



January 22, 2018

Ms. Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Docket Nos. OP-1586; OP-1587; OP-1588

Re: Federal Reserve Board request for comment on package of proposed changes to the supervisory stress testing framework

Dear Ms. Misback:

The Center for American Progress (“CAP”) welcomes the opportunity to comment on the Federal Reserve Board’s (“Fed”) package of proposed changes to the stress testing policy statement, the policy statement on the scenario design framework for stress testing, and enhanced disclosure of the models used in the Fed’s supervisory stress tests. CAP is an independent nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action.

The Fed’s stress tests for large bank holding companies and systemically important nonbank financial companies have been arguably the most important prudential regulatory tool implemented following the 2007-2008 financial crisis. Stress testing, when executed well, helps regulators ensure that financial firms have enough capital to continue serving the real economy following a negative shock and severe economic downturn. In 2009, the 19 banks with over \$100 billion in assets took part in the first stress tests conducted by the Fed.¹ The program, known as the Supervisory Capital Assessment Program (“SCAP”), in conjunction with other crisis-era initiatives, helped efficiently recapitalize the banking sector and gave markets confidence in the banking sector’s ability to provide credit and financial intermediation coming out of the crisis.

Based on the success of SCAP, the Dodd-Frank Wall Street Reform and Consumer Protection Act included both supervisory stress testing and company-run stress testing requirements for banks with over \$50 billion in assets and over \$10 billion in assets respectively, and for systemically important nonbank financial companies supervised by the Fed. The Fed also used existing supervisory authority to formalize a parallel stress testing framework known as the Comprehensive Capital Analysis and Review (“CCAR”). Both the Dodd-Frank Act Stress Tests (“DFAST”) and CCAR stress tests have continued to strengthen the capital positions and capital planning processes at the largest firms. Since the first stress tests in 2009, banks with more than \$50 billion in assets have

¹ Board of Governors of the Federal Reserve System, “The Supervisory Capital Assessment Program: Design and Implementation” (2009), available at <http://www.federalreserve.gov/bankinfo/bcreg20090424a1.pdf>.

doubled their common equity capital, increasing their loss-absorbing cushions by more than \$750 billion.²

Stress Testing Principles

The package of proposals released for comment by the Fed includes a statement of principles for stress testing, as well as a list of policies and procedures meant to implement those principles. Several principles outlined in the proposal are appropriately strong and must be preserved. Stress testing must remain independent, forward-looking, and conservative. Supervisory stress tests rely on models and assumptions developed by the Fed and do not rely on the internal models developed by the firms being tested. This regulatory independence is an important principle to maintain. Firms' own internal stress testing models may be designed, to the greatest extent possible, to limit their capital requirements. As a prudential regulator tasked with maintaining financial stability and the safety and soundness of the financial sector, the Fed clearly has different motivations—making true independence vital.

The stress tests conducted by the Fed must also be forward looking. Repeating the same scenarios and shocks year after year would rely too heavily on historical data and would allow banks to easily predict the following year's exercise design. While incorporating historical data is necessary, the shocks and stress in stress test scenarios should reflect how the financial sector and the economy writ large is changing over time, and include emerging threats.

Furthermore, it is crucial that stress test scenarios are conservative. Prior to the 2007-2008 financial crisis, both regulators and financial market participants lacked imagination regarding the type of shocks that could rattle the financial sector and the impact that those shocks could have on the financial sector's ability to serve the real economy. Accordingly, the possibility of severe shocks was significantly discounted. Few thought a sharp, national downturn in the housing market was possible or that financial engineering could magnify risk instead of strictly limiting it. Robust stress testing scenarios must ensure the financial sector is resilient to both normal and severe downturns. CAP strongly supports the inclusion of conservative stress testing as a key principle in the Fed's framework. But recent stress test results have led to concern as to whether this principle is being fully carried out in practice.³

One important element of stress testing assumptions outlined by the Fed is maintenance of the credit supply. The point of stress testing is to ensure that firms have adequate capital to absorb losses during a period of severe stress, while still fulfilling the credit provision and financial intermediation roles the real economy needs to thrive. Resilient firms must be able to lend during times of stress. If firms simply pulled back on their lending and deleveraged to survive, the financial sector may have limited firm failures, but the economy as a whole will experience the sharp pains of a credit contraction. The Fed correctly highlights the importance of keeping the aggregate credit supply constant or increasing in the stress testing framework.

² Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2017: Assessment Framework and Results" (2017), available at <https://www.federalreserve.gov/publications/files/2017-ccar-assessment-framework-results-20170628.pdf>.

³ Marcus Stanley, "Stress Tests: Less Stressful Than Ever," Americans for Financial Reform, June 29, 2017, available at <https://medium.com/@RealBankReform/stress-tests-less-stressful-than-ever-fbe68b8e161a>.

Short-Term Funding Stress

In addition to stress testing principles, the Fed’s package of proposals includes the addition of short-term funding risk to the supervisory scenarios. Adding this risk factor, by including a significant increase in the cost of short-term funding, would be a positive addition to the stress testing framework. An over-reliance on runnable, short-term funding was a key factor in the 2007-2008 financial crisis. For example, before its downfall Lehman Brothers was funding as much as \$200 billion of its balance sheet through overnight repurchase agreements.⁴ Firms that rely heavily on short-term funding put themselves at significant risk to runs, as creditors may not roll over short term loans during a period of stress. A run on short-term funding markets, in which the cost of said funding would increase significantly, can force a firm to liquidate assets at fire-sale prices—leading to steep losses and potentially pushing down assets prices across certain markets.

Stressing this source of funding during the supervisory stress tests would help regulators determine which firms might be over-reliant on less stable forms of funding and would rightfully require additional capital buffers to protect against that run risk. The Fed, through the Global Systemically Important Bank (“G-SIB”) surcharge recognizes the additional risks posed by short-term funding within the Method 2 calculation. Adding a short-term funding component to the stress testing framework would be consistent with Fed’s justification for including short-term funding as a factor in the calculation of the G-SIB surcharge.

Transparency

An appropriate level of transparency surrounding stress testing is an important goal. The public, including policymakers and academics, should have enough information to judge the robustness and execution of stress tests—from the severity of the scenarios to the bank-by-bank projected losses. Over the past seven years, the Fed has significantly improved the transparency surrounding the stress tests. The Fed’s public release of the 2011 CCAR results was 21 pages and did not include a bank-by-bank breakdown of pre- and post-scenario capital levels.⁵ The 2017 CCAR public release was 100 pages and included detailed bank-by-bank information with an explanation of the adverse and severely adverse economic scenarios.⁶

In making any changes to the stress testing transparency regime, the Fed must be cautious of going too far. Making too much information on loss projections and the Fed’s models public might enable firms to reverse engineer the stress tests. And providing detailed information on the scenarios in advance of the tests, alongside projected loss estimates for certain portfolios, may give banks the opportunity to tailor their balance sheets in advance of the test to minimize their projected losses, and in turn their required capital cushions. Balance sheet tailoring ahead of stress testing periods would increase the correlation risk across the banking sector and undermine the effectiveness of the stress tests. In its final rule, the Fed must clearly demonstrate that its proposal to disclose projected loss rates on a pool of loans does not cross that line. Again, the Fed should be sure that the disclosure of this information in no way weakens the efficacy of the stress tests. Moreover, there are other steps the Fed should take to increase transparency in an appropriate manner. For example,

⁴ Linda Sandler, “Lehman Had \$200 Billion Overnight Repos Pre-Failure,” Bloomberg, January 27, 2011, available at <https://www.bloomberg.com/news/articles/2011-01-28/lehman-brothers-had-200-billion-in-overnight-repos-ahead-of-2008-failure>.

⁵ Board of Governors of the Federal Reserve System, “Comprehensive Capital Analysis and Review: Objectives and Overview” (2011), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20110318a1.pdf>.

⁶ Board of Governors of the Federal Reserve System, “Comprehensive Capital Analysis and Review 2017: Assessment Framework and Results” (2017).

roundtable discussions with advocacy organizations, academics, and financial institutions have been helpful to facilitate communication with the Fed on the stress testing framework. These discussions should be formalized and held regularly to ensure adequate public engagement on a going forward basis.

Stress Testing Priorities

While appropriate stress testing transparency is a worthy goal, it is unclear as to why this is the top stress testing priority of the Fed under the leadership of Chair-nominee Powell and Vice Chair Quarles. Proposing a rule to incorporate the G-SIB surcharge into the stress tests' post-stress capital minimums is a policy that has been discussed at the Fed for quite some time and should be a top priority.⁷ Currently the largest firms have the same post-stress minimum capital requirements as smaller firms, despite different regulatory capital requirements. The most systemic firms should internalize the potential systemic costs associated with their failure, both in regulatory capital requirements and in stress testing. Increasing the post-stress minimums for the largest firms was previously discussed as part of a move to propose a stress capital buffer as a replacement for the capital conservation buffer.⁸ The stress capital buffer would integrate stress test losses with regulatory capital requirements. Since Governor Tarullo departed the Fed, there has not been any additional update on these potential proposals. Stress test transparency, affirming stress testing principles, and the inclusion of short-term funding market stress in the scenarios are all important, but increasing post-stress capital minimums and the implementation of a stress capital buffer should be priorities for the Fed.

The Center for American Progress thanks the Fed for its thoughtful stress testing proposals and looks forward to further engaging on this issue. Any questions on this comment or on related issues should be directed to Gregg Gelzinis at ggelzinis@americanprogress.org.

Sincerely,



Gregg Gelzinis
Research Assistant, Economic Policy
Center for American Progress

⁷ Daniel K. Tarullo, "Next Steps in the Evolution of Stress Testing," Board of Governors of the Federal Reserve System, September 26, 2016, available at <https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm>; Janet L. Yellen, "Supervision and Regulation," Testimony before the U.S. House of Representatives Committee on Financial Services, September 28, 2016, available at <https://www.federalreserve.gov/newsevents/testimony/yellen20160928a.htm>.

⁸ Ibid.