Stress Testing the Securities Market

The ongoing ramifications of the COVID-19 pandemic on financial markets globally further emphasises the importance of organisations implementing appropriate risk mitigation strategies. As mandated under Section 6(l) of the Securities Act, 2012 (SA 2012), it is the duty of the Trinidad and Tobago Securities and Exchange Commission (TTSEC) to assess, measure and evaluate risk exposure in the securities industry. Therefore, conducting periodic stress testing of the market is a critical function.

In financial terminology, stress testing is a risk management technique used to gauge vulnerabilities of an institution's financial condition, as a result of a set of specified unfavourable scenarios. It is essentially used to assess the resilience of a company or sector in the event of poor financial conditions.

The 12 Step Stress Testing Process

Step 1: Defining the institutional capture

When conducting stress testing, it is important to select the entities to be included based on various criterion, such as size, complexity of activities and market interconnectedness. The TTSEC's stress tests may focus on specific areas of the market, for example Collective Investment Schemes (Mutual Funds), or may look at registrants registered under Sections 36 and 51(1) of the SA 2012 i.e. self-regulatory organisations, broker-dealers, investment advisers and underwriters.

Step 2: Identifying the key trigger events

A trigger event is any situation that causes a disruption wherein it is difficult for registrants to operate normally. These trigger events are not to be confused with transmission channels (as seen in Step 4), as they need to be directly related to a specific stress event and should arise independently of other stresses in the industry. For example, a mass migration of clients would require firms to find enough funding to repay the departing clients.

Step 3: Translating the key trigger events into tangible impacts

After triggers are identified, they will be converted so that they are experienced individually by registrants. The time period for these impacts are also identified during this stage; whether short-term or long-term, as well as potential outcomes from these events.

Step 4: Identifying all relevant transmission channels and linkages

In conducting a stress test there exists the possibility that ripple effects are felt by other registrants as a result of a specific stress scenario affecting a particular registrant. It is therefore important to consider these indirect stresses that may be passed on and the channels through which they may be amplified. For example, if we continue to consider a situation where a registrant is unable to source funding in the event of a mass migration of clients, this can create a "knock-on" effect for other registrants as investors may lose confidence in the market, which further amplifies the scenario.

Step 5: Defining and quantifying the stress test scenarios

An initial suite of scenarios will then be created from the list of trigger events, as well as the potential impacts and transmission channels are identified. Both single factor and multivariable tests can be utilised. Single factor tests are aimed at understanding and calibrating the vulnerability of the markets to particular stresses while multivariable tests are aimed at understanding how real-world crises might impact the market.

Step 6: Obtaining relevant data

The TTSEC currently utilises its Micro and Macro Prudential Reporting Framework (MMRF) to capture key metrics and conduct analysis to evaluate the health, soundness and vulnerabilities of the local securities industry. This data informs key indicators for all segments of the securities industry (mutual funds, repos, etc.) and is utilised to conduct stress testing on registrants.

Step 7: Performing the stress test (First Round)

The first round of stress testing will be performed once scenarios, triggers, impacts and transmission channels are identified and quantified. Stresses will be applied on individual firms and subsequently aggregated to show segment-wide or market-wide results.

Step 8: Assessing the results of the stress test and reviewing assumptions

As stated previously, the intention of the stress tests is to assess whether firms are able to continue to operate under the specific conditions of the test scenarios. If firms are unable to operate normally, the main stresses which will impact capital adequacy (solvency test) and liquidity (liquidity test) must be understood.

Step 9: Performing the stress test (Second Round)

A second round of stress testing will only be included and analysed after the results of the first round are considered. The adjusted financial statements, as a result of the first round, will be tested with a new set of scenarios to see if ultimately firms failed or passed the solvency and liquidity test.

Step 10: Communicating the stress test results

Results will be communicated to internal and external stakeholders, as determined, to assist in the identification of proper risk mitigation strategies. Note though that the results are not viewed as forecasts and predictions in any way

Step 11: Following up

Once the stress tests results are consolidated, the TTSEC will decide on the actions are required. This may include micro-prudential actions such as closer monitoring of firms or their management actions, or macro-prudential actions such as regulatory policy decisions aimed at identifying and mitigating systemic vulnerabilities.

Step 12: Institutionalising the tests

Stress testing of the local securities industry is continuously refined by the TTSEC so as to create a culture of risk management; which ultimately strengthens the financial sector.

Through stress testing the TTSEC will conduct a sector-wide analysis of risks, vulnerabilities and dependencies. This therefore plays an important role in our supervisory effort by identifying weaknesses in the security industry’s health and operations, and providing an opportunity to formulate appropriate micro or macro level responses. Through the monitoring of the securities market and its participants, the TTSEC is better able to predict and/or address shortfalls before they negatively impact the market and investors. Stress testing therefore helps in creating a safer and more robust securities market, in which investors can feel confident.

Regulating the securities industry so you can invest with confidence.

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