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BANK THINK

In Short Term, Stress Tests Destabilize

By Eugene A. Ludwig

One of the biggest changes in modern regulation and supervision has been the stress test and capital conservation standards developed by the Federal Reserve and required in regulation by the Dodd-Frank Act.

These are significant not merely for the depth and breadth of the exercise, nor for the severe consequences being utilized to compel compliance, including enforcement orders, dividend restrictions, and increased capital requirements. The results of this process are being made public and will be the broadest disclosure to date of bank hypotheticals.

Of course, stress testing, utilizing various analytical scenarios, is a sound business practice, and one that is certainly not new. For some time now virtually every well-run bank has had some forms of stress testing that it has applied to the evaluation of its operations.

I personally have attended board meetings of banking companies in this country and abroad where detailed discussions were had with the boards, business management, and risk managers on how various scenarios would play through the bank's balance sheet and income statements, were such stress-testing scenarios to become real.

What is new with respect to stress testing is the way the Fed and

Dodd-Frank have institutionalized the process, and in doing so, have transformed it into a new cornerstone of supervision. Consider these facts:

- The required frequency of the exercise has been set at twice a year for the largest bank holding companies and once a year for bank holding companies over \$10 billion.
- For the annual exercise, the regulator sets the downside parameters and runs its own stress tests against which the banking company's internal tests are graded.

Stress testing is here to stay. Banks should prepare for the increasingly public nature of this exercise.

• Some form of stress testing is now required for all banks above \$10 billion in asset size and for all significantly important nonbank financial institutions – though since the latter companies have not been named, it is too soon to tell how important this requirement will be to them.

• The Fed expects banking companies to meet a 5% equity-to-risk-based-assets test under stress scenarios while still ramping up to Basel III standards.

• Results of these tests are to be disclosed publicly, meaning that an



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unprecedented amount of information about hypothetical bank financial models will be open to scrutiny.

As with most supervisory procedures that regulators have been pursuing these days, the bar has been getting higher each year, and banks can expect the same with respect to stress testing.

Equally important, the regulators won't give banks an "A" for merely having taken the test and come out with the right answers. Banks have to show the steps that led them to the answers and those steps have to satisfy the regulators as substantively sound. The emphasis is on having robust practices, procedures and data quality.

Some banks have come up with perfectly correct answers but have been severely criticized because their systems are outdated and their methodologies unreliable and not sufficiently rigorous. Making sure stress-test methodologies are viewed by regulators as rigorous in light of changing standards will be very important indeed for covered organizations.

Of course, if stress-test assumptions are sufficiently extreme – particularly if viewed as producing a systemic, as opposed to an idiosyncratic, event – most banks will struggle to pass the test without adding to capital. Usually, however, the regulators will not push the tests this far.

But extreme or not, it is worth re-emphasizing that the regulators care as much about how a bank plans for dealing with the fallout from a severe shock as whether it can withstand the shock itself.

Historically, regulators and bankers would have made a strong case that this kind of supervisory effort, however important, should absolutely be kept private.

Supervisory secrecy has long been

viewed as the bedrock of the relationship between supervisors and the supervised, fundamentally over the concern that transparency could lead to liquidity runs that would be damaging, if not catastrophic, for the supervised entity. A secondary, but certainly important, concern has been in respect of client privacy.

This has not been the direction of modern regulation and supervision.

For good or ill (and I believe it is a bit of both) we have been moving to a more mark-to-market and transparent world. The stress testing and capital conservation process that the Fed is championing is clear step toward greater transparency.

In its first effort in this regard, the SCAP in 2009, a combination of the stress-test approach and transparency worked well to calm markets and form a basis for the financial services turnaround.

However, in that case, the government was also standing ready, and was authorized, to provide capital infusions for entities that could not make their capital numbers work with the stress-test results (though in the end, no bank

required this assistance). The same is not necessarily true going forward; since the end of the Troubled Asset Relief Program and the passage of the Dodd-Frank Act, the government has far fewer tools to help fill any capital gap.

Though the public nature of stress testing has been handled well by our government to date, we must also face up to the reality that stress-test transparency can also be destabilizing. We have seen this in respect of the European stress-test protocols.

One thing is for sure: stress testing is here to stay. Banks should expect ever more rigorous capital conservation requirements and stress testing. They should also be prepared for the increasingly public nature of this exercise.

This may ultimately lead to a much safer financial services environment, but in the shorter term, my bet is that it will lead to greater volatility. Powerful medicines often can produce powerful side effects. We need to be prepared for this eventuality.■

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