

Math Gone Mad: Why Stress Tests Don't Work

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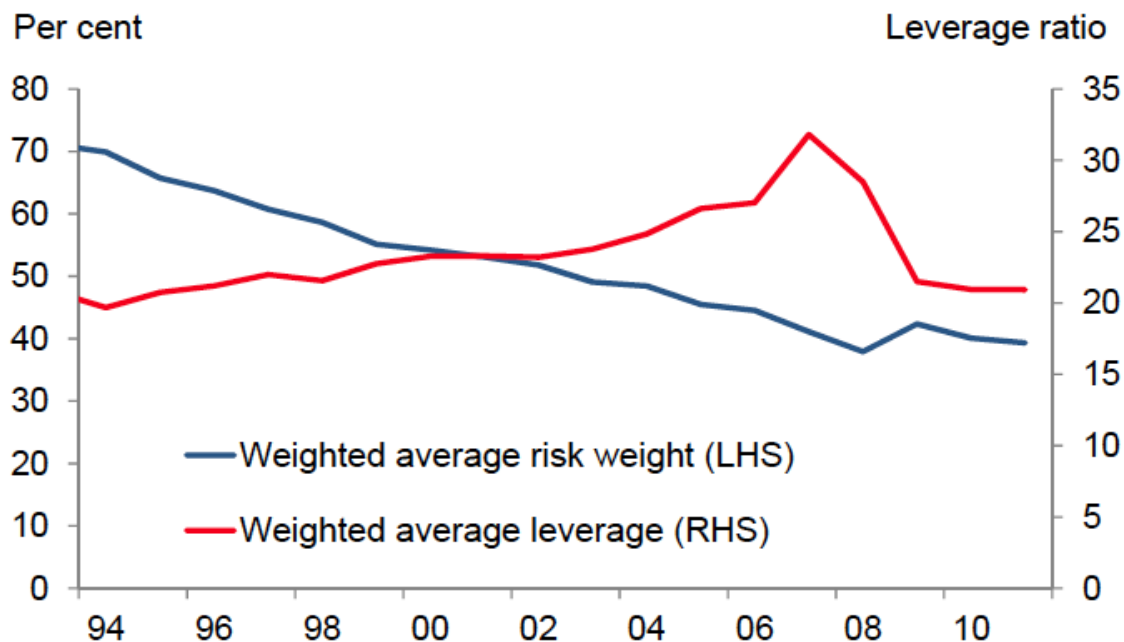
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Main message

- Risk models worse than useless
 - Gameable
 - Provide false comfort
- Examples
 - US, Iceland, UK, Europe

Leverage vs. RWAs as measures of risk

Average risk weights and leverage for 17 G-SIBs^{(a)(b)}



Source: The Banker, Bloomberg and Bank calculations.

(a) Sample consists of Deutsche Bank, HSBC, BNP Paribas, Barclays, Citigroup, UBS, BAML, BONY, Commerzbank, ING, JPM, LBG, RBS, Santander, State Street, UniCredit, Wells Fargo. Data is not available for the remaining G-SIBs.

(b) Leverage ratio defined as Total assets / Tier 1 capital.

Criteria for Stress Testing

- Do not use gameable metrics, e.g., RWAs
- Consider multiple scenarios
- Simple models
- Appropriate to specifics of each bank
- Avoid heavy compliance costs and systemic risk exposure
- Transparent and accountable

US Stress Tests

- Fannie Mae/Freddie Mac stress tests
- Federal Reserve Stress tests

UK Stress Test 2014

- One dodgy stress scenario
- All tests used a **4.5%** CET1/RWA ratio
- Governor Carney: banking system strong enough to continue to operate in a severe stress
- Even his predecessor does not agree

Stress Testing the UK Stress Tests

- Under Basel III, minimum CET1/RWA ratio is 7%-12%
 - Most of UK banking system fails a 7% CET1/RWA test
- Most of UK banking system fails a 3% leverage ratio test
- Why didn't Bank of England perform these tests?

European Stress Tests

- Committee of European Banking Supervisors Stress Test (2009 + 2010)
- European Banking Authority Stress Test (2011)
- ECB Stress Test (2014)
- Each involved one unstressful stress scenario
- All tests used the RWA ratio

ECB 2014 Stress Test

- Didn't include possibility of deflation
- Why?
- ECB Vice-President Vitor Constancio: "The scenario of deflation is not there because ... we don't consider that deflation is going to happen," he said – as it **was** happening.

ECB 2014 Stress Test

- Acharya and Steffen estimate shortfalls 30x those of ECB
- Problem arises because ECB only considers an RWA ratio, not the leverage ratio
- Big French and German banks have very low leverage ratios and very low RWA/TA ratios
- So they are more risky, but better at hiding risks

Deutsche Bank

- NY Fed: “systemic breakdown” in controls
- Derivatives exposure 100x deposits, 22x German GDP
- Thomas Hoenig: “horribly undercapitalized ... no margin of error”
- Zero Hedge: “the most systematically important, and undercapitalized, bank in the world”
- Easily passed the ECB Stress Test

What to Do?

- An Act to prohibit all regulatory financial modeling
 - No Stress Tests, no Basel
- A simple, robust, conservative capital regime
 - Banks with low capital ratios automatically closed down
 - No regulatory discretion

But if you want a safe and strong banking system, you need free banking

- Restore extended personal liability for key decision makers
- Abolish financial regulation
 - Roll back Dodd-Frank etc.
 - No deposit insurance, no lender of last resort etc.
 - Capital regulation would then be unnecessary
- Abolish the central bank!