

The Australian Prudential Regulation Authority's system-wide stress test

Key considerations for banks
and superannuation funds

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Stress testing plays a crucial role in assessing the resilience of financial institutions. Regulators continue to focus on this and are broadening this focus to consider the interconnected nature of the financial system, and the risks this creates.

The Bank of England (BoE) recently completed its System-Wide Exploratory Scenario (SWES) exercise, a new initiative designed to assess the resilience of the United Kingdom (UK) financial system to a severe market shock. The Australian Prudential Regulation Authority (APRA) is set to conduct a similar stress test in 2025, focusing on Australian banks and superannuation funds.

We think the learnings from the SWES and how it was conducted will provide useful insights for Australian Banks and superannuation funds. Below we outline how the SWES was conducted, including key focus areas.

The Bank of England's SWES: A new type of stress test

Unlike traditional stress tests that focus on individual institutions, the BoE's SWES took a system-wide perspective. This involved incorporating complex firm behaviours and interactions through the active engagement of around 50 different firms including banks, pension funds, hedge funds, money market funds and insurers. The intention of the SWES was to identify mismatches in firms' expectations of how they will act in a stress. The goal was to enhance risk management approaches across the system, particularly regarding the assumptions that are made on how other parties will act, and the potential for market dynamics that could amplify shocks in markets and potentially pose risks to financial stability.

The SWES Scenario

The scenario was different to the regular BoE capital stress test, in that it did not intend to consider the capital resilience of banks. In other words, it was behaviourally focused – seeking to understand the actions that would be taken by participants given a set of circumstances.

The SWES scenario was a hypothetical stress event comprised a sudden, sharp, and severe shock to global financial markets, triggered by the crystallisation of geopolitical tensions that ran over a period of 10 days, with two information submissions. This shock was designed to be faster, wider-ranging, and more persistent than those observed in recent stress episodes. Key elements of the scenario included:

- A sharp decline in global financial markets, leading to significant losses for some SWES participants and triggering a spike in variation margin calls.
- Increased volatility, causing initial margin requirements by central clearing parties to increase, and some funds experiencing redemptions.
- Elevated counterparty credit risk, culminating in the default of a hedge fund.
- Single notch downgrades of several jurisdictions (including the UK) and a small number of financial institutions and corporates.
- The unexpected announcement by sovereign wealth funds that they will reduce holdings of advanced-economy debt.
- The expectation of longer-term shocks to economic fundamentals beyond the horizon of the 10-day scenario, meaning that participants needed to consider realistic actions in the context of protracted uncertainty.

Transmission Channels of Stress

The SWES exercise focused on three key transmission channels to understand how stress propagates through the financial system:

- **Drivers of firms' liquidity needs under market stress:** This includes factors such as investor redemptions, margin calls, and collateral requirements.
- **Firms' actions in response to those liquidity needs and the liquidity available to them:** This includes actions like selling assets, drawing down on credit facilities, and utilising liquidity management tools particularly the repo market.
- **Additional actions taken to deleverage, reduce risk exposures, or rebalance portfolios:** This includes actions taken in response to the elevated risk environment, such as limiting counterparty exposures or reducing positions in certain markets.

Key Lessons from the Bank of England's System-Wide Exploratory Scenario

The SWES yielded several key lessons for the Bank of England and market participants



Firms' collective actions amplify the initial shock.

The SWES highlighted how individual firms' responses to a market shock, such as rapid asset sales or deleveraging, can interact and amplify the initial shock, potentially leading to broader instability. The exercise showed that some firms rapidly sold assets or limited their intermediation activity, amplifying the shock.

Repo market resilience is crucial.

The exercise demonstrated the central role of repo markets in supporting core markets during stress. It also revealed that banks may not be able to provide all the additional repo financing that non-banking financial institutions (NBFIs) required and assumed, despite their access to central bank lending facilities.

Gilt market resilience has improved, but vulnerabilities remain.

The SWES showed that actions taken by authorities and market participants in response to recent difficulties (such as Truss mini-budget/Covid) have enhanced gilt market resilience (which refers to balance of buying and selling pressure). However, this may be representative of a defensive posture which could unwind over time and therefore more work was required in this area.

The BoE were clear that firms should be considering system-wide dynamics in internal risk management and stress testing, and this is perhaps not something that has done previously – for example, the willingness for repo financing to be rolled-over or expanded was overestimated and alternative liquidity sources were required in the scenario.

The corporate bond market is susceptible to illiquidity.

The exercise revealed that the sterling corporate bond market could experience a "jump to illiquidity" in stress, where selling pressures significantly outstrip purchasing capacity, leading to rapid price declines.

Unpredictable behaviour can exacerbate stress.

The BoE observed that firms are often unable to anticipate how their counterparties, investors, or markets they operate in behave in stress, which could leave them underprepared. This underscores the importance of considering the potential for unexpected behaviour from counterparties and market participants during stress.

System-wide stress exercises are an effective tool.

The BoE concluded that system-wide stress exercises are valuable for understanding system-level vulnerabilities and informing surveillance and risk assessment.

The Australian Prudential Regulation Authority's system-wide stress test

The objective of APRA's system-wide stress test appears to be similar to the SWES, although APRA has mentioned specifically liquidity and capital considerations. There are some structural differences between the UK pension market and Australian Superannuation, most notably the size of the Australian Superannuation sector when compared to Australian Gross Domestic Product being approximately 30% larger than in the UK. APRA's test will only examine banks and superannuation, rather than the inclusion of insurance and other financial institutions.

APRA has mentioned 'severe but plausible' scenarios that include market shocks from geopolitical events, trade tensions, and technological vulnerabilities. APRA's mention of capital considerations suggests they may examine bank strength in more detail than the BoE, who specifically state that it was not their intention to do this. The BoE also did not specifically include an operational risk incident, but asked participants to reflect on how this would have impacted their analysis.

APRA's Chair in a recent speech identified four potential risk transmission channels of interest:

01 The impact of a crisis on superannuation fund liquidity and how trustees might respond to any shortfalls.

02 The impact on banks' liquidity due to large outflows from institutional counterparties.

03 Banks' ability to rely on superannuation as a source of capital in time of stress.






04 The impact of asset markets from banks' and superannuation trustees' synchronised responses to the stress.

The scenario will likely involve a major financial market shock, a series of secondary shocks that erode bank capital and superannuation member contributions, compounded by an operational risk component that disrupts entities' ability to respond to the financial challenges.

Some key questions as you prepare for APRA's system-wide stress test

Stress testing is a complex area requiring significant collaboration from across an organisation. Banks in Australia and globally have been running stress tests in recent years and expectations from regulators are high and continue to increase.

Some questions for Australian banks and superannuation funds in preparation for the APRA system-wide stress testing:

-  **1** ▶ **What third parties are relevant to this stress test, and what impact might this have?**
Consideration should be given to speed, decision making rights and delegations, feedback loops, opportunistic buying, and points of vulnerability in process.
-  **2** ▶ **What ability is there to revalue investments quickly across a large portion of the portfolio in both listed and unlisted areas?**
-  **3** ▶ **What are the underlying assumptions we have in a stressed scenario? This would include how liquidity would be sourced, and how willing investors would be to make investments in the stress. What could undermine or support those assumptions?**
-  **4** ▶ **What are the assumptions as to how we would estimate margin requirements? Where would margin be required?**
-  **5** ▶ **How will relevant stakeholders be brought together?**
– finance, risk, treasury, group executives and the board.

APRA's upcoming system-wide stress test presents a significant opportunity for Australian banks and superannuation funds to put processes, policies and systems to the test. Learning from the outcomes of the BoE SWES should set participants up for success through a high-quality process and outcome.

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