Conference:
"Stress Testing: A Discussion and Review"
Panel One
"Stress Tests as Policy Tool"
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I'd first like to thank Chairman Powell and Vice Chairman Quarles for holding this conference and for inviting me to participate. It is refreshing to see that they understand and act on the need not only for more transparency with the public, but also for going outside the usual suspects and including alternate views and even dissenting voices.

As Chairman Powell recently said, disagreement is not only healthy, but important. In my view, that is true not only for the Fed, but for the public and the country.

Better Markets

Before I turn to the discussion paper for the panel, for those of you who have asked me about Better Markets, it is a non-profit, non-partisan, and independent organization founded in the wake of the catastrophic 2008 financial crisis to promote the public interest throughout the economic and financial policy and rulemaking process. We have participated in more than 200 rulemakings, many of the related lawsuits, testified in Congress numerous times and issued many reports and policy papers, among other things.

Better Markets is pro-market, pro-business, and pro-growth while also believing in robust rules that promote transparency, financial stability, fair competition, and investor and consumer protection. Our goal is to promote a financial system that helps the real economy produce jobs, raise standards of living, increase broad-based prosperity, and make the American Dream a reality for everyone. (For more information, please refer to our Annual Report.)

The Panel Topic: "Stress Tests as a Policy Tool"

Turning to the topic of the panel, "Stress Tests as a Policy Tool," I'm going to offer the following observations on ***policy*** related to the issues raised by Andrew and Greg in their thoughtful and thought-provoking paper, which I encourage you all to read.

1. What is at stake when we talk about stress tests.
2. Don't snatch defeat from the jaws of victory.
3. Stress tests are credibility tests for the Fed.
4. The banks' so-called comparative advantage can be a huge disadvantage to the public.
5. A so-called "peacetime/wartime" framework is dangerous and unworkable.

6. This is exactly the wrong time to reduce the rigor of stress tests or the amount and quality of capital.
7. Conflict between bankers and regulators in financial regulation is inevitable, healthy and, indeed, a sign of success.
8. Evil actors in – or evil motives by – the private sector and bankers are not required.
9. Transparency properly understood and applied is key.
10. Market discipline is essential to regulating the banks, which requires the Fed to increase disclosure.
11. Protecting the public, taxpayers, the financial system, and our economy must be the central objective of stress tests and financial regulation broadly.

The observations discussed here are general. If you want to know Better Markets' views on the ***details*** of stress tests and the Fed's specific proposals, please go to our website at www.bettermarkets.com here where you'll find many comment letters, commentary and other information. I also hope to be posting more detailed thoughts on the paper and the conference in the coming days.

My first observation relates to what is at stake when we talk about stress tests.

The only thing standing between a failing bank, a taxpayer bailout and an economic and human catastrophe is loss absorbing capital. Period. Full stop.

That is really what we are talking about when we are talking about stress tests. That's also why this discussion cannot be limited to bankers, academics and regulators.

The last crash is going to cost the US more than $20 trillion in lost GDP, which Better Markets detailed in a Cost of the Crisis Report. And, those dollars don't reflect the human suffering all across this country as tens of millions of Americans lost their jobs, homes, health care and so much more.

Remember, just thirteen months after the collapse of Lehman Brothers, in October of 2009, the U6 rate exceeded 17% and it stayed there for five of the next seven months. That's 27 million Americans out of work or forced to work part-time because they could not find full-time employment. Many of those Americans were heads-of-households, meaning that the unemployment tsunami alone likely hit around 50 million Americans at its peak and tens of millions for years thereafter as shown in Exhibit 1 attached below. There were also more than 15 million foreclosure filings and almost 40% of homes were underwater, where the mortgage was higher than the houses could be sold for. The economic impact – much of which continues to this day – on hardworking Americans from the 2008 crash simply cannot be overstated.

Compounding those costs, the taxpayer and US resources used to bail out the largest financial institutions in this country were diverted from the country's other priorities and needs and the deficits incurred as a result caused the debt to explode, which has continued to limit otherwise available resources. The US has never appropriated $700 billion of taxpayer dollars to address any social need and no entity like the Federal Reserve has spent, lent, guaranteed or otherwise used trillions of dollars on a social need. Yet, all of this and more (much of it intentionally kept secret from the public and their elected officials) was done to prevent the collapse of the financial industry in 2008-2009.

This is not history for history's sake. If the Fed's stress tests fail, are inadequate or otherwise wrong and banks again don't have sufficient loss absorbing capital, then the public is again going to get the bill for that failure. They should, therefore, have a seat at the table and their interests should be at the center of any discussion about stress tests or similar financial protection rules, which I will come back to at the conclusion of my remarks.

<u>My second observation is: Don't snatch defeat from the jaws of victory.</u>

US stress tests are the gold standard worldwide. They have worked exceptionally well. You don't need to be told that they have been used at one of the most perilous times in our country since the Great Depression of the 1930s. That real-time, live "stress test" of stress tests in 2009 restored the confidence of the financial system and the public.

Then, remember that the opposite happened in Europe. They too employed stress tests after the 2008 crash and virtually all banks passed. But, the tests weren't considered rigorous, lacked transparency, and left very substantial capital holes. Thus, Europe's stress tests lacked credibility.

That is the risk here: the gold-standard US stress tests losing credibility.

You don't have to believe me. You don't have to just look at the factual record. You can watch then-President and COO of Goldman Sachs, Gary Cohn, singing the praises of stress tests and capital on Bloomberg News in February 2016.

That was when the periodic concerns about distressed and possibly failing European banks reached a crescendo. Their stock prices were plummeting, and spreads were blowing out, but none of that impacted US banks. That was because, as Gary Cohn said,

> "[US banks were] subject to enormously robust stress tests here in the United States, and I give the Fed enormous credit for what they've done in stress testing the major banks here in the United States."

Thus, we're not talking about ancient history or even 2009. We're talking about as recently as 2016 and we're talking about a dramatic market impact: European bank stocks were cratering, and US bank stocks were not even impacted.

This was, again, an actual stress test of stress tests and an unqualified success that simply cannot be overstated.

<u>That leads to my third observation: Stress tests are really primarily "credibility tests" for the Fed.</u>

While the banks are subject to stress tests, they are really credibility tests for the Fed, and that credibility has already taken some hits. Some refer to them as well on the way to being "no-stress stress tests." Others have observed that stress tests have gone from confidence builders to mere "capital ejection mechanisms." Some have noted that what was originally thought of as a process to create a capital floor has become a capital ceiling, and one that is falling with each deregulatory move.

That's why we saw these headlines in June:

a. "Big Banks Face Less Stress in this Year's Fed Tests"
b. "Big Banks Ace First Round of Federal Reserve's Stress Tests"
c. "Big Banks Sail Through Dodd Frank Stress Tests"

We should ask if a test where 100% of the test-takers pass every time, with flying colors, is a valid, credible test. Such results are usually a red flag.

We also need to ask if it is wise that a bank failing the stress tests should be avoided at all costs. Entire new words and processes are being deployed to avoid even saying the word "fail." When Goldman Sachs and Morgan Stanley failed the tests by falling under the capital requirements last year, the Fed didn't fail them. Rather, it invented a euphemism: "conditional non-objection."

That's not all. In addition to the recent decision to stop disclosing information to the public about the results of the qualitative part of the stress tests, the Fed already allows banks to reduce shareholder payouts and resubmit their capital plans if they would otherwise fail. That's why the last bank to fail the quantitative part of the test was in 2014.

We need to think about how these actions, changes and mindsets are fundamentally challenging the credibility of the tests and, yes, the credibility of the Fed.

<u>I'll turn to the paper with my fourth observation, which is about the authors' first observation: The banks' so-called comparative advantage can be a huge disadvantage to the public.</u>

Regarding the authors' observations on the purported comparative advantages between banks and regulators, it is correct that "banks will always know more than any outside party about their businesses, profitability and risks" and bankers will always "retain the advantage."

But, before there is too much reliance on banks' models or bank-run stress tests, we need to think much more deeply about the fact that banks' knowledge can always be – and often is – wrong, incomplete, inadequate or otherwise deficient or tainted. That's even before thinking about the upside-down incentives that affect behavior, thinking and business conduct (discussed more below). As the authors noted,

> "The capital hole that the largest banks had to fill in 2008[1] was largely caused by their own failure to understand the risks they had retained in highly rated

[1] It should be noted that this "capital hole" has never been robustly determined and/or made publicly available for independent analysis. While the Fed and the FSB have elliptically referred to top line numbers from time to time, no comprehensive, data-driven analysis has ever been released to the public (or known to have been done at all). This raises significant questions about assertions of "adequate" or "sufficient" capital buffers.

> securities and derivative exposures against which they held little or no capital before the crisis."

So, while there are no doubt comparative advantages, there are also extreme and extremely important comparative ***disadvantages*** in thinking that banks' comparative advantages will be conceived of, implemented and executed in appropriate or sufficient ways. While the paper properly notes that "we cannot expect profit-maximizing banks to act as their own prudential regulators," this truism must engender skepticism and be applied broadly and deeply.

<u>My fifth observation relates to the suggested analytic framework organized around the concepts of "peacetime" and "wartime" regulation, which is dangerous, has not worked and will not work.</u>

While theoretically interesting, the likelihood of correctly knowing when it is peacetime is impossible, and being wrong, even a little bit, will be dangerous if not catastrophic. We don't have to speculate about that. We have definitive proof.

Let's take a minute to speak honestly and openly about the years before the 2008 crash. We had failures of judgment of historic proportions by policymakers, by elected officials and by regulators, including, prominently, the Federal Reserve Board, its staff and its many affiliates, like the New York Fed.

They were mostly wrong, dead wrong, with the gravest consequences. A tragic groupthink, if not ideology, blinded most to growing risks and the coming catastrophe. We're not talking ancient history, like the 1990s.

Think back to the "celebration" of the Greenspan years at the 2005 Jackson Hole conference. Even the mildest, indirect academic dissent was greeted not just with disagreement, but also with disdain, ridicule and name-calling. What would occasion such a reaction? A paper entitled "Has financial development made the world riskier?"

Even asking such a question was apostasy. Peacetime reigned. No need to even question the prevailing, dare I say, wisdom. It was peacetime. Everyone agreed:

1. Markets knew best.
2. The least regulation was best.
3. The biggest financial institutions in the world could and would self-regulate and self-police.
4. None of them would ever take outsized risks that might endanger the viability of their firms or their reputations for brilliance, sophistication and risk management.

No less a luminary than Robert Rubin, former CEO of Goldman Sachs, former Secretary of the Treasury and then a Director, Chairman of the Executive Committee and member of the Office of the Chairman at Citigroup, joined in the Jackson Hole cheerleading, giving the luncheon address. Yet, just three years later, Citi would be saved for the 4th or 5th time in its history by the US government. It received the largest single bailout of any bank. It was insolvent and, as it continued to fall apart, its bailout had to be restructured three separate times.

Tellingly, it was the only bank not to pay back the TARP cash it received in cash. The government took common stock at a very high conversion price that itself was seen as yet another backdoor bailout.

None of that is to cast aspersions – those are just facts. Facts no one saw coming. Even the brightest of the bright. And, importantly, the Fed was by no means alone in being grievously wrong.

All that means that deep, deep humility about our ability to determine when a crisis is coming or when we are even in the middle of it must be the rule. That means that artificial constructs of "peacetime" and "wartime" – and the false comfort the former instills – should be rejected as unworkable and should not be a guide for policy, and certainly not for deregulation because it is supposedly "peacetime."

For example, exactly when in the years before the 2008 crash did we move from peacetime to wartime?

1. When subprime loans or synthetic CDOs reached a certain level?
2. When the Bear Stearns hedge funds collapsed in the summer of 2007?
3. When they shopped their books much earlier in 2007?
4. When Goldman flipped to the big short?
5. When Northern Rock failed?
6. When Morgan Stanley started taking huge losses in December 2007?

To ask these questions is to reveal that they aren't answerable. Even in hindsight. Certainly not when in the middle of peacetime, much less wartime, or the "cold war" in between.

<u>That leads to my sixth observation: This is exactly the wrong time to do anything that in form or substance reduces the rigor of stress tests or the amount and quality of capital.</u>

I disagree with the paper's assertion of "*normal* times, like today" (emphasis original). While used in the context of triggering countercyclical buffers, the observation is more broadly applicable, but these are not normal times by any reasonable definition of normal.

We are now in the longest economic recovery in the country's history, but the business cycle has not been repealed. What goes up, must go down. It's not a question of if, but when.

Before any changes in stress tests – and other financial protection regulations, for that matter – we should wait until we see how they all work or don't work during a full business cycle. Certainly not when we're at the peak of a historic upswing.

This is particularly true given the objective evidence proving that the Dodd Frank law and financial regulation more broadly have not impaired the banks in any way. They are quarter-by-quarter and year-by-year breaking revenue, profit and bonus records while continuing to increase lending. To the extent lending is not as high as some would hope, there is no evidence that is due to a credit availability problem, which does not exist. If anything, it is obviously due to a credit-demand deficit by creditworthy borrowers, which is related to the ongoing economic distress and anxiety caused by the lingering effects of the 2008 crash.

On top of that, there are red warning signs flashing everywhere:

1. According to the Fed, US household debt hit record levels—reaching $13.67 trillion in the first quarter of 2019, and default rates are up for credit cards, auto and student loans.
2. We have just experienced an artificial economic sugar high induced by the deficit-financed $2 trillion in tax cuts and spending increases, which has created a stock market bubble.
3. A decade of low to zero interest rates has induced widespread "reaching for yield" while creating a historic level of debt financing and leveraged assets, with reduced underwriting standards and "cov light" terms proliferating.
4. Broad-based deregulation of finance and business generally is proceeding apace, which has reduced the number of early warning signs and weakened the early warning systems while simultaneously reducing the ability to rapidly and effectively respond to systemic deterioration.
5. There is very little if any fiscal or monetary capacity to respond to serious recessions, much less a financial crisis.
6. The Fed cannot even get out of the emergency programs it put in place to respond to the 2008 crash and crisis.

Given these facts and circumstances, among others, is this really the time to be seriously thinking about reducing the rigor of the stress tests and/or the amount of loss absorbing capital in systemically significant banks?

This is a particularly apt question given that the quantity of capital at the banks is already at the low end of the range for appropriate levels, even ignoring the quality composition of that capital. As the paper notes, "[a]cademic estimates of the optimal level for bank capital that take system risks into account range from 9 percent to as high as 25 percent…." Thus, the so-called "recalibration" and "tailoring" of stress tests are happening when there are already serious questions about the sufficiency of the existing capital buffers. If such "recalibration" and "tailoring" are ever to be done, one has to ask if doing so at this fragile and dangerous time is really the appropriate policy. [2]

One would think that an unbiased, objective, rational analysis would lead to employing countercyclical measures and building up the economic and financial protections before the next downturn.

An interesting question is: "Why is that not happening?" I would suggest there are a number of reasons, but one never discussed is that the banker-regulator dynamic is misunderstood, which leads to public interest outcomes being subordinated to the objectives of profit-maximizing banks.

[2] Given that, thus far, such "recalibration" and "tailoring" (and changes purportedly for "efficiency") seem to always - or almost always - result in lower amounts of capital and often of lower quality, one also has to ask if the stated justifications for such changes are pretextual, seeking to conceal an outright deregulatory agenda that the biggest financial institutions are demanding.

<u>My seventh observation is that policymakers in general and regulators in particular should accept that conflict in financial regulation is inevitable, healthy and, indeed, a sign of success.</u>

The paper says the stress test exercise "remains a more or less contentious process," which the authors attribute to "bankers bristl[ing] at the perceived loss of control over basic capital planning decisions and what they see as an opaque process." They note also that "it is important that there will always be conflict here," but largely limit that to "speed of [capital] adjustment after a stress test."

That limitation is too limited, and the view overly credits what the bankers ***say*** as opposed to what they really ***want and do***. Put differently, don't listen to what bank executives and their communications teams say; watch what their highly paid lawyers and lobbyists are doing in the dark corners of DC where policymaking and rulemaking actually get done. There is often very little overlap between those two.

That's why I say that regulators and bankers are always and inevitably at war, even if that isn't their everyday experience of the relationship. However, that's only because it's not always a "hot" war, but usually a steady-state "cold war."

The largest, most complex financial institutions are pressing the limits at all times as they seek to profit- and bonus-maximize. Some will cross the limits and won't be caught or, if caught, not sanctioned or, if sanctioned, not sanctioned enough to be more than an acceptable cost of doing business. That is just the ever-present state of financial regulation where the overriding mandate throughout the private sector is profit – if not bonus – maximization.

Thus, attempts, as the authors suggest, by regulators to change this or that to enable "[a] constructive dialogue about scenarios, assumptions, formulas, and models [that] could lead to a **more cooperative, less adversarial relationship** between banks and supervisors" (emphasis added) simply misconceive the most basic terms of the relationship. No one wants or benefits from disagreement for disagreement's sake, but that is not what is at the core of the disagreement between bankers and regulators.

On the most fundamental issues, individual/firm/industry profit maximizers will conflict with regulators' public/taxpayer protection mandates, either in good faith, due to different judgements and weighting, or because it is often a zero-sum game, i.e., banks externalizing/shifting their costs to the public benefits the banks in increased profits, etc., while commensurately increasing the costs and risks to the public, taxpayers, the financial system and the economy.

Everyone should stop pretending that bankers and regulators agree *broadly* on the financial reform goals, and *mostly* on the ways to achieve them. Regulators and bankers bring – and should bring – different perspectives to these issues, which in turn lead to different views and, inevitably, disagreement. That's why the authors noted that the ***"banks have said thank you" for greater transparency provided by the Fed, but the banks have nonetheless "asked for***

even more." Of course they did; that's their job, and it is in direct conflict with the job of the regulators.

On the one side, you have private-sector profit maximizers who measure success by ROI, which is dramatically increased by leverage and deregulation. On the other side, you have financial regulators mandated to implement the law to promote financial stability and, importantly, to make sure a crash like 2008 – or worse – never happens again.

Ending too-big-to-fail and workable resolution plans are prime examples. Those are both imperative public goals that benefit everyone in the country ***except*** the too-big-to-fail banks and bankers who would much rather fall into the comforting arms of the American taxpayer than have to file for bankruptcy. The same is true for effective stress tests and sufficient loss absorbing capital: They are absolutely essential to protect the public, but terrible for banks and bankers who will not be able to take as much risk or make as much money. That's why they are "bristling"!

These facts are also not casting aspersions, banker-bashing or anti-private sector. They are just the facts, and profit maximizers making rational, self-interested choices.

Take the very contentious issue of ending too-big-to-fail on Wall Street (via capital, liquidity, counterparty exposure, proprietary trading limitations, resolution plans, derivatives regulation, etc.). You run a very big bank; your career, reputation, wealth, self-image, social milieu and social standing are all inextricably linked to your bank and its performance. You have a choice: you can organize and run your bank to internalize costs, lower profits and be readily resolvable in bankruptcy in the event of failure, at which point you will lose your wealth, reputation, social standing and more.

Or, you could organize and run your gigantic bank to externalize your costs and increase your profits and bonuses while making resolvability without collateral consequences questionable. You don't have to be too-big-to-fail in fact, only possibly, which shifts the burden for action in a crisis to elected officials or their representatives, who are unlikely to gamble with being wrong by concluding you're not too big to fail.

No matter what anyone says, too-big-to-fail bankers[3] and regulators simply do not share the same goals – and anyone not candidly admitting that is fooling themselves.

Thus, the goal is not and should not be to "perfect" stress tests or to please everyone or even enable consensus; the goal is to have workable, effective and credible stress tests as part of a comprehensive financial reform architecture that actually protects the public, taxpayers, the financial system and our economy.

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[3] Of the more than 5,000 banks in the US, less than 40 had more than $50 billion in assets as of March 31, 2019 according to the Fed. Therefore, it is important to distinguish between the relatively straightforward banks that engage primarily if not exclusively in retail and commercial banking from the complex, often global bank holding companies that engage in a significant amount of trading and investment activities having nothing to do with servicing the banking needs of Main Street Americans or businesses.

All of this will inevitably result in tension and disagreement. That is a good sign. That means that the regulators and bankers are doing their respective jobs.

<u>That leads to my eighth observation: Evil actors in – or evil motives by – the private sector and bankers are not required for any of these observations or concerns.</u>

These facts and circumstances arise from the natural and legal structures of markets and financial firms, individually and, ultimately, collectively. It's the siren songs of profit maximization and competitive pressures. As Upton Sinclair said so well:

> "It's difficult to get a man to understand something when his salary depends upon his not understanding it!"

That is the unsettling, but undeniable, truth behind former Citigroup Chief Executive Officer Chuck Prince's infamous quote in July 2007:

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

<u>Translation</u>: When a financial institution and its peer group are making lots of money doing roughly the same thing (<u>meaning</u>, the market "music" is playing), they have to keep doing the same thing ("dancing") or their revenues, profits, bonuses and stock will go down ***relative*** to their peer group.

While doing otherwise may be tolerated by a board and stockholders for a short time, it will not last long as revenues, profits and stock drop relative to their peers. That is why Mr. Prince was right: "As long as the music is playing, you've got to get up and dance" or, what he didn't say was, you will be replaced with someone who will.

That is the (oversimplified) history of Morgan Stanley in the 2000s. John Mack was CEO until ousted in 2001, when Paul Purcell was appointed CEO. Morgan Stanley then pursued a business diversification strategy, seeking relatively stable revenues and profits from a broad mix of businesses that avoided the high-risk, high-leverage, and high-return trading and investment activities that were taking off at its rivals.

As its revenues, profits, bonuses, and stock lagged its rivals, the board ousted Mr. Purcell, and in June 2005, brought back Mr. Mack as CEO, clearly with the mandate to catch its rivals by doing what they were doing. As the siren song of deregulatory music played, he got Morgan Stanley up and dancing to the tune of big proprietary trading, structured products, and subprime mortgage activities. However, just a little over two years later in the fall of 2007, Morgan Stanley was forced to begin recognizing gigantic losses from proprietary trading at the same time it was forced to take substantial subprime-related write-downs. Eventually they were cumulatively so crippling that Morgan Stanley was on the verge of failure in the days following Lehman's bankruptcy and required a bailout by the Fed to survive.

To his credit, Mr. Mack recognized what had happened and in 2009 embraced financial reform, regulation and regulators. In fact, he went so far as to say, "[w]e cannot control ourselves. You [lawmakers and regulators] have to step in and control the Street. Regulators? We just love them."

This cautionary tale and the broader history before, during, and after the 2008 crash demonstrate why banking regulators and supervisors, as well as oversight, regulation, and enforcement generally, are so critically important. Put differently, regulators have to step in and slow the tune if not change the song or stop the “music” altogether, regardless of how much “dancing” the bankers want to do.

Without taking such independent and, at times, unpopular actions, the public interest is subordinated and exposed to the erratic and volatile dynamics of the marketplace, with devastating crashes the inevitable result. That, to some extent, is what is happening now. The industry and its allies are effectively yelling, “Strike up the band, consequences be damned!”

<u>My ninth observation is agreement about transparency, among other things</u>.

Before I conclude, I don’t want you to think I disagree with everything in the paper. I do not, but talking about what we agree on when we have only a short time doesn’t illuminate the different perspectives that are critical to understanding those key issues.

That said, I do want to talk very quickly about a key area of agreement. I agree with the authors that ***<u>transparency</u>*** is overwhelmingly important, but not just ***to*** and ***for*** the banks, as they see it. In my view, transparency ***to*** and ***for*** the public is equally if not more important.

One reason the discussion sometimes misses and under-values that point is, I believe, the framing, which is all about ***supervision***. Framing it, however, as ***regulation*** would, I believe, remove some outdated thinking driven by historic notions of supervision. Thought of this way, the so-called costs to the banks, the overweighting of their so-called “concerns,” and the paper’s suggestions to reduce disclosure to the public of what they refer to as “outputs,” should lead to some very different ideas. To protect the public and implement the law as intended, the Fed needs to think about regulation separate and apart from (albeit complementary to) supervision as it has historically been understood and executed.

However, the concerns expressed about increasing the transparency of “inputs” to the banks are well-taken. It bears repeating that there has already been substantial – and in our view, unwise – disclosure of inputs to the banks. This is not providing them merely with the textbook for the test, but with sufficient information to almost certainly reverse engineer the tests and game the system.

Moreover, as noted earlier, the authors’ observation that the ***“banks have said thank you,” but nonetheless have “asked for even more”*** is key. This is an insatiable request and attempting to satisfy the banks will not be possible consistent with credible stress tests. The paper is correct that reducing transparency by not disclosing the qualitative results of the stress tests is unwise and almost certainly will have deleterious implications.

There can be no doubt, as the authors stated, that “the qualitative objection has been a powerful tool for micro-prudential supervisors to ensure that risk managers weren’t becoming complacent." Moreover, as they also stated, "the possibility of public embarrassment had been a significant motivator for banks to improve their risk management practices and had lent credibility to supervisory stress test exercises."

I'd like to make a point here that is applicable elsewhere. Regulators, policymakers, academics and other involved in the discussions must guard against using and adopting industry talking points and spin, which is done too often. Such biased industry rhetoric – that is usually the result of careful analysis and testing – is meant to predispose regulators and the public to a preordained pro-industry view.

In this case, saying public disclosure of the qualitative results is "public shaming" is a misleading disservice to the debate, analysis and the public. The public and taxpayers paid the bill for banks' bad judgements, blind spots, and reckless and illegal conduct last time. And, they will be doing so again next time. Informing them about the status of those banks' qualitative practices seems like the very least regulators should do. If there is a compelling, data-driven and principled objection, then it should be disclosed and discussed among interested parties with disinterested language.

There are other areas of agreement as well. For example, the paper makes the very important point that stress tests simply cannot be understood and should not be thought of in isolation. The paper also discusses the critically important role of regulatory arbitrage, gaming and the shadow banking system, all of which have been longstanding concerns of Better Markets.

Markets discipline is the focus of my penultimate observation: It is essential to regulating systemically significant banks and ending too-big-to-fail, but that requires the Fed to increase disclosure.

Another key point regarding transparency needs to be emphasized: Disclosure to "the public" necessarily includes disclosure to the markets. Such disclosure is imperative for there to be any hope of market discipline being applied to systemically significant banks. Regulation of those banks and, in particular, the attempted elimination of too-big-to-fail will never work without effective market discipline, which depends on the quality and quantity of information available to the markets, i.e., transparency.

Viewed through the prism of market discipline, the banks' stated concerns about so-called "volatility" related to disclosure of stress test information could just as easily be understood as objecting to the markets processing and applying that information to the then-current condition of the systemically significant banks. While those banks would no doubt wish to avoid such market discipline, regulators must prioritize providing such information to the markets so that they can best assess the actual condition of those banks and ensure that the market prices reflect the total mix of information. This is true for stress tests, living wills and so much more.

Put differently, regulators generally and the Fed in particular simply must recognize that market discipline is an ally and an essential pillar to ending too-big-to-fail and enacting effective financial regulation more broadly. While such thinking about transparency and disclosure may be inconsistent with the Fed's historic anti-transparency proclivities and longstanding fear of accidentally precipitating bank runs, the post-crash regulatory and legal requirements and goals demand that the Fed change and increase disclosure regarding the banks to the public.

My concluding observation is a cautionary note on the focus of regulatory attention.

The concluding section of the paper, entitled "Balancing the Costs and Benefits ***for*** Banks and Regulators," raises some very serious concerns. It begins with a troubling question that frames the discussion of the entire section:

> "Have we struck the right balance between **the needs of banks and their regulators** (and taxpayers) in stress test policy?" (Emphasis added)

"Taxpayers" are only mentioned in the parenthetical, never to appear again. Banker needs and wants are, in contrast, very prominent to the point that the conclusion is:

> "A bank's Board should have more power over capital planning in peacetime, while regulators should be able to intervene as war approaches."

In addition to rejecting the peacetime/wartime framework, I would also suggest that focusing on "balancing" the so-called "needs" of banks and regulators turns the world upside down. Taxpayers and their needs should be at the center of the question, analysis and answer. I would propose asking this question:

> Do stress tests serve their purpose in protecting the public, taxpayers, the financial system and our economy from undercapitalized, overleveraged too-big-to-fail banks that pocket profits and bonuses in peacetime and shift losses to taxpayers and Main Street in wartime?

Let's look at the evidence. Banks had to be bailed out in 2008 by taxpayers because they didn't have the capital to absorb their own losses. Why was that?

Because those banks spent down their capital on stock buybacks and dividends in the years before the 2008 crash and, indeed, up to and ***after*** the collapse of Lehman Brothers on September 15, 2008. The banks intentionally and needlessly reduced their capital cushions even as the crisis was upon them, even as they were taking big losses starting in 2007, even after Bear Steans collapsed, and even after Lehman crashed.

And the regulators said nothing and did nothing. There's a terrific NBER working paper on this.

So, I ask again, when was peacetime and when was wartime? All the clearly ominous events and warning signs of 2007 didn't slow the capital ejections. Not by the bankers and not by the regulators.

In closing, taxpayers must be central to the entire discussion and above the "needs of banks," and as I said I would at the start, I reiterate the question that should frame all analysis and policymaking:

> Do stress tests serve their purpose in protecting the public, taxpayers, the financial system and our economy from undercapitalized, overleveraged too-big-to-fail banks that pocket profits and bonuses at all times and shift losses to taxpayers and Main Street in a crisis?

Exhibit 1:

Total Un- and Under-Employed

(At One Month Peak: Almost 27 Million Americans)