



International Regulators: Lessons Learned from Recent Exercises

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We're gathered here in June 2015...

- Regular, comprehensive stress-testing and evaluation of capital planning processes are now a significant part of the regulatory/supervisory programs in the US, Europe and UK
 - Regulators and supervisors in each jurisdiction are grappling with challenges associated with developing and implementing an effective stress-testing regime
 - Financial institutions in each jurisdiction are grappling with challenges associated with complying with both the letter and spirit of these stress-testing regimes

What if we were sitting here in June 2005?

- We would likely be talking about...
 - ...how spreads and risk premiums remain at very low levels and the yield curve continues to flatten, and puzzling over why...
 - ...how to manage and address risks associated with nontraditional mortgage products...
 - ...how to deal with the potential for marked changes in the economic and financial environment, including rising interest rates and risk premia...

What if we were sitting here in June 2005?

“We were once again the most profitable financial services company in the world in 2005 and we returned the most capital to our shareholders of any financial services company, while continuing to invest in our businesses. Income from continuing operations was \$19.8 billion; our equity base increased to \$118.8 billion; and our balance sheet topped \$1.49 trillion. In 2006, we announced an 11 percent increase to our quarterly dividend, our 21st consecutive year of common dividend increases.”

-- Excerpt from 2005 Annual Report of large US bank holding company

What if we were sitting here in June 2005?

- We would likely NOT be talking about...
 - ...the potential for a nearly complete loss of investor and creditor confidence in the US banking system...as would in fact occur just a few years later...

Features of initial stress-tests that helped to restore confidence*

- Evaluating many firms at once
 - SCAP: 19 largest BHCs, approx. 66% of assets and over 50% of loans
 - CEBS: 22 largest European cross-border banking groups (including UK) accounting for 60% of consolidated EU bank assets
- Producing an integrated/comprehensive measure/projection of financial performance
- Imposing a common, credibly severe of scenario
- Imposing an implicit or explicit *pro-forma* capital standard
- Disclosing results to general public

**Note: not all features were present in all jurisdictions*

These features represented significant departures from “normal” supervision

How have these initial features (bugs?) fared over time?

Integrated, comprehensive evaluation of financial performance across many firms

- Constitutes a costly, time-consuming exercise from both regulator and firm perspective
- Imposes models and assumptions that might not be the “right” ones for the firm's idiosyncratic portfolios/business
- May create a pull toward “one model” across the set of firms subject to the test

Pro-forma standard

- Effectively imposes shifting capital requirements over time, making it difficult for firms to know how much *regulatory capital* they have to hold

Common, severe scenario

- Essentially asking a firm to capitalize to a different environment each time, one that may not even occur
 - OK the first time, but now?
 - Shouldn't regulators just tell firms how much capital to hold each time each time and remove the element of surprise associated with changing the scenario?

Public disclosure

- Creates a range of timing and logistical challenges for regulators, particularly given size and complexity of the exercise
- Creates challenges for firms, as they need to be able to manage their public communication and disclosure, particularly in situations where their performance was weak or below standard

How have these initial features (bugs?) fared over time?

Integrated, comprehensive evaluation of financial performance across many firms

- Evaluates more than just potential losses, also captures revenue and expenses, allowing an assessment of capital accretion under stress
- Allows for comparability of results across firms
 - Requires some reduction in recognition of firms' idiosyncratic strengths (and weaknesses)
 - Pull toward "one model" remains a commonly cited fear, but other aspects of evaluation of good capital planning should naturally counter such a tendency

Pro-forma standard

- Crisis illustrated that investor and counterparty confidence in capital adequacy can erode rapidly in the face of changes in current or expected economic and financial conditions
 - Loss of confidence can imperil an institution's viability even when regulatory capital ratios are well in excess of regulatory minimums

Common, severe scenario

- Stress-tests are not about trying to predict a crisis or about having firms capitalize against one or two specific scenarios
 - No scenario is "right"
 - About ensuring *ongoing* robustness of decision-making around capital given the inherent uncertainty of economic and financial environment
 - About running the types of "tests" the market itself might run, and did in 2008

Public disclosure

- Important tool for maintaining public confidence in both firms and regulators over time
- Supported by other disciplines such as common scenario, common treatment and approach and common time horizon

Where are we now?

- We continue to improve and learn, but we need to maintain these important features if the stress-testing exercise is to serve as a tool for translating the risks and uncertainty inherent in the economic and financial environment into reasonable doubt about whether capital levels that appear strong in one state of the world will be sufficient to maintain investor and counterparty confidence in another.
 - The presence of this reasonable doubt can serve to alter decision-making around capital and risk management *today* in ways that help to maintain capital commensurate to risk on an ongoing basis, reducing the risk of the type of collapse that occurred in 2008.

