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## COVER STORY

# Doubts Mount Over Stress Test Consistency

Big banks may get big fits over varying interpretations

By Joe Adler

**W**ASHINGTON – The sheer number of stress test requirements – which may differ by a bank’s asset size, business or charter choice – has some doubting regulators’ ability to apply the rules consistently to the largest banks.

Stress tests were already a major part of the government’s crisis response in mid-2009, but the Dodd-Frank Act added more requirements to the equation.

The reform law essentially institutes three different tests for large institutions and involves multiple regulators to implement them. But, rather than requiring a joint rule, the law calls on agencies to each draft a separate regulation for their respective institutions.

The three bank regulators have each issued similar but different proposals. Observers said that, while the agencies are working to ensure consistency across the board, failure to do so will make the rules difficult for institutions to navigate.

“If these rules are interpreted in different ways by the different regulators, it’s going to create some inconsistencies and problems for the institutions,” said James Rockett, a partner at Bingham McCutchen LLP.

The Federal Reserve Board already runs stress tests for large financial firms. Under Dodd-Frank, however, the central bank is required to conduct

new tests on bank holding companies whose assets top \$50 billion, and companies of that size must develop their own criteria for a separate set of company-run tests.

In addition, the law requires smaller firms – holding companies and subsidiaries with assets exceeding \$10 billion – to do internal stress tests based on criteria established by their primary regulator.

As a result the Fed, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency have all issued their own proposals, stoking fears about potential differences.

Despite a desire for uniformity, however, most observers said differences are necessary given the different structures of banking firms.

“It’s cumbersome. But in general regulators expect stress testing to be performed not only enterprisewide, but also at key business-line levels,” said Susan Krause Bell, managing director for Promontory Financial Group and a former OCC official. “It’s not really inconsistent to say it has to be done separately for the insured depository institutions.”

The stress test requirements do not end there. While the pending rules focus on tests that assess capital adequacy, regulators have signaled they will be writing rules examining a firm’s liquidity strengths in a crisis scenario.



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“I’m still trying to count” the stress-test rules, said Karen Shaw Petrou, managing partner of Federal Financial Analytics. “It’s great that they are aware of the potential of multiple and even conflicting stress tests. But the challenge is to be sure that the actual implementing rules address this.”

So far regulators seem focused on keeping the rules streamlined, especially in the hypothetical economic scenarios on which banks will test their capital strength. Dodd-Frank required the agencies’ stress test requirements to be “consistent and comparable.”

While each agency issued a distinct proposal on internal stress tests by institutions with assets of more than \$10 billion, the proposed requirements are substantively the same. Generally banks would have to conduct an annual test based on scenarios in three different categories: relatively normal economic

# Doubts Mount Over How Stress Test Rules Will Work

conditions, adverse conditions and severely adverse conditions.

“We’re going to try to impose a common set of standards for all of the insured institutions,” Martin Gruenberg, the acting FDIC chairman, said at the Jan. 17 board meeting where the agency unveiled its proposal.

An OCC spokesman echoed that sentiment after the OCC released a companion proposal a week later.

“While Dodd-Frank required the primary regulators to issue rules independently, it is not unusual for federal banking regulators to coordinate on the development and implementation of those independently issued rules to promote consistency across federally regulated financial institutions,” the spokesman said. “The Dodd-Frank Act requires that the separate rules issued by the primary federal financial regulators be consistent and comparable, and the OCC anticipates that the final rule will be as similar as possible to those of the other agencies.”

However, the separate rulemakings mean that in some cases companies will be tested for compliance by multiple different agencies. For example, American Express Co., with

assets of \$70 billion, would be subject to Fed-run stress tests and the Fed’s criteria for a company-run test. The internal stress test for its \$30 billion-asset state nonmember bank would fall under the FDIC, and that of its \$40 billion-asset thrift would come under the OCC.

“It appears that the agencies understand that overlapping stress test requirements are an issue, and they have publicly stated they will attempt to address” it, said a lawyer familiar with the issue who spoke on the condition of anonymity. “However, it remains to be seen whether, in practice, the agencies will be successful in coordinating their efforts, other than in developing the stress scenarios, in a way that will minimize the overlapping burdens on subject institutions.”

Brian Gardner, an analyst with Keefe, Bruyette & Woods, said collaboration will likely rely on a more informal process than the binding nature of a joint rule.

“It will largely be determined by the personalities in place at the various agencies,” he said. “This could be one of those things that is very personality- and relationship-driven.”

But other observers said authorizing the agencies to develop distinct rules makes sense. For example, unlike broader policy aims in Dodd-Frank such as curbs on proprietary trading and required resolution plans, known as “living wills, stress tests are not a new concept.

“Stress tests are merely an outgrowth of the supervisory and exam process. It’s not like living wills or something else that’s new. I suspect that’s how the agencies are viewing it,” said Douglas Landy, a partner at Allen & Overy. “If you have multiple charters, you always have multiple exams. This is like a bigger one.”

Krause Bell said the regulators, while maintaining consistency as a priority, may prefer having separate rules. “When I was in government, the only time regulators would do a common rule was when it was required, because it adds many hurdles to the development process,” she said. “Each agency has its own legal authority and bureaucratic process, and to essentially be dependent on the other agencies’ approval is difficult. It’s easier to stay largely consistent and have separate rules.”

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