

## SCAP in Review: A look at the megabanks' stress test

Stress tests are not new but the Supervisory Capital Assessment Program, or SCAP, was unique in several ways

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"First, we're going to require banking institutions to go through a carefully designed, comprehensive stress test, to use the medical term. . . . To do this, we are going to bring together the government agencies with authority over our nation's major banks and initiate a more consistent, realistic, and forward-looking assessment about the risk on balance sheets, and we're going to introduce new measures to improve disclosure."

--from Feb. 10 statement from Treasury Secretary Tim Geithner, announcing federal measures dealing with financial crisis

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What exactly was going on will no doubt be unearthed years from now by historians combing through private diaries, or, more likely, e-mails. But through interviews with financial experts, ex-regulators, and other knowledgeable analysts, both on and off the record, and through the cooperation of one of the 19 large banks that took part in the stress tests, we can bring you some perspective. (The 19 companies, all with more than \$100 billion in assets, hold two-thirds of the industry's assets and more than half of its loans.)

Bankers need to understand this not only because of the historically and economically significant event that has just passed. Fed officials have already stated that there will be lessons and elements of the stress test that will be applied by its supervisors in the future.

What was different?

Financial stress tests, as a concept, aren't new. Banks of all sizes, for instance, are required to shock-test their investment portfolios to see how they would perform in various interest-rate scenarios. Many do more than that. And, when the Federal Reserve in late April released the blueprint for the stress test, officially, "The Supervisory Capital Assessment Program," or SCAP, there was nothing in the 19 single-spaced pages that doesn't normally come under supervisory review in examinations or otherwise. While an emphasis of the tests was their "forward-looking" nature, examiners always want to have a sense of where an institution is heading, not just where it's been.

Nor was there anything unique about the regulators comparing the results of reviews of multiple institutions. To a degree, every exam performed becomes material for overall consideration. More to the point, regulators have long done "horizontal reviews." These are special examinations that look solely at a particular slice of a group of banking firms' activities—say, commercial real estate lending.

"The SCAP," the government blueprint explained, "is a forward-looking exercise designed to estimate losses, revenues, and reserve needs for BHCs in 2009 and 2010 under two macroeconomic scenarios, including one that is more adverse than expected." Three things made the stress tests stand out, experts explain:

1. Breadth and scope. Even among large institutions, stress testing has typically looked at certain portfolios that management wished to subject to certain stresses, according to research from Deloitte & Touche LLP, overseen by Edward Hida. The study found that 21% of large financial institutions worldwide don't use stress tests designed to evaluate credit portfolio risks, a key focus of the federal effort. By contrast, the federal stress test "was more of a macroeconomic look at each institution, and it was more of an institution-wide test," says Hida, global leader of the Risk and Capital Management service. Instead of subjecting an institution—and therefore its capital adequacy—to stresses based on interest-rate shifts, the federal stress test relied on two economic scenarios, the "baseline" case and the "more adverse" case. Companies had to project credit losses and revenues for 2009 and 2010, including the reserves necessary to cover expected losses in 2011.

2. Simultaneous and common application. Experts say another element that marked SCAP was that the same test was being applied to all the banks covered at the same time—apples to apples, to adapt the cliché. Furthermore, the banks' application of the stress test to their operations was run in parallel with the regulators' own independent review of the institutions' projected situations. (To review the economic scenarios used, see pp. 5-7 in "The Supervisory Capital Assessment Program: Design and Implementation" [click here](#).)

"There was a tradeoff between one-size-fits-all testing versus different tests for each institution where everyone comes out looking fine, and you can't compare," explains Chris Thompson, senior executive, Financial Services, at Accenture, whose firm, like Hida's, worked with some of the companies covered by SCAP. Thompson notes that current troubles make it clear that "people weren't running hard enough scenarios" during the boom years.

3. Disclosure and publicized action. As noted in the May 7 final report on SCAP, supervisors took "the unusual step of publicly reporting the findings of this supervisory exercise." Bankers embroiled in the stress tests kept a tight lid on what was going on even amongst themselves, but the federal report was issued in fulfillment of Geithner's pledge (at the opening of this article) regarding disclosure.

Not only did the report cover the results of the stress test in aggregate and in detail, but each participating institution was represented in the report's appendix by a sheet of data regarding the test results. These pages culminated in one of two items: the amount of additional capital, intended to build a regulatory capital buffer (the "SCAP buffer"), that it would be required to raise, or, alternatively, the news that no additional capital had to be raised. (In the event, 9 did not have to raise more capital, 10 did.)

In a statement at the time, ABA noted that the tests "confirmed that all 19 banks are well capitalized; and, &hellip; that, generally, existing total Tier 1 capital levels are adequate to meet even the negative scenario. &hellip; These results show that our banking system is fundamentally sound despite the very difficult economic times we face." The buffers required were exactly that—additional capital layered over what the institution already held, sometimes to bring up the level of tangible common equity in the institution's capital mix. (To read the entire ABA statement, [click here](#).)

By Steve Cocheo, executive editor

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