Macroeconomic Stress Testing and The Resilience Assessment of the Banking Sector in Sri Lanka

E. M. D. N. B. Ekanayake[1] and J. M. R. Fernando[2]
Department of Finance, University of Kelaniya, Sri Lanka[1,2].
dushanmgt@gmail.com[1], ruwani@kln.ac.lk[2]

ABSTRACT

Introduction - Financial stability and Macroeconomic stress testing of the banking system turned out to be an increasingly important objective in economic policymaking in the global context as well as in Sri Lanka. Although macroeconomic stress testing at the level of individual banks has been widely applied, macroeconomic stress testing at the level of entire financial systems is a more recent instrument. The study conducts a stress test to assess the banking sector vulnerabilities in Sri Lanka to the most extreme but plausible macroeconomic shocks.

Methodology - The model attempt to account for the dynamics between banks' asset quality and key macroeconomic variables through conditioning the stress test based on the historical correlation between the variables and allowing for feedback effects from credit risk to the macro economy. Further, it uses historical and hypothetical stress scenarios to capture the most extreme but plausible key macroeconomic impulses on financial soundness indicators to evaluate the banking sector vulnerabilities.

Findings - Results indicate a cointegration relationship between credit quality and key macroeconomic variables. The expansionary monetary policy positively and significantly affects credit quality and capital adequacy through economic growth.

Conclusion – Study concludes that the Sri Lankan banking sector is not substantially vulnerable to and hence not threatened by various significant adverse shocks considered in the

analysis domestically and externally via stressed GDP growth rate as per current BASEL norms. Even if the most extreme economic stress conditions witnessed over the past two decades were repeated, the Sri Lankan banking sector should remain robust in terms of tier 1 and tier 2 capital requirements.

Keywords: *Stress testing, Banking sector, Asset quality, Scenarios, capital adequacy*