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January 19, 2018

Ann Misback
Secretary
Board of Governors
Federal Reserve System
20th St and Constitution Ave, NW
Washington, D.C. 20551

Re: Policy Statement on the Scenario Design Framework for Stress Testing
Docket No. OP-1588
Stress Testing Policy Statement
Docket No. OP-1587
Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test
Docket No. OP-1586

Dear officers,

On behalf of more than 400,000 members and supporters of Public Citizen, we offer the following comment on a package of proposals regarding the Federal Reserve Board's (Board, Fed) stress tests.

Stress tests count as a pillar of Wall Street reform, one of the central tools to promote prudential banking. Stress testing provides a forward-looking assessment of losses suffered under adverse scenarios. More specifically, the test applies a series of assumptions about adverse conditions (rising unemployment, declining home prices, changes in overall economic growth, and loan losses) to the future results of a bank. These results then translate into whether the bank's assets remain sufficiently larger than its liabilities so as to remain solvent. In the years leading to the financial crash of 2008, many major banks failed to maintain enough capital (the difference between assets and liabilities) to remain in operation and extend credit. In 2009, 19 large banks—each with more than $100 billion in assets—participated in the forerunner of today's stress test. Ten of these fell a collective $75 billion short in required capital.[1] Following this exercise, Congress approved Section 165 of the Dodd-Frank Act Wall

[1] Martin J. Gruenberg, Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *"Fostering Economic Growth: Regulator Perspective,"* FEDERAL DEPOSIT INSURANCE CORP. (June 22, 2017,) https://www.banking.senate.gov/public/_cache/files/7ea46c04-a030-4bba-bb90-741e36ee1978/0156DC39EAA99E3C4D1E9D26D9805EF1.gruenberg-testimony-6-22-17.pdf. ↩

Street Reform and Consumer Protection Act in 2010 to provide for regular stress testing.[2] These tests figure in a firm's capital plan.[3] Stress test results control whether firms can raise dividends, or repurchase shares.[4] Because capital is the frontline defense of bank safety, stress tests are critical. Further, stress tests help with risk management, and are welcomed by many industry participants, according to a review by the U.S. Government Accountability Office. [5]

The Board's Proposal

With this series of proposals, the Fed plans to increase transparency, and restate its policies regarding how it approaches the construction of the stress tests. Regarding transparency, the Fed proposes to make public:

- A range of loss rates, estimated using the Board's models, for loans held by firms subject to the test;
- Portfolios of hypothetical loans with loss rates estimated by the Board's models; and
- More detailed descriptions of the Board's models, such as certain equations and key variables that influence the results of those models.

Further, the Board proposes "Stress Testing Policy Statement." This describes the Board's approach to model development, implementation, use, and validation. (This statement replaces a prior statement.)

Generally, Public Citizen supports transparency. The Board's changes can help observers determine how an individual bank would perform under adversity. Greater transparency can promote market discipline, as independent observers will be better able to understand the results of a stress test. To promote public confidence in the banking system, results of the stress should be understandable.

In a recent round of tests, the Board approved all results and permitted major dividend payments and share repurchases. Some experts argued that the Board had relaxed the test in the face of industry pressure.[6] Some even questioned the validity of the exercise. Cato Institute scholar Kevin Dowd asserts that the Board's goal "to reassure the public that the banking system is safe" compromises its objectivity. "The stress tests are *not* some independent assessment of the financial strength of the

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[2] Stress testing is not new. The CAMALS supervisory system includes, as the last factor, "sensitivity."
[3] The plans then factor in the Board's Comprehensive Capital Analysis and Review exercise.

[4] The Dodd-Frank Act Stress Tests (DFAST) applies to Federal Reserve-supervised banking institutions with more than $10 billion in total consolidated assets. DFAST projects how banking institutions' capital levels would fare in hypothetical stressful economic and financial scenarios. It applies to a broad range of banking institutions and consists of supervisory- and company-run stress tests that produce capital adequacy information for firms' internal use and for public disclosure. The Federal Reserve also conducts a Comprehensive Capital Analysis and Review (CCAR), which uses DFAST information to assess the capital adequacy (a quantitative assessment) and capital planning processes (a qualitative assessment) for bank holding companies with total consolidated assets of $50 billion or more. CCAR generally does not require additional stress tests and uses the same data, models, and projections used for DFAST.

[5] Additional Actions Could Help Ensure the Achievement of Stress Test Goals, US GOVERNMENT ACCOUNTABILITY OFFICE (Nov. 15, 2016) https://www.gao.gov/products/GAO-17-48
[6] Kevin Dowd, Are US Banks Really in Good Shape, ALT-M (August 17, 2017) https://www.alt-m.org/2017/08/17/the-2017-stress-tests-are-us-banks-really-in-good-shape/

banking system carried out by experts who are free to arrive at conclusions that might not suit the Fed; instead, the stress tests are part of a publicity campaign by a public agency with its own interests and agenda. Therefore, the credibility of the exercise is compromised before it has even started." [7]A clearer picture of parameters would help satisfy such concerns. Observers could judge better whether the test is sufficiently rigorous so as to demonstrate a healthy financial sector.

At the same time, as the Board acknowledges, increased transparency can help a bank game the test. A bank might even adjust its portfolio.[8] Both the Treasury Department and a measure in Congress call for the test to subject to public notice and comment, as with a new rulemaking.[9] These would make the tests fully transparent. We oppose such measures. They would render the test meaningless as firms would simply adjust their portfolios at the time of the test. We appreciate that the Board does not embrace these disclosures.

Specific Transparency Additions

Broadly, we support the Board's proposed refinements. They will add transparency without compromising the integrity of the test. For example, a range of loan loss rates will help the public understand the intensity of problems that the banks would face. The Board also proposes to publish a number of equations. We think these loan loss rates and equations are broad enough so as to add transparency with negligible chance that a bank could temporarily adjust its portfolio to pass the test.

We support several proposed additions. For example, the Board proposes to include the cost of short term funding in its scenarios. Dependence on such runnable funding is a key source of risk and should be examined. (We believe the Board should also include a run of a certain percentage of funding as part of the test.) We also support the Board's assumption that the bank's largest counterparty would fail. This should yield a relatively extreme condition and survival of this event would help demonstrate the vitality of the bank.

We also urge the Board to release the models for previous stress tests. This will help academics and the market understand better the rigors of the tests. Such models could be released on a confidential basis.

Restatement of Principles

We support the Board's seven principles of supervisory stress testing. Regarding the policy statement describing how it develops, implements and validates each model, the Board explains it will use conservative assumptions about the risk of a portfolio. Given equal assumptions, the Board will use those that result in larger losses of revenue. We encourage this bias towards stress. The Board also proposes to incorporate shocks unlike those already experienced. We support this as common sense, since banks should be prepared to withstand events beyond the dimensions previously endured.[10] The

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[7] Kevin Dowd, Are US Banks Really in Good Shape, ALT-M (August 17, 2017) https://www.alt-m.org/2017/08/17/the-2017-stress-tests-are-us-banks-really-in-good-shape/

[8] Already, the Board wisely varies the market shocks for each test to reduce the chance that firms will adjust their holdings or adopt identical hedging strategies.

[9] Banks and Credit Unions, TREASURY DEPARTMENT (June 2017) https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf. Also See HR 4293

[10] For example, the Board should consider extraordinary shocks, such as a war with North Korea, the collapse of the Bitcoin market, or even misconduct, such as major losses by a rogue trader. The Board has noted it applies some 35,000 risk factors, but it is not clear that these involve a catastrophic event such as a war.

Board also assumes that a firm will retain or grow its balance sheet in a stressed period. We believe this is pivotal, as the role of banks in providing additional credit in a trouble economy will be vital to recovery.

Generally, we urge the Board to keep the tests "stressful." As more transparency helps the public understand the parameters of the test, a test with sufficient stress will truly ratify that the banking system is healthy.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org

Sincerely,

Public Citizen