

## Randal K Quarles: Beginning stress testing's new chapter

Speech by Mr Randal K Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, at the "An International Perspective on the Future of Bank Stress Testing" Symposium, sponsored by Harvard Law School Program on International Financial Systems, Cambridge, Massachusetts, 16 November 2018.

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Professor Scott, and our hosts from Harvard and the Program on International Financial Systems, thank you for the chance to participate in today's meeting. Looking around the room, I see a mix of past and current colleagues, from academics, to supervisors and central bankers, to researchers and practitioners in industry. All of you have seen, felt, and lived different aspects of the transition to the post-crisis regulatory framework, and I am grateful to hear your perspectives on such a critical aspect of it.

In the depths of the financial crisis, the first regulatory stress tests were designed under intense scrutiny with high-stakes consequences. Their contribution—an independent public view of the capital adequacy of the largest firms—helped reinforce the banking system at a critical juncture. Since then, stress testing has meaningfully increased the post-stress resiliency of large financial institutions, and become a critical tool in keeping the system strong.

Those accomplishments are real, and we should aim to do more than simply preserve them. Now is a prudent time to consolidate the gains we have made, and to promote the efficiency and transparency of our processes. Today, I will review some of our efforts along those lines, focusing on proposed changes to our stress-testing program. These changes, which I described in more detail in remarks last week, are intended to improve the program, maintaining its dynamism and flexibility while providing adequate notice to regulated firms, without altering materially the stringency of the tests or the overall level of capital in the system.<sup>1</sup>

I share these views with a deep appreciation of the decades of international experience represented in this room. The crisis came with a reminder that the financial system is global, that risks in one country can quickly spread to another, and that in keeping the system and the economy safe, we have no choice but to work together. I look forward to hearing your thoughts on the changes I outline, and on how to improve our stress testing processes in the years ahead.

### **Stress Capital Buffer**

Many of you are familiar with the Federal Reserve's proposed stress capital buffer (SCB), which would replace the current fixed buffer requirement of 2.5 percent of risk-weighted assets with one based on each firm's stress test results.<sup>2</sup> I believe the proposal represents an important milestone in crafting an integrated capital regime, and in keeping with its importance, we have received extensive and thoughtful public comments, identifying elements of it that could benefit from further refinement. I described several of these elements last week, including my views on some areas which I believe we should revisit: improving measurement of risks in the trading book; encouraging less sticky forms of capital distribution without requiring dividend pre-funding; and reevaluating the interaction of the capital buffer with capital distributions. Today, I want to highlight three elements in particular.

Foremost among these is the volatility of stress test results. Some volatility in annual results is necessary to preserve the dynamism of the stress test, and to reflect changes in macroeconomic conditions, salient economic risks, and the composition of firm balance sheets. However, when the largest banks in the system are fully meeting their capital requirements, a highly variable capital requirement from year to year can present a significant management challenge. I believe there is an important balance to strike in this area, which will let us preserve

dynamism while reducing volatility, and we plan to seek comment on a relevant proposal in the not-too-distant future.

The second is the sequencing of stress test results with capital plan submissions. Currently, and under the SCB proposal, a firm must decide whether to increase or decrease its planned dividends and share repurchases for the upcoming year without knowledge of a key constraint: the results of the stress test. Initially, this phasing reflected the view that firms should think rigorously about their capital uses and needs, rather than relying primarily on the results of the supervisory stress test to guide those plans. However, now that we all have several years' experience with this system, firms have told us that they would be able to engage in more thoughtful capital planning if they had knowledge of that year's stress test results before finalizing their distribution plans for the upcoming year. I am sympathetic to their concerns, and will ask the Board to adjust the operation of the rule, so that firms know their SCB before they decide on their planned distributions for the coming year. Of course, we expect firms to continue to maintain robust stress testing practices and use those results to inform their capital distribution plans, and we will continue to use the supervisory process to reinforce this expectation.

The third is the post-stress leverage requirement. As the Federal Reserve has long maintained, leverage requirements are intended to serve as a backstop to the risk-based capital requirements. By definition, they are not intended to be risk-sensitive. Thus, I am concerned that explicitly assigning a leverage buffer requirement to a firm on the basis of risk-sensitive post-stress estimates runs afoul of the intellectual underpinnings of the leverage ratio, and I would advocate removing this element of the stress capital buffer regime. Of course, leverage ratios, including the enhanced supplementary leverage requirements, would remain a critical part of our regulatory capital regime, and we will maintain the supervisory expectation that firms have sufficient capital to meet all minimum regulatory requirements.

To give these issues the careful consideration they deserve, I expect we will adopt a final rule in the near future, settling the basic SCB framework while re-proposing certain elements. I expect that the first SCB would not go into effect before 2020, and that CCAR will remain in place in 2019 for firms with over \$250 billion in assets or that are otherwise complex. However, we will consider whether we can move forward with any aspects of the SCB proposal for CCAR 2019, such as assumptions related to balance sheet growth, and I will ask the Board to exempt firms with less than \$250 billion in assets from the CCAR quantitative assessment and supervisory stress testing in 2019.

## **Transparency**

In the meantime, several initiatives are also underway to provide additional transparency into stress testing. I expect you will soon see the Federal Reserve issue a policy statement describing governing principles around the supervisory stress testing process—and with it, a commitment to disclosing additional detail about supervisory stress test models and results, along with portfolios of hypothetical loans and associated loss rates. I expect we will begin providing some of this additional detail starting in early 2019. I also expect the Board will seek comment on the advisability of, and possible approaches to, gathering public input on scenarios and salient risks facing the banking system each year.

Transparency matters not only because it provides additional due process to affected participants; it also creates an opportunity for broader, more insightful comments from the public. As a result, it can allow us to be more nimble and better informed in our scenario design. However, we want to maintain incentives for firms to conduct their own stress tests rigorously and thoughtfully, and avoid the risk that firms will use this new information to engage in transactions that are solely designed to reduce losses in the test without reducing actual risk. Firms have indicated that additional disclosure about models would not affect their own stress tests. We expect them to make good on that representation, as the Federal Reserve's stress

test is not, and cannot be, a full picture of a firm's resiliency in light of its idiosyncratic risks. We are confident that we can address these concerns through the regular examination process, by closely monitoring changes in firms' portfolios and ensuring sufficient capital, controls, and governance in light of the risk characteristics of their activities.

### **Qualitative Objection**

I also want to reiterate a point regarding the role of the qualitative objection. The Federal Reserve eliminated this element of CCAR for large and noncomplex firms in 2017, in part because of improvements in risk management at those firms.<sup>3</sup> In my view, the time has come to normalize the CCAR qualitative assessment by removing the public objection tool, and continuing to evaluate firms' stress testing practices through normal supervision. While supervisory assessments would continue to center on a firm's capital plan submissions, examination work would continue on a year-round basis, taking into account the firm's management of other financial risks, and culminating in a rating of the firm's capital position and planning. Firms with deficient practices would receive supervisory findings through the examination process, and would be at risk of a ratings downgrade or enforcement action if those deficiencies were sufficiently material.

### **Conclusion**

These changes are aimed at preserving the foundation laid over nearly a decade of stress testing experience, including by many of the people in this room. Our goal is to bolster the program's credibility by increasing its transparency, simplicity, and stability, while maintaining the strength of the supervisory and internal stress testing elements that are central to the program today. These adjustments will be coupled with our continued commitment to strong supervision, and our expectation that financial institutions manage their risks and hold sufficient capital to continue operations through times of stress. I look forward to hearing your insights into these changes, and I thank you for your time.

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<sup>1</sup> See Randal K. Quarles (2018), "[A New Chapter in Stress Testing](#)," speech delivered at the Brookings Institution, Washington, DC, November 9. [Return to text](#)

<sup>2</sup> [Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules \(PDF\)](#), 83 Fed. Reg. 18,160 (April 25, 2018). [Return to text](#)

<sup>3</sup> The capital planning evaluation remains as part of the normal supervisory process for these firms. [Return to text](#)