

SURF Spotlight
Conference Summary — Stress Testing: A Discussion and Review¹
2019 Q3

On July 9, 2019, the Federal Reserve Bank of Boston hosted **Stress Testing: A Discussion and Review**, a conference that brought together a diverse group of speakers and attendees, including domestic and international regulators, bankers, and academics. The goal was to discuss the transparency and effectiveness of stress tests, focusing on how these tests can remain a dynamic and useful tool of large bank supervision.

Federal Reserve Chair Jerome Powell provided opening remarks for the conference via video, saying: “The Federal Reserve is strongly committed to stress testing as a cornerstone of our bank supervisory and financial stability missions. Stress testing is perhaps the most successful supervisory innovation of the post-crisis era.” He also said that for stress tests to continue to serve their critical function, the tests will “need to evolve in the years ahead to keep pace with the ever-changing financial system,” as they have in the past decade.

As financial institutions and the financial system continue to evolve and when “the next episode of financial instability presents itself,” Chair Powell said, “banks will need to be ready not just for expected risks, but for unexpected ones.” Thus, stress tests will “need to vary from year-to-year” and “explore even quite unlikely scenarios.”

Chair Powell warned that if stress tests do not evolve, then “they risk becoming a compliance exercise,” which could inadvertently encourage a banking system in which “all banks would look much alike rather than the banking system we want and need, one with diverse institutions with different business models.”

Randal Quarles, vice chair for Supervision of the Federal Reserve, was the keynote at the event. During his speech, Vice Chair Quarles focused on three main changes to the Comprehensive Capital Analysis and Review (CCAR) program concerning: (1) transparency, (2) simplicity, and (3) volatility.

First, regarding transparency, Vice Chair Quarles referenced the [enhanced disclosure](#) released on March 28, 2019. The document provided additional information on the Federal Reserve’s stress testing program, including:

- ranges of loss rates (projected using the Federal Reserve’s models) for loans that are grouped by distinct risk characteristics,
- portfolios of hypothetical loans with loss rates projected by the Federal Reserve’s models, and
- enhanced descriptions of the Federal Reserve’s models.

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Vice Chair Quarles explained that the Federal Reserve will continue to enhance transparency around models and processes each year. He added that the Fed “is also exploring ways to provide additional transparency around stress test scenarios and scenario design.”

Second, Vice Chair Quarles discussed the use of the Stress Capital Buffer (SCB) and suggested that this simpler method of integrating stress testing with the minimum capital rules could be ready by CCAR 2020. He stated that “the stress capital buffer would not reduce the stringency of the regulatory capital framework for large banks, but it would affect a substantial simplification of that framework.” The SCB replaces the static 2.5 percent capital conservation buffer with a firm-specific buffer calculated from the firm’s stress test results.

Third, in terms of volatility, Vice Chair Quarles explored the possibility of averaging the stress test results from previous years to make the tests less volatile. He explained that doing so “would mean that no single year could have an outsized influence on the amount of capital that a bank is required to maintain.”

The conference also included moderated panels on “Stress Tests as a Policy Tool,” “Dynamism and Transparency in Stress Testing,” and “The Effects of Stress Tests.”

The initial panel included the paper “Stress Tests and Policy” by Greg Feldberg and Andrew Metrick from the Yale University School of Management, with discussants Charlotte Gerken (Bank of England), Dennis Kelleher (Better Markets), and Brian Lee (Goldman Sachs). The session illustrated the diverse opinions on how stress testing should evolve. The Feldberg and Metrick paper focused on whether general principles can be used to guide the evolution of stress tests moving forward. The authors used the concept of “wartime versus peacetime” stress testing, which was introduced by Til Schuermann. Wartime and peacetime refer to crisis and noncrisis periods, respectively. The authors offered several views in light of recent changes and proposals to the stress testing program under discussion:

- sticking with the stress capital buffer proposal,
- promoting the macroprudential goals of the supervisory stress test by probing bank and nonbank linkages and by tying it to a revised countercyclical capital buffer, calibrated for normal times,
- considering some easing of the immediate impact of stress tests on banks’ capital planning to ensure banks don’t face rapidly shifting capital requirements during peacetime,
- holding firm on the G-SIB buffer, which is designed to mitigate the additional risks that the failure of a large and systemic financial institution would pose to financial stability,
- reconsidering the move to ease stress test requirements for apparently medium-risk big banks,
- slowing the transparency train to avoid gaming, herding, and complacency in bank risk management, and
- considering the resurrection of the qualitative objection, possibly with softer capital impacts.

Discussants offered some different views. Gerken stated that Feldberg and Metrick’s paper is a reminder of why stress testing is a useful tool. It ensures that banks can absorb, rather than amplify, shocks and continue to lend in times of stress, both points that guide the UK approach to stress testing. Gerken stated that the Bank of England has an explicit link to macroprudential policy through the countercyclical buffer. The aim is to systematically adjust the severity of the scenario that, in turn, makes changes “fairly predictable” to reduce volatility around requirements, which Feldberg and Metrick highlight as a design issue.

Kelleher questioned the notion of a so-called peacetime/wartime stress testing framework. He referred to this label as “dangerous and unworkable.” He said he believes it is impossible to know at any given point in time whether one is in peacetime vis-à-vis wartime. He focused on the \$20 trillion cost of the financial crisis, a figure calculated by Better Markets, to drive home one of his main points: Banks must hold sufficient loss-absorbing capital to avoid taxpayer bailouts, so the Federal Reserve should retain the rigor of stress tests at *all* times.

Lee referred to Feldberg and Metrick’s paper as balanced and well researched. He provided remarks covering three components. First, he agreed that stress testing should be involved in peacetime. However, Lee said he believes it is time to recalibrate stress tests, a stark contrast to Kelleher’s view. He states that common equity for U.S. banks has more than doubled since the financial crisis, and, in his view, stress testing has evolved from a capital-raising tool to a capital-allocation tool.

Second, Lee said he believes bank models can be powerful microprudential tools. He prefers to have bank models determine capital requirements, which he sees as a solution to a model monoculture. In contrast to bank models, the Fed’s internal models would be used as macroprudential tools to monitor System-wide risks.

Third, he notes that coherence is critical within stress testing and broader capital framework. Specifically, Lee said he fears that we are not viewing capitalization rates at the business level, which is leading to shifts in intermediation from the regulated banking sector to the shadow banking sector.

The other two panels also offered divergent views and robust discussions on the current and future state of stress testing. You can find the recorded webcast of the event and the papers associated with each panel at the [conference webpage](#) (scroll to the bottom of the webpage to find the associated recordings and links).