

In Praise of Stress Tests

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A. Introduction

Several interconnected generic problems with financial regulation.

- 1) Financial regulators generally have no (democratic) legislative competence. Hence feel unable to impose (a ladder of) sanctions.
- 2) They *are* accorded right to licence, and hence to withdraw licence of credit institutions, but a 'nuclear' option.
- 3) Solution has been ratio controls, maintained by peer pressure and reputation, and trigger for authorities' investigation, and possible closure.

B. Problems with Ratio Controls

- D.H. Robertson saw as early as the 1920s.
- Restated by Milne and Hellwig.
- A cliff-edge system, both micro and macro, made worse by potential stigma effects.
- Peter Cooke and the BCBS.
- Concern over imposition of a ladder of sanctions may now be eroding (Conservation ratio) in Basel III.

C. Recovery and Resolution

When a reform is two-pronged, one prong is often much stronger than another. A few examples:-
EMU, C&CC, BRRD.

Recovery more desirable than Resolution, and all SIFIs must now prepare a recovery plan ('living wills').

But when?

- 1) EBA – Bankers call time on themselves?
- 2) Econometric – Goodhart and Segoviano, IMF (2015).
Based on Merton type measures and empirics. But neither bankers nor PRAs will want to follow.

So too late, and ineffective.

D. Stress Tests, (accounting/statistical basis, i.e. mark-to-crisis, much better than mark-to-market)

Can help to mitigate both problems:-

If under plausible stress, certain banks would have insufficient capital/liquidity, then:-

- 1) Initiate recovery mechanisms.
- 2) Impose sanctions until ratios improve.

But,

- If results published, stigma;
- If results confidential, suspicion (no confidence, but UK).

So, if results published, essential to have backstop. Problem of market access under stigma. Essential to have prior financing arranged, could be from some kind of banking insurance fund or public sector.

- US/Scandinavia – TARP
- Europe?

E. Other Problems

- 1) Occasional. And may not address the weakness that turns out to be relevant.
- 2) May relate to the wrong ratio, (RWA vs. leverage).
- 3) Does not deal with interactive, second-round effects.

Nevertheless stress tests are here to stay and will remain a valuable part of the regulatory system.