

18 September 2020

Prof. Dr. Claudi Buch, Chair  
Working Group Evaluating Too-Big-To-Fail Reforms  
Financial Stability Board  
Centralbahnplatz 2  
4051 Basel  
Switzerland

Dear Vice President Buch,

I applaud you and your colleagues. Your evaluation report published on 28 June 2020 does an excellent job of summarizing progress on solving too big to fail. It provides a comprehensive evaluation, including state-of-the-art analytical work utilizing a broad array of information.

In my view, we should now turn our attention to what to do next. My hope is that, in the next stage, the FSB will turn its focus to stress tests. The experience both in the U.S. and in Europe in last few months show that these have enormous, but as yet unfulfilled, promise.

The big challenge in addressing too big to fail is how, during a long and damaging downturn, how to can we recapitalize an institution in a manner that ensures both continuity of service and the ability of institutions to continue to serve as a source of credit to healthy firms.

I believe that stress tests, which should apply to domestic as well as global systemic banks, are an important part of the answer. Stress tests do two things: During normal times, they provide information to set capital buffers. And, during periods of heightened stress, they resolve uncertainty and measure to the need for additional equity finance.

Focusing on the second, stress tests are one element of a system in which intermediaries facing capital shortfalls are automatic recapitalized without recourse to public funds. either through raising of capital in the market or through the conversion of subordinated debt holders. Stress tests identify capital shortfalls that can then automatically be remedied either through capital raising in markets or through the conversion of subordinated debt into equity. Having such a system in place has two important characteristics. First, the fact that it

ensures continuity of bank operations makes the stress test credible. Second, by making it clear that equity and subordinated debt holders are at risk, the test creates incentives for monitoring in a manner that directly addresses the debt overhang problem.

So, this evaluation rightly points to progress in increasing capital buffers and improving resolution regimes. To further reduce the likelihood of public sector bailouts of banks, we now need to take the next step and exploit the untapped potential of stress tests as an important complement to the reforms that are already in place. My hope is that one morning I will open the period alerts that I receive from the FSB and there will be an announcement of the publication of key attributes of an effective stress testing regime.

Sincerely,

A handwritten signature in black ink, reading "Stephen A. Cecchetti". The signature is written in a cursive style with a long horizontal line extending to the right.