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Stressless "Stress" Tests for Wall Street's Banks Endanger Main Street Families, Businesses, and Community Banks

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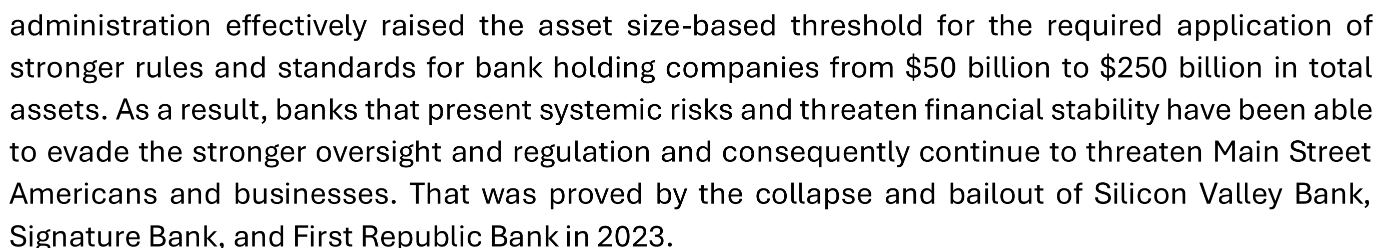
Done right, stress testing the biggest banks for various scenarios that could cause failure is one of the most important regulatory actions to prevent bank failures, crises, contagion, and taxpayer funded bailouts of Wall Street's biggest banks. Done wrong, stress tests give false comfort, make crashes and bailouts more likely, and endanger Main Street families, businesses, and community banks.

The lost jobs, homes, savings, retirements, and dreams of tens of millions of Americans due to the financial crisis of 2007-2009 ("financial crisis") highlight the imperative of having strong banking regulations combined with effective supervisory oversight to ensure the largest banks are both financially sturdy and properly managed. Pre-financial crisis banking rules for the largest banks were grossly deficient, ineffective, and lacked robust stress testing. Weak standards for liquidity and capital in particular allowed Wall Street's biggest banks to take on too much risk, which ignited and fueled the crisis that had devastating effects on Main Street families and businesses as well as the financial system and entire economy. At the same time, banking supervision—the day-to-day oversight of these firms that should complement and fill in potential gaps in rules to ensure banks are not dangerously run—failed dramatically. Combined with weakened rules, this created a particularly fragile banking system that was a ticking time bomb in the 2000s – until it blew up with disastrous consequences.

While the post-financial crisis reforms have not come close to removing the Damocles Sword of Wall Street's too-big-to-fail banks problem as the law requires, they did substantially strengthen the U.S. banking system by ratcheting up the regulation and oversight of the largest banks. Indeed, post-crisis banking sector reforms are the key reason the largest banks entered the COVID-19 pandemic in relatively strong financial condition. Remarkably, all this was done while bank lending increased, and bank profits skyrocketed. Financial reform proved to be a win-win.

Nevertheless, many of the reforms have been under attack by the banking industry from the start, and, under periodic deregulatory efforts, a number of these reforms have been seriously weakened by legislation, rulemaking, and reduced supervision. For example, in 2018 Congress passed the mis-named Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"). That law combined with misguided discretionary actions by the Federal Reserve ("Fed") during the Trump



administration effectively raised the asset size-based threshold for the required application of stronger rules and standards for bank holding companies from $50 billion to $250 billion in total assets. As a result, banks that present systemic risks and threaten financial stability have been able to evade the stronger oversight and regulation and consequently continue to threaten Main Street Americans and businesses. That was proved by the collapse and bailout of Silicon Valley Bank, Signature Bank, and First Republic Bank in 2023.

Although many of the post-financial crisis reforms remain intact for the very largest banks (those classified as Global Systemically Important Banks or "GSIBs"), there have been significant changes that undermine the value of what is perhaps the most important post-crisis initiative—the Fed's stress testing program and related banking supervision efforts. Stress tests are critical tools to protect the economy and Main Street Americans. Such tests, which regulators conduct on banks to see if they could survive a financial shock without failing and costing taxpayers trillions of dollars, would have been invaluable before the 2008 crash that cost American families their homes, savings, and jobs.[1]

That's because the only thing standing between a failing bank, a financial crisis, a taxpayer bailout, and economic and human catastrophe is the amount of capital a bank has. If a bank has enough capital to absorb its own losses, then it won't fail, cause a crisis, or require a bailout. Stress tests are what inform regulators, the banks, and the public whether banks in fact have enough capital to withstand severe yet plausible stress events without requiring a bailout or other government assistance to survive.

In the aftermath of the financial crisis, the Fed and U.S. Treasury stress-tested the largest U.S. banks to restore public confidence in the financial system. And it worked. For example, the then-President and COO of Goldman Sachs, Gary Cohn was singing the praises of stress tests and capital:

> [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.[2]

The banking regulators also understand the vital role of stress tests, the enormous importance of bank resiliency in preserving the stability of the financial sector, and the key role of capital requirements in achieving that goal:

> The resiliency of large financial institutions is critical to the stability of the financial sector. As shown in the 2007-2008 financial crisis, problems at large financial institutions can lead to significant market disruption, spread rapidly throughout the financial system, and cause a credit crunch, worsening economic downturns. To be resilient, a financial institution must maintain sufficient levels of capital to support the risks associated with its exposures and activities. In the years leading up to the financial crisis, neither the regulatory capital regime nor financial institutions' own

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1 BETTER MARKETS, THE COST OF THE CRISIS (July 2015), https://bettermarkets.org/newsroom/20-trillion-cost-financial-crisis-3.

2 Dakin Campbell, *U.S. Banks Safer Than Europeans Due to Early Medicine*, BLOOMBERG (Feb. 9, 2016), https://www.bloomberg.com/news/articles/2016-02-09/u-s-banks-safer-than-europeans-due-to-early-medicine-cohn-says.

> models sufficiently captured the actual risk exposures of financial institutions, resulting in a level of capital that was inadequate to cover losses as conditions deteriorated, putting the economic activity at risk.[3]

Despite statements such as this, changes made by the Fed (often with other banking regulators) have made the financial system and the economy much more vulnerable to the threats that large banks present. They have also reduced the confidence taxpayers can have that the banking system is resilient enough to withstand a severely stressful period without requiring another taxpayer-funded bailout. These outcomes are unacceptable; Main Street Americans deserve more protection from the risks that Wall Street's biggest banks create in seeking to maximize their profits and bonuses.

Background

The Dodd-Frank Act established stress testing requirements for certain bank holding companies and nonbank financial institutions ("covered companies") by the Fed.[4] These tests are intended to discover whether covered companies "have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions." Section 165(i)(1) of the Dodd-Frank Act requires the Fed and other federal banking regulators to conduct annual stress tests of covered companies with assets greater than $50 billion. Section 165(i)(2) of the Dodd-Frank Act requires covered companies semiannually and all other financial companies with assets greater than $10 billion and for which there is a primary federal regulator annually to conduct their own stress tests.

The value of stress tests as a tool for stabilizing markets and reassuring the public was proven in 2009—during the heat of the financial crisis—before the Dodd-Frank Act was passed. Fed Vice Chairman for Supervision Michael Barr explained:

> In the winter of 2008–09, markets had lost confidence in banks amid wide uncertainty about the future path of the economy and the losses banks could face. This prompted the Federal Reserve and Treasury to conduct a stress test to determine the health of the 19 largest banks under a severely adverse economic scenario and to publish the findings. The release of the results provided transparency about the status of the largest banks, made it easier for firms to re-capitalize themselves, and restarted the provision of credit to the economy that began the process of recovery.[5]

As Fed Governor Daniel Tarullo, in his final official speech before his departure from the Fed in 2017 said, stress tests are now regarded as "the key innovation in capital regulation and supervision," which makes the other reforms such as enhanced capital standards "more effective."[6]

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3 Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules 18167; 83 FED. REG. 18160 (Apr. 25, 2018), https://www.federalregister.gov/documents/2018/04/25/2018-08006/amendments-to-the-regulatory-capital-capital-plan-and-stress-test-rules.

4 Public Law No. 111-203, 124 Stat. 1376 (July 21, 2010), https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf.

5 Board of Governors of the Federal Reserve System, *Multiple Scenarios in Stress Testing* (Oct. 19, 2023), https://www.federalreserve.gov/newsevents/speech/files/barr20231019a.pdf.

6 Board of Governors of the Federal Reserve System, *Departing Thoughts* (Apr. 4, 2017), https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.

Key Changes in Stress Tests Since Dodd-Frank

In 2020, the Fed and other banking regulators made several key changes that undermined the progress that had been made since the financial crisis. The net effect of these changes is a reduction in the amount of capital that large banks must maintain to ensure their financial stability. These changes made the economy more vulnerable to threats that large banks present and reduced the confidence that Main Street American can have that the banking system is resilient enough to withstand a severely stressful period without requiring another taxpayer-supported bailout. Better Markets opposed many of these changes, detailing why they were misguided and unwise.[7] The most dangerous of the changes are discussed in more detail below, including:

- The Size of Banks that Are Subject to the Stress Tests Was Increased;
- Assumptions in the Stress Tests Were Weakened and the Leverage Ratio Requirement was Removed;
- The Qualitative Assessment—a Critical Component of the Overall Stress Testing Program—Was Effectively Eliminated; and
- Stress Test Models Were Made More Transparent and thus More Vulnerable to Gaming.

The Size of Banks that Are Subject to the Stress Tests Was Increased

While the initial set of stress tests that were done in 2009 included only 19 of the largest banks, the Dodd-Frank Act established a much broader and stronger framework for supervisory stress tests. The Dodd-Frank Act directed the Fed to conduct annual stress tests for all banks with $50 billion or more in total consolidated assets. However, the regional banks lobbied for looser regulation, arguing that these tests imposed an undue strain on their financial and human resources.

The deregulatory EGRRCPA legislation severely weakened the stress testing program by increasing the minimum size of banks subject to the Fed stress tests from $50 billion in total assets to $100 billion in total assets. It further weakened the program by allowing the Fed to determine the frequency of periodic stress tests for covered companies with total assets between $100 billion and $250 billion. The Fed determined that firms with $100 billion to $250 billion in total assets would only be subject to stress tests every other year.

Without question, conditions in the banking system as a whole and at individual companies change very rapidly. The spring 2023 bank failures proved that the condition and viability of banks can deteriorate to critical levels in a matter of days. It also proved that banks in the $100 billion to $250 billion asset size range absolutely do present systemic risks to the financial system as a whole. Therefore, it is clear that the decision to increase the frequency of stress tests for these banks to two years was a mistake.

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7 Better Markets Comment Letter, *Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules* (June 25, 2018), https://bettermarkets.org/sites/default/files/Better%20Markets%20CL%20to%20Fed%20-%20Cap%20buffer%20and%20stress%20testing%206-25-18.pdf.

Assumptions in the Stress Tests Were Weakened and the Leverage Ratio Requirement was Removed

Like in any model, the assumptions used in the stress test matter a great deal to the final results. In the bank stress tests, key assumptions have been materially weakened by the Fed, so not only are the more recent test results not comparable to prior test results, but the current results are also less viable, informative, and trustworthy. As Better Markets has detailed, several changes have eroded the stress test, increased the post-stress capital ratios, and resulted in an overstatement of the strength of the banks being tested, including:

1. Banks are no longer assumed to continue to pay dividends during stress periods; and
2. Banks' balance sheets are not assumed to grow during stress periods.[8]

With regard to the dividend assumption, prior to 2020, the stress test included banks' actual planned common stock dividends and share buybacks for the full 9 quarters of the stress scenario timeframe. In addition to lowering the amount of capital banks that are required to have, this change weakens the forward-looking nature of the stress test and undermines the countercyclical approach of requiring banks to build capital during good times in preparation for an extended downturn.[9]

The change to the assumption that large banks will cease growth during periods of stress is inaccurate and not consistent with actual bank behavior. For example, during the COVID-19 pandemic, many of the large banks continued to grow.[10]

Furthermore, the post-stress leverage ratio requirement was removed. The leverage ratio was intended to serve as a backstop to risk-adjusted capital requirements since it does not weight assets (which can become the subject of debate, as we are seeing now with the Basel Endgame proposal) and only considers how much capital a bank holds relative to its assets (and off-balance sheet exposures). Such a backstop is critically important, especially during times of stress when financial conditions and bank positions are changing rapidly.[11]

The Qualitative Assessment—a Critical Component of the Overall Stress Testing Program—Was Effectively Eliminated

Together with the quantitative model- and scenario-based portion of the stress tests, the Fed's broader program for assessing bank resilience under stress originally included a qualitative portion. This qualitative portion has been wrongly eliminated. As Better Markets' expert Tim P. Clark explains,

> ***The qualitative assessment focuses on practices that support banks' ability to run their businesses safely, to identify and assess risks, and to make informed decisions about the capital needed to survive another economic meltdown*.**

[8] *See, e.g.*, *The Federal Reserve's 2021 Stress Test Results: All Bark and No Bite* 2, Better Markets (June 28, 2021), https://bettermarkets.org/sites/default/files/documents/BetterMarkets_Fed_Stress_Test_FactSheet_07-28-21.pdf.

[9] *See, e.g.*, Dennis Kelleher & Tim Clark, *Federal Reserve Actions Under the Trump Administration Have Significantly Weakened Post-Crisis Banking Protection Rules* 3, Better Markets (Dec. 3, 2020), https://bettermarkets.org/wp-content/uploads/2023/03/Better_Markets_WhitePaper_Fed_Actions_Under_Trump_Administration_12-03-2020.pdf.

[10] *Id.*

[11] Better Markets, *supra* note 7.

Importantly, it also supports the Fed's quantitative assessment. Weaknesses in bank practices that are reviewed during the qualitative assessment, particularly those supporting risk measurement and data integrity, can undermine the Fed's supervisory stress test because the Fed uses information it receives from the banks as inputs. . . .

The Fed could object to the bank's planned capital payouts under the qualitative assessment. This was known as the "qualitative objection," which was publicly disclosed in an annual announcement that outlined the reasons for the objection and could lead to temporary restrictions on a bank's ability to make capital distributions to investors, restrictions that could remain in place until the bank fixed its weak practices.

In announcing the decision to scuttle the qualitative objection, the Fed assured us a similar, but not publicly disclosed, qualitative assessment will remain a key part of its supervision of the largest banks. Nonetheless, this decision all but guarantees the banks won't put as much effort into maintaining or strengthening their practices as they have over the past nine years. It also indicates the Fed Board shares the banks' desire to return to more "traditional" pre-crisis supervision, which was less transparent to the public, less restrictive on the banks and, not coincidentally, far less effective.

The qualitative objection has been used sparingly. The process never *required* the Fed to object to a bank's planned capital distributions on qualitative grounds; it allowed for an objection when Fed bank supervisors found it warranted and the Board of Governors agreed. ***The Fed has now given away this valuable option seemingly in exchange for nothing more than bankers' appreciation. This raises concerns about what might be given away next.***[12]

Stress Test Models Were Made More Transparent and Thus More Vulnerable to Gaming

Better Markets has also detailed how changes the Fed made in 2019—billed as an effort to make the stress test ***more transparent*** by providing more detailed information to banks and the public about the modeling the Fed uses in its stress tests— ***actually undermines*** the value of the stress test in multiple ways.[13]

First, giving the banks too much information on how the Fed is estimating losses allows banks to reverse engineer the test and as a result make it less effective at capturing the banks' risks. In other words, banks may design products or structure their balance sheets in ways that carry the same risks they did before but are less likely to be picked up as clearly during the stress test. This would allow them to hold less capital without reducing their risks.

[12] Tim P. Clark, *Is the Fed in Retreat?*, POLITICO (Apr. 9, 2019), https://www.politico.com/agenda/story/2019/04/09/federal-reserve-stress-tests-banks-000889/ (emphasis added).

[13] Kelleher & Clark, *supra* note 9 at 4-5, 7.

Second, increased disclosure on modeling increases the risk that banks will simply use the Fed's models rather than focusing on developing their own independent and robust measurement techniques specifically designed to capture their own idiosyncratic risks. This makes the system riskier if the Fed and the banks are all focusing on the exact same measurement techniques because it makes it more likely they could all miss the same risks in the same way and at the same time. A diversity of approaches is best and greater disclosure of Fed modeling techniques risks reducing that diversity.

The Fed's stated desire for greater transparency is, at best, unevenly applied and, at worse, appears to be driven by industry interests rather than the public interest. For example, regarding the qualitative objection discussed earlier, the Fed has made the stress testing program ***less transparent*** to the public by changing the qualitative assessment process in a way that reduces public disclosure of information about risk management and capital planning weaknesses at specific banks. However, as discussed here, ***the Fed did the exact opposite regarding the steps to increase modeling transparency in ways that could make the stress test both easier for banks and less effective at promoting resiliency***. What is the common theme? The biggest banks lobbied relentlessly for both changes.

Changes to the Stress Testing Program Were Premature and Unnecessary

The American people depend on the Fed and other banking regulators to properly oversee banks to protect their life savings and avoid taxpayer-funded bailouts. Better Markets has detailed several reasons that the stress testing framework prior to the changes discussed above worked well and why the changes that were made were "an unforced error" by the Fed.[14]

- **Prior to the Changes, Banks Were Safer Than Ever:** By all accounts, U.S. banks are more resilient than ever and much better able to withstand stress than before the financial crisis.[15] In fact, 2018 was the first year since the financial crisis, and only the third year since 1933, in which ***not a single bank failed***.[16] Credible stress testing has been key to this success. As Fed Governor Brainard observed, "One key benefit of our stress testing program is that it promotes a dynamic forward-looking assessment of a bank's capital adequacy in the face of severe stress."[17] Weakening regulations that have been so successful in making the financial system safer should only be considered if there is a substantial countervailing data-driven basis.

- **Prior to the Changes, Banks Were More Profitable than Ever:** The Fed should not be swayed by the banks' pleas to reduce "unnecessary" or "needless" compliance costs. In the first

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14 *See, e.g.*, Better Markets Comment Letter, *supra* note 7; Tim P. Clark, *supra* note 12.

15 Board of Governors of the Federal Reserve System, *Lael Brainard Remarks at the Global Finance Forum, Safeguarding Financial Resiliencies Through the Cycle*, at 7, 10 (Apr. 19, 2018), https://www.federalreserve.gov/newsevents/speech/files/brainard20180419a.pdf.

16 Hugh Son, *For the First Time Since 2006, Not a Single U.S. Bank Failed Last Year*, CNBC (Jan. 10, 2019), https://www.cnbc.com/2019/01/09/for-the-first-time-since-2006-not-a-single-us-bank-failed-last-year.html.

17 Board of Governors of the Federal Reserve System, *supra* note 15.

instance, the important role of **annual** stress tests fully justifies their costs. Moreover, those costs are plainly not unduly burdensome: not only has the current regulatory framework made banks more resilient, it has done so while allowing them to make record profits.[18] If under the current framework banks are having no trouble making massive if not historic profits even as they are safer, what justification could there be for weakening the framework? There is none.

- **The Fed's and Other Banking Regulators' "Experience" with Stress Tests Is Insufficient:** Despite the Fed's assertion, it does not, in fact, have sufficient experience to determine whether it is safe and appropriate to reduce the frequency of company-run stress tests. As Fed Governor Brainard has pointed out, it is imperative to "wait until we have tested how the new framework performs through a full cycle before we make judgments about its performance."[19] Until such time, at a minimum, the Fed cannot reasonably assert that it can weaken the regulatory framework while still fulfilling its statutory obligation under Dodd-Frank to protect the public from another $20 trillion crisis.[20]

- **Credible Stress Tests Are Critical to Financial Stability:** As shown by prior experience, stress tests are an essential component in the regulatory toolbox for preventing or mitigating financial crises. In the midst of the financial crisis, stressed if not panicky markets were reassured when the government published stress test results demonstrating the resiliency of the largest banks. Indeed, many consider these tests and the related disclosure to be the turning point of the crisis.[21] However, stress tests are only useful if they are credible and viewed as such. Yet in rapidly changing economic conditions during a period of market distress, tests conducted up to two years earlier are not sufficiently current and are unlikely to be considered credible. As one expert observer cautioned:

  > Doing stress tests less frequently, such as only once every two years, would not be frequent enough to meaningfully promote financial stability. First, firms make choices about dividends and share repurchases at least once a year. Capital planning which should incorporate projected capital positions and risks to those positions should not be done less frequently than decisions about shareholder payouts.[22]

- **Stress Test Weaknesses Are Amplified By Other Deregulatory Actions**: The effects of reducing the frequency and strength of stress tests cannot be considered in isolation. Instead, the potential effects must be considered in light of the other deregulatory actions

[18] Kate Berry, *Four Myths in the Battle over Dodd-Frank*, AM. BANKER (Mar. 10, 2017), https://www.americanbanker.com/news/four-myths-in-the-battle-over-dodd-frank.

[19] Board of Governors of the Federal Reserve System, *supra* note 15.

[20] BETTER MARKETS, THE COST OF THE CRISIS, *supra* note 1.

[21] MORRIS GOLDSTEIN, BANKING'S FINAL EXAM: STRESS TESTING AND BANK-CAPITAL REFORM 2 (2017).

[22] Nellie Liang, *Higher Capital Is Not A Substitute For Stress Tests*, BROOKINGS INST. (2017), https://www.brookings.edu/wp-content/uploads/2017/04/es_liang_stresstests_04-24-17.pdf.

that were taken between 2016 and 2020, including a series of regulatory changes to weaken capital and liquidity requirements for banks.[23]

Challenges with Using Stress Testing as a Tool to Measure Capital Adequacy

While stress testing is certainly important, users of this tool and consumers of the information it yields must ensure that they are fully informed of both the tool's strengths and weaknesses. As Better Markets said after the results of the 2023 stress tests were released showing that all tested banks again passed:

> [T]he 2023 stress test results ***merely suggest that the 23 tested banks might meet regulatory capital minimums under the scenarios designed and tested by regulators***. . . . Thus, ***if the future plays out exactly as the regulators' stress test scenarios assume***, then the regulatory capital minimums should be ***sufficient***.[24]

Industry experts[25] as well as the Fed itself[26] have identified numerous challenges and pitfalls related to stress testing, which are highlighted by the banking industry's repeated attempts to conflate passing the annual stress tests with a blanket badge of safety and resilience, and free pass to eject capital to their shareholders. In a recent speech Fed Vice Chair Barr highlighted several key limitations of stress testing:[27]

- **Reliance on a single stress scenario:** While the scenarios that the Fed develops to guide the stress testing process are reasonable educated guesses on what risks might materialize in the future, it is impossible to actually predict the future. Therefore, the results of the stress tests are based solely on the events in the scenarios and banks remain vulnerable to a range of other risks and shocks that are not included in the scenarios. We do not have to look far to see this problem in reality:

  > In February of 2022, the Fed disclosed the full array of banks to be tested for the year, and what it considered the worst possible economic scenario. The lenders would get passing grades if they held sufficient capital to weather what the central bank viewed as the heaviest possible headwinds all gusting at the same time.
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  > The Fed got the baseline scenario pretty much right in predicting a healthy economy, and more or less hitting the marks on robust GDP growth and low

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[23] *E.g.*, Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements 83 Fed. Reg. 66024 (Dec. 21, 2018).

[24] Better Markets Press Release, *Wall Street is the New Lake Woebegon with All Banks Again Passing Federal Reserve's Stressless Stress Tests* (June 28, 2023), https://bettermarkets.org/newsroom/wall-street-is-the-new-lake-wobegon-with-all-banks-again-passing-federal-reserves-stressless-stress-tests/ (emphasis added).

[25] *See, e.g.*, Dr. Christian Thun, *Challenges and Pitfalls of Stress Testing*, MOODY'S ANALYTICS RISK PERSPECTIVES (Sept. 2013), https://www.moodysanalytics.com/risk-perspectives-magazine/stress-testing-europe/principles-and-practices/challenges-and-pitfalls-of-stress-testing.

[26] Board of Governors of the Federal Reserve System, *supra* note 5.

[27] *Id*.

> unemployment. But it was spectacularly wrong on inflation and interest rates. Consider that in February of 2022, when the Fed issued these numbers, the consumer price index (CPI) was already advancing at 6.5%, and the 10-year Treasury yield had spiked to 2% and was rising fast. Yet somehow, the Fed had inflation dropping to 2.3% in Q1 of 2023, and going a touch lower by early 2025. It predicted that right now, the three-month Treasury would be yielding 0.9%. . . .
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> 'What the Fed saw as the big potential threats didn't materialize, and the threat that did materialize they didn't see coming,' says [Thomas Hogan, former chief economist at the Senate Banking Committee and now a senior fellow at the American Institute for Economic Research]. 'By the end of 2021, Chairman Powell had retired the word 'transitory' in talking about inflation, but he didn't act until much later. He only started raising rates in March of 2022. . . . And as we've seen with SVB and First Republic, soaring rates can turn what look like stable regional banks into hotbeds of risk overnight.[28]

- **Models**: While the Fed staff work diligently to develop models that incorporate the latest economic research and industry practice, and while the models are validated by experts outside the stress testing program, by their very nature, models are limited in their ability to reflect reality. As Fed Vice Chair Barr stated,

> [A]ll models have limitations—they are generally trained on historical data and therefore may not be robust to structural breaks, such as a once-in-a-lifetime pandemic, or important changes in technology.[29]

- **Effect of the Stress Test on Bank Behavior:** As discussed earlier, a clear weakness of the stress testing program is the transparency of the models that are used, which allow the banks to "game the system." It is the equivalent of providing the questions to test participants well in advance of the actual test, which most always results in more test subjects passing the test or at least performing better than they otherwise would. Fed Vice Chair Barr highlights how this practice could also lead to a buildup of risk in other areas that the tests do not emphasize, but may have substantial risk:

> Using scenarios that test for the same underlying risks year after year could disincentivize firms from investing in their own risk management as the test becomes predictable, and may encourage concentration across the system in assets that receive comparably lighter treatment in the test.[30]

[28] Shawn Tully, *The Fed's 'Stress Tests' Were Supposed to Save Banks From The Exact Crisis Now Engulfing Markets. Here's How They Were So Spectacularly Wrong*, FORTUNE (Mar. 20, 2023), https://fortune.com/2023/03/20/fed-stress-tests-banking-crisis-silicon-valley-bank/.

[29] Board of Governors of the Federal Reserve System, *supra* note 5.

[30] *Id.*

- **Financial System Interconnectedness:** Vice Chair Barr appropriately highlighted the severe second-order effects of stress within the financial system that the stress test framework does not consider:

> We also do not take into account second-order effects of stress within the financial system, which are channels that amplify the effects of the shocks hitting bank's balance sheets, leading to losses spreading throughout the financial system. A good example of this is the reaction of funding markets to stress at an individual firm or many firms. These network effects may result in losses across the system not fully captured by our stress tests. While the severely adverse scenario is calibrated to historical recessions that have included contagion, our stress tests may not fully capture the evolving interconnections in today's financial system.[31]

The Stress Testing Program Needs Further Change

As detailed earlier, stress testing done right pushes a system to its breaking point. The American people rely on the Fed to develop a test that is sufficiently challenging and one that will be an accurate indicator of the resilience of the largest banks in the face of a serious shock or economic downturn because it is taxpayer money on the line if such a shock or downturn does occur and banks fail.

The current stress tests are based on scenarios and economic projections that are rooted in past recessions. During each of these historical periods, the banks and other sectors of the economy were the beneficiaries of enormous amounts of government support. Instead, the stress tests must be severe enough to test banks' resilience in a situation where they have to stand on their own – without any government assistance. While the stress tests need not predict every potential bad outcome, they must be sufficiently severe to show that the banks are strong enough to withstand a range of severe outcomes – including those that the Fed and banks may have not even conceived.

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.[32]

Finally, recent evidence has proven how banks have been gaming other regulatory tests that directly affect capital levels, as the Fed's stress tests also do. Therefore, it is reasonable to expect that the banks are doing everything they can to work around the stress tests using the plethora of information that the Fed has provided to maximize profits, without concern for the array of negative

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31 *Id.*

32 Statement of Dennis Kelleher, Stress Testing: A Discussion and Review; Panel One: Stress Tests as a Policy Tool, Federal Reserve Bank of Boston Conference (July 9, 2019), https://www.federalreserve.gov/conferences/stress-testing-a-discussion-and-review.htm.

consequences for this behavior for financial stability or Main Street Americans. As Better Markets recently highlighted, research from the Basel Committee and from the Fed shows:

> [C]lear evidence. . .that the biggest global banks that pose the gravest risks to the financial system and economies of the world have been systemically, knowingly, and intentionally cheating on critical regulatory tests for many years. Worse, they are cheating so that their highest risk activities will be under-regulated, that they can increase short term profits and bonuses, and shift the costs of losses and failures to society.[33]

We recommend several changes that would move in the right direction toward strengthening the stress testing framework:

The Fed Should Reinvigorate and Strengthen the Stress Tests

Key elements of the stress testing framework that were altered during the recent deregulatory effort must be returned to their original form to strengthen the stress testing program and its results.

- It should be assumed that banks will continue to make dividend payouts for the full nine-quarter duration of the stress test. It is not realistic that banks will discontinue dividends to shareholders and assuming that they will only inflates the amount of capital that they will have through the test period.
- It should be assumed that banks can and will continue to grow during periods of stress. Assuming that banks will not grow makes their capital levels appear larger than they would otherwise be, which inflates the test results.
- The Fed should reinstate the qualitative objection, which had become a powerful tool to ensure that bank risk managers were not becoming complacent.[34]

The Fed Should Expand the Stress Tests to Include More Scenarios With Capital Implications

The Fed has recently ventured into broadening the scope of its stress testing framework. According to the Fed, the exploratory scenarios complement the rest of the stress testing framework with a different set of risks and that provide information on how banks' losses are affected by different risks. In the 2023 stress test, Fed included for the first time an additional exploratory market shock that was only applied to the eight U.S. GSIBs.[35] The Fed built on its success and included exploratory

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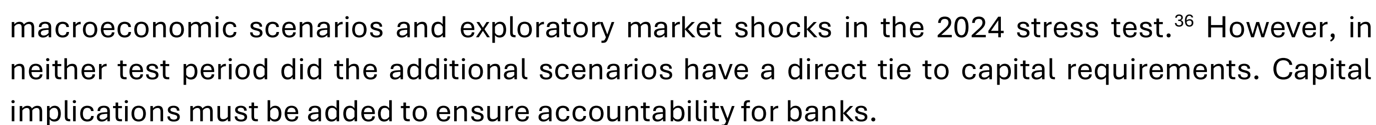
[33] Better Markets Press Release, *Basel Committee Must Stop Global Banks From Continuing to Cheat on Key Regulatory Tests and Endangering Financial Stability* (June 10, 2024), https://bettermarkets.org/newsroom/basel-committee-must-stop-global-banks-from-continuing-to-cheat-on-key-regulatory-tests-and-endangering-financial-stability/; *see also* Better Markets Comment Letter, *Global Systemically Important Banks—Revised Assessment Framework; Basel Committee on Banking Supervision* (June 7, 2024), https://bettermarkets.org/wp-content/uploads/2024/06/Better-Markets-Comment-Letter-BCBS-GSIBS-Revised-Assessment-Framework.pdf; Better Markets Comment Letter, *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)* (Jan. 16, 2024), https://bettermarkets.org/wp-content/uploads/2024/01/Better-Markets-Comment-Letter-Risk-Based-Capital-Surcharges-for-GSIBS-1-16-24.pdf.

[34] Dennis Kelleher, *supra* note 32.

[35] Board of Governors of the Federal Reserve System, *2023 Stress Test Scenarios* 1 (Feb. 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230209a1.pdf.



macroeconomic scenarios and exploratory market shocks in the 2024 stress test.[36] However, in neither test period did the additional scenarios have a direct tie to capital requirements. Capital implications must be added to ensure accountability for banks.

Policymakers and Regulators Should Accept that Conflict in Financial Regulation Is Inevitable, Healthy and a Sign of Success

The largest, most complex financial institutions are constantly pressing the limits as they seek to maximize profits and bonuses. Therefore, to endeavor to enable a dialogue about stress testing models, assumptions, and scenarios with the goal of fostering a more cooperative and less adversarial relationship between banks and supervisors is to misconceive the most basic terms of the relationship between banks and their regulators. We must stop pretending that bankers and regulators broadly agree on financial reform goals or 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.[37]

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[36] *See, e.g.,* Board of Governors of the Federal Reserve System, *supra* note 5; Board of Governors of the Federal Reserve System, Exploratory Analysis of Risks to the Banking System (Feb. 2024), https://www.federalreserve.gov/publications/files/exploratory-analysis-of-risks-to-the-banking-system-20240215.pdf.

[37] Dennis Kelleher, *supra* note 32.

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Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

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