Preface

Following the most serious financial crisis since the Great Depression, bank supervisors and regulators undertook a set of reforms to reduce the likelihood of and harm from a recurrence. Attention has rightly focused on efforts, implemented under the international Basel III agreement and the Dodd-Frank Act in the United States—to improve the quantity and quality of bank capital and to make regular stress-testing of large banks a key element in the supervisory assessment of that capital adequacy.

Despite these improvements, Senior Fellow Morris Goldstein argues in this book that bank-capital requirements and stress tests currently conducted in the United States and the European Union fall short of what is needed to promote financial stability. In Goldstein's view: Minimum and actual capital ratios for the largest banks are still way too low; the metrics used in the stress tests are not good enough at distinguishing fragile from sound banks and at gauging systemic risk; and the contagion and amplification of financial shocks that played such a large role in the global financial crisis of 2007–09 are yet to be integrated satisfactorily into today's stress tests.

In light of these deficiencies, Goldstein puts forward a bold plan for further reform. The plan would be implemented over a ten-year period—first in the United States and, if successful, later globally. Under this plan, minimum tangible leverage ratios (the highest quality of bank capital) would be set at 14 to 18 percent for the eight US banks deemed to be global systemically important (G-SIBs), at 11 to 13 percent for other large banks (those with total assets greater than $50 billion), and at 10 percent

© Peterson Institute for International Economics | piie.com
https://piie.com/bookstore/bankings-final-exam-stress-testing-and-bank-capital-reform

for smaller banks. Such an increase in minimum bank-capital ratios is intended to vastly raise the loss absorbency of America's largest banks and to decrease significantly the chance of a future taxpayer bailout. The plan would also supplement these much higher minimum leverage ratios with a risk surcharge based on a set of indicators.

According to Goldstein, this combination of a leverage ratio and an indicator-based risk surcharge would be better than the current system at identifying vulnerable banks and at monitoring systemic risk. It would likewise be easier to understand and less costly to maintain than the more complex current counterpart, while being less susceptible to manipulation by banks. There also would be larger incentives for too big to fail banks to shrink over time their systemic footprint, because the difference in minimum capital ratios between G-SIBs and other banks would be much greater. Finally, Goldstein offers evidence that implementing this plan would not harm good US macroeconomic performance, in contrast to concerns that forcing banks to raise capital would constrain lending and growth.

The Institute has a long history of undertaking relevant policy studies on bank regulation as well as on financial stability more broadly. These studies include Goldstein's 1997 book, *The Case for an International Banking Standard*; his 1998 book, *The Asian Financial Crisis: Causes, Cures, and Systemic Implications*; and his 2000 book (with Graciela Kaminsky and Carmen Reinhart), *Assessing Financial Vulnerability: An Early Warning System for Emerging Markets.* More recently, the Institute has conducted a set of studies on policy recommendations arising out of the global financial crisis. Among them are William Cline's 2010 book, *Financial Globalization, Economic Growth and the Crisis of 2007-09;* the 2013 study edited by Adam Posen and Changyong Rhee, *Responding to Financial Crisis: Lessons from Asia Then, the United States and Europe Now*; the 2015 book edited by Marcus Noland and Donghyun Park, *From Stress to Growth: Strengthening Asia's Financial System in a Post-Crisis World,* Cline's 2017 book, *The Right Balance For Banks: Theory and Evidence on Optimal Capital Requirements*, and a number of shorter studies by Anna Gelpern, Simon Johnson, Adam Posen, Edwin Truman, and Nicolas Véron on financial stability and bank reform in the European Union and the United States.

The Peterson Institute for International Economics is a private nonpartisan, nonprofit institution for rigorous, intellectually open, and in-depth study and discussion of international economic policy. Its purpose is to identify and analyze important issues to making globalization beneficial and sustainable for the people of the United States and the world, and then to develop and communicate practical new approaches for dealing with them.

© Peterson Institute for International Economics | piie.com
https://piie.com/bookstore/bankings-final-exam-stress-testing-and-bank-capital-reform

The Institute's work is funded by a highly diverse group of philanthropic foundations, private corporations, public institutions, and interested individuals, as well as by income on its capital fund. About 35 percent of the Institute's resources in our latest fiscal year were provided by contributors from outside the United States. A list of all our financial supporters for the preceding year is posted at http://piie.com/institute/supporters.pdf.

The Executive Committee of the Institute's Board of Directors bears overall responsibility for the Institute's direction, gives general guidance and approval to its research program, and evaluates its performance in pursuit of its mission. The Institute's President is responsible for the identification of topics that are likely to become important over the medium term (one to three years) that should be addressed by Institute scholars. This rolling agenda is set in close consultation with the Institute's research staff, Board of Directors, and other stakeholders.

The President makes the final decision to publish any individual Institute study, following independent internal and external review of the work. Interested readers may access the data and computations underlying the Institute publications for research and replication by searching titles at www.piie.com.

The Institute hopes that its research and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

Adam S. Posen
President
March 2017

© Peterson Institute for International Economics | piie.com
https://piie.com/bookstore/bankings-final-exam-stress-testing-and-bank-capital-reform