Item #1:
Testing for “X” when you care about “Y”

• The goal of stress tests is to identify banks that will be able to ...
  “The Federal Reserve expects these BHCs to have sufficient capital to withstand a severely adverse operating environment and be able to continue operations, maintain ready access to funding, meet obligations to creditors and counterparties, and serve as credit intermediaries.”

• Sometimes, self-reported loan loss accounting has been suspect.

• Stress tests seem to address this well: “X”. 
An alternative way to value a bank:

Equity’s market value ( = “Y”)  

MVEQ = PV of net cash flows from
- Assets in place – focus of stress test.
- Future growth – absent from stress test.

Market value includes an assessment of continued solvency.
- Right or wrong, that assessment affects a firm’s market value.
• Continuing customer service requires adequate MARKET valued capital.

• “Adequate” BOOK value may not suffice.

Caveat: does passing a stress test entitle the BHC to DW access? If so, depositor runs pose a much smaller threat.
Book vs. Market: Historical Relations

• Largest 25 U.S. BHC at each yearend

• 1986-2011

• Compute accounting vs. market measures of equity value, relative to total assets.
2008

Graph showing the relationship between BVEQ/TA and MVEQ/TA for the year 2008.

Graph showing the relationship between BVEQ / TA and MVEQ / TA for the years 2002-2007 and 2008-2011.
Item #2: Performance-based plan revisions

A. Funding costs: vary with balance sheet condition?

B. PPNR
   – Immensely important part of the stress tests.
   – Strategic changes in response to initial stress?
   – Everyone cannot “expand market share”.
Shocking the trading book

c. Stress test shocks hit all-at once.
   Gives risk at a point in time.

BUT, gradual stress build-up generates endogenous responses.
   Is that a more accurate type of risk?

Rick Bookstaber, “Using Agent-Based Models for Analyzing Threats to Financial Stability”
Item #3: Improving the Stress Tests

• Compare own loss estimates to the Fed’s: maybe they are right.
  • Goose
  • Gander

• Value of growth options (intangibles) depends on the state of the \( i^{th} \) firm relative to the sector.
CONCLUSIONS

1. MV is important (too)

2. Funding spreads vary with stress?

3. PPNR – key to strategic planning

4. Dynamic trading book responses (ABM?)