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The Real Stress Scenario Will Be the Next Boom

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Abstract

Do the Federal Reserve's recently released Comprehensive Capital Analysis and Review scenarios pose challenging new questions for bank capital planners, or are they mundane? Last year, the Adverse and Severely Adverse scenarios were very different from each other in nature as well as magnitude. The Adverse event was a mild stagflation, while the Severely Adverse scenario was a severe deflationary depression.

The Real Stress Scenario Will Be the Next Boom

BY TONY HUGHES

Do the Federal Reserve's recently released Comprehensive Capital Analysis and Review scenarios pose challenging new questions for bank capital planners, or are they mundane? Last year, the Adverse and Severely Adverse scenarios were very different from each other in nature as well as magnitude. The Adverse event was a mild stagflation, while the Severely Adverse scenario was a severe deflationary depression.

In 2014, the Severely Adverse scenario envisions conditions similar to those of the Great Recession. This seems very reasonable both for continuity and for the ability to consistently compare capital plans over time. The notion of posing different, potentially interesting questions in the Adverse event has, however, been jettisoned. The middle simulation is now largely a watered-down copy of the Severely Adverse scenario with an overlay of slightly spooked bond markets. This is a very reasonable scenario, though one wonders what it will add to our knowledge of the banking industry over and above what we glean from the Severely Adverse results.

This is a missed opportunity for the banking industry and federal regulators. A broad spectrum of possible macroeconomic events exists, and many of them would pose problems for ensuring bank capital adequacy. Stagflation may not be on top of this list, given that such a scenario reduces the real burden of repayments for debtors, but such an event does pose some interesting challenges on the funding side of the balance sheet. Bank CCAR modeling systems are probably too underdeveloped to capture the nuances of a stagflation versus a deflation scenario, though that does not mean that the question is not worth asking. Models should be able to capture a wide variety of possible economic paths; the fact that they cannot means that the models need to be improved.

Thanks to recent events, several interesting macro scenarios exist. A month ago, the U.S. came excruciatingly close to a government default. How would banks have performed had the crisis not been averted? Many commentators have suggested near-term hikes in short-term interest rates to short-circuit a threat of inflation that has not materialized. What if policymakers succumb to such calls and raise rates at the short end of the curve? What if the dollar crashes? Or surges? What if you're predominantly an auto-loan lender, and used-vehicle prices crash because of a surge in supply? These are all realistic downside events that are probably too similar to the Severely Adverse scenario to be truly groundbreaking.

The most interesting alternative CCAR scenarios are actually on the upside of the ledger. One of the legacies of the CCAR process is that we now know, very well, how bank capital is likely to be sustained in a severe generic recession. Less well-understood is how banks are expected to manage their capital during the next economic boom. In many ways, booms are far more dangerous for banking sector stability than recessions, since the seeds of bank failure are invariably sown during booms.

In Moody's Analytics research, the highest credit losses are observed when a severe recession follows on the heels of a surging economy. Not only does a boom encourage banks to chase volume and revenue, but a strong economy also encourages businesses and households to more fully utilize the credit lines they have already been granted. Once the economy is releveraged, a far better sense of capital adequacy and the efficacy of boom time capital decisions can be obtained. In other words, you need the accelerator to adequately test the performance of car airbags.

Aside from the academic interest in bank balance sheets under boom conditions, there is also a very salient strategic question at play for the Fed. During the next boom, whenever it occurs, banks will try to reduce capital buffers in a bid to double down on the prevailing performance of the economy. They will cite low baseline loss projections as the justification for these actions. If banks have, by this stage, already filed a capital adequacy plan covering a boom scenario, it would be much easier for regulators to remove the punch bowl. Normally during booms, the Fed faces political constraints that preclude it from taking stern action against banks when it is most necessary. If banks had already filed an austere capital plan, the Fed could raise a simple technical compliance issue and not be seen as a stingy party pooper by the broader populace.

The Adverse scenario this year is of some interest to stress testers, but not that much. A lot of sweat and tears will be spilled over the next six months as banks try to understand the effects of the scenario on their capital levels. Will the results of the Adverse scenario add enough value to justify time spent? If not, why bother building the extra scenario? If the results come out roughly halfway between the baseline and the Severely Adverse scenario, exactly how will our understanding of bank capital planning be improved?

Financial institutions would benefit if policymakers included scenarios that pose difficult but highly pertinent questions for banks. With capital levels now high and the threat of major bank failures almost removed, regulators should declare the early battles won and start to refocus on winning the war. One day, soon we hope, the CCAR will be conducted in a booming economy where the battle lines are drawn differently and where political pressure will act to curtail the Fed's ability to be tough with banks.

With a bit of foresight, policymakers could gain a decisive advantage.

About the Author

Tony Hughes

Tony Hughes is managing director of Credit Analytics at Moody's Analytics, where he oversees the company's credit analysis consulting projects for global lending institutions. An expert applied econometrician, Dr. Hughes manages the Moody's CreditCycle and CreditForecast.com products. He has helped develop approaches to stress testing and loss forecasting in retail, C&I and commercial real estate portfolios and lately he has introduced a methodology for stress-testing a bank's deposit book. Currently he is developing ways to streamline the economic scenario building process and exploring ways to simulate economic paths more effectively.

A native Australian, Dr. Hughes was formerly the lead Asia-Pacific economist for Moody's Analytics, before which he held academic positions at the University of Adelaide, the University of New South Wales, and Vanderbilt University. He has been published in leading statistics and economics journals as well as several major industry publications. He received his PhD in econometrics from Monash University in Melbourne, Australia.

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Moody's Analytics added Economy.com to its portfolio in 2005. Now called Economic & Consumer Credit Analytics, this arm is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.

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