Comments on:
Stress-Testing Macro Stress Testing: Does it Live up to Expectations?

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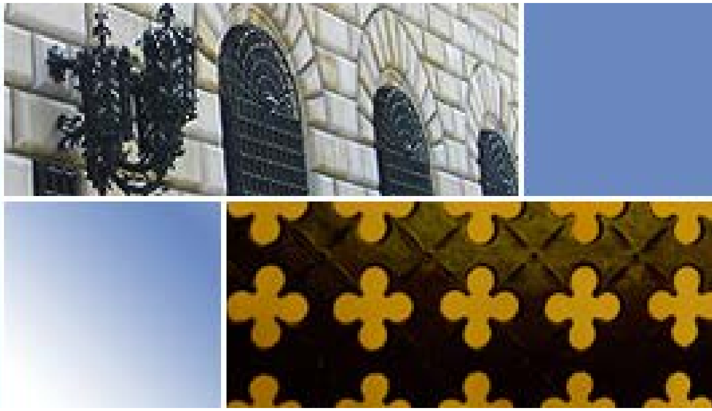

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Overview

- Borio, Drehmann, and Tsatsaronis (BDT) make a valuable contribution to the increasingly important area of stress testing of banks
  - Consider the impact of SCAP and CCAR in the U.S. and the EBA stress tests in Europe, and the ongoing public interest
- BDT offer five propositions about “macro stress tests”:
  - A tool box, not a single tool
  - Not early warning devices
  - Big help in crisis management / resolution
  - Generate additional benefits
  - If done, should be done right
- Discuss each proposition, informed by experience from SCAP, CCAR, and CCAR 2012

#1: A Tool Box, not a Single Tool

- Agree
  - Stress tests vary by goals, universe, horizon, level of granularity, firm v. system view, modeling approach, etc.

- Potentially conflicting goals complicate implementation and policy actions
  - Example: How to assess balance sheet growth if concerned about:
    - Microprudential safety and soundness of a given firm
    - Macroprudential lending capacity of the system
    - Macroprudential reduction of a firm’s systemic importance

- Applied stress tests contain many component models
  - Modular approach is needed, but adds to complexity and operational risk
  - Difficult to do standard errors or sensitivity analysis

- Little progress on incorporating feedback effects to the macroeconomy
  - Complicated conceptually and practically
  - Important area for future work

#2: Not Early Warning Devices

- Agree, but…
  - Should not expect stress tests to be early warning devices
- Stress test results are only as good as the shocks
  - Would we have predicted a 30% decline in U.S. home prices in 2006?
  - BDT want a "strong will to stress the system" and conservative mapping to losses, but inherently difficult to identify relevant shocks ex ante
- Early warning devices are critical (and the subject of much of this conference), but stress tests are unlikely to be the best tool for that objective

#3: Big Help In Crisis Management / Resolution

- Agree
  - Stress tests create new information for supervisors and markets
- Important benefit of SCAP was to “size the hole” and reduce uncertainty by providing more bank-specific information to the market
  - Made more credible by official sector capital backstop
- But, benefits for supervisors in other areas
  - Assess sufficiency of bank capital to support potential capital distributions
  - Ensure banks have comprehensive assessments of all risks
  - Evaluate integration of stress tests into the bank’s capital planning and risk management processes

#4: Generate Additional Benefits

- Agree, and…
  - BDT may undersell the importance of stress testing to banks

- Supervisors get critical cross-sectional information
  - Range of loss rates and revenues
  - Better understanding of the risk management frontier
  - Plausibility of business line assumptions, e.g., market share reallocation or balance sheet growth

- Banks should benefit from developing more rigorous stress testing processes
  - Effective capital planning by the banks requires an assessment of capital needs across a range of potential scenarios

- Stress testing should be part of the bank's internal capital adequacy processes, not a separate add-on just for the supervisors
  - Avoid situation where banks perform stress tests for supervisors, but do not integrate implications into decisions for how they manage the business

#5: If Done, Should Be Done Right

- Agree, but…
  - This is really hard

- Disclosure and communication is complex
  - BDT recognize the importance, but big questions
    - What is the purpose of disclosing results?
    - Does the market want detailed inputs or insight into supervisor's perspective?

- Need to specify range of policy actions ex ante
  - BDT want a "clear follow-up plan"
    - What post-stress test actions are feasible – reduce distributions, raise capital, shrink balance sheet, change corporate structure, exit high-risk/high-return businesses?
    - How sure must one be to take action to mitigate low probability/high impact outcomes?

- Modular approach and scale/complexity of large banks requires an enormous resource commitment from the official sector

Additional Thoughts on Stress Tests

- Assessment of balance sheet evolution drives a possible divergence between microprudential and macroprudential goals
  - Fallacy of composition
  - Negative spillovers, e.g., margin spirals
  - May need to respond to safety and soundness, lending capacity, and systemic importance concerns separately with distinct tools

- Stress test results are primarily positive exercises, not normative ones
  - What would likely happen if a scenario occurred, not what one would like to happen
  - Example: A microprudential view of a firm’s capital adequacy across a range of scenarios, rather than a macroprudential tool to avoid credit contraction

Additional Thoughts on Stress Tests

- The severity of the scenario should not be a cyclical policy choice
  - BDT suggest to tighten the severity of the shocks in a boom
    - Would they suggest weaker shocks during tough times?
  - Stress testing may not be the best countercyclical tool

- Need to consider the authority to act against possible future outcomes
  - Many regulations are based on actual conditions, not projected stressed conditions
  - “Capital Plans Rule” in the U.S. provides new authority based on forward-looking metrics

Conclusions

- Stress testing is an increasingly important part of the supervisory process
  - Borio, Dhrehmann, and Tsatsaronis outline many key issues with practical implications
- Key takeaway – critical for all stakeholders to understand what stress testing can and cannot do
  - Some concern that stress testing will be seen as the answer to all problems – it isn't
- Two areas for continued improvement
  - Conceptual research
    - Need a "general theory of stress testing" with goals in both and bad good times
    - Clarify the trade-off between potentially conflicting micro- and macroprudential goals
    - Feedback effects from financial sector to real outcomes
  - Practical knowledge-sharing
    - Dialogue among supervisors, banks, and private sector to identify best practices
    - Systematic ex post analysis to help understand what "works" and what doesn't

Appendix

Comprehensive Capital Analysis and Review

- Federal Reserve began CCAR 2012 exercise last week
  - Capital plans rule was adopted to amend Regulation Y for large bank holding companies
    - Requires annual capital plans
    - Requires prior notice to the Federal Reserve before certain capital distributions
  - Instructions for 2012 exercise, including macro scenarios, made publicly available on the Fed's website

- Key points for CCAR 2012
  - More than a stress test – assessment of capital plans, capital adequacy processes, capital policies, Basel III transition path, risk identification and measurement, etc.
  - Scenarios are not forecasts, but hypothetical outcomes designed to test the strength and resilience of the banks
  - Commitment to transparency
    - Publish scenarios now and disclose firm-specific results in March 2012
  - Complements the legislative mandates from the Dodd-Frank Act