Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Stress Tests*

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The results of the Federal Reserve's stress tests have been in the headlines again, something to which we will become more and more accustomed as time passes and headlines about them become routine. While one could say that, generally speaking, the results showed broad improvement in the capital positions of the 18 largest bank holding companies, there were some exceptions and some quasi-exceptions, the latter being found in the creation of a new category that said, your numbers look okay, but we don't think your systems for developing those numbers are up to snuff — stop by and see us before finally implementing your distribution plans.

By and large, however, it would be hard to quarrel with a conclusion that capital positions on those bank holding companies that have 70 percent of the assets of the U.S. banking system are much better than they were during the past four years. For example, the Tier 1 common equity ratio of the group has risen from 5.6 percent to 11.3 percent between the periods 4Q08 to 4Q12. That's an improvement, and the evaluation is probably difficult to contest.

Nevertheless, questions abound. Are the tests hard enough — i.e., have the regulators made sufficient negative assumptions in their scenarios? Have they accounted for contagion in any realistic way? Are they wrapped up in too much mystery, so much that the regulated companies cannot tell why the Federal Reserve found their capital positions to be so different from what the BHCs themselves found? Do the results of the tests on their face show that regulators do not know how to measure the safety of the largest banking companies? In brief — are these tests useful at all and, if not, should they be eliminated?

In one sense, that last question is one of those "clown questions," to quote a not yet Hall of Fame baseball player.[1] They are here, both in

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[1] Bryce Harper, in refusing to answer what was later described as a stupid and irrelevant question asked by a reporter.

statutes and in regs, so they will continue to be used until someone changes the law, and the possibility of that happening in this particular area of financial services is, at best, remote. Yet, it remains important to continue to discuss the question because there are ways that might be explored to make them better.[2]

For example, in most matters in financial services, most investors would like to see more transparency, no matter how transparent the subject might already be. In fact, in some parts of financial services transparency is the driver for policy.

Yet, the Federal Reserve does not want to disclose the methods by which it analyzes the submitted CCAR capital plans, fearing that to do so would result in the BHCs gaming the system and adjusting their accounting to meet the benchmarks laid down by the Federal Reserve in its analysis. There are those that will argue that doing what the Fed thinks it should be doing would not be a bad thing, so revealing the models used would simply provide another path for BHCs to achieve better capital standards. So far, the Fed disagrees.

Similarly, the Federal Reserve has now told a few companies that even though the metrics turned out fine and they are well in excess of all regulatory capital standards, the process by which they determined the elements of their plan and the governance of the risk management activity or its robustness were in some undisclosed way insufficient. Frankly, that seems like an easier fix, even though there are no metrics to guide the companies, since the questions boil down to one overriding point — is the institution taking risk management as seriously as the Dodd-Frank Act and the Federal Reserve believe it should. Perhaps I underestimate, or perhaps that by itself doesn't provide enough guidance to the companies to make major changes that might be necessary to meet the Fed's standards.

There are other ways to deal with this, although they may not meet the DFA requirements.

One way would be for the Federal Reserve to reveal "best practices" that it found among the institutions whose plans it reviewed. Without disclosing the names of institutions, it could release practices in various areas that

[2]For example, the Cypriot banks passed the European Banking Authority stress tests in 2010 and 2011. Something about either the tests themselves or the supervision and analysis of them should be able to be learned from that.

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satisfied its own analysis and that provided alternative ways of dealing with one or more elements in the construction and maintenance of the plan. In fact, it need not limit itself to one practice in an area — there may be more than one that would be satisfactory. If they are best practices, the Fed should want to advertise them. If for some reason they were viewed as proprietary, then accommodations would have to be made.

Second, it could create and publish annually a set of stress scenarios and a hypothetical BHC financial statement with necessary background data, perhaps provide some assumptions about future activity (or leave that to the BHCs) and ask the 18 BHCs to analyze the capital position of that hypothetical BHC over the next nine quarters. Each company would publish its analysis of the capital position of that company, and observers could then acquire a feel for the relative position of the attitude (conservative or liberal) that the BHCs might take toward their own balance sheets.[3] In fact, analysts not in those institutions could develop their own assumptions about the appropriate capital plan for the hypothetical institution and have yet another measuring stick against which to compare various of the 18 institutions.

Another approach it might take has already been alluded to. The Fed could simply reveal in detail its analysis, its assumptions and its methodology. Let's assume that once revealed by the Fed, the institutions could shape their statements to be in concert with the Fed's position. How can that be bad? One assumes that the position of the Fed produces a sound basis for a capital plan, and that the financial statements of the institutions reflect reality.

For one thing, it might be misleading if there is a way for the institutions to be in accord with the Fed's rules and still have a capital plan that is inconsistent with the one the Fed wants. Reaching that conclusion, however, might require the Fed to conclude that it had failed to include sufficient rules necessary to properly analyze the data. That would be difficult for the Fed to do, and would put into question all of the tests, not just the one in which the Fed thought the plan was insufficient. That would present a difficult dilemma for the Fed.

In addition, financial statements are accounting statements and sometimes accounting statements do not present reality in a way that is sufficient for regulators. Quarrels between accountants and regulators over the reality

[3] See ***Our Perspective, October 2011***

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of the books of banking institutions are notorious. Therefore, accounting treatment that causes books to be in accord with the Fed rules may or may not reflect the reality of GAAP or the rules of IASB. Adjustments might have to be made different from those in the stress tests in order to be in line with applicable accounting standards. If so, that is a serious complication.

Finally, there may be merit in ensuring that the banks do not slavishly copy the rules of the Fed. The Fed has been known to fail to predict a major risk in advance, and while the stress tests are designed for ensuring that there is a lot of capital in the institutions, the Fed view of the analysis done by the banks may be taken by the institutions to be the appropriate model for risk analysis. That might stifle visionaries at some institutions that in fact spot the oncoming risk, but cannot build that into their models because the Fed has not included it in its view of the appropriate risks.

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