The case for market-based stress tests

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Proposal for supplementary market-based stress tests

For major banks with price-to-book ratios less than one, stress tests based on market values should be run and published by regulators alongside existing stress test results.
Bank price-to-book ratios since 2006
Bank market-adjusted capitalization

IMF, *Global Financial Stability Report*, October 2018, Figure 1.20, panel 3. Figures as at September 2018.
Bank price-to-book ratios 2019 Q1

Some banking systems need to continue strengthening their balance sheets.

IMF, Global Financial Stability Report, April 2019, Figure 1.5
Price-to-book ratio > 1 if market values are in line with accounting measures

Market capitalisation reflects a view of:

- the value of current assets less liabilities
  
  +

- the franchise value of future profits (> 0 given managerial competence)
  
  +

- Implicit TBTF subsidy (reduced but still > 0)

So PTB ratio < 1 raises serious questions – for stress tests and more generally
UK bank profits under stress

Chart A1.2 Projections for aggregate profits before tax

Bank of England, Stress testing the UK banking system: 2017 results, November 2017
Current CCyB rates – mostly zero
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