Reforming Bank Stress Tests
—by Ashali Singham MPP '13

The Dodd-Frank financial reform legislation was designed to mitigate the risks of another financial crisis. Part of that reform involved instituting annual stress tests – tests designed to see how well banks can handle adverse situations. But these stress tests could be improved to reduce the risk of financial problems. A Regulatory Policy Program event on March 20, 2012 covered possible ways to reform stress tests. This event featured Anil Kashyap, the Edward Eagle Brown Professor of Economics and Finance at the University of Chicago Booth School of Business, who discussed his co-authored paper “Stressed Out: Macroprudential Principles for Stress Testing.”

Kashyap discussed how stress tests currently focus primarily on the amount of risk in the loans that banks make, and whether the bank will require some sort of taxpayer bailout. But he argues that these stress tests ignore a fundamental issue on the other side of a bank’s financial ledger – the wholesale funding levels and interconnections among banks.

He argued for a macroprudential approach that aims to reduce the risk of market contraction. He argued that wholesale funding and interconnectedness lead to bank runs, contraction of the market, and deleveraging. He also discussed how banks might still be solvent after economic shocks at a medium level, but might have contracted dramatically, leading to problematic economic effects.

Kashyap presented five “lessons” for stress tests: regulators should review wholesale funding as well as the quality of the loans on a bank’s books, regulators should assess what happens with wholesale creditor runs and other shocks, capital requirements should be placed in absolute terms, banks that are solvent should still have capital requirements, and liquidity should be considered.

The seminar was part of a series sponsored this spring by the Regulatory Policy Program (RPP) at the Mossavar-Rahmani Center for Business and Government on the role of cost benefit analysis in regulatory policy and new directions in financial regulation. For information, go to: http://www.hks.harvard.edu/m-rcbg/rpp/index.html