January 22, 2018

Ms. Ann Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test (Docket No. OP–1586) ("Model Disclosure Proposal"); Stress Testing Policy Statement (Docket No. OP-1587) ("Stress Testing Policy Proposal"); and Policy Statement on the Scenario Design Framework for Stress Testing (Docket No. OP-1588) ("Scenario Design Proposal")

Dear Ms. Misback:

Better Markets, Inc.[1] appreciates the opportunity to comment on the three proposals captioned above. They would provide for more transparency about supervisory stress tests under the Dodd-Frank Act, offering more disclosure about the stress testing models, the stress testing scenarios, and the general principles that will guide the Boards' ongoing implementation of the stress testing framework. While these proposals contain many positive elements, the Board must provide a more comprehensive explanation of the proposed stress testing **model disclosures.** Investors, markets, and the public must be assured that the banks subject to the tests will not be able to use that information to undermine the critically important stress testing process.

Given that the stress tests have been one of the Board's most significant and indisputable successes since the 2008 financial crash, we would urge the Board to be extremely careful regarding any changes to ensure that its hard-won credibility is not damaged. This is not a theoretical concern. As the Board well knows and the world observed, this is exactly what happened when Europe implemented what turned out to be "no-stress" stress tests, where banks collapsed shortly after passing those tests. European stress tests still have little credibility as a result. The Board's stress tests have proven to be exactly the opposite, engendering the confidence of investors, markets, and the public.

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support financial reform, and re-balance our financial system to work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

No less an authority than Gary Cohn, when he was President of Goldman Sachs and while European banks were under significant pressure, effusively praised the Board in 2016 for, among other things, its stress tests:

> [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 Board must be extremely careful not to snatch defeat from the jaws of victory here, particularly when the pleas for any such changes are largely self-interested complaints with no demonstrated objective or valid basis.

## BACKGROUND

Stress tests are a vital component of the set of prudential regulations that grew out of the financial crisis of 2008. Their value as a tool for stabilizing markets and reassuring the public was proven in 2009, during the heat of the crisis and before the Dodd-Frank Act was passed. Since then, they have increased in rigor and transparency, and are now regarded as "the key innovation in capital regulation and supervision," which makes the other reforms such as enhanced capital standards "more effective."[3]

The central role of stress tests in helping to preserve and protect the financial stability of the U.S. is clear on its face. As explained in the Stress Testing Policy Proposal,

> Supervisory stress testing is a tool that allows the Board to assess whether the largest and most complex financial firms are sufficiently capitalized to absorb losses in stressful economic conditions while continuing to meet obligations to creditors and other counterparties and to lend to households and businesses . . . Post-crisis reforms to regulation and supervision have strengthened financial institutions and have **reduced the likelihood and severity of future financial crises.** [4]

Any regulatory reform that plays such a direct and substantial role in helping the country avoid another financial crisis is enormously consequential. Unquestionably, the financial crisis of 2008 was the single most damaging economic calamity in America since the Great Depression nearly a century ago. It inflicted monumental financial losses and human suffering on the

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

3 Daniel K. Tarullo, *Departing Thoughts*, The Woodrow Wilson School, 13-14 (Apr. 4, 2017) (transcript available at https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm); *see also* Morris Goldstein, *Banking's Final Exam: Stress Testing and Bank-Capital Reform,* Peterson Institute for International Economics (May 2017).

4 Stress Test Policy Statement, 82 Fed. Reg. 59528 (Dec. 15, 2017) (emphasis added).

American people, as it destroyed more than $20 trillion in gross domestic product,[5] threw millions of Americans into long-term unemployment, and cast over 15 million homes into foreclosure.[6] Making sure that the stress testing process is consistently rigorous, effective, and transparent is and must remain among the highest regulatory priorities, as the stakes are so high.

Section 165(i) of the Dodd-Frank Act sets forth the basic framework for supervisory stress tests. It provides that the Board must conduct annual stress tests of banks with $50 billion or more in total consolidated assets under three scenarios (baseline, adverse, and severely adverse). It further gives the Board broad authority to "develop and apply such other analytic techniques as are necessary to identify, measure, and monitor risk to the financial stability of the United States," and it provides that the Board must require covered banks to update their resolution plans, or living wills, as appropriate in light of the results of the stress tests. With respect to transparency, the statute simply provides that the Board "shall publish a summary of the results of the tests."[7]

A series of rules, amended rules, and policy statements have fleshed out and refined the stress testing process over the years.[8] In formulating these rules and policies, the Board has wrestled with the degree of transparency that should accompany each phase of the stress testing process, including the degree of public disclosure that is appropriate for the models and scenarios that are the core ingredients of the tests, as well as the amount of disclosure that should accompany the results and findings of the tests. Its approach has been incremental.[9]

Throughout this regulatory evolution, calls for greater transparency have been made. Public interest advocates, including Better Markets, have emphasized the need for transparency to ensure that the public has confidence in the tests, that the tests can be vetted by independent experts to ensure their effectiveness, and that market participants have the benefit of accurate information about bank viability.[10] For their part, the banks have fought to limit the amount of information released to the public about the test results, while at the same time insisting that they should have more detailed information regarding the models that drive the stress tests. In recent years, and especially under the new Administration, calls for increased transparency in the stress tests have grown in intensity, with some even arguing that stress tests be subjected to a rulemaking process under the Administrative Procedure Act.[11]

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5 Better Markets, The Cost of Crisis, $20 Trillion and Counting, (2015), https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

6 *Id.*

7 12 U.S.C. § 5365(i) (2012).

8 *See, e.g.,* Supervisory And Company-Run Stress test Requirements for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012) ("2012 Release"); Capital Plan And Stress Test Rules, 79 Fed. Reg. 64026 (Oct. 27, 2014) ("2014 Release"); 12 C.F.R part 252, appendix A, "Policy Statement on the Scenario Design Framework for Stress Testing."

9 *See* Tarullo *supra* note 3 ("the Federal Reserve has publicly disclosed progressively more information about its supervisory model, the scenarios, and the results").

10 Better Markets, Comment Letter on Policy Statement at 6 (Jan. 14, 2013), available at https://www.federalreserve.gov/secrs/2013/january/20130129/op-1452/op-1452_011413_110941_341692282642_1.pdf.

11 *See, e.g.,* U. S. Gov't Accountability Office, GAO-17-48, Federal Reserve, Additional Actions Could Help Ensure the Achievement of Stress Test Goals, 49-52, 72 (Nov. 2016); U.S Dept. of the Treasury, A Financial System That creates Economic Opportunities, 12, 52 (2017); Hal S. Scott, Stress Tests: Restore Compliance

**THE PROPOSAL**

The Board is seeking comment on a several related proposals that would affect both the transparency and the substance of the supervisory stress tests:

- First, the Model Disclosure Proposal would—

    (1) provide more detailed information about the structure of the models, including formulas used in the models, and would include a loan table that lists the key loan characteristics and macroeconomic variables that influence the results of a given model;

    (2) disclose estimated loss rates for groups of loans with distinct characteristics; and

    (3) publish portfolios of hypothetical loans and associated loss rates.

- Second, the Stress Testing Policy Proposal would formalize and describe the general principles, policies, and procedures that guide the development, implementation, and validation of the models used in the supervisory stress tests, including—

    (1) general principles of supervisory stress testing;

    (2) principles guiding development and use of models, including the general policy against disclosing firm-specific results or any other information related to the stress tests to covered companies that is not also publicly disclosed; and

    (3) principles of supervisory model validation, including the establishment of independent teams within the Board that develop and validate models, as well as the formation of an independent council of academic experts to assess the models bi-annually.

- Third, the Scenario Design Proposal would amend the existing policy statement on the scenario design framework in three specific ways, by—

    (1) clarifying when the Board may change the unemployment rate in the severely adverse scenario;

    (2) instituting a more quantitative and counter-cyclical guide for changes in the housing price index in the severely adverse scenario; and

    (3) providing notice that the Board plans to incorporate wholesale funding costs for banking organizations in the scenarios.

with the APA, Banking Perspective (2017), available at https://www.theclearinghouse.org/research/banking-perspectives/2017/2017-q3-banking-perspectives/stress-tests-apa-compliance.

## COMMENTS

### 1. The Board's Model Disclosure Proposal may result in beneficial public transparency, but it fails to demonstrate that it has struck the right balance between too much and too little disclosure.

To maximize the effectiveness of the stress testing regime, the Board must carefully balance the vital role of robust transparency against the risk that the release of specific types of information, such as the formulas underlying the models, will enable banks to game the process, thus reducing the effectiveness of the tests and undermining the Board's credibility. The proposal appropriately recognizes this tension. First, it catalogues the many advantages of robust transparency:

> The Federal Reserve recognizes that disclosing additional information about supervisory models and methodologies has significant public benefits, and is committed to finding ways to further increase the transparency of the supervisory stress test. More detailed disclosures could further **enhance the credibility** of the stress test by providing the public with information on the fundamental soundness of the models and their alignment with best modeling practices. These disclosures would also **facilitate comments** on the models from the public, including academic experts. These comments could **lead to improvements**, particularly in the data most useful to understanding the risks of particular loan types. More detailed disclosures could also **help the public understand** and interpret the results of the stress test, furthering the goal of maintaining market and public confidence in the U.S. financial system. Finally, more detailed disclosures of how the Federal Reserve's models assign losses to particular positions could **help those financial institutions** that are subject to the stress test understand the capital implications of changes to their business activities, such as acquiring or selling a portfolio of assets.[12]

The proposal then lists the concerns surrounding full disclosure of the models:

> The Federal Reserve also believes there are material risks associated with fully disclosing the models to the firms subject to the supervisory stress test. One implication of releasing all details of the models is that firms could conceivably use them to make modifications to their businesses that **change the results** of the stress test without changing the risks they face. In the presence of such behavior, the stress test could give a **misleading picture** of the actual vulnerabilities faced by firms. Further, such behavior could **increase correlations in asset holdings** among the largest banks, making the financial system more vulnerable to adverse financial shocks. Another implication is that full model disclosure could **incent banks to**

[12] Model Disclosure Proposal at 59547-48.

> **simply use models similar to the Federal Reserve's**, rather than build their own capacity to identify, measure, and manage risk. That convergence to the Federal Reserve's model would create a ''model monoculture,'' in which all firms have similar internal stress testing models which may miss key idiosyncratic risks faced by the firms.[13]

Other authorities on the subject have strongly cautioned against the disclosure of the stress testing models to the banks. For example, former Governor Tarullo has explained in some detail the substantial risks associated with that degree of transparency:

> In the financial area, the dangers of [model] disclosure are much greater. We are trying to evaluate what may happen to a bank's assets under stress. If a bank has the model, it will be able to optimize its balance sheet for the day on which the stress test is to apply by shifting into assets for which relatively lower loss functions apply. But it can then shift those assets back over succeeding days or weeks. Thus, the test will give a misleading picture of the actual vulnerabilities of the firm. In this and other ways, banks would use the models to guide changes in their behavior that do not change the risk they pose to financial stability, but do change the measured results of the stress test. Regulators and academics have long recognized that this type of behavior by banks, known as regulatory capital arbitrage, has been a persistent threat to financial stability. Additionally, giving the firms the model will likely encourage increased correlations in asset holdings among the larger banks--a trend that increases systemic risk, since everyone will be exposed should those asset classes suffer reversals. . . . In short, we should recognize that what might appear to be a reasonable transparency measure in publishing the models will in fact result in less protection for the financial system.[14]

In light of these concerns, and having correctly identified the competing factors that surround this critical policy decision, the Board must more fully and clearly explain whether and exactly how the proposed disclosure of additional and detailed information regarding the stress testing models strikes the optimal balance. For example, under the proposal, the Board would expand the descriptions of the models in several respects:

- It would provide more detailed information about the structure of the models, including, of particular concern, "certain important equations that characterize aspects of the models;"[15]

- It would disclose "lists of the key loan characteristics and macroeconomic variables that influence the results of a given model;"[16]

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13 *Id.* at 59548.
14 Tarullo, *supra* note 3, at 23-24.
15 Model Disclosure Proposal at 59548.
16 *Id.*

- It would include estimated loss rates for groups of loans with distinct characteristics, revealing how the supervisory models treat specific assets under stress;[17] and

- It would include portfolios of hypothetical loans and associated loss rates.[18]

It may well be that this level of specificity in model disclosure serves the beneficial purposes of transparency without enabling the banks to game the models. But that cannot be gleaned from the Proposal, and there is reason to be concerned, especially with respect to any disclosure of the "formulas" integrated into the models. Instead of addressing these concerns with specificity, the proposal offers only the conclusory observation that "[t]he proposed enhancements are designed to balance the costs and benefits discussed above in a way that would further enhance the public's understanding of the supervisory stress test models without undermining the effectiveness of the stress test as a supervisory tool."[19] Unanswered, for example, is the question of exactly how this additional transparency stops short of "undermin[ing] the effectiveness of the stress test as a supervisory tool."

There are a number of factors that the Board should address in further clarifying the basis for these additional disclosures. For example, it should identify with particularity those who are advocating for the specific proposals and the specific justifications they have proffered. Notably, the Proposal indicates that during an extensive review of the stress testing and capital planning programs, the Board "received feedback from senior management at firms subject to the Board's capital plan rule."[20] The public should know which firms have advocated in support of which aspects of the proposal, the reasons they offered, and most importantly, the data or evidence they claimed as support for the changes they sought.

That information is critically important in assessing the basis for the proposals. While regulated entities are entitled to advocate for whatever they want and to aggressively pursue their self-interest, that self-interest should only become policy (or a change policy, rule, or practice) if it in fact serves the public interest as well. However, often the claims for changes simply do not withstand scrutiny. The most prominent and now familiar example is the mantra that the Dodd-Frank Act reforms must be changed because they are needlessly limiting banks' revenues and income, hampering the banks' lending activities and stifling economic growth—all claims that have proven objectively false given the banks' record revenues and profits, their robust and increasing lending activity, and the steady rate of economic growth.

Several other factors bear on the appropriate degree of transparency in the stress testing models, and the Board should address each of them and explain how they influence the decision-making process. First, what is the current level of transparency, and where are the gaps or

17 *Id.*
18 *Id.*
19 *Id.* at 59548.
20 *Id.* at 59547 & n. 3.

shortcomings in the already significant amount of disclosure regarding the models?[21] Second, what are the current assurances of reliability in the models, including, for example, the independent model development and model validation teams at the Board, as well as the Model Validation Council, and how do they influence the Board's perspective on the need for additional model disclosure. Finally, are there other means of ensuring that the public, including academic experts, have sufficient information to independently assess and validate the models, without posing any risk of divulging too much information to the banks?

In short, in such an important area of prudential regulation, where the stakes are so high in terms of preventing another financial crisis and sustaining the Board's credibility, and where the issues are inherently technical and opaque, the Board can and should better serve the public by providing a more robust analysis of the proposed disclosures and how they promote transparency without providing the banks with information they could use to circumvent the very successful stress testing regime.

## 2. <u>The Board's other proposals are positive and will help add valuable transparency and strength to the stress testing process.</u>

Several of the proposals represent especially valuable and noteworthy enhancements to the stress testing framework. The Board should adhere to these reforms as it works to finalize them.

The Stress Testing Policy Proposal would describe the principles, policies, and procedures that will guide the development, implementation, and validation of the Board's supervisory stress test models.[22] We strongly support a number of the principles. For example, the Board is correctly committed to maintaining "independence" by developing its models separately from the models used by covered companies.[23] It also intends to be commendably "forward-looking." As explained in the Proposal, models "should generally avoid relying solely on extrapolation of past trends in order to make projections, and instead should be able to incorporate events or outcomes that have not occurred."[24] The Board's commitment to a conservative approach is also laudable: "Given a reasonable set of assumptions or approaches, all else equal, the Federal Reserve will opt to use those that result in larger losses or lower revenue."[25] The proposal also reflects the Board's commitment to information parity, under which it "will not disclose firm-specific results or other information . . . to covered companies if that information is not also publicly disclosed."[26] Finally,

21 The Proposal notes in general terms that the Board currently discloses a significant amount of information about the models, including, for each modeling area, the structure of the model, the key features, and the most important explanatory variables. Model Disclosure Proposal at 59548.

22 Stress Testing Proposal at 59529.

23 *Id.* at 59530. Banco Popular's recent failure a year after passing the company run stress test mandated by European regulators show the limitations of solely relying on company run stress tests and the need for strong and independent supervisory stress tests. *See* Ferdinando Giugliano, Here's What the Banco Popular Post-Mortem Shows, Bloomberg View (June 14, 2017), https://www.bloomberg.com/view/articles/2017-06-14/here-s-what-the-banco-popular-post-mortem-shows.

24 Stress Testing Proposal at 59530.

25 *Id.*

26 *Id.*

the proposal highlights the importance of increasing the "breadth" of public disclosure about the stress tests, subject to the limits acknowledged in the Model Design Proposal.[27]

The Scenario Design Proposal also contains beneficial technical improvements, and two in particular warrant mention. First, for purposes of developing the "severely adverse" scenarios, the proposal would move the Board from a "judgmental approach" in setting the trajectory of housing price changes to a quantitative guide, promoting transparency and reliability.[28] Second, it would announce that the Board is "exploring the inclusion of an increase in the costs of funds for banking organizations as an explicit factor in the scenarios."[29] This has been a significant gap in scenario design and the Board must follow through as expeditiously as possible by incorporating that factor in the stress testing scenarios. As explained in the Proposal, "shocks to the costs of short-term wholesale funding played a prominent role in the recent financial crisis, and had a notable effect on firms' ability to operate as financial intermediaries."[30] It is clearly an important component of any comprehensive stress testing framework.

## CONCLUSION

We hope these comments are helpful as you work to finalize the proposals.

Sincerely,

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27 *Id.*
28 Scenario Design Proposal at 59535.
29 *Id.* at 59536.
30 *Id.*