stress tests, says "they have never been fit for purpose".

Dowd has written a series of stinging papers for think-tank the Adam Smith Institute, trashing the tests' methodology. Among his criticisms is that the tests provide "false comfort" by focusing on the book value of lenders' assets rather than their fairer market value, over-representing lenders' resilience. The academic also argues the Bank suffers from a conflict of interest as part of its remit is to maintain the stability of the financial system.

"The Bank has an obligation to shore up confidence in the banking system," he says. "So when it asks the question 'is there a systemic risk', the answer it produces is always 'no'. How can they have credibility when you can only ever get one outcome?" He argues the Bank sets onerous stress tests on paper, but rarely applies them properly to lenders' balance sheets. He says the Bank makes too many assumptions favourable to the lenders, leading to lower projected losses.

The smart money is on the Bank setting a "hard Brexit" stress test next year. "If they believe their own rhetoric, the Bank should do a severe test to prepare the lenders for Brexit," says Dowd.

Earlier this month, Bank official Sam Woods warned around 10,000 City jobs were at risk on day one of Brexit and it was plausible up to 75,000 jobs in total could go. Robert Smith, a partner at KPMG who has advised some of the lenders on this year's stress tests, agrees Brexit was not factored in. "This isn't meant to be a hard Brexit stress," he says. "They could have structured it as such but they didn't."

Opinions vary on how a hard Brexit might impact the UK financial system. But for the purposes of a hard Brexit stress test, Smith says it might be rational to include further sterling weakening against the euro, unemployment getting higher, reallocation of capital to European entities and movement of banking operations to the continent.

The Bank set a second, longer-term stress test this year called the "biennial exploratory scenario". This explores the potential impact of structural threats over 10 rather than the usual five years. The maiden scenario models a slump in global GDP, a 0pc Bank rate, low volatility and intense competition. The Bank will report on the seven lenders' overall performance, rather than giving individual results. KPMG's Smith says the banks have found it "really helpful to think through the strategic implications". A long-term model like this might be better suited for a hard Brexit style test in future. But because it is biennial the Bank won't be able to set it next year ahead of departure in March 2019.

The Bank declined to comment on the suitability of its stress tests. But a source familiar with its thinking said regulators "fundamentally disagree" with criticism its tests are too lenient. "It's pretty hard to imagine a scenario tougher than this that would be realistic," the source said. "It's about striking a balance. It's an incredibly valuable tool." This week we'll see how widely this view is shared.