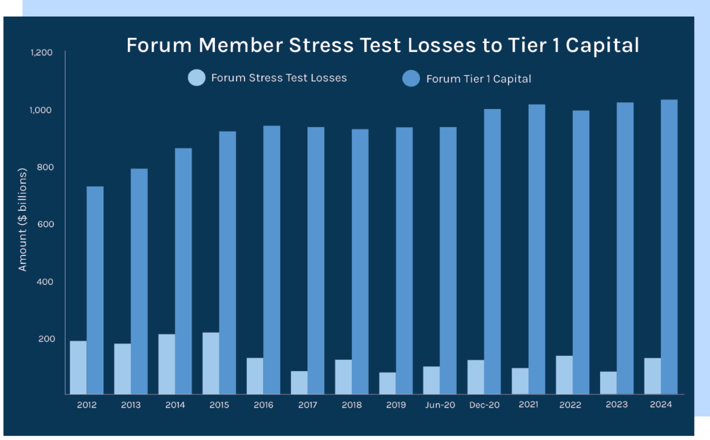
Stress Testing for the Largest U.S. Banks

The largest banks in the country undergo stress tests at least once a year that measure their ability to absorb losses and continue to support the economy during a severe economic downturn. The Federal Reserve has repeatedly determined in its stress tests that the largest U.S. banks have robust levels of capital.

Stress Testing Process: How Does It Work?

- **The Scenario** – Each year, the Federal Reserve publishes a rigorous and dynamic stress test scenario for the nation's largest banks without opportunity for public comment. The scenarios for the annual stress tests are **substantially worse than the 2008 financial crisis** and typically assume a rise in the **unemployment rate to at least 10 percent,** a **50 percent drop in the stock market,** and **a more than 25 percent decrease in housing prices.**
- **The Data** – The Fed collects comprehensive, granular data from banks on their exposures to various assets on its "Y-14" forms.
- **The Models** – The Fed maintains numerous complex quantitative models, which take the scenarios and data and then projects losses and income over the stress test period (12 quarters). Only the Fed knows the precise specification and calibration of the models.
- **The Results** – Results are released at the firm level. The Fed has long provided transparency on the results as a means of communicating the health of the banking sector to the public.
    - While the theoretical losses to banks in the tests are significant, they are **consistently a fraction of the capital maintained by Forum member banks.**



Fed's Stress Tests Show Banks' Resiliency

Sources: FR Y-9C data, available at https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx; Federal Reserve Board Dodd-Frank Act Stress Tests, available at https://www.federalreserve.gov/supervisionreg/dfa-stress-tests.htm, staff calculation.
Note: Capital amounts are reflective of the regulatory definition of capital at each point in time.

"Large banks are well positioned to weather a severe recession and continue to lend to households and businesses even during a severe recession."

Federal Reserve Board Press Release, June 2023

What Decisions Are Made Based on the Stress Tests?

- Stress tests inform the annual calibration of a bank's stress capital buffer (SCB), a binding capital requirement.
- Importantly, stress tests directly impact how a bank will manage its risk and make a number of decisions, including how much it will lend, to whom and how much.
    - Without knowing how the tests are designed and calibrated, it is harder for banks to practice prudent risk management and affects their lending decisions, meaning access to credit can be directly and negatively impacted.

Transparency Is Good Governance & Results in a Strong, Robust Financial System

- Greater transparency in the stress test scenario and modeling process is good governance and would promote the mutual goals of regulators and banks to enhance stability across the financial system in two main ways:
    - **Allow banks to effectively make decisions.** A wide array of research has documented that the stress tests have real impacts for bank customers. As an example, research has shown that banks subject to the stress tests make fewer loans to small businesses and to firms in the healthcare sector.
    - **Better serve the lending needs of Americans.** By allowing banks to better account for their risks under a stress scenario, they can have a clearer picture of their lending capacity. Greater transparency will allow the public to understand how the stress tests impact credit allocation throughout the economy and allow banks to make better informed credit and investment decisions.

Transparency in the rest of the capital framework is the norm. Greater transparency in the stress testing regime would reduce duplication and ensure a consistent approach to capital requirements.

- Risk-based capital requirements are fully transparent, subject to public comment, and are internalized by banks when making asset allocation decisions.
- Beyond capital, essentially every prudential regulation to which banks are subject – liquidity requirements, exposure limits, activity restrictions – are all fully transparent to the public and banks.