

# Understanding the Effects of the U.S. Stress Tests

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Macroprudential Policy and Financial Stability  
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# Three Part Presentation

- I. Review paper findings, which were based on data through 2018
- II. Update for 2019 results
- III. Consider effects of proposed changes to CCAR stress tests

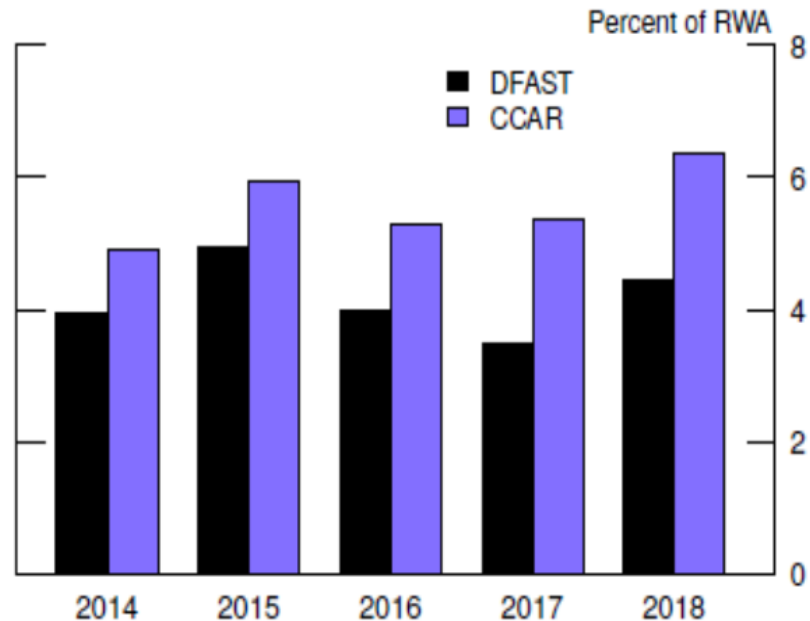
# I. Paper results: tried to answer three questions

1. Have the stress tests helped to counter potential procyclicality of bank capital?

- *Yes, which should help support lending in the next recession, though more from the requirement to pre-fund dividends and share repurchases than the macroeconomic scenarios*

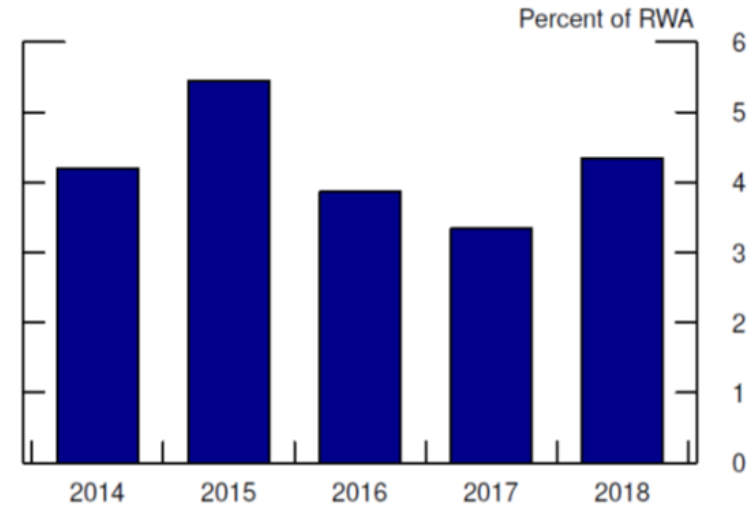
# STCB buffers have risen, but scenario-related losses at GSIBs have not

Stress Test Capital Buffer (Decline in Common Equity Ratio)



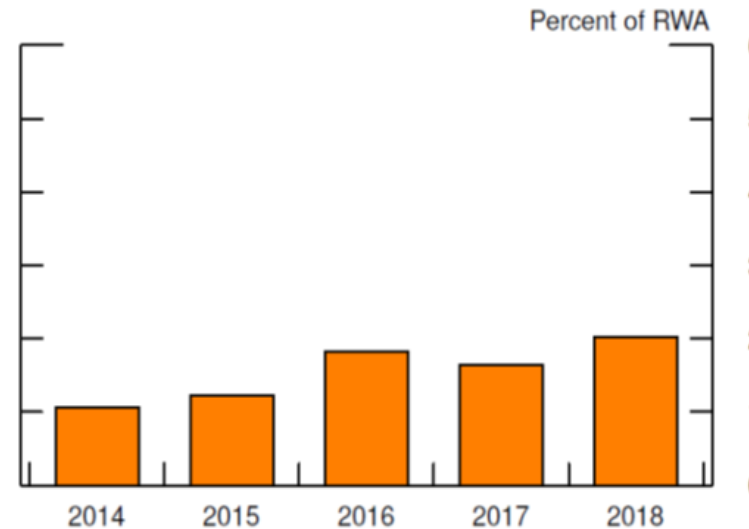
Capital buffer is starting capital minus minimum capital for domestic BHCs.  
Source: Public DFAST and CCAR disclosures

Stress Test Capital Buffer Excluding Dividends, GSIBs



Note: DFAST capital buffer is starting capital minus minimum capital, less estimated dividends for 8 BHCs subject to the market shock and counterparty default.  
Source: Public DFAST stress test disclosures.

Stress Test Capital Buffer Excluding Dividends, Non-GSIBs



Note: DFAST capital buffer is starting capital minus minimum capital, less estimated dividends for other domestic BHCs.  
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# Questions

2. Have the stress tests improved risk management and capital planning at tested institutions?

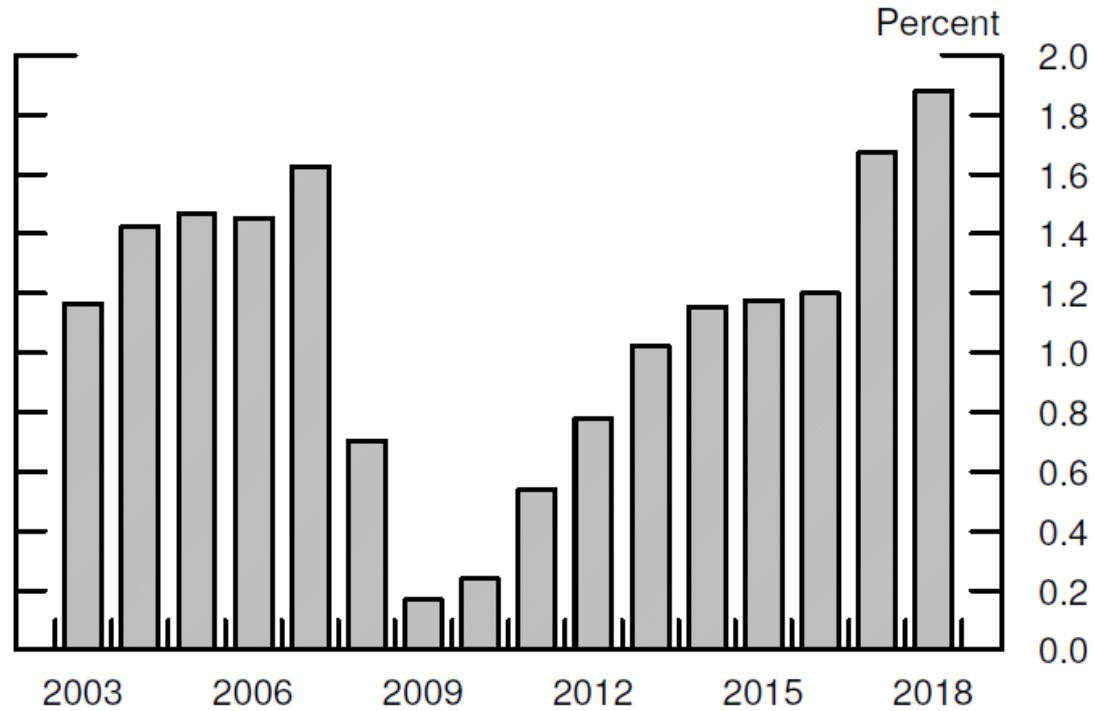
- *Yes, absolutely, driven importantly by the public qualitative assessment*

# Risk management and capital planning greatly improved

- Based on interviews with experts
- Very broad agreement on improvements, driven importantly by the public qualitative assessment
  - Better data: Sufficient, accurate and accessible data to model risks across the entire organization.
  - Better risk identification and measurement: bringing forward-looking tail risk and scenario analysis to loan books and PPNR.
  - Stronger governance: much greater involvement of upper management and directors in risk management and capital planning.
  - Better links between risk identification and capital planning: both CRO and CFO involved in discussions of risks and distributions.

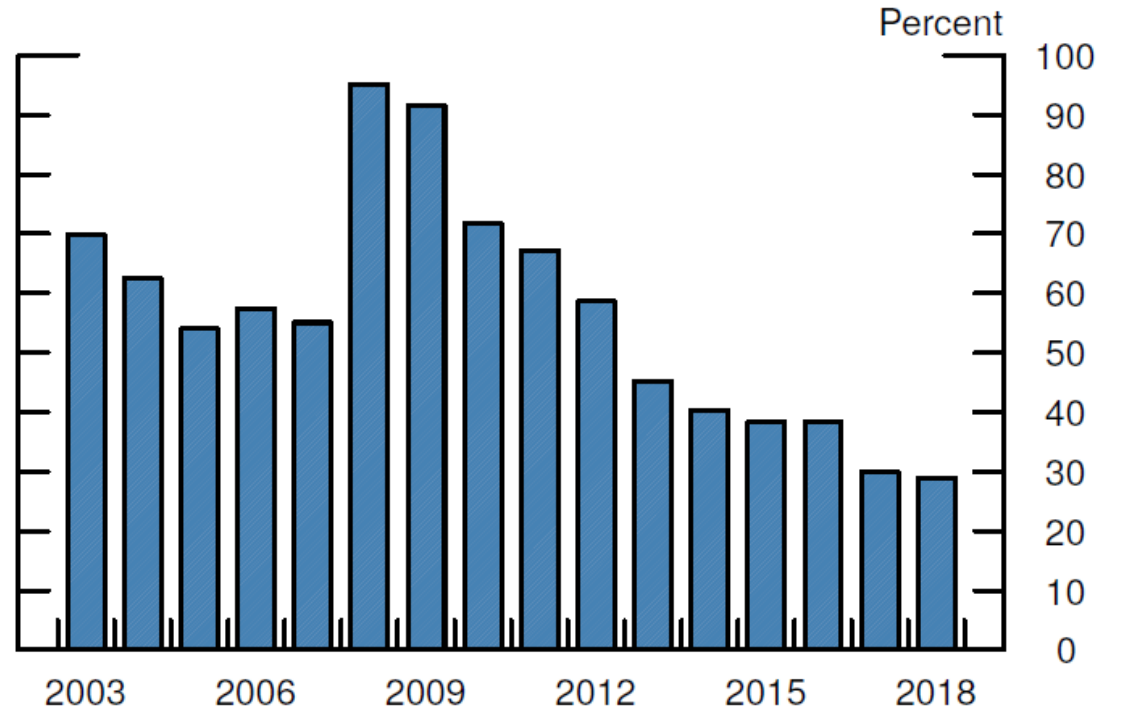
# Shareholder payouts rising, but dividend share is lower

Mean Total Payouts/RWA, 2003-2018



Source: FR Y-9C.

Mean Dividends/Total payouts, 2003-2018



Source: FR Y-9C.

# Questions

3. Have the stress tests affected the cost and availability of credit from the largest banks?

- *Yes, but this may be a feature rather than a bug*



Credit for businesses from the stress-tested banks is reduced but total business borrowing may not be

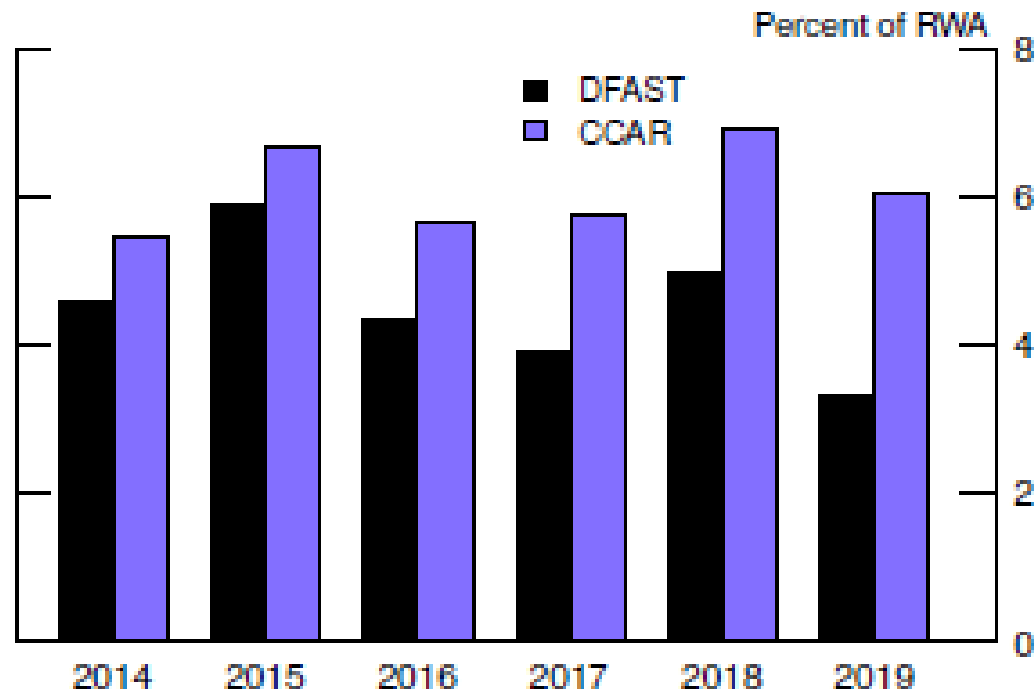
- Based on a number of studies, but difficult to isolate effects of stress tests from other regulatory and market changes
- In general, higher C&I loan spreads, reduced credit, and shift to less risky loans from banks with larger stress test capital buffers
- However, studies that use loan-level data and can control for demand at the borrower or local market level find no material effect on business borrowers
  - Large business borrowers have alternatives
  - Small businesses have fewer alternatives, but county-level data suggest that county credit growth is not related to stress test exposures as smaller banks have increased their share of lending when non-local stress-tested banks pull back

Bank credit from the tested banks is reduced  
... but may be a feature not a bug

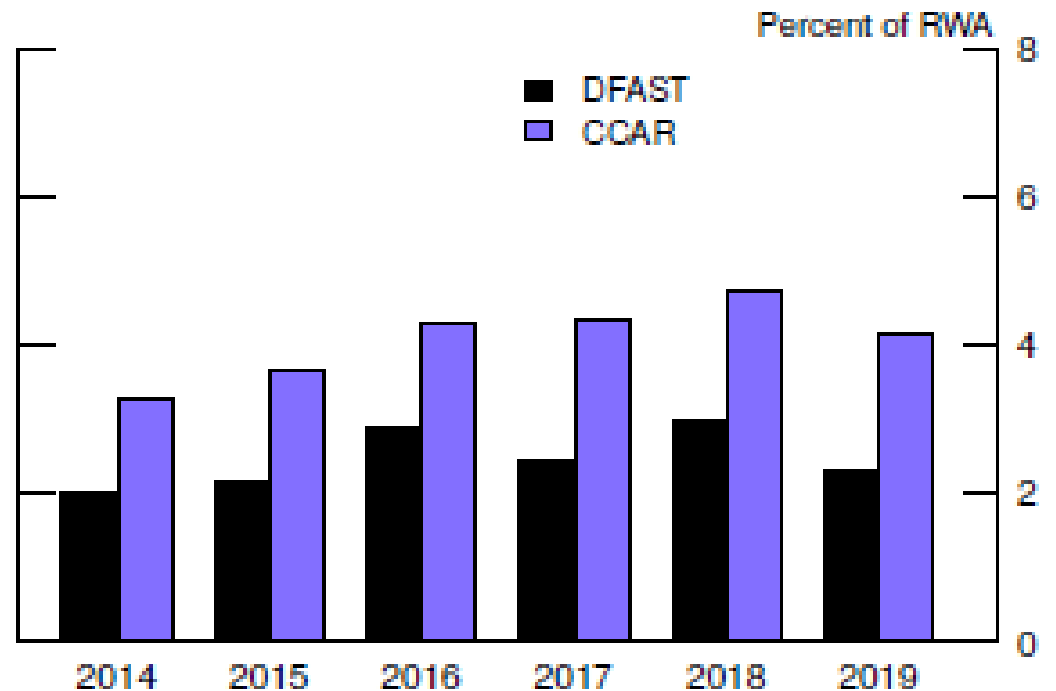
- Credit growth was rapid before the crisis
- Reforms that reduced some credit growth in exchange for lower probability of failure of the largest banks with the greatest externalities could well be welfare-enhancing
- Studies have looked during transition periods and long-run effects may be lower

## II. 2019 DFAST and CCAR capital buffers declined. Prefunded payouts rose...

Stress Test Capital Buffer (Decline in Common Equity Ratio): GSIBs

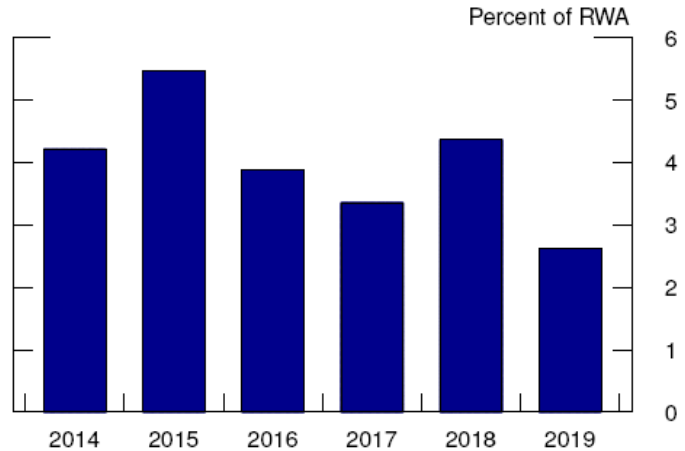


Stress Test Capital Buffer (Decline in Common Equity Ratio): Non-GSIB BHCs



# ...but there was a sharp drop in losses in the severe scenario

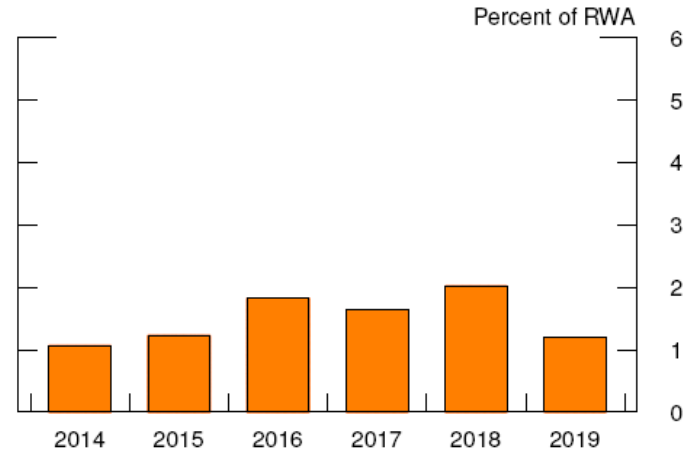
Stress Test Capital Buffer Excluding Dividends, GSIBs



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Source: Public DFAST stress test disclosures.

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Effects of slow runoff of pre-2008 assets together with improving portfolios in an expansion more than offset the countercyclicality of the scenario.

Policy implication: If the US wants countercyclical bank capital, it will need to make active use of the CCyB.

III. Some of the **proposed changes** to stress tests will make them less effective macroprudential tools

1. Substantially reducing the prefunding requirement for distributions will make the stress test capital buffers procyclical. (2018 proposal)

2018 proposal retains prefunding for four quarters of dividends, but (in a speech) Vice Chairman Quarles prefers no prefunding and would substitute either a CCyB, which could be countercyclical if used aggressively, or a higher minimum buffer which would be static.

Some of the **proposed changes** to stress tests will make them less effective macroprudential tools

2. Eliminating the *public* “qualitative” objection to capital plans based on deficiencies in risk management and other aspects of capital planning takes pressure off banks to invest in risk management technology and to involve boards intensively in oversight. (already implemented)
3. Eliminating the 30 percent “soft limit” on dividends as a proportion of distributions will tilt distributions to dividends and away from share buybacks, which are easier to trim in a stress situation. (2018 proposal)

Some of the **proposed changes** to stress tests will make them less effective macroprudential tools

4. Assuming a constant balance sheet and RWAs in the stress test instead of a small increase will reduce the stress capital buffer and runs counter to the messaging that the point of the tests is to insure that banks can continue to lend in bad times as well as good. (2018 proposal)
5. Moving the leverage ratio more definitively into a backstop role in the stress test will lower effective capital requirements for some GSIBs. (VC Quarles speech)

Thank you