CCAR Issue Summary

The Federal Reserve uses its Comprehensive Capital Analysis & Review (CCAR) stress testing framework to measure the ability of banks to withstand a very severe economic downturn. Under CCAR, the Fed runs its own proprietary models to determine the effect of various scenarios on banks' capital adequacy. To pass the Fed's stress test, a bank must show it not only has sufficient capital to avoid failure, but to do so without taking any defensive actions that would be considered normal under such scenarios. CCAR has now become the binding capital standard for the largest banks.

BPI's Position

Bank capital regulation has played an essential role in building a stronger and more resilient banking system. Stress testing is an important and effective tool to evaluate risk and to serve as validation of the strength of the system. However, the current approach to CCAR inhibits economic growth and lacks appropriate levels of transparency, predictability, and accountability. It is thus important to consider how CCAR can be improved because stress tests have a direct impact on economic growth.

Recommendations: 1. Greater transparency and rigor should be brought to bear to CCAR by subjecting the annual stress test scenarios to a 30-day public notice and comment period and disclosing models to the public. 2. CCAR accuracy should be improved by correcting the counterfactual and inaccurate assumptions about how banks would behave in a crisis. For example, CCAR assumes that balance sheets grow and stock buybacks continue during the crisis scenario.

Limits Economic Growth

Banks pass or fail CCAR based on their projected levels of capital under stress. Recent stress tests have required banks to demonstrate that they would remain well-capitalized even if unemployment rose 6 percentage points while the stock market fell 62%. The excessively high capital levels needed to pass CCAR have a direct impact on lending to consumers and small businesses. The CCAR framework translates into a real constraint on lending, economic growth and liquid capital markets. Specifically, banks must hold significantly high amounts of capital against small business lending and mortgage lending to pass the test.

Lacking Transparency

The Fed's CCAR scenarios are highly opaque, relying on macroeconomic scenarios that are never published for public comment and are conducted under a series of unidentified models. The Fed uses its own internal models to estimate stressed credit losses and net revenues but provides virtually no detail regarding the statistical specifications of these models. Critics argue that clarity on the Fed scenarios would amount to a "teaching to the test" process by banks. Instead, as Vice Chairman of Supervision Randal Quarles has stated, this is akin to giving banks a textbook, not the test itself.

CCAR Scenarios Are More Extreme than the Fed's Own Standard

The severely adverse scenario in CCAR is far more sudden and stressful than that of the 2008 financial crisis, and significantly worse than even the Fed's own self-imposed standards that stress tests be consistent with "post-war U.S. recessions," including an increase in unemployment more severe than the 2008 financial crisis. CCAR bases its capital assessment not on a bank's current financial condition or how it assets are likely to behave in the future, but rather on how they would behave under a single exceedingly unlikely scenario. The severity of stress scenarios in CCAR disincentivizes banks to lend to borrowers with less than pristine credit scores because the risk of such borrowers rises significantly under the stress scenarios.