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The Final Chapter on Modernizing Bank Regulatory Stress Testing

Remarks by

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at

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at Mansion House

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Thank you for the invitation to join you today.[1]

It is especially fitting to gather in the majestic and historic surroundings of Mansion House—a monumental building that has long stood at the center of London's civic and financial life. Its setting reminds us that banking has always depended on public confidence as much as on private enterprise. Situated opposite the Bank of England and beside the Royal Exchange, it lies at the physical heart of a financial system shaped over centuries by the interaction of markets, regulatory bodies, and government.

It is an honor and a pleasure to join you to discuss our efforts to modernize U.S. banking regulations and supervision. Today, my remarks will highlight our work to enhance and improve the bank regulatory stress test framework. This framework creates a legally sound regulatory process for setting capital requirements and enhancing supervision.

The program I will discuss today represents the culmination of a multiyear effort to address fundamental flaws in how we have approached bank capital requirements and supervision since the introduction of the stress testing program following the financial crisis. In an effort to address legal challenges and make overall improvements to this framework, the Federal Reserve has incorporated lessons learned from the outset of this program. Some of these have been difficult lessons, especially for an institution like the Federal Reserve Board.

The process of learning and incorporating these lessons is absolutely critical to the legitimacy of the stress test results. For example, we have addressed the imperative of process and model transparency, public accountability, supportable and repeatable

[1] The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

outcomes, and proactive regulatory action. In finalizing these reforms, we will finally close the book on an opaque and unnecessarily unpredictable framework. We can soon begin anew with a framework that complies with U.S. administrative procedure laws, that better promotes the stability of our financial system, and that better ensures the safety and soundness of our largest banks.

In the coming weeks, the Federal Reserve Board will consider final revisions to the Board's stress testing framework. These changes will improve transparency and public accountability, strengthen the reliability and accuracy of the models, and reduce the volatility of the capital requirements flowing from the annual stress test results. In the U.S. framework, the Board incorporates forward-looking supervisory stress testing into large bank capital requirements through the stress capital buffer (SCB). In addition, and before the end of this year, I expect the Board to finalize reforms to risk-based capital requirements for large and small banks as well as improvements to the global systemically important bank (GISB) surcharge. In totality, these reforms create a durable and lasting framework to produce capital requirements that are rational, robust, aligned with risk, and transparent.

Stress testing is a valuable mechanism for gauging large-bank resilience. As those in this room know, hypothetical scenarios allow the public and our Federal Reserve supervisors to assess whether the nation's largest banks hold sufficient capital to absorb losses and continue lending to households and businesses through times of severe stress. While stress testing is a critical supervisory tool, it is not without flaws. Under my direction, our staff has worked diligently to improve the stress testing framework and its implementation. These enhancements will ensure that the stress testing framework is credible, effective, and fair, with the goal of eliminating opacity and unpredictability.

Today, I will describe the new stress testing program that has been subject to public comment and under consideration by the Board over the past 12 months. I will then discuss how these enhancements will ensure that transparent and granular SCB requirements are sensitive to current and potential risks.

After reviewing the two outstanding regulatory proposals, I will preview an expanded approach for stress testing in the future. These forward-looking exercises will make stress testing a more effective tool for identifying firm-specific vulnerabilities under various economic and financial scenarios. They will leverage the underlying data from our capital-based stress tests but will be targeted to identify risks and vulnerabilities. Importantly, the results of these forward-looking tests would not affect capital requirements. Instead, the knowledge gained from this exercise will deepen our understanding of exposures to material financial and nonfinancial risks and their resiliency to those risks.

The Current Landscape

Before diving into the substance of these proposals, let me provide some context. The Board made a public commitment to seek comment on comprehensive changes to the supervisory stress test and incorporate public input as an ongoing feature of the process. In December 2024, the Board committed to the basic contours of these changes, including to disclose and then seek public comment on all models used to determine the hypothetical losses and revenues of the banks subject to the tests. This includes soliciting public comment on changes to the framework that guides the design of the hypothetical scenarios and, beginning with the 2026 stress test, on the hypothetical scenarios themselves.

Since its inception, the Board's stress testing program has been broadly criticized for its limited transparency, its unreasonable year-over-year volatility, and the absence of any meaningful appeals process. The Board has been keenly aware of these deficiencies for many years but considered them to be a feature, not a bug. Unfortunately, and even after mounting threats of litigation were realized, the Board did not take meaningful remedial action. Upon my confirmation as Vice Chair for Supervision, I swiftly changed course.

Enhancing the Stress Testing Framework

Last year, the Board issued two proposals designed to increase the transparency and public accountability of the capital-based stress test while maintaining its dynamism. The existing framework—including the stress test models, scenario design framework, and specific scenarios—is not adequately disclosed or subject to public comment. This lack of transparency can lead to uncertainty for banks in capital planning, potential misalignment of capital requirements with actual risks, and limited public understanding and scrutiny of the stress testing process.

In considering the finalization of the rules that underpin the framework, the first is the Enhanced Transparency and Public Accountability final rule. As proposed, this rule requires the Board to publish detailed information on the stress test models and on the scenario design process, resulting in greater transparency and public accountability. Model disclosures will publish the equations, variables, coefficients, underlying assumptions, limitations, and decisionmaking rationale for each model. They will also include alternative model considerations and specific model changes the Board plans to implement for the 2027 stress test. This approach appropriately creates public accountability for the models that determine losses under stress and lead to the calibration of the resulting capital requirement.

Publishing the scenario design process will also enhance and increase the accompanying guides for scenario variables. Currently, guides for only two variables are provided, which are the unemployment rate and housing prices and their change over the test projection horizon. These two guides will be enhanced, and additional detailed guides for variables related to the U.S. and international economies will be developed. Further, details will be disclosed about variable paths in the macroeconomic model, the framework and model components used to create the global market shock, and other changes in how the scenarios are designed. This will enable the public to access all relevant information to properly evaluate the hypothetical scenario each year.

The second final rule reduces the volatility of the SCB requirement by averaging the results of a bank's two most recent annual stress tests. These tests examine the effect of stress capital levels on the resilience of large banks. They estimate losses, revenue, and capital levels under a hypothetical severe recession scenario. The results are used to determine the calibration of the SCB, which is one component of the amount of capital that large banks must hold to provide a buffer to absorb potential losses. Changes in annual test administration and the hypothetical scenario design have resulted in significant volatility over time.

The new approach reduces volatility by averaging results over two consecutive years. In addition, by delaying the annual effective date of the SCB requirement from

October 1 to January 1 of the following year, the change aligns compliance to calendar year and provides additional time to implement the resulting capital requirements.

Together, these rules reduce SCB volatility by half without materially changing aggregate levels of required capital.

We received a number of comments during the process, two of which I will highlight for this discussion. The first addresses risk sensitivity. It recommends establishing a specified date to freeze firm balance sheets prior to the release of the proposed scenarios shortly thereafter.

The second improves risk capture. It recommends incorporating two global market shock scenarios on the same as-of date, with the larger loss used to calculate the SCB. This approach will reduce volatility in stress test results. I look forward to considering these approaches in the final rule.

Proposed Revisions to 2027 Models

In addition to finalizing these two rules, I will recommend consideration of a third proposal that will revise the 2027 test models. This approach was also informed by public feedback, once again underscoring the value of public comment.

The proposal will seek public comment on a revised model for noninterest income, which is the fee and trading revenue that banks earn from activities including wealth management, investment banking, and market making. This model would better capture business diversity across firms and would replace the existing noninterest income model for the 2027 stress test.

Benefits of These Reforms

Addressing long-standing criticisms is just one motivation for our work to improve the tests. There are a number of other important benefits.

First, greater transparency increases public accountability, instills confidence in the fairness of the supervisory test, and strengthens market discipline. With a clearer view, the public—including investors, counterparties, and rating agencies—can better assess a firm's risk profile.

Second, the improved disclosure process will lead to better models because it creates a new mechanism for obtaining public feedback.

And, finally, firms will better understand how their risk profile factors into their capital requirements. Combined with lower year-over-year volatility, this will allow firms to more effectively plan capital and business decisions.

The rationale for these changes is straightforward. A risk-sensitive stress testing framework ensures that SCB requirements align with risk-taking behavior. If firms take additional risks, they should expect those risks to be reflected in greater losses in the stress test, which in turn would lead to higher capital requirements. The reverse is also true.

Combined with minimum risk-based capital requirements, risk-sensitive SCBs ensure that large banks remain resilient and can continue lending under severely stressful conditions. These improvements, which stem from the public comments we received, further underscore the clear value of greater transparency and accountability in the stress testing framework.

Using Stress Testing to Strengthen Supervision

As we move forward to conclude our work on the regulatory stress tests, we should thoughtfully consider whether we have fully captured the potential value of stress testing. To date, our reform efforts have focused on bringing transparency and public accountability to the capital-related stress test. But stress testing is also intended to more broadly improve the resilience of the financial system and increase the public's confidence that the banking system will be resilient to a wide range of shocks. So I will turn now to discuss our plan to move beyond simply informing capital requirements.

In theory, stress tests should identify unique firm vulnerabilities to material financial and nonfinancial risks. They should also provide insight into stressful scenarios that would cause those risks to materialize. This allows both firms and supervisors to understand scenarios that pose material threats to a firm's safety and soundness and to U.S. financial stability.

This is not a novel concept or new approach. Large banks already deploy a range of stress testing exercises, including scenario analyses and enterprise-wide stress tests. They use those results for their own business purposes—to inform risk management, business planning, and continuity of operations throughout times of economic and financial stress. Just as banks rely on stress testing to manage their own risk, the Fed's stress tests should do more for our supervisors than calculate a single capital requirement. Fed stress tests should also identify a firm's vulnerability to various material financial and nonfinancial risks before those risks emerge. That information, in turn, will help inform how best to focus our supervisory attention across our large bank portfolios.

Because these exercises would serve principally as forward-looking supervisory tools, their results would not be made public.

I envision this approach being implemented in a number of ways, but for the purpose of brevity, I will highlight those I see as most likely to take shape.

Additional scenarios that stress bank balance sheets can serve as a forward-looking tool for early identification of idiosyncratic and emerging risks. These are the precise risks that could threaten the safety and soundness of a firm or U.S. financial stability. The results of these analyses will further help prioritize our supervisory approach toward material financial and nonfinancial risks.

Let me use the Silicon Valley Bank (SVB) experience to illustrate. Had the Fed applied this type of analysis, supervisors could have measured the effect of a range of stressful scenarios on SVB's portfolios, exposures, and capital and liquidity positions. A plausible recession scenario, with rising interest rates and investment securities measured at fair value, would have shown the firm's capital falling below minimum required levels as early as the fourth quarter of 2021.

In my view, the early identification of that firm's vulnerability to interest rate risk and concentration of uninsured deposits would have made it nearly impossible to defer prompt and decisive action to require the firm to reduce its vulnerabilities. Combined with other supervisory evidence, it would have prompted earlier action. Analysis like this would inform supervisors where to direct their attention and encourage timely escalation. This type of forward-looking analysis could be run on a part of a bank's portfolio using bespoke models and assumptions, which could be used to better inform and direct examinations.

The SVB example illustrates that scenario analysis is powerful on its own. It becomes even more powerful when it is not a one-way exercise. As I noted, banks are already running their own versions of this work internally—and I believe there is tremendous value in comparing notes.

Open dialogue between firms and supervisors promotes mutual learning about firm-specific risks, alternative scenarios pertinent to a firm's unique risks, and second-order effects to the broader banking system. Large banks design and assess, in some cases on a daily basis, the most severe scenarios they may face. Supervisors will engage to understand their vulnerability to risks uncovered by the banks' analyses and contrast them with our stress test analyses of the same banks.

Enterprise-wide stress tests, for example, translate a narrative about that firm's risks, combined with severe macroeconomic and financial drivers, into projected losses, net revenues, and capital levels under stress. Depending on its business model, a firm might use this exercise to probe a specific vulnerability, like concentrated exposure to a single counterparty or to private credit, or a combination of risks that quietly erode its financial health over time. These are the kinds of risks that can build over multiple quarters without triggering an alarm. This is precisely why we must encourage direct dialogue between Fed supervisors and firms about what their own analysis shows.

One final approach is reverse stress testing. In this exercise, firms design a scenario that would materially impair their financial condition. This effort provides supervisory staff with valuable insights into a bank's risk management, solvency, and liquidity under stress. It is also valuable for supervisors to understand a firm's strategy and plan to mitigate risks during stress. Reverse stress testing can also help address gaps in our understanding of other firms' risk because a severely stressful scenario for one firm can also be severe for firms with similar balance sheet characteristics. This exercise provides an important opportunity for supervisors and firms to engage on firm-specific vulnerabilities and potential spillovers to the broader U.S. financial system.

Conclusion

Stepping back, the theoretical purpose of stress testing is not simply to set capital requirements. From its roots as a reform emerging from the global financial crisis, stress testing has always been intended to build resilience and confidence in the U.S. banking system. Now, nearly two decades later, as the Board's Vice Chair for Supervision, it is my responsibility to reinforce the Board's commitment to regulatory stress testing and to enhance transparency and public accountability in the regulatory process. Our approach will achieve this increased transparency and public accountability while making capital-related stress testing more accurate, effective, predictable, and fair.

As we count down to finalization of these rules, we are ready to begin a new era for stress testing: using this powerful tool to enhance supervision. This work will not replace the judgment of our examiners or the responsibility of banks to manage their own risks—implemented effectively, it will sharpen both. In the coming months, as we finalize these proposals, I will share more about how supervisors will explore scenario analysis and open dialogue with firms, and how reverse stress testing can become a regular part of our supervisory process for the largest banks.

Thank you for the opportunity to join you today. I look forward to our discussion.