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Financial Institutions and Monetary Policy
hearing on
"Stress Testing: What's Inside the Black Box?"

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Chairman Barr, Ranking Member Foster and Members of the Subcommittee: thank you for the opportunity to discuss stress testing. My testimony is my own. I am speaking today solely in my personal capacity; I am not speaking on behalf of any clients or my law firm.

Stress testing has transformed bank capital from a backwards-looking, static concept into a forward-looking, dynamic requirement. But its current integration into the overall capital framework rests uneasily with the requirements of administrative law. And agency *over*-emphasis on regulatory capital as the primary supervisory tool risks marginalizing the important role of examination in ensuring the safety and soundness of banks.

Origins and Evolution of Supervisory Stress Testing

The modern form of supervisory stress testing traces its roots to the 2008 financial crisis. To restore confidence in the health of the largest bank holding companies, the federal government designed and administered the Supervisory Capital Assessment Program or SCAP.[1] Under this program, regulators assessed whether banks would remain well-capitalized in an adverse macroeconomic scenario. The SCAP was widely viewed as a success. But, like many crisis-era actions, legal authorities and process were not scrutinized too closely given the exigencies of the moment.

Congress subsequently endorsed and ratified the concept of supervisory stress testing in the Dodd-Frank Act the following year. That law required the Federal Reserve to conduct stress tests of large bank holding companies to determine "whether such companies have the capital … necessary to absorb losses as a result of adverse economic conditions."[2] Congress further required covered bank holding companies to "update their resolution plans … based on the results of the [stress test] analyses."[3] There is no explicit requirement that these supervisory

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[1] *See* Federal Reserve, "The Supervisory Capital Assessment Program: Design and Implementation" (April 24, 2009), available at https://www.federalreserve.gov/bankinforeg/bcreg20090424a1.pdf. *See also* Federal Reserve Bank of New York, "The Supervisory Capital Assessment Program: Motivation and Results of the Bank Stress Test" (Jan. 14, 2010), available at https://www.newyorkfed.org/medialibrary/media/education/pdf/Hirtle.pdf.

[2] 12 U.S.C. § 5365(i)(1)(A). The Dodd-Frank Act also required company stress tests, but those are less relevant in today's context.

[3] 12 U.S.C. § 5365(i)(1)(B)(iv).

stress tests supplement binding regulatory capital requirements or limit capital distributions. Like the SCAP itself, these supervisory stress tests were designed to provide transparency to the market. To that end, Congress required the Fed to publish a summary of the results of its stress tests.[4]

But, like other extraordinary programs borne of the crisis,[5] supervisory stress testing has evolved into something more. As the Fed embarked on the creation of its Comprehensive Capital Adequacy Review or CCAR,[6] it melded regulatory capital, stress testing, and capital planning into an omnibus framework – part supervisory exercise and part regulatory requirement, making liberal use of guidance to knit the new edifice together. Supervisory stress testing became a "cornerstone of a new approach to regulation and supervision of the nation's largest financial institutions."[7] In and of itself supervisory stress testing would be merely hortatory and, at critical times, illuminating for regulators, markets and the banks themselves. For example, supervisory stress testing during the COVID event provided the Fed and other regulators with valuable insights into bank exposures and increased public confidence in the banking system, just as it had done in 2009 with the original SCAP.[8] But, under the Fed's hybrid framework, supervisory stress testing is also used to limit capital distributions and has now become the means for setting binding capital requirements for large banks through the introduction of the stress capital buffer.[9]

Components of Supervisory Stress Testing

Supervisory stress testing is a subjective exercise in that its outputs are dependent upon judgment calls made by the Fed and reflected in its scenario design, financial models and related assumptions. As directed by Congress, the Fed must specify at least two different sets of conditions under which stress tests are conducted.[10] The Fed announces these "baseline" and

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[4] *See* 12 U.S.C. § 5365(i)(1)(B)(v).

[5] Resolution planning has, for example, evolved from a targeted requirement for bank holding companies under the Dodd-Frank Act into a web of regulations and effectively binding guidance, and backdoor liquidity and capital requirements (driven by new modeling mandates), among other things, which may alter the Congressional allocation of agency responsibilities as well as the balance between business as usual operations and failure planning in counterproductive ways.

[6] *See, e.g.*, Federal Reserve, "Dodd-Frank Act Stress Tests 2023" (last updated July 27, 2023), available at https://www.federalreserve.gov/supervisionreg/dfa-stress-tests-2023.htm; Federal Reserve, "Comprehensive Capital and Analysis Review and Dodd-Frank Act Stress Tests: Questions and Answers" (last updated April 3, 2024), available at https://www.federalreserve.gov/publications/ccar-qas/comprehensive-capital-analysis-and-review-questions-and-answers.htm.

[7] Daniel K. Tarullo, "Stress Testing after Five Years" (June 25, 2014), available at https://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm.

[8] *See* Randal K. Quarles, "Themistocles and the Mathematicians: The Role of Stress Testing" (Feb. 25, 2021), available at https://www.federalreserve.gov/newsevents/speech/quarles20210225a.htm; Randal K. Quarles, "The Adaptability of Stress Testing" (June 19, 2020), available at https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm.

[9] *See* 12 C.F.R. § 225.8; 12 C.F.R. § 217.11.

[10] *See* 12 U.S.C. § 5365(i)(1)(B)(i). But note that the Fed regularly introduces additional scenarios beyond these baseline and severely adverse conditions. Some of the additional scenarios, like the global market shock

"severely adverse" scenarios, as well as other scenarios chosen by the Fed, on an annual basis prior to applying them in the supervisory stress test. The Fed then feeds bank financial information, together with its scenario assumptions into various models of its own creation to determine how the bank would fare under the specified stress conditions. These models then project the bank's financial statement information over several quarters, including balance sheet items, income and expense components, investment portfolio performance, and, of course, risk-weighted assets. Armed with its modeled outputs, the Fed then mechanically sets the stress capital buffer and may limit the bank's planned capital distributions.[11]

<u>Legal Vulnerabilities</u>

The Fed's continuing failure to seek public comment on its stress test models and scenarios and, in the case of the former, even disclose them at all raises significant concerns under basic principles of administrative law.[12] *First*, the Administrative Procedure Act requires agencies to pursue legislative rules through notice-and-comment rulemaking.[13] But the Fed has not sought public comment on its models and scenarios. In the case of the stress capital buffer and planned capital distributions, its related rulemakings are, at best, incomplete, omitting the most critical components. These omissions are particularly egregious since they not only inform but dictate what is arguably the most important regulatory requirement on banks – their capital levels. Nor is this an area of particular legal ambiguity or first impression. Courts have repeatedly held that models treated by agencies as binding must go through public comment.[14] *Second*, because the Fed's models and assumptions are the basis for its actions (*i.e.*, stress capital buffers and limits

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scenario, are directly binding on banks' capital requirements, while others, such as last year's "exploratory market shock," are not. *See* Federal Reserve, "Federal Reserve Board releases hypothetical scenarios for its 2023 bank stress tests" (Feb. 9, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230209a.htm?utm_source=substack&utm_medium=email.

[11] *See* 12 C.F.R. § 225.8; 12 C.F.R. § 217.11.

[12] The Fed does disclose its scenarios, but does not seek public comment on them. *See, e.g.*, Federal Reserve, "Federal Reserve Board releases the hypothetical scenarios for its annual stress test" (Feb. 15, 2024), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20240215a.htm. The Fed also provides some information on its models, but not the models themselves. *See, e.g.*, Federal Reserve, "2023 Supervisory Stress Test Methodology - June 2023" (last updated Aug. 1, 2023), available at https://www.federalreserve.gov/publications/2023-june-supervisory-stress-test-methodology-preface.htm.

[13] The APA contains exceptions to its notice-and-comment procedures for "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice" and "for good cause," but none seems relevant here, and the Fed has not suggested any of these exceptions apply. 5 U.S.C. §§ 553(b)(A), (B). *See also* Bank Policy Institute and American Bankers Association, "Petition for Rulemaking and FOIA Request Concerning Models and Stress Scenarios Used to Determine Stress Capital Buffer Requirements" (July 24, 2023), available at https://bpi.com/bpi-and-aba-seek-transparency-around-fed-supervisory-models-and-stress-scenarios/.

[14] *See, e.g.*, *Sierra Club v. Costle*, 657 F.2d 298, 334 (D.C. Cir. 1981); *American Radio Relay League, Inc. v. F.C.C.*, 524 F.3d 227, 236 (D.C. Cir. 2008); *McLouth Steel Products Corp. v. Thomas*, 838 F.2d 1317, 1320-22 (D.C. Cir. 1988); *U.S. Air Tour Ass'n v. F.A.A.*, 298 F.3d 997, 1008 (D.C. Cir. 2002); *Owner-Operator Indep. Drivers Ass'n, Inc. v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 202 (D.C. Cir. 2007). Nor can there be any doubt that the Fed treats its models as binding: "[t]he stress capital buffer requirement … is determined from the stress test results." Federal Reserve, "Federal Reserve Board announces the individual capital requirements for all large banks, effective on October 1" (July 27, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727b.htm.

on planned capital distributions), and it has not disclosed its models, it is unable to explain its decision-making process. As a result, its actions appear arbitrary and capricious.

At its core, the Fed has created a framework that allows it discretion to set capital levels for banks through scenario choice and model design with limited accountability.[15] Its only constraint is the models themselves, but the public lacks visibility into these models as well as their design, back-testing and revision.[16] Put another way, the Fed's stress capital buffer is like a highway with an unposted speed limit that changes on a regular basis. And one only learns the speed limit after being pulled over. Whatever the value of stress testing, its utility is no substitute for its legality.

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Supervisory stress testing and the capital edifice it supports are the paradigmatic post-2008 reforms. But this "new approach to regulation and supervision" is too often marked by its complexity, opacity and only episodic adherence to basic principles of administrative law. Resolution planning, another feature of the post-2008 landscape, shares many of the same legally-suspect characteristics of capital regulation, including the use of binding guidance. As Federal banking agencies appear poised to double-down in these and other areas, Congress should ensure the agencies abide by applicable legal requirements and assess the effectiveness and costs of current post-2008 regulatory reforms before expanding them.

Thank you again for the opportunity to testify. I look forward to your questions.

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[15] There is little, if any, evidence that the reconsideration process for appealing stress test results or stress capital buffers provides any meaningful check on the Fed's discretion.

[16] A model of one's own design that is not even disclosed does not serve as a constraint on an agency's range of action. The agency can manipulate or modify the model, much less set the scenario inputs, to arrive at any outcome it seeks. By way of contrast, the Fed has articulated extensive supervisory expectations for the risk management, governance and validation of all models utilized by the banks it regulates. *See, e.g.*, Federal Reserve, "Supervisory Guidance on Model Risk Management" (April 4, 2011), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1107a1.pdf.