Client Update
Federal Reserve Proposes to Increase Transparency of Stress Testing Regimes

On December 7, 2017, the Federal Reserve Board (the "FRB") released a set of proposals aimed at increasing the transparency of its stress testing programs. The proposals include enhanced model disclosure, amendments to the FRB's policy statement on scenario design, and a new policy statement on supervisory stress testing.[1] The proposals follow years of criticism that the FRB's stress testing programs are opaque and requests for increased transparency regarding the models that the FRB uses to conduct stress tests. The comment period for the proposals ends on January 22, 2018.

The proposed changes to the FRB's policy statement on scenario design would apply to all banking organizations subject to the FRB's stress testing program. The two other proposals would be relevant for banking organizations subject to the FRB's supervisory stress testing programs (*i.e.*, bank holding companies and U.S. intermediate holding companies of foreign banking organizations with total consolidated assets of $50 billion or more).

BACKGROUND ON STRESS TESTING

The FRB's capital planning and stress testing framework consists of two related programs: (1) the Comprehensive Capital Analysis and Review ("CCAR") program, conducted pursuant to the FRB's capital plan rule; and (2) the Dodd-Frank Act stress tests ("DFAST"), conducted pursuant to the FRB's stress test rules. As a part of these programs, the FRB creates a number of supervisory scenarios (consisting of macroeconomic and financial conditions) and (in the case of supervisory stress tests) estimates the effect of these supervisory scenarios on banking organizations' revenues, losses and capital ratios using internally developed supervisory models and assumptions.

Currently, the FRB discloses descriptions of the supervisory stress test models in an appendix to the annual DFAST methodology and results documents. For each modeling area, the appendix

[1] Press Release, Federal Reserve Board requests comment on package of proposals that would increase the transparency of its stress testing program (Dec. 7, 2017). To access a copy of the proposed rules, *see* the FRB's website here.

includes a description of the structure of the model, key features, and the most important explanatory variables in the model. Notably, however, the FRB stops short of fully disclosing the complete details of its supervisory stress test models.

For years, industry participants have criticized the opacity of the supervisory stress testing process, calling for the FRB to improve the consistency of its stress testing requirements and increase the transparency of the process. In a June 12, 2017 report setting out a series of recommendations for revisions to the U.S. bank regulatory framework in response to President Trump's Executive Order on "core principles" for financial regulation, the U.S. Department of the Treasury recommended that "the Federal Reserve subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies."[2]

Proponents of additional disclosure maintain that disclosing additional information about supervisory models and methodologies would:

- Increase the credibility of stress tests by providing the public with information on the soundness of the models used;
- Facilitate comments on the models from the public, including academic experts, that could lead to improvements to the models and better understanding of the risks of particular loan types;
- Help the public understand and interpret the results of the stress tests; and
- Help financial institutions subject to the stress tests understand the capital implications of changes to their business activities.

Although the FRB generally has supported increased transparency in the stress test process, the FRB has expressed reluctance to fully disclose the models that it uses to conduct supervisory stress tests. In particular, it is concerned that firms would use details of the models to make modifications to their business that change the results of the stress test without changing the underlying risks. Furthermore, the FRB is worried that full model disclosure would incent banking organizations to use models similar to the FRB's, resulting in a "model monoculture," in which all firms have similar internal stress testing models that may miss key idiosyncratic risks.[3]

---

[2] A Financial System That Creates Economic Opportunities, U.S. Department of Treasury, Report, at 53 (June 2017), *available* here.

[3] *See* Governor Daniel K. Tarullo, Stress Testing after Five Years, Speech, at 7 (June 25, 2012) available here.

Earlier this year, the FRB released finalized revisions to the capital plan and stress test framework, which relaxed requirements for "large and noncomplex" banking organizations.[4] Those earlier changes, along with the new administration's selection of FRB Chair Jerome Powell and FRB Governor and Vice Chair of Supervision Randal Quarles, suggest additional changes to the FRB banking rules and other banking frameworks are forthcoming.

THE PROPOSED ENHANCEMENTS

The FRB issued three separate proposals that purportedly are designed to increase the transparency of both its CCAR and DFAST programs. Although broadly consistent with industry suggestions for increased disclosure around the FRB's supervisory stress testing processes, the proposals fall short of full disclosure of the FRB's processes. The three proposals are described below.

PROPOSAL ON ENHANCED MODEL DISCLOSURE

The first proposal would require the FRB to release additional information about the models that it uses to estimate hypothetical losses in its supervisory stress tests. In particular, the FRB would be required to disclose:

- Enhanced descriptions of supervisory models, including key variables;
- Modeled loss rates on loans grouped by important risk characteristics, and summary statistics associated with the loans in each group; and
- Portfolios of hypothetical loans and the estimated loss rates associated with the loans in each portfolio.

The FRB expects to publish these disclosures in the first quarter of each calendar year (*i.e.*, prior to the current CCAR and DFAST deadline of April 5). Although these additional disclosures fall far short of complete transparency into the FRB's supervisory stress test models, the proposals call for much more detailed and granular disclosures than those contained in the appendix to the annual DFAST methodology and results documents, at least with respect to loan-related models.

AMENDMENTS TO POLICY STATEMENT ON SCENARIO DESIGN FRAMEWORK FOR STRESS TESTING

Currently, the FRB uses a policy statement to develop macroeconomic scenarios and additional scenario components used in CCAR and DFAST. The second proposal would amend the FRB's policy statement to:

[4] For more discussion about those rules, *see* this Client Update.

- Clarify that the FRB may adopt a change in the unemployment rate of less than 4 percentage points in the severely adverse scenario, when the unemployment rate at the start of the scenarios is elevated but the labor market is strengthening and credit losses stemming from the previously elevated unemployment rates were either already realized or are in the process of being realized;
- Establish explicit guidance for changes in the nominal house price index (a key scenario variable) in the severely adverse scenario, based on a new ratio (nominal house price index to nominal per capital disposable income) aimed at limiting procyclicality; and
- Indicate that the FRB is considering including wholesale funding costs for banking organizations in the adverse and severely adverse scenarios in order to account for the impact of increased costs of certain "runnable" liabilities on net income and capital.

With the exception of the introduction of wholesale funding costs, the FRB does not expect the proposed amendments to affect the severity of the scenarios in a manner that persists through the economic cycle. In particular, although certain aspects of the amendments would increase the severity of the stress tests (*e.g.*, the stress to house prices would be high at the beginning of the stress test when the ratio of house prices to disposable personal income is expected to be the highest), these changes are not expected to persist throughout the scenario.

STRESS TESTING POLICY STATEMENT

The FRB is proposing a new policy statement on its approach to supervisory stress testing under CCAR and DFAST. This policy statement includes specific guidance on:

- Principles of supervisory stress testing, including guidelines to ensure that the supervisory stress test models result in projections that are: (1) independent; (2) forward-looking; (3) consistent and comparable across banking organizations subject to the stress tests; (4) generated from simple approaches, where appropriate; (5) robust and stable; (6) conservative; and (7) able to capture the impact of economic stress;
- Supervisory stress test model policies, which guide the development, implementation, and use of all models used in supervisory stress test projections; and
- Principles and policies of supervisory model validation, including guidance on structural independence, technical competence of validation staff, and the stature of validation function.

The policy statement would be codified as Appendix B to the FRB's Regulation YY.

* * *

Please do not hesitate to contact us with any questions.

NEW YORK

Gregory J. Lyons
gjlyons@debevoise.com

David L. Portilla
dlportilla@debevoise.com

Chen Xu
cxu@debevoise.com

Courtney Bradford Pike
cbpike@debevoise.com

WASHINGTON

Satish M. Kini
smkini@debevoise.com