bpi | BANK POLICY INSTITUTE

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 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 like reducing dividends. CCAR has now become the binding capital standard for the largest banks, which has a direct impact on economic growth and lending, particularly to small businesses.

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 validate the strength of the financial system. However, the current approach to CCAR inhibits economic growth and lacks appropriate levels of transparency, predictability, and accountability.

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 during the crisis scenario, which is counter to economist expectations.

Limits Lending and Economic Growth

The excessively high capital levels needed to pass CCAR have a direct economic impact on lending to consumers and small businesses. Research has shown that the U.S. stress tests impose significantly higher capital requirements on loans to small businesses through higher implicit risk-weights. 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. According to BPI research, subjecting banks to the supervisory stress tests is estimated to have caused a 10 percent decrease in the aggregate holdings of small business loans secured by real estate collateral; moreover, the share of small business loans made in low-and moderate-income neighborhoods by stress tested banks steadily declined as a result of stress tests. Also, research shows that stress tests also have led to a decline in labor productivity and employment growth via the reduction in credit availability to small businesses. (Doerr, Sebastian; "Unintended Side Effects: Stress Tests, Entrepreneurship, and Innovation," Manuscript, May 2019.)

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 specifications of these models. These models have never been subject to peer review or public comment. The Federal Reserve should use banks' own internal, Federal Reserve-approved models to estimate stress losses, restrict the Fed's use of its own models to a non-binding supervisory assessment and require the Federal Reserve to disclose those models to the public and backtest them. Critics argue that clarity on the Fed's 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." CCAR bases its capital assessment not on a bank's current financial condition or how its assets are likely to behave in the future, but rather on how it would behave under a single exceedingly unlikely scenario.