Minutes of the June 8 2012 Financial Advisory Roundtable (FAR) meeting

Present: FAR Members: Terry Belton, Markus Brunnermeier, Darrell Duffie, Mark Flannery, Laurie Goodman, John Geanakoplos, Charles Himmelberg, Andrew Kuritzkes, Tano Santos. FRBNY staff: Tobias Adrian, Christine Cumming, Sarah Dahlgren, William Dudley, Krishna Guha, Beverly Hirtle, Antoine Martin, Jamie McAndrews, Meg McConnell, Sandra Krieger, Joseph Tracy.

The overall topic for this meeting was the design and implementation of supervisory stress tests. The meeting commenced with two prepared discussions from roundtable members highlighting different aspects of stress tests and capital planning (slides of those discussions are available online at http://www.newyorkfed.org/aboutthefed/far.html). These discussions were followed by an open discussion, focusing on the issues listed in the meeting agenda.

The main topics discussed were as follows:

Design of macroeconomic scenarios

Several issues were discussed relating to the specification of macroeconomic scenarios used for stress testing. These included 1) how to determine the appropriate severity of the scenarios, 2) consequences of the assumption that macroeconomic variables follow a fixed path, rather than being influenced endogenously by the outcome of the stress test, 3) the costs and benefits of specifying a larger number of scenarios, rather than a single scenario, 4) whether macroeconomic scenarios should be tailored to firms based on the types of risks they face, or should be common across firms.

Members also discussed the risks of misjudgments in selecting scenarios, and particularly whether scenarios developed prior to the financial crisis would have appropriately accounted for risks facing the economy at that time, especially to housing. Members had differing opinions as to whether using a larger number of scenarios could mitigate these problems, and about how a larger number of scenarios would be utilized by supervisors in practice.

Liquidity stress testing and feedback effects

Members highlighted the importance of stress testing banks' liquidity and access to funding during adverse periods. It was noted that the recent U.S. supervisory stress tests (the Comprehensive Capital Analysis and Review, or CCAR) focuses on capital adequacy, rather than liquidity. Members noted that bank access to funding can deteriorate rapidly, even for well-capitalized institutions, and that uncertainty and feedback loops make it difficult to model liquidity risk and liquidity stress events.

It was also argued that liquidity stress tests should extend through bankruptcy, allowing supervisors to evaluate whether a failed firm could continue to provide economic services while being reorganized.

Several members argued that liquidity stress tests should take into account access to lender of last resort facilities provided by the official sector. Members also discussed the extent to which there is a tradeoff between liquidity and capital adequacy. Some members argued that higher capital helps maintain confidence in a firm's financial position, and can act as a substitute for a more liquid balance sheet. Some suggested that linking the two in regulation could be useful (e.g. requiring firms with lower liquid assets or greater funding risks to hold more capital).

Members also discussed the relative merits of different measures of liquidity, as well as the liquidity rules developed in Basel III, particularly the liquidity coverage ratio.

More broadly, members described how feedback loops can exacerbate the effect of an initial negative shock to a financial firm. One example given was that predatory trading can make it difficult for a bank to quickly unwind loss-making positions. It was suggested that liquidity and capital requirements can amplify shocks, unless relaxed during periods of stress.

Risk management
Members highlighted the importance of promoting strong internal risk management systems and internal stress tests within financial firms, rather than a reliance by firms on supervisory stress testing standards. It was noted that bank supervisors regularly evaluate the quality of risk management practices, and that the CCAR involves an assessment of firms' internal capital planning processes, in addition to a supervisory stress test.

Credibility and timeliness of stress tests
Members noted the importance of credibility for effective stress tests. The 2009 Supervisory Capital Assessment Program (SCAP) was cited as an example of a credible test, in part because of public funds were available through the Capital Assistance Program (CAP)as a backstop in case firms asked to raise capital could not do so in private markets. It was noted that supervisors currently have access to a range of tools to strengthen firms' capital adequacy, including requiring firms to reduce dividends or raise capital. Members also noted the importance of conducting regular, frequent stress tests, in order to identify system fragilities in a timely way. Members also discussed the European experience with stress testing, in the context of the overall financial turmoil facing Europe.

Specialized firms
Members questioned how best to conduct stress testing for specialized firms such as custodian and processing banks. It was argued that, particularly for such firms, stress testing

should not just focus on capital projections, and that other metrics could be more informative about the firm's ability to continue as a going concern.

Microprudential versus macroprudential stress testing

Members broadly agreed that supervisory stress tests should take macroprudential concerns into account, and should attempt to ensure that the financial system as a whole could continue to provide core financial services during a period of adverse conditions. Members expressed a range of opinions about whether stress testing as currently implemented in the U.S. reflects a macroprudential approach.

Disclosure

Members expressed a range of views about the costs and benefits of greater disclosure of stress testing models and results. It was noted that the disclosure of stress testing results could trigger a bank run or loss of confidence unless accompanied by a plan to stabilize firms facing financial distress. It was also suggested that supervisors should be transparent up-front about what type of information is to be made publicly available at the conclusion of the tests. Members also suggested that disclosing a large amount of information about failed firms could be beneficial.