

# DOWNLOAD PDF INTERNATIONAL FINANCIAL GOVERNANCE UNDER STRESS

## Chapter 1 : The European Crisis and the role of the financial system

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Despite a more severe adverse scenario than in the stress test, the average CET1 capital ratio of all 33 banks after a three-year stress period was higher at 9. The EBA published the stress test results today on its website. Owing to their efforts to address legacy assets together with the consistent build-up of capital in recent years, the average capital base of the 33 banks when they entered the stress test was much stronger, with Common Equity Tier 1 CET1 standing at 10. The scenario focuses on the repricing of global risk premia, adverse feedback loops between low growth and weak bank profitability, and private and public debt sustainability concerns. These risks were identified by the ESRB at the end of last year as the most relevant for European economies. The scenario does not take into account more recent events. With an assumed euro area gross domestic product (GDP) contraction of 2.5%. The larger capital depletion reflects not only a more severe macroeconomic scenario, but also the introduction of International Financial Reporting Standard 9. This new accounting standard requires banks to provision for expected losses from impaired loans earlier in the credit cycle, at least those banks that did not benefit from a phasing-in period. The impact of the scenario was also stronger owing to changes in the stress test methodology. On a positive note, having reduced their volumes of non-performing loans, banks benefited from improvements in asset quality. The overall high level of resilience achieved by the euro area banking system, however, should not hide the fact that challenges remain, and that there is still work to be done on business models and legacy issues. The ECB will carefully monitor developments in these areas. Earlier this year, the ECB also tested the four Greek banks it directly supervises. While following the same methodology and approach as the EU-wide EBA stress test, it followed an accelerated timetable to complete the test before the end of the third European Stability Mechanism support programme for Greece. Supervisors ask banks to build up Pillar 2 capital as a prudential capital buffer in addition to the legally required minimum capital. The EBA stress test covers a wide sample of 48 banks across 15 countries. Unlike the Bank of England stress tests it uses a constrained methodology that does not take account of actions banks would take in a real stress, such as cutting employee remuneration. Despite these constraints, UK banks show they could absorb the effect of the EBA stress scenario in their capital buffers. The results of the Bank of England stress test will be published on Wednesday 05 December. Transitional capital arrangements are in place to allow the effect of this new standard to be phased in over time. The EBA has also published stress test results on the basis that the new accounting standard is fully phased in. The Bank will similarly publish the results of its stress tests on the basis of both the transitional and full new accounting standard. As the Bank has stated previously and is shown by the EBA test results, the new accounting standard will result in bigger drawdowns of capital in stress tests as more provisions are made earlier. The Bank announced in March that it would, subject to some constraints, take steps to avoid an unwarranted de facto increase in bank capital requirements, which could result from the interaction between IFRS 9 and the stress-testing framework.

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## Chapter 2 : Basel III: international regulatory framework for banks

*The Asian crisis was the worldeconomy's closest shave since the Latin American debt crisis of the early s and, arguably, since the Great Depression of the s. A combination of currency and financial crises which erupted in east Asia during mid- and late rapidly developed into a global.*

Abstract Persistent episodes of global financial crises have placed the existing system of international monetary and financial governance under stress. The resulting economic turmoil provides a focal point for rethinking the norms and institutions of global financial architecture and the policy options of public and private authorities at national, regional and transnational levels. This volume moves beyond analysis of the causes and consequences of recent financial crises and concentrates on issues of policy. Written by distinguished scholars, it focuses on the tension between global market structures and national policy imperatives. Accessible to both specialists and general readers, the analysis is coherent across a broad range of theoretical and empirical cases. Offering a series of reasoned policy responses to financial integration and crises, the volume grapples directly with the institutional and often-neglected normative dimensions of international financial architecture. The volume thus constitutes required reading for scholars and policy-makers. Suggested Citation Underhill, Geoffrey R. To find whether it is available, there are three options: Check below whether another version of this item is available online. Perform a search for a similarly titled item that would be available. More about this item Access and download statistics Corrections All material on this site has been provided by the respective publishers and authors. You can help correct errors and omissions. See general information about how to correct material in RePEc. For technical questions regarding this item, or to correct its authors, title, abstract, bibliographic or download information, contact: General contact details of provider: If you have authored this item and are not yet registered with RePEc, we encourage you to do it here. This allows to link your profile to this item. It also allows you to accept potential citations to this item that we are uncertain about. We have no references for this item. You can help adding them by using this form. If you know of missing items citing this one, you can help us creating those links by adding the relevant references in the same way as above, for each referring item. If you are a registered author of this item, you may also want to check the "citations" tab in your RePEc Author Service profile, as there may be some citations waiting for confirmation. Please note that corrections may take a couple of weeks to filter through the various RePEc services. More services and features.

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## Chapter 3 : EBA Stress Test - Banks Are More Resilient To Financial Shocks, Barclays and Lloyds Are Lag

*"Persistent episodes of global financial crises have placed the existing system of international monetary and financial governance under stress. The resulting economic turmoil provides a focal point for rethinking the norms and institutions of global financial architecture and the policy options of public and private authorities at national.*

Clark and Lisa H. Ryu 1 Federal Reserve Board 1. Introduction The financial crisis of 2009 highlighted a number of deficiencies in the risk measurement and management practices and in the financial resiliency of large, systemically important financial institutions. In short, the crisis made clear the need for more robust supervisory and internal capital adequacy assessment processes at BHCs that incorporate a comprehensive, forward-looking assessment of capital adequacy under a variety of stressful scenarios, as well as the need for better firm-wide risk identification and measurement practices to support this analysis. The annual stress tests conducted by the Federal Reserve supervisory stress test and the Comprehensive Capital Analysis and Review CCAR were designed as complementary programs to strengthen both supervisory assessments of capital adequacy and the processes through which large, complex BHCs internally assess their capital needs. By ensuring that the largest BHCs each have sufficient capital to withstand significant stress and continue to operate, these programs can also help the Federal Reserve meet its macroprudential supervisory objective of ensuring that the financial system as a whole can continue to function under adverse conditions. Supervisory stress tests provide the Federal Reserve with a concurrent, forward-looking assessment of capital adequacy across large, complex BHCs, using a common set of scenarios, models, and assumptions to support comparability. The remainder of this chapter is organized as follows. First, we will briefly describe the evolution of stress testing and related supervisory capital assessment programs since the Supervisory Capital Assessment Program SCAP in 2009. Second, we will discuss key features of and considerations for supervisory stress tests. Finally, we conclude the chapter with some additional thoughts about the role of CCAR. How did we get here? SCAP – The Beginning Although both supervisors and financial institutions conducted various forms of stress testing prior to the crisis, the genesis of the current supervisory stress tests and CCAR dates back to early 2008, when supervisors conducted simultaneous stress tests of the 19 largest U.S. At the time of the SCAP, the 19 BHCs faced unprecedented deterioration in economic and financial market conditions and the medium-term outlook remained highly uncertain. Investor confidence in the financial health of the banking system was low and negative sentiment was exacerbated by the uncertain outlook. The SCAP sought to address this uncertainty by quantifying the potential effect on capital of further deterioration in the economic environment—to a level that was unprecedented post World War II. Specifically, the SCAP stress test assessed potential losses and capital shortfalls at the 19 large BHCs under a uniform scenario that was, by design, even more severe than the expected outcome at that time. The design of the SCAP stress test partly reflects a view that ensuring that large BHCs have sufficient capital to weather a worse-than-expected outcome could mitigate the propagation of adverse shocks to the financial markets and the economy as a whole. In addition, the U.S. Treasury Department provided a capital backstop in the event any of the 19 BHCs that were found to be in need of capital that is, had post-stress tier 1 common equity ratios below 4 percent or tier 1 risk-based capital ratios below 6 percent under the SCAP were unable to raise that equity in private markets. Notably, while 10 out of 19 BHCs that participated in the SCAP failed to meet the post-stress capital target, almost all BHCs with projected capital shortfalls were able to privately raise sufficient equity after the public release of the SCAP results. The stress tests conducted under the SCAP tested the capital adequacy of the 19 BHCs in a meaningful way—using a severe scenario that yielded estimates of significant potential losses and declining revenues, and a substantial reduction in capital—which supported the perceived credibility of the exercise. In addition, supervisors released bank-by-bank results, the first time such a public disclosure of supervisory information was made. The public disclosure, which included projected losses by asset type and capital shortfalls relative to the post-stress target, reduced the information asymmetry between the market participants

and BHCs. Overall, the combination of the widely perceived credibility of the SCAP stress test and the public disclosure of the results helped reduce uncertainty about the financial health of the large BHCs and restored confidence in the U. CCAR and Dodd-Frank Act Stress Tests Building on the lessons learned from the SCAP, the Federal Reserve initiated CCAR in late to assess the capital adequacy and the internal capital planning processes of large, complex BHCs and to explicitly and permanently incorporate the forward-looking capital assessment provided by stress testing into the supervisory evaluation of capital adequacy. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act of Dodd-Frank Act required the Federal Reserve to conduct annual supervisory stress tests under three scenarios--baseline, adverse, and severely adverse--and to publicly disclose the results of the stress tests. As a result, supervisory stress tests conducted under the Dodd-Frank Act incorporate a standardized set of capital action assumptions: The inclusion of the baseline planned capital actions tests whether the BHCs would remain above the minimum post-stress supervisory targets even if they maintained their planned capital actions and the stressful conditions were realized. Public disclosure continues to be an important feature of stress testing, and of CCAR. In the spring of , the Federal Reserve published the results of its supervisory stress tests under the severely adverse scenario conducted under the Dodd Frank Act for 18 BHCs. Notably, the aggregate tier 1 common equity ratio of the 18 BHCs that have participated in CCAR through has more than doubled in the nearly five years since year-end , from 5. In addition, CCAR is leading to improvements in risk measurement and capital planning practices across the firms. Key Features and Considerations for Supervisory Stress Tests The Federal Reserve conducts concurrent supervisory stress tests for all large BHCs, based on the same set of scenarios and models, providing a comparable view of capital adequacy across large BHCs. The concurrent nature of the supervisory stress tests and CCAR allows the Federal Reserve to take a cross-BHC perspective and an aggregate industry perspective across time in its assessment, serving both microprudential and macroprudential objectives. While some of the key elements of the supervisory stress tests--including a common set of scenarios, concurrent stress testing of a large share of the U. Currently, supervisory stress tests use extensive data collected at regular intervals from the BHCs through regulatory reports. In addition, the data collection created strong incentives for large BHCs to develop internal processes that allow for better aggregation across different systems and to provide very detailed data about their borrowers, positions, and sources of revenue. A positive byproduct of the supervisory stress test has been enhancements in the data BHCs themselves now have available for use in their risk measurement and capital planning. In part due to the detailed data that are now available, supervisory models have become both more independent and more sophisticated, allowing the Federal Reserve to project revenue, expenses, and losses using the data provided by the BHCs, without relying on BHC estimates. The increasing independence of the supervisory models not only further enhances the comparability of results across BHCs, but also supports the credibility of the results. While the supervisory stress scenarios contain severe stresses that would likely affect BHCs broadly, they are not meant to provide an all-encompassing assessment of the potential stress events or risks each BHC faces. Rather, supervisory scenarios are designed to identify and stress vulnerabilities to common risk factors across BHCs, even if these scenarios may not necessarily be the most severe scenarios for each individual BHC. While these objectives are similar to more traditional supervision program elements, they differ in their focus on forward-looking stress analysis in the capital planning process. For example, with CCAR, supervisors expect the BHCs to identify, measure, and capture their risk exposures, and also to consider how risks may emerge and grow under stress. In addition, supervisors also expect key decisionmakers within each BHC to consider a variety of stress scenarios in the analysis supporting their assessments of capital needs and capital distribution decisionmaking. These BHC scenarios are expected to capture BHC-specific, idiosyncratic risks, in addition to a broad macroeconomic downturn that characterizes the supervisory scenarios. The qualitative assessment covers a broad array of supervisory expectations around risk-identification, risk-measurement, and risk-management practices that BHCs use to support their capital planning and internal stress tests, including practices used to estimate stressed net revenue and stressed losses, and the governance and controls around

these practices. As noted by a number of observers, to avoid the danger of a "model monoculture,"<sup>15</sup> it is important to ensure that BHCs develop internal models that best capture their own risks, rather than relying on models that closely mirror supervisory models. The public disclosure provides significant information about the financial health of large BHCs, and improves the transparency of supervisory assessments of the capital adequacy of these firms. The Federal Reserve has also disclosed an overview of the models used to conduct supervisory stress tests. The overview of supervisory models published in the spring of 2009 and was comprehensive, but stopped short of revealing the exact specifications of the models or parameter estimates in order to reduce the risk of model convergence. However, some observers continue to express concerns about the extent of current stress test and CCAR disclosure, particularly as the stress testing becomes an annual exercise, arguing that the bank-level disclosure may damage market discipline. They argue, for example, that bank-by-bank disclosure of results may diminish the usefulness of market prices if it creates a disincentive for investors to obtain and produce private information about the banks. Given a widely held view among supervisors and most third-party observers that the public disclosure of stress testing results enhances available information and supports market discipline, it will continue and it is perhaps even likely to be expanded over time. This disclosure provides more information for investors and other market participants than was previously available. It is important to note, however, that while providing valuable information to market participants, supervisory stress testing results that are disclosed annually are not meant to be a substitute for market prices, or for other privately developed information about the strength and performance of BHCs, that are available at a much higher frequency. Rather, the information this disclosure provides should be seen as complementary to these other sources. Given the breadth of information market participants typically utilize in analyzing large BHCs, it is difficult to envision that the generation of other information critical for market participants in conducting their business each day would be reduced simply because of the annual disclosure of stress testing results. Indeed, given the reality of minimum regulatory capital requirements, such incentives have always existed and would exist irrespective of public disclosure of stress test results. Finally, disclosing aggregate but not bank-specific results could be viewed as masking important information about specific banks, undermining the credibility of the supervisory stress tests and potentially creating or exacerbating market uncertainties. It is also important to note that publishing stress testing information promotes high-quality supervision, as the disclosure serves as a commitment device and holds supervisors accountable. In the SCAP, the disclosure of capital shortfalls clearly held supervisors accountable for producing sound stress test results and following through to ensure banks raised the necessary capital. The annual CCAR disclosure reinforces supervisory accountability for similar reasons. The minimum supervisory post-stress capital targets are set clearly: BHCs must meet all minimum regulatory capital ratios that will be applicable over the stress test planning horizon, 18 and a 5 percent tier 1 common equity ratio, all post-stress. The implications of falling below those targets or of having capital planning practices that do not meet supervisory expectations are also clear. Perhaps rather than limiting disclosure, the more relevant response to concerns about supervisory disclosure is to ensure that scenarios and supervisory models do not remain static over time and to balance the need for transparency of supervisory models against the need to create an incentive for banks to create their own models and to appropriately manage their portfolio risks. Conclusion Stress testing and the related supervisory expectations for capital planning have fundamentally changed the way the capital adequacy of large, complex BHCs are assessed by both supervisors and the BHCs. BHCs now consider post-stress capital ratios, in addition to current capital ratios, when making decisions around capital allocation and capital actions. As a result, many view CCAR as an alternative measure of a capital buffer above the regulatory minimum, one that in some cases may be more binding than the buffers that already exist in point-in-time regulatory capital requirements. Based on this view, some argue for full transparency and greater consistency over time both in supervisory scenarios and supervisory models used to support stress testing and CCAR to provide greater certainty of the outcome. While some consistency over time may be desirable, moving toward a more formulaic or rule-based approach that remains mostly unchanged over time

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would undermine the main strength of stress testing--namely, the flexibility to adapt over time to shifting economic environments, business models and products, and risk-taking behaviors. Given the inherent uncertainty about the environment in which BHCs operate, stress testing should also incorporate such uncertainty. In addition to large BHCs, stress testing will be used to assess the capital adequacy of systemically important nonbank financial institutions with business models and risk profiles that are materially different from BHCs. Under the proposed rule for large foreign banking organizations operating in the United States, stress testing would also expand to U. Nevertheless, forward-looking assessments of capital adequacy, supported by strong risk measurement and management, stress testing, and the internal controls and governance processes needed to ensure their integrity will likely remain the core element of supervisory expectations around capital planning. The opinions expressed in this chapter are views of the authors and do not necessarily represent the views of the Federal Reserve Board or the Federal Reserve System. We also thank Sarah Harper for her editorial review of the draft. Return to text 2. Summary Instructions and Guidance November Return to text 3. The tier 1 common capital ratio is defined as tier 1 capital less the non-common elements of tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities, divided by risk-weighted assets. Return to text 5. Return to text 6. Stroh, "Macprudential Supervision of Financial Institutions: Return to text 7. Return to text 8. Return to text 9. Return to text However, common stock issuance associated with expensed employee compensation is incorporated in the analysis. Assessment Framework and Results March Bernanke, "Stress Testing Banks: What Have We Learned? Supervisory Stress Test Methodology and Results Starting with CCAR , both supervisory and company-run stress test projections must reflect revised capital rules that will become effective for the largest BHCs on January 1, , with required phasing-in of various components. Return to text Last update:

### Chapter 4 : FRB: CCAR and Stress Testing as Complementary Supervisory Tools

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### Chapter 5 : International Financial Governance under Stress

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