Federal Reserve Conference – Stress Testing: A Discussion and Review
Federal Reserve Bank of Boston, July 9, 2019
Speaking Notes for Discussion Panel 2 -- Dynamism and Transparency in Stress Testing

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I would like to start by thanking the Federal Reserve for inviting me to participate in this conference. And applaud them for the openness to hearing from a variety of perspectives, including those that may not be in agreement with their proposed changes to stress testing and changes already made to CCAR.

I hope that this openness will extend to taking these views into consideration when it comes time to make policy decisions about the proposed changes. There are three excellent papers being discussed today and, I think when you take their observations all together as a group, it leads to a conclusion that a number of these proposed changes would be as unwise as they are unnecessary.

It's always important to start with the objectives of the program.

- The Fed's stress testing program – through requirements to maintain strong capital planning and risk management practices and the use of post-stress capital requirements – is meant to reduce the probability that the largest banks are the source of, contribute to, or exacerbate a downturn.
- If banks are able to continue lending to households and businesses throughout a crisis, the downturn should be less severe. And a downturn itself could stem from or be exacerbated by issues starting within systemically important banks; being better run, always on the lookout for bad outcomes, and more resilient to a wide range of possible stress events should reduce that likelihood.

Three considerations related to the need for an effective stress testing program. 1.) Most importantly, while difficult to estimate, the costs of the GFC to the economy were huge and for many many people the disruption was literally life changing, and not for the better. Efforts to reduce the chances we end up in that position again should remain job number one for supervisors; 2.) Some of the tools used to address the crisis in the US have been weakened – certain actions taken by the Fed, Treasury and FDIC may no longer be allowed or would certainly be more difficult to put to use quickly; 3.) While it is important to acknowledge that there have been some advances with respect to recovery and resolution preparedness for the largest banks, including OLA, the work is far from done and seems to be losing steam. The uncertainties around trying to resolve a SIFI in 'good times' are huge. This increases exponentially in a downturn, when several may be in deep distress. I suspect it's a decision that will be deferred when it comes around again.

Given these and other considerations, the focus on minimizing the probability of default of systemically important banks should remain the core concern of Fed supervisors. And the good news is that most observers seem to agree that the CCAR/stress testing program has been a powerful supervisory enhancement promoting that goal. Will it continue to be?

Discussions of the reasons for proposed adjustments to the current U.S. stress testing regime usually include considerable emphasis on making it more efficient. We can all agree efficiency is good, all other things equal. But while a focus on efficiency when it comes to overseeing and regulating the largest banks is not unimportant, it should be second order. Increasing its effectiveness should be the goal. And by that, I mean the ability to promote the objective noted earlier.

The set of proposals put out by the Fed for comment -- or referred to as being in the works – fall into three major categories:

1. Reducing the volatility and uncertainty of stress test results and resulting post-stress capital requirements so banks can more easily manage to it;
2. Lowering the effective capital requirements generated through the stress testing program – primarily by eliminating the prefunding of dividends and other distributions and eliminating a post-stress leverage requirement; and
3. As has unfortunately already been done, reducing the pressure on banks to maintain strong risk management, controls and governance to support forward-looking capital planning by eliminating the possibility of the so-called qualitative objection in CCAR.

I disagree with each of these.

The Fed is right to review and assess their post-crisis supervisory developments, and to make adjustments where those are needed. This was begun in 2015 for the stress testing program, and included meeting with people coming from a variety of differing perspectives to seek their input – including bankers, analysts, academics, public interest groups, etc. We received a lot of interesting and valuable input through that process.

I recall at the time being somewhat struck by the input from the banks, which was basically a list of the same things they had complained about regarding the CCAR program from the start. Today what I find most striking is that most of the 'challenges' the proposed changes are meant to address are the same complaints the industry has been raising from day one. Their concerns were often couched in those early days in terms of being punitive and likely to do damage to the largest banks' competitiveness and/or their capacity to support economic growth. Nine years in and neither has happened. As noted in one of the papers for this conference, we still don't know how the program will perform during a downturn, and that's a big open question, but we do know it's made the banks safer, stronger, and better run. Indeed, the banks have actually benefitted from the program as their competitive position relative to large banks from other countries has generally improved, not been weakened, and this has been to their financial benefit. And of course, the goal of strengthening their financial resilience has been promoted and, while more needs to be done, the system is safer.

So, we get to the key question covered by this panel: Can the Fed maintain, or (even better) enhance, the effectiveness of the stress testing program by making proposed changes that will make it more predictable and less dynamic?

- Transparency is also noted as a goal, but seems to be largely in the service of promoting these two others. I will return to transparency a bit later.

Mark Flannery's paper offers reasons to be skeptical. As noted in the paper, some of these changes may reduce the stress test's effectiveness by making it harder to flesh out banks' actual risks. Specifically, they may make it easier for banks to shift into and out of positions explicitly to reduce the Fed's loss estimates in the stress test, and be able to structure their positions in such a way as to reduce ST loss estimates and required capital required to support them. In addition, they may promote herd-like behavior -- with banks taking similar actions of these types to manage towards the test – and increase systemic risk.

In addition to meaningfully changing scenarios periodically to address this potential problem (my suggestion not Mark's), models should be regularly updated, upgraded and continue to evolve as the environment changes, as positions are restructured and/or new types of exposures created, and as better modeling methods are developed. The slower this process of adjustment is the greater the danger of missing important risks, undermining effectiveness.

Mark provides some thoughts in his paper on the importance of maintaining the dynamism of the stress tests and on ways it could be increased. These include suggestions for considering enhancements to the PPNR estimation process, using the global market shock in more creative ways and the importance of shifting loss model parameters to capture potentially changing dynamics under stress. All of these suggestions are worthy of further consideration by the Fed.

I will add a couple thoughts on scenarios. In a more perfect world, supervisors might be making regular significant changes to scenarios, possibly with even greater than annual frequency and always poking for the weaknesses at the banks and across the system. And they would make the most systemically important banks capitalize against the material vulnerabilities identified this way. That should simply be a cost of doing business for banks that can create massive financial instability and negatively effect the entire economy when they falter. For a variety of reasons, some technical and operational, this is not feasible.

- The Bank of England's 'biennial exploratory scenario' is a good example of using differing scenarios as a tool to flesh out vulnerabilities. While to my understanding they have chosen not to require their banks to capitalize against these scenarios directly, this process nonetheless promotes a better understanding of the banks' risk and is a good use of the tool.

Having said it's important to use varying scenarios to probe for many different sources of vulnerability, I need to clarify what I think is a misperception among many who criticize the Fed's stress test. The Fed is not trying to predict the next crisis when designing stress test scenarios, nor should it be. This would be sheer folly and they know that. It is trying to calibrate capital needs against a hypothetical severe downturn to provide a greater level of confidence banks will be resilient to a variety of possible outcomes of similar severity, not just the one scenario being used. This is the right way to go about it in my opinion, though I encourage the Fed to make even greater use of the 'salient risk' feature of its scenario design process to probe specific areas where risks may be mounting.

On scenario severity -- I'm not sure how exactly to do this operationally, and given the lack of historical evidence, but stress scenarios should contemplate that the authorities will take no actions in support of banks or the markets in which they operate. Banks should capitalize for their potential needs in exclusion of even indirect tax-payer funded or other government support. I am not arguing that the authorities should not take action in the event of a critical need to keep the economy from falling off a cliff, but rather that the measure of capital needs at the largest banks should assume they will not. The largest banks' capital requirements should not be reduced by assumptions the government will take actions that reduce capital needs at the risk of loss to taxpayers. Critiques of Fed scenarios for being 'more severe than the GFC' seem to me to be quite misplaced in this context. I would argue they are not severe enough because they don't contemplate the state of the world where the taxpayer provides no material support that is of benefit to the banks.

Lastly, it is often acknowledged that banks' internal stress tests are 'just as important' as the Fed's, and that ensuring they work hard to be able to effectively carry out capital planning using stress tests is critical. I couldn't agree more. It shouldn't all be about the Fed's supervisory stress test. While I appreciate that the Fed plans to continue to focus on capital planning in its 'normal supervision', changes already made are weakening banks incentive to focus on and continue to get better at this, with predictable results, as is noted in one of the papers written for this conference.

Moreover, should the Fed decide not to include the initial proposal for the prefunding of at least four quarters of dividends in the SCB, and a related requirement that banks submit and stick to an annual capital plan of their own design, the planning element -- which is quite broadly acknowledged to have been effective, including by many in the industry -- may possibly be weakened to the point of near irrelevance. This should not be allowed to happen. The same could be said about the proposal to give the banks results of supervisory stress tests in advance of receiving the banks' capital plans. The banks should make plans based on their own internal assessments of their capital needs.

Three concluding points –

1.) We should not forget the critical importance of the objective – don't let memories fade, it was a disaster and could easily have been much worse
2.) Focus should be on making the tests more effective, with increasing 'efficiency' a reasonable but second order goal
3.) Discussions of transparency in the Fed proposals are mostly aimed at providing the banks with more information about the inner workings of the stress test so they can more easily manage to it. More consideration should be given to being more transparent in providing more qualitative information to the public. As Mark's paper notes in the context of *quantitative* disclosures, this can provide a strong self-disciplining mechanism that may reduce the likelihood the Fed moves too slowly to address important problems as they arise. At least as importantly, the public deserves

to have more information and a better understanding of the Fed’s views on the largest banks and the actions it is taking towards strengthening these banks and the banking system more broadly.

Thank you. I look forward to the panel and expect we’ll get some good questions.