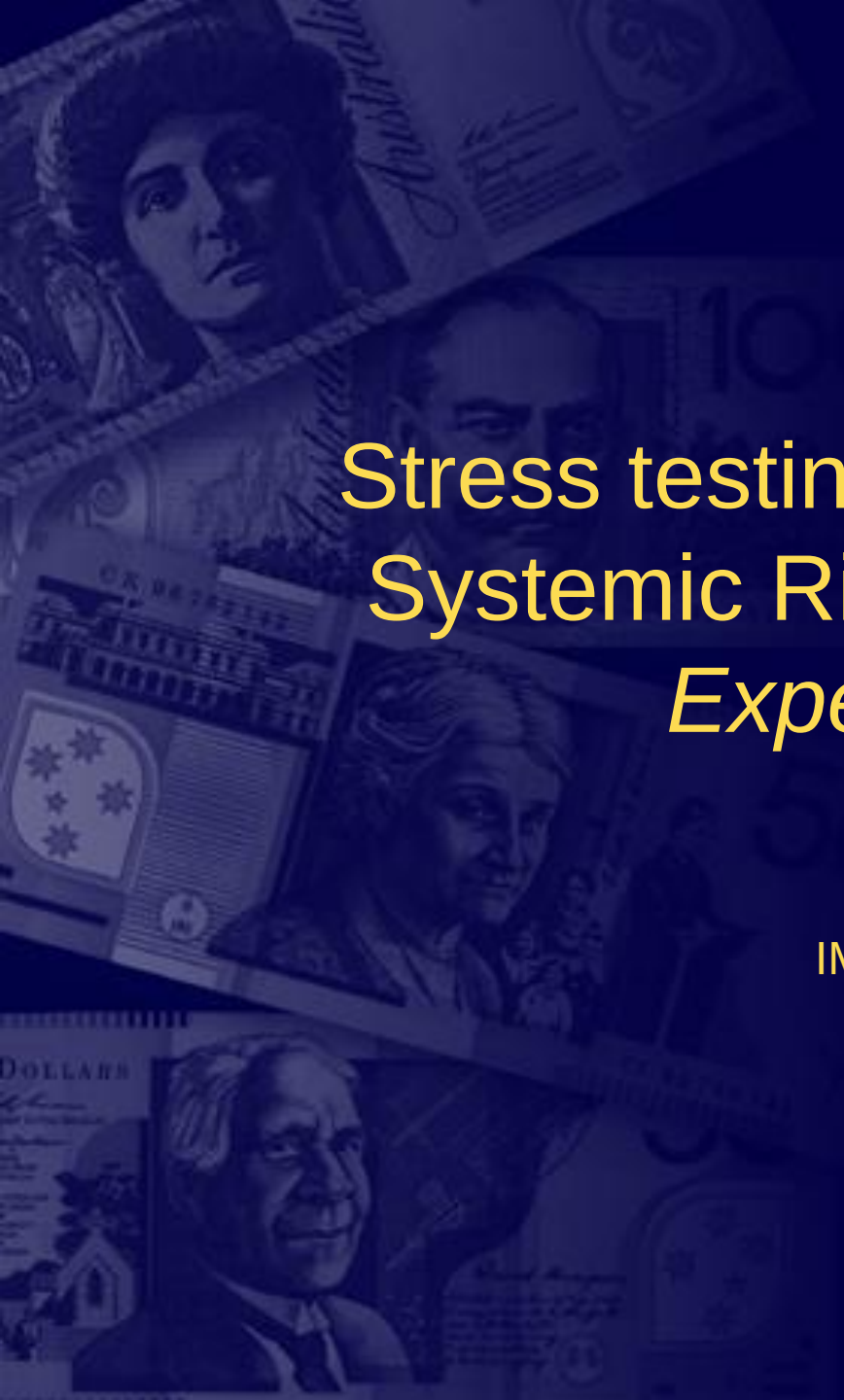

Stress testing Approaches to Systemic Risk: *Reasonable Expectations*

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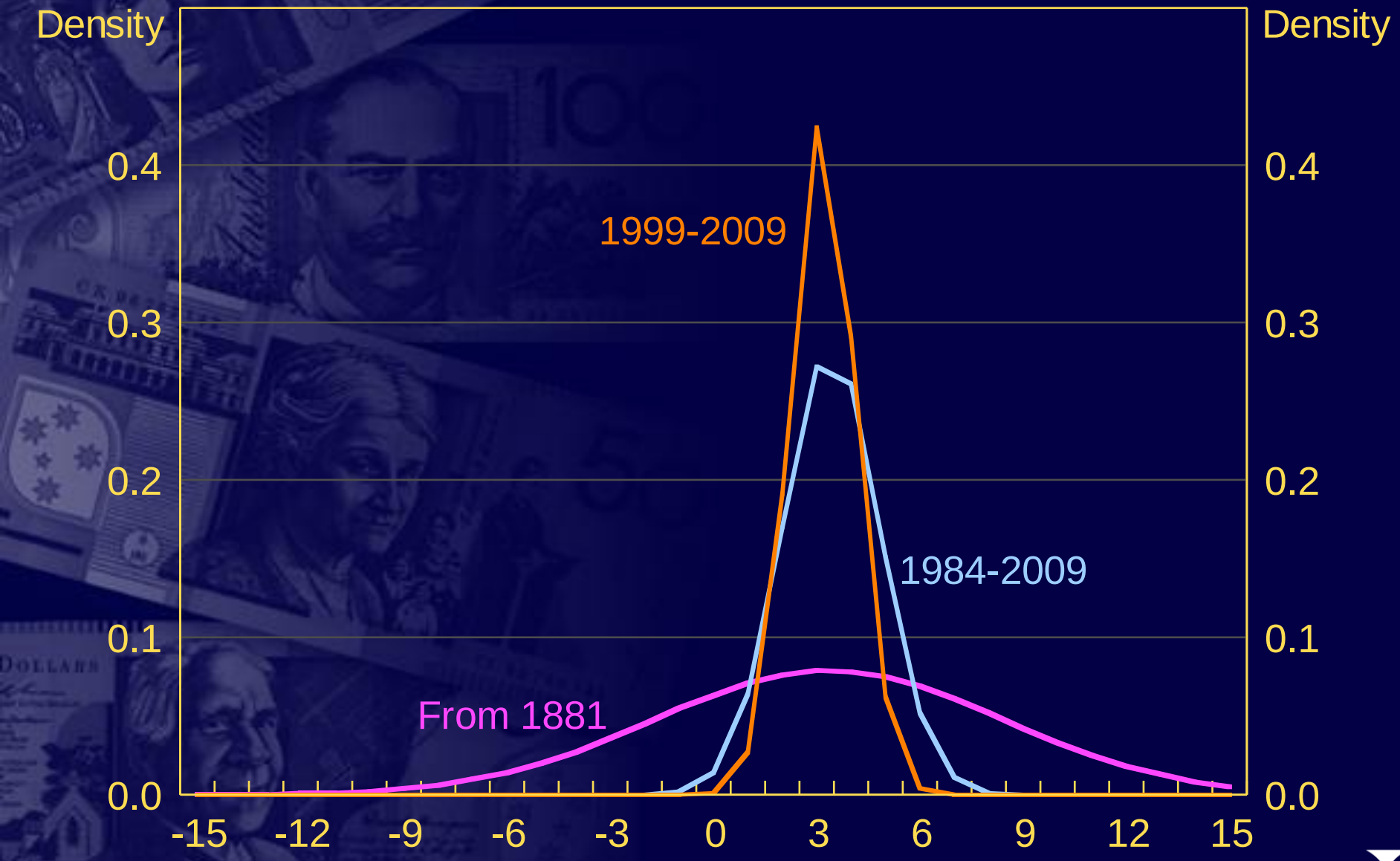
Reasonable expectations?

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.

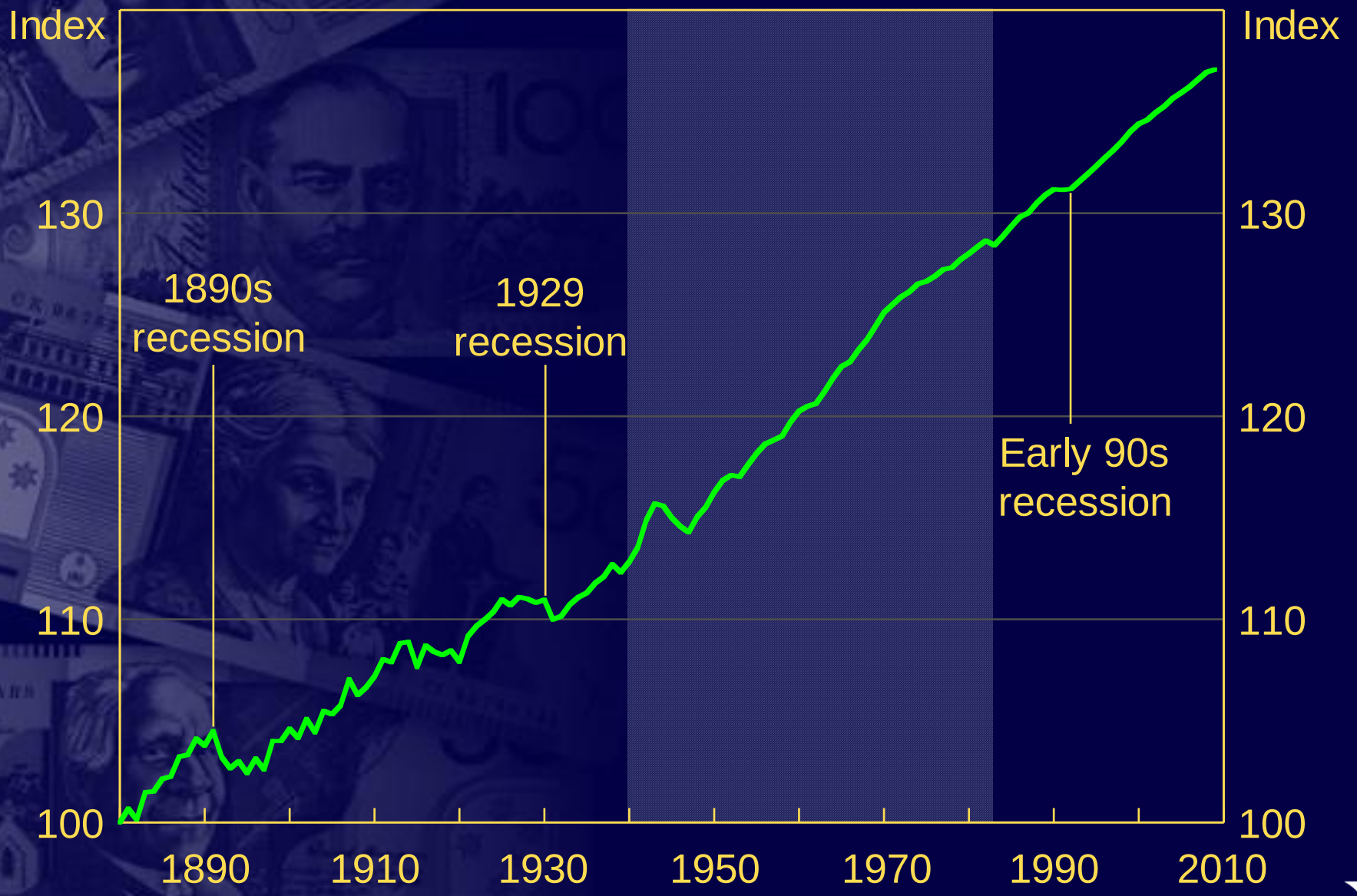
Probability Densities of Australian GDP Growth



Sources: ABS; RBA

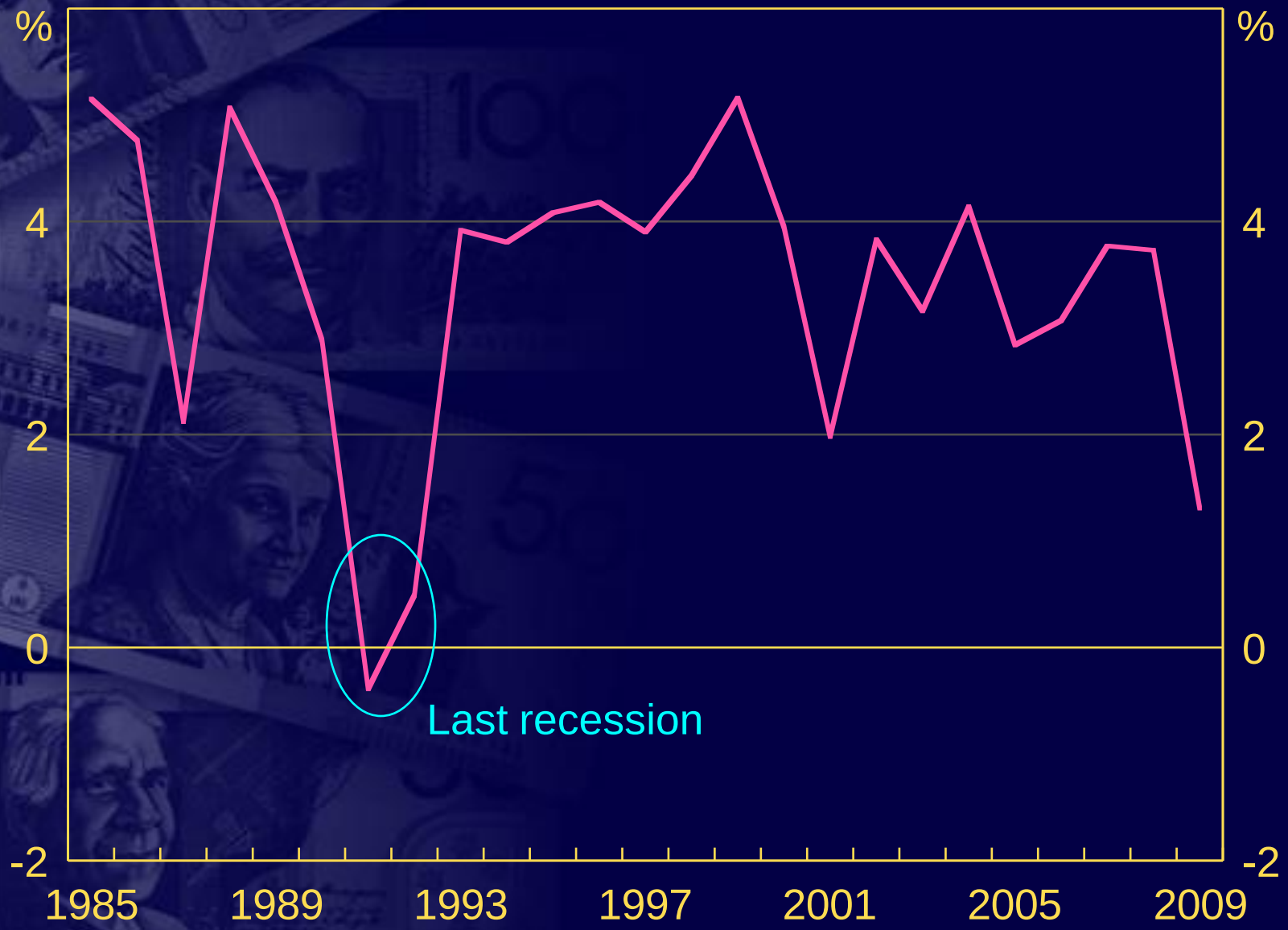
Real GDP

Log level, 1880 = 100



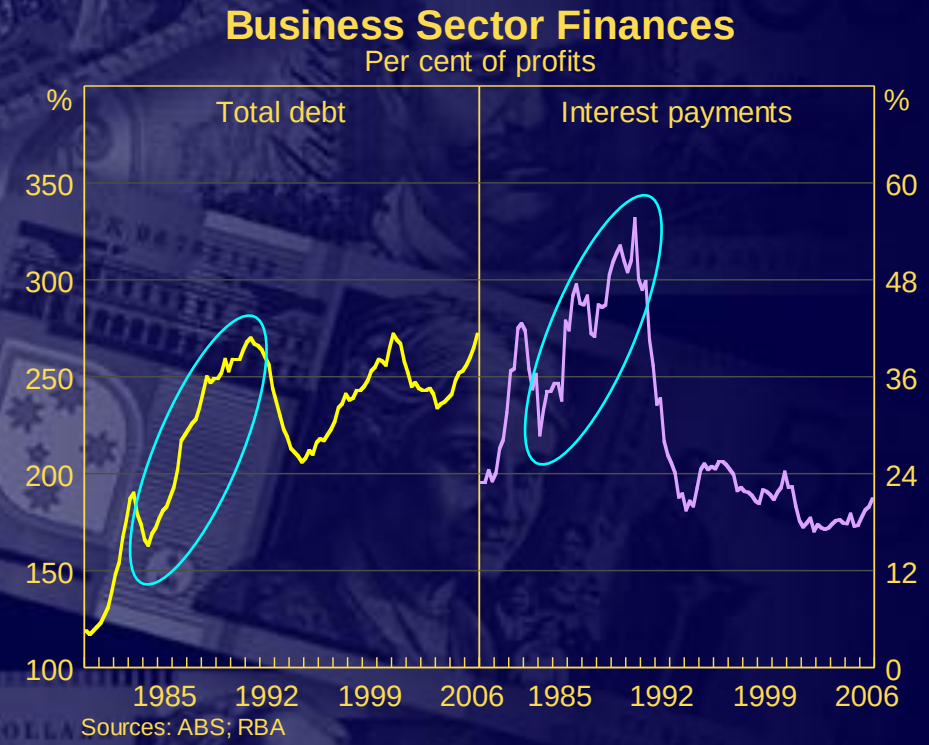
Sources: Butlin RDP7701; Fisher and Kent RDP9906; ABS National Accounts

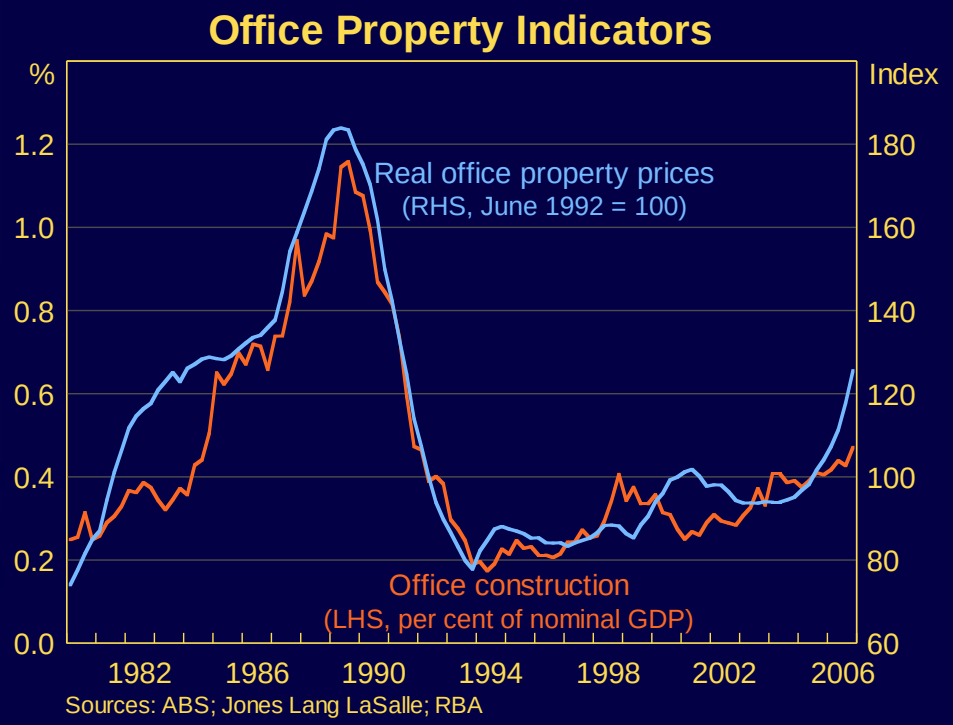
Australian Real GDP Growth



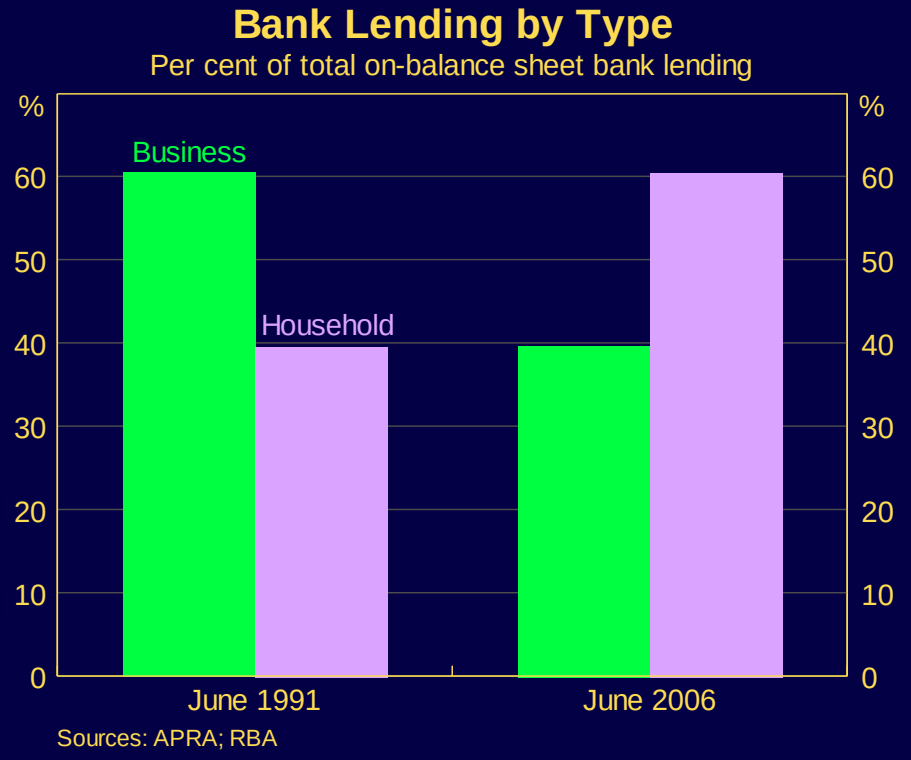
Sources: ABS National Accounts; Butlin RDP7701; Fisher and Kent RDP9906

Corporate sector risks in the early 1990s

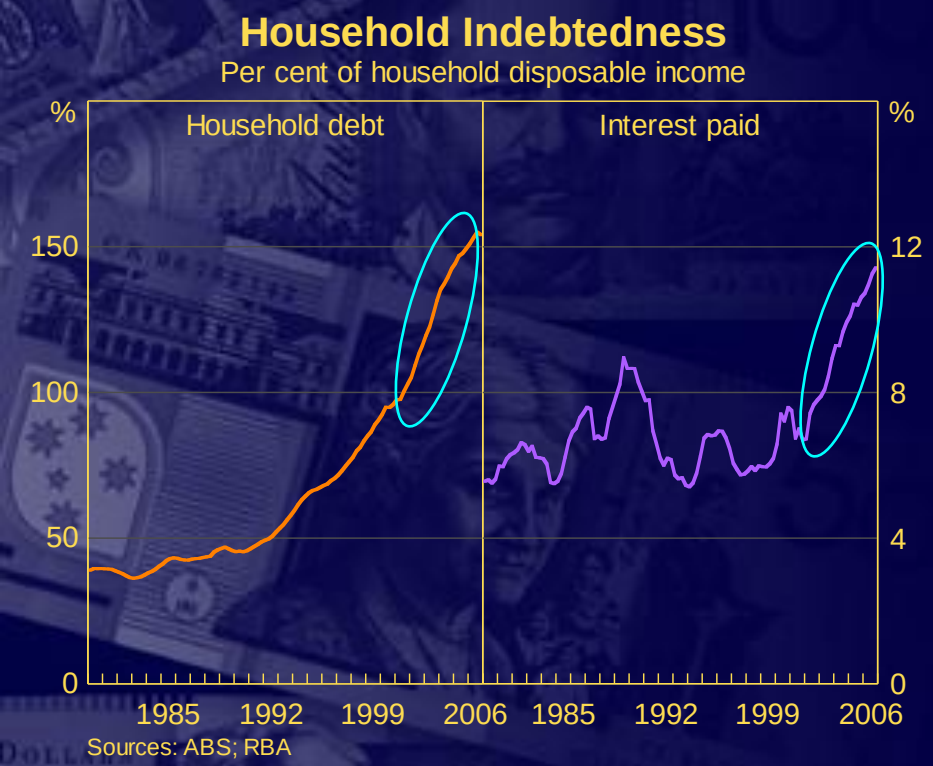


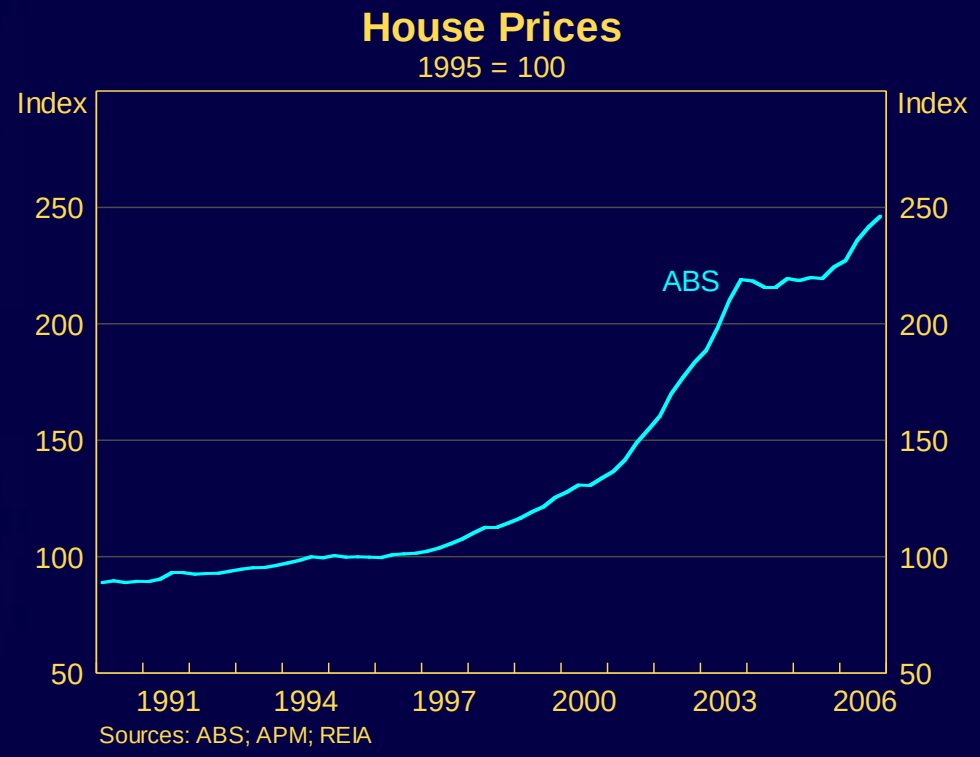


… and the implications for Australian banks



Household sector risks in the 2000s'





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.