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Do Unregulated Banks Need Stress Tests?

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Society benefits greatly from bank stress testing. However, stress testing also costs society a bundle. We can have a vigorous debate about whether the societal benefits outweigh the costs. I think they do, by a margin, but I will understand if we disagree on this point.

A more interesting question, in light of the gutting of the Dodd-Frank Act that occurred earlier this year, is whether banks, their managers and investors benefit *individually* from rigorous stress tests. Now that many banks are not required to engage in the practice on an annual basis, will they continue to do so anyway?

The simple answer is that it depends. The critical determinant revolves around the seriousness of elected officials in saying that they will never bailout banks in a future financial crisis.

There are three categories of banks that are relevant for this discussion. First, we have the truly too-big-to-fail banks that will almost certainly be bailed out if the unthinkable ever happens. These institutions will be forced to submit to regulatory stress test scrutiny until memory of the Great Recession has completely vanished.

The second category are those banks that are small enough that they have never relied on the possibility of a bailout and humble enough to know they will never warrant one. (These banks have never previously been subject to regulatory stress tests.)

The third category are banks that are not sure either way. These might-be-too-big-to-fail banks were the primary beneficiaries of the recent Crapo legislation that killed the erstwhile DFAST stress test for banks with between $10 billion and $250 billion in assets.

The 'No-Bailout' Scenarios

Let's assume first that elected officials are deadly serious in their "no-bailouts" conviction and will remain so from here to eternity.

Under such circumstances, the might-be-too-big-to-fail banks will be unable to employ the strategy of capitalizing profits in booms and socializing losses in recessions. Instead, investors will be risking their

hard-earned capital should the banks ever fail in a recession. A rational investor would likely prefer to know the odds of such an eventuality, and may be willing to fund the cost of a stress test to find out.

We can observe, however, that the sub-$10 billion banks – those for whom the bailout question is irrelevant - have never engaged in serious stress testing activities on their own volition. This does not mean that their shareholders are not interested in gauging the recession resilience of the banks, though they clearly do not value the information sufficiently to warrant the high cost of discovery.

A cheap, easy-to-conduct stress test may therefore be a game changer for small bank investors, so long as it is accurate enough in gauging the bank's ability to withstand severe economic pain.

For the large-ish banks, meanwhile, economies of scale – together with the greater demands of investors in this category – should mean the threshold for conducting some sort of stress test will be breached. While they may not exert the same level of effort that was required when regulators were running the show, it’s reasonable to believe that the high-value, low-cost stress testing skills they developed during the Dodd-Frank era will survive into the post-Crapo period.

The Case for Responsible Self-Regulation

We next turn to the more realistic situation where bailouts of sub-CCAR banks are still on the table and may be used in a future crisis. On face value, investors in banks that can count on a future bailout don’t need to be concerned about stress testing – but this analysis runs far too shallow.

It is prudent to remember that political will in favor of regulation or deregulation can change with each election cycle. Banks can choose to either revel in their current state of newfound freedom or demonstrate a clear commitment to responsible self-regulation.

If the banks bring out the Hawaiian shirts and the punch bowl, it's easy to imagine a future administration doubling down on previous regulatory efforts. This might include even tougher capital controls as well as actions (e.g., the forcible break-up of the big banks) specifically avoided by Dodd-Frank.

Barney Frank, the Democratic co-sponsor of the original bill, came out in support of several elements of the Crapo legislation, though he ultimately concluded that it went too far in deregulating the might-be-too-big-to-fail banks. His pragmatic views on the Crapo legislation should give banks some comfort, but also move them to action.

I would not suggest that the large-ish (might-be-too-big-to-fail) banks will need to engage in a CCAR-style, full-court-press stress test. They should, however, be motivated to run serious, credible, capital

planning exercises to reassure legislators that they can be trusted to manage their own affairs up to and beyond the next financial crisis.

Such actions need not paralyze the banks' near-term business ambitions. The key, again, is to absorb the best lessons from the Dodd-Frank stress testing experience and remove as much of the now unnecessary administrative process as possible.

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