COMMITTEE ON CAPITAL MARKETS REGULATION

Stress Testing During a Pandemic: Enhancing Transparency & Financial Stability

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The Committee on Capital Markets Regulation (the "Committee") is an independent 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations. The Committee's membership includes thirty-nine leaders drawn from the finance, business, law, accounting, and academic communities. The Committee Co-Chairs are R. Glenn Hubbard, Dean Emeritus of Columbia Business School, and John L. Thornton, Former Chairman of the Brookings Institution. The Committee's President is Hal S. Scott, Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems. Founded in 2006, the Committee undertook its first major report at the request of the incoming U.S. Secretary of the Treasury, Henry M. Paulson. Over ten years later, the Committee's research continues to provide policymakers with an empirical and non-partisan foundation for public policy.

Stress Testing During a Pandemic: Enhancing Transparency & Financial Stability

The Committee on Capital Markets Regulation (the "**Committee**") strongly supports the use of regulatory stress tests to ensure that banks have sufficient capital to absorb losses under adverse economic conditions. The severe economic effects of COVID-19 have further heightened the importance of stress testing to ensure the stability of the banking system. In this statement, the Committee sets forth recommendations for the Federal Reserve Board's (the "**Fed**") Fall 2020 stress test.

Part I of the Committee's statement describes the Fed's 2020 Dodd-Frank Act stress test ("**DFAST**"), COVID-19 sensitivity analysis and the temporary restrictions on banks' distribution of capital to shareholders. We also review recent actions by the Fed, Federal Deposit Insurance Commission ("**FDIC**") and Office of Comptroller of the Currency ("**OCC**") that have clarified that a bank may draw down its "capital buffers," including the stress capital buffer ("**SCB**") and the global-systemically important bank surcharge ("**G-SIB surcharge**"). However, a bank that draws down its capital buffers is then subject to limitations on its capital distributions. We then review the Fed's Fall 2020 stress test and the lack of clarity as to the effects of the Fall 2020 stress test on the SCB and temporary restrictions on banks' distribution of capital to shareholders.

Part II of the Committee's statement sets forth recommendations for the Fall 2020 stress test. First, banks should not be automatically required to recalculate their SCBs based on the results of the Fall 2020 stress test. Instead, consistent with the Fed's capital framework and principles, the Fed should use the results of the Fall 2020 stress test to inform its supervisory discretion to require banks to revise their SCBs. However, the Fed should use extreme discretion in increasing the SCB for any banks due to the Fall 2020 stress test, as increasing capital requirements during the current economic environment can be procyclical. Indeed, Vice Chair Quarles and Chair Powell have acknowledged the importance of not increasing capital requirements during stressed economic conditions.[1]

Second, once the Fall 2020 stress test is complete and the results are public, the Fed should end its temporary restrictions on capital distributions, as the Fed can now rely on the Fall 2020 stress test to make decisions as to the minimum capital levels for covered banks. Third, in our view, the purpose of the Fed's Fall 2020 stress test should be to determine whether capital requirements need to be adjusted to take into account the real economic situation. However, the severely adverse economic scenario in the Fall 2020 stress test includes projections for GDP and unemployment that are much more negative than projections by economists. Such stress scenarios are appropriate for the Fed's annual stress test but should not be the focus of the interim Fall 2020 stress test. The inconsistency of the scenarios with the real economic situation is further reason for the Fed to exercise extreme discretion in increasing the SCB for any banks due to the results of the Fall 2020 stress test. Fourth, although banking regulators have notified banks that they may draw

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[1] Vice Chair for Supervision Randal Quarles, *The Adaptability of Stress Testing*, FEDERAL RESERVE SYSTEM (June 19, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm ("We kept in mind the principle that if possible we should avoid measures that tighten minimum capital levels during a crisis, to avoid intensifying that crisis."); U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES, *Hybrid Hearing - Oversight of the Treasury Department's and Federal Reserve's Pandemic Response*, 47:20 (June 30, 2020), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=406688, (Federal Reserve Chairman Jerome Powell: "We're not looking to raise capital standards during a crisis—that's not what's going on here").

down their capital buffers, we believe that banks are unlikely to do so because of the regulatory restrictions that would apply to their capital distributions. We therefore recommend that the Fed allow banks to draw down a share of their capital buffers (e.g. 10-15%) before subjecting banks to restrictions on their capital distributions. In other words, during the COVID-19 pandemic, the effective SCB and G-SIB capital surcharge should be temporarily relaxed to 85-90% of their full levels. Finally, we note our longstanding and separate recommendation that the Fed should provide full transparency of its stress testing model as doing so would enhance the quality of the stress test model and provide the public with increased confidence in the stress testing process and resiliency of the banking system.

Part I: Stress Testing and Capital Requirements

CCAR, DFAST and the SCB

The Fed's stress tests are a forward-looking dynamic analysis used by the Fed to determine whether the 33 U.S. banks with more than $100 billion in total assets ("**covered banks**") have sufficient capital to absorb losses during adverse economic situations.[2] Each year, the Fed designs and discloses a hypothetical adverse economic scenario and applies its own model, which is not disclosed, to determine the losses that covered banks would incur in the hypothetical scenario.[3]

Prior to 2020, the Fed's annual supervisory stress test process consisted of two key components—the DFAST stress test and the Comprehensive Capital Annual Review ("**CCAR**").[4] Both tests relied on the same Fed-designed economic scenarios and models to determine losses.[5] However, there were two key differences between CCAR and DFAST. First, DFAST assessed whether a bank maintained sufficient capital to meet regulatory minimums in a stress scenario, effectively assuming that the bank would not distribute any capital beyond prior dividend levels to shareholders. On the other hand, CCAR assessed the sufficiency of a bank's capital in the same stress scenario but based on the bank's existing capital *and* planned capital distributions, which banks were required to submit to the Fed. Second, DFAST did not impose any regulatory consequences on a bank that breached minimum capital requirements in a stress scenario. However, if a bank breached minimum capital requirements under CCAR (this would in practice be the outcome if the bank breached minimum capital requirements under DFAST), then the Fed had the authority to prevent the bank from distributing capital to shareholders.[6] Banks that "failed" CCAR were required to resubmit a capital plan to the Fed that would ensure that the bank had sufficient capital to exceed minimum requirements in the stress scenario, in order to distribute capital to shareholders.[7] Ally Financial, in 2013, and Zions Bancorp, in 2014, are the only two banks that breached minimum capital requirements under DFAST and CCAR and both banks resubmitted capital plans to the Fed that included raising capital to meet regulatory minimums under the stress scenario.[8]

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[2] FEDERAL RESERVE SYSTEM, *Stress Tests and Capital Planning* (Aug. 10, 2020), https://www.federalreserve.gov/supervisionreg/stress-tests-capital-planning.htm#:~:text=Dodd%2DFrank%20Act%20stress%20testing,support%20operations%20during%20adverse%20economic.

[3] *See, e.g.*, FEDERAL RESERVE SYSTEM, *Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Methodology*, 3 (March 2020), https://www.federalreserve.gov/publications/files/2020-march-supervisory-stress-test-methodology.pdf.

[4] *See, e.g.*, FEDERAL RESERVE SYSTEM, *2019 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule*, 1 (Feb. 2019), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190213a1.pdf ["**Fed Scenarios (2019)**"].

[5] Fed Scenarios (2019), *supra* note, at 4, at 1.

[6] FEDERAL RESERVE SYSTEM, *Comprehensive Capital Analysis and Review 2019 Summary Instructions*, 3 (March 2019), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190306b2.pdf ["**CCAR 2019**"]

[7] CCAR 2019, supra note 6, at 3, 17.

[8] https://www.federalreserve.gov/newsevents/press/bcreg/dfast_2013_results_20130314.pdf, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20140320a1.pdf
Ally Financial 10-K(2013), page 69, Zion Bancorp 10-K (2014), page 87

When the Fed adopted the stress capital buffer ("**SCB**") in March 2020, the "distinction between CCAR and DFAST [was] collapsed."[9] Under the revised framework, covered banks are still required to submit capital plans to the Fed.[10] However, banks no longer have to perform a separate CCAR stress test that banks can "fail."[11] Instead, the Fed performs one supervisory stress test (referred to herein as "**DFAST**"), and the results of this test are used to determine a covered bank's stress capital buffer ("**SCB**").[12] The SCB represents the projected common equity tier 1 ("**CET1**") capital that a bank must hold to offset the bank's projected losses from the severely adverse scenario in the supervisory stress test plus certain planned capital distributions as a percentage of risk-weighted assets.[13] If a bank fails to maintain sufficient capital to satisfy the SCB, then the bank is restricted from distributing capital to shareholders.[14] The SCB has a floor of 2.5% (the same as the capital conservation buffer which it replaced) and an unbounded maximum.[15] On August 10, the Fed announced the SCB for each covered bank—ranging from 2.5% to 7.8%.[16] Covered banks that do not have sufficient capital to comply with the SCB by October 1 would become subject to incrementally increasing restrictions on their capital distributions and discretionary bonus payments.[17]

COVID-19 Sensitivity Analysis

In Spring 2020, the Fed conducted a separate COVID-19 sensitivity analysis in addition to DFAST,[18] as the Fed determined that the DFAST stress scenario had become stale because the COVID-19 pandemic resulted in a baseline economic outlook that was worse than the DFAST stress scenario.[19] The COVID-19 sensitivity analysis was similar to DFAST as it was based on economic stress scenarios designed by the Fed and on the same Fed models as DFAST for

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[9] CLEARY GOTTLIEB, *Federal Reserve Finalizes "Stress Capital Buffer,"* 7 (March 16, 2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/federal-reserve-finalizes-stress-capital-buffer.pdf. *See generally* FEDERAL RESERVE SYSTEM, *Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules*, 85 FED. REG. 15576 (May 18, 2020), https://www.federalregister.gov/documents/2020/03/18/2020-04838/regulations-q-y-and-yy-regulatory-capital-capital-plan-and-stress-test-rules.

[10] CLEARY GOTTLIEB, supra note 9, at 3; FEDERAL RESERVE SYSTEM, *Comprehensive Capital Analysis and Review 2020 Summary Instructions*, 3-4 (March 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200304a3.pdf.

[11] CLEARY GOTTLIEB, supra note 9, at 4.

[12] FEDERAL RESERVE SYSTEM, *Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules*, 85 FED. REG. 15576 (March 18, 2020), https://www.federalregister.gov/documents/2020/03/18/2020-04838/regulations-q-y-and-yy-regulatory-capital-capital-plan-and-stress-test-rules.

[13] 85 FED. REG. 15576, at 15578.

[14] 85 FED. REG. 15576, at 15577; 12 C.F.R. § 3.11(a)(4).

[15] 85 FED. REG. 15576, at 15577.

[16] FEDERAL RESERVE SYSTEM, *Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results* (June 2020), https://www.federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf ["**DFAST Results (2020)**"]. FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces individual large bank capital requirements, which will be effective on October 1* (Aug. 10, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm.

[17] 85 FED. REG. 15576, at 15582; 12 C.F.R. § 3.11(a)(4).

[18] FEDERAL RESERVE SYSTEM, *Assessment of Bank Capital during the Recent Coronavirus Event* (June 2020), https://www.federalreserve.gov/publications/files/2020-sensitivity-analysis-20200625.pdf ["**Sensitivity Analysis (2020)**"].

[19] Vice Chair for Supervision Randal Quarles, *The Adaptability of Stress Testing*, FEDERAL RESERVE SYSTEM (June 19, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm.

projecting bank losses.[20] The results of the COVID-19 sensitivity analysis were released at the same time as the results of DFAST in June 2020.

The COVID-19 sensitivity analysis included three scenarios—a V-shaped economic recovery, a U-shaped recovery and a W-shaped recovery.[21] Compared to the severely adverse economic scenario in DFAST, all three alternative scenarios assumed higher peak unemployment rates and larger peak-to-trough declines in GDP in connection with COVID-19, as shown below in **Table 1**.[22]

Table 1
COVID-19 Sensitivity Analysis

Scenario	Peak Unemployment Rate	Peak-to-Trough GDP Decline
DFAST Severely Adverse Scenario	10.0%	-8.5%
V-shaped Scenario	19.5%	-10.0%
W-shaped Scenario	16.0%	-12.4%
U-shaped Scenario	15.6%	-13.8%

As would be expected, the projected losses for banks from each scenario under the COVID-19 sensitivity analysis, especially the U-shaped and W-shaped scenarios, are significantly higher than the projected losses for banks from DFAST.[23] The Fed also made certain assumptions that further increased the severity of the sensitivity analysis.[24] Most notably, the sensitivity analysis did not take into account the effects of government support programs for the private sector, including the Paycheck Protection Program, direct payments from the CARES Act, or the Fed's lending facilities.[25] The sensitivity analysis also did not take into account increased bank revenues from trading activities or the contraction in certain bank balance sheets experienced since the onset of the pandemic.[26]

According to Fed Vice Chair Randal Quarles, the rapidly changing economic environment meant that while the COVID-19 sensitivity analysis provided insight as to the performance of the financial system generally, the analysis was not sufficiently robust to provide insight as to the performance of particular institutions.[27] For this reason, the Fed did not disclose firm-specific

[20] Vice Chair for Supervision Randal Quarles, *The Adaptability of Stress Testing*, FEDERAL RESERVE SYSTEM (June 19, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm. *See also* Sensitivity Analysis (2020), *supra* note 18, at 5.
[21] Sensitivity Analysis (2020), *supra* note 18, at 5.
[22] Sensitivity Analysis (2020), *supra* note 18, at 7, Table 2.
[23] Sensitivity Analysis (2020), *supra* note 18, at 11, Figures 5-6.
[24] Sensitivity Analysis (2020), *supra* note 18, at 8-10.
[25] Sensitivity Analysis (2020), *supra* note 18, at 14.
[26] *See, e.g.*, Declan Harty, *In trading results, Wall Street's big banks find some relief from tumultuous Q2*, S&P GLOBAL MARKET INTELLIGENCE (July 16, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/in-trading-results-wall-street-s-big-banks-find-some-relief-from-tumultuous-q2-59430160.
[27] FINANCIAL STABILITY BOARD, *Question & Answer Session with Randal Quarles*, at timestamp 34:24 (July 7, 2020), https://www.youtube.com/watch?v=y4TzE2nGIvM ("If, as in the case with the sensitivity analysis we just ran, we are very confident that it gives us insight into the performance of the system, but not enough that we can

results of the COVID-19 sensitivity analysis to the banks or to the public.[28] However, the Fed disclosed that "under the U- and W-shaped scenarios, most firms remain well capitalized but several would approach minimum capital levels."[29]

In light of the COVID-19 sensitivity analysis, the Fed announced that it would restrict capital distributions for all 33 covered banks for the third quarter of 2020.[30] The Fed required covered banks to suspend share repurchases and prohibited banks from increasing dividends from the amount paid in the second quarter or exceeding the firm's average net income over the preceding four quarters.[31] The Fed announced that it will reassess its existing restrictions on capital distributions each quarter, [32] and on September 30, the Fed extended its restrictions to the fourth quarter of 2020.[33]

Capital Requirements and "Buffers"

The SCB is only one component of bank capital regulation, as illustrated in **Table 2**. Under the Basel III framework and the federal banking agencies' rules, banks generally must maintain at

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attach labels to particular institutions, then we would make that judgment [to disclose firm-specific results] accordingly.").

[28] Vice Chair for Supervision Randal Quarles, *The Adaptability of Stress Testing*, FEDERAL RESERVE SYSTEM (June 19, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm.

[29] FEDERAL RESERVE SYSTEM, *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event* (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm.

[30] FEDERAL RESERVE SYSTEM, *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event* (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm ("In light of these results, the Board took several actions following its stress tests to ensure large banks remain resilient despite the economic uncertainty from the coronavirus event."); Greg Baer, *What Is Next for Capital Regulation? Hard Choices About Dynamism and Procyclicality*, BANK POLICY INSTITUTE, 7 (July 24, 2020), https://bpi.com/wp-content/uploads/2020/07/What-Next-for-Capital-Regulation-Hard-Choices-About-Dynamism-and-Procyclicality.pdf; SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, *Unpacking the Federal Reserve's COVID-19 Sensitivity Analysis* (July 21, 2020), https://www.sifma.org/resources/news/unpacking-the-federal-reserves-covid-19-sensitivity-analysis/ ("The Fed used the COVID-19 analysis to support its decision to suspend share repurchases, place caps on dividends, and require banks to resubmit capital plans and conduct additional stress analyses later in the year."); WHF FOUNDATION, *WHF PPL with Vice Chair Randal Q Quarles*, 22:43 (June 23, 2020), https://youtu.be/5x4Z-xrGp1s?t=1363 ("We will be using the sensitivity analysis to make more informed judgments about the current capital positions of banks and potential capital conservation measures[.]"). *See also* Sensitivity Analysis (2020), *supra* note 18, at 19.

[31] FEDERAL RESERVE SYSTEM, *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event* (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm.

[32] FEDERAL RESERVE SYSTEM, *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event* (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm ("The Board will conduct additional analysis each quarter to determine if adjustments to this response are appropriate."). Sensitivity Analysis (2020), *supra* note 18, at 19.

[33] FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces it will extend for an additional quarter several measures to ensure that large banks maintain a high level of capital resilience* (Sept. 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200930b.htm.

least 4.5% in CET1 capital against their total risk-weighted assets.[34] In addition to the minimum requirements, and in order to avoid restrictions on capital distributions, covered banks must also maintain certain regulatory capital buffers, which consist of: (i) the SCB; *plus* (ii) for global-systemically important banks ("**G-SIBs**"), the G-SIB capital surcharge. The G-SIB surcharge is intended to increase the resilience of G-SIBs and reduce the risk to U.S. financial stability from the failure of a G-SIB.[35] The G-SIB capital surcharge varies based on a G-SIB's size and scope of activities.[36] Banks are also subject to additional Tier 1 and Tier 2 capital requirements and leverage ratios that are not risk-weighted.[37]

Table 2
Capital Requirements (Oct. 2020) for GSIBs [38]

Bank	**Minimum CET1 Capital Ratio**	**Stress Capital Buffer**	**GSIB Surcharge**	**Total CET1 Capital**
The Goldman Sachs Group, Inc.	4.5%	6.6%	2.5%	13.6%
Morgan Stanley	4.5%	5.7%	3.0%	13.2%
JPMorgan Chase & Co.	4.5%	3.3%	3.5%	11.3%
Citigroup Inc.	4.5%	2.5%	3.0%	10.0%
Bank of America	4.5%	2.5%	2.5%	9.5%
Wells Fargo & Company	4.5%	2.5%	2.0%	9.0%
The Bank of New York Mellon Corporation	4.5%	2.5%	1.5%	8.5%
State Street Corporation	4.5%	2.5%	1.0%	8.0%

On March 19, the Fed, FDIC and OCC issued a joint letter encouraging banks to use their "capital buffers" to continue to serve households and businesses during the COVID-19 pandemic.[39] However, capital buffers could be interpreted to include the SCB and G-SIB surcharge, or buffers could only include capital that banks voluntarily hold above the SCB and G-SIB surcharge minimums (often referred to as a "management buffer"). On August 10, the Fed

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[34] 12 C.F.R. part 3 (national banks and federal savings associations); 12 C.F.R. part 217 (bank holding companies, savings and loan holding companies and state member banks); and 12 C.F.R. part 324 (state nonmember banks and state savings associations). Banking organizations with total consolidated assets under $10 billion that meet other qualifying criteria may opt into a simplified community bank leverage ratio framework to satisfy their minimum capital requirements.
[35] FEDERAL RESERVE SYSTEM, *Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies*, 80 FED. REG. 49081 (Aug. 14, 2015), https://www.federalregister.gov/documents/2015/08/14/2015-18702/regulatory-capital-rules-implementation-of-risk-based-capital-surcharges-for-global-systemically
[36] FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces individual large bank capital requirements, which will be effective on October 1* (Aug. 10, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm.
[37] 12 C.F.R. § 628.10(b).
[38] FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces individual large bank capital requirements, which will be effective on October 1* (Aug. 10, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm.
[39] FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL RESERVE BOARD, AND OFFICE OF THE COMPTROLLER OF THE CURRENCY, *Financial Institution Letter: Regulatory Capital Rule: Clarification on the Use of Buffers* (March 19, 2020), https://www.fdic.gov/news/financial-institution-letters/2020/fil20020.html.

further clarified that the SCB and G-SIB surcharge are "capital buffers" that are different from minimum capital requirements and can be drawn down.[40]

Fall 2020 Stress Test with Unclear Effects

Due to the COVID-19 pandemic and highly uncertain economic environment,[41] the Fed has announced that it intends to run another stress test in the fall of 2020 and is requiring covered banks to resubmit their capital plans for that purpose (referred to herein as the "**Fall 2020 stress test**").[42] This is the first time since the adoption of the Dodd-Frank Act that the Fed will require multiple capital plans in the same year.

The Fed has released key details of the Fall 2020 stress test.[43] First, covered bank balance sheets will be as of June 30.[44] Second, the Fed will release firm-specific results for each bank before the end of 2020.[45] Third, the Fall 2020 stress test will have two stress scenarios.[46] The Fed noted that its scenarios "are significantly more severe than most current baseline projections for the path of the U.S. economy."[47] According to the severely adverse scenario, the unemployment rate would peak at 12.5% at the end of 2021[48] and GDP would shrink by another 3.25% from the third quarter of 2020 until the fourth quarter of 2021.[49] In the second scenario, unemployment would reach 11% by the end of 2020 and stay above 9% through 2022.[50] We focus on the Fed's severely adverse scenario as it is the more adverse of the Fed's scenarios.

However, the effect of the Fall 2020 stress test on the SCB is unclear. In its recent Q&A, the Fed stated that it "had not made a decision to recalculate the SCB requirements" based on the Fall 2020 stress test.[51] As to the third quarter prohibition on stock buybacks and cap on bank

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[40] FEDERAL RESERVE SYSTEM, Fe*deral Reserve Board announces individual large bank capital requirements, which will be effective on October 1* (Aug. 10, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm ("Capital buffers, such as the SCB and GSIB surcharge, are different than minimum capital requirements for each firm.").
[41] Sensitivity Analysis (2020), *supra* note 18, at 1.
[42] Sensitivity Analysis (2020), *supra* note 18, at 19. SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, *Unpacking the Federal Reserve's COVID-19 Sensitivity Analysis* (July 21, 2020), https://www.sifma.org/resources/news/unpacking-the-federal-reserves-covid-19-sensitivity-analysis/.
[43] FEDERAL RESERVE SYSTEM, *Comprehensive Capital and Analysis Review 2020 Resubmission" Questions and Answers* (July 2020), https://www.federalreserve.gov/publications/files/CCAR-Resubmission-QAs.pdf ["**Resubmission Q&A**"].
[44] Resubmission Q&A, *supra* note 43, at 1.
[45] FEDERAL RESERVE SYSTEM, *Federal Reserve Board releases hypothetical scenarios for second round of bank stress tests* (Sept. 17, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200917a.htm ["**Scenario Press Release (Sept. 2020)**"]; FEDERAL RESERVE SYSTEM, *Supervisory Scenarios for the Resubmission of Capital Plans in the Fourth Quarter of 2020* (Sept. 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200917a1.pdf.
[46] Scenario Press Release (Sept. 2020), *supra* note 45.
[47] Scenario Press Release (Sept. 2020), *supra* note 45.
[48] Scenario Press Release (Sept. 2020), *supra* note 45.
[49] FEDERAL RESERVE SYSTEM, *Supervisory Scenarios for the Resubmission of Capital Plans in the Fourth Quarter of 2020*, 4 (Sept. 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200917a1.pdf.
[50] Scenario Press Release (Sept. 2020), *supra* note 45.
[51] Resubmission Q&A, *supra* note 43, at 3.

dividends, the Fed recently extended those capital restrictions for the fourth quarter.[52] However, the Fed has not announced how the results of the Fall 2020 stress test would further affect those restrictions.

[52] FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces it will extend for an additional quarter several measures to ensure that large banks maintain a high level of capital resilience* (Sept. 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200930b.htm.

Part II: A Transparent Way Forward for Stress Testing During COVID-19

The Committee supports the use of forward-looking stress tests as a key component of bank capital regulation.[53] Stress tests are particularly important in the midst of a crisis and during an uncertain economic environment. Indeed, during the 2008 crisis, the Supervisory Capital Assessment Program provided policymakers and the public with much needed information and confidence in the stability of the financial system.[54] We therefore support the Fed's plan to conduct the Fall 2020 stress test for covered banks. However, banks presently face a high degree of uncertainty as to the effects of the Fall 2020 stress test and their ability to distribute capital to shareholders. Indeed, the Fed has established a temporary prohibition on share repurchases and cap on bank dividends for the fourth quarter, but the Fed has yet to disclose how these restrictions will be affected by the Fall 2020 stress test.[55] The Fed also has not clarified whether the Fall 2020 stress test will be used to calculate a new SCB. [56]

Effects of the Fall 2020 Stress Test

We recommend that the Fed immediately clarify that the publicly disclosed results of the Fall 2020 stress test will not be used to automatically recalculate each firm's SCB. Instead, consistent with the Fed's capital framework and principles, the Fall 2020 stress test results should be used to inform the Fed's supervisory discretion to revise each firm's SCB. The Fall 2020 stress test will provide additional insight as to the resiliency of covered banks and the Fed can exercise its supervisory authority to require an increase (or decrease) in each firm's SCB, if the Fed determines that such an increase or decrease is appropriate based on the stress test results. However, the Fed should exercise extreme discretion in increasing capital requirements as doing so during a downturn can be procyclical. Indeed, as noted by the Fed, "the capital framework emphasizes the value of not increasing capital requirements under stress and thus exacerbating a downturn. In particular, the capital framework is based on the principle that during normal periods firms build capital buffers that they can draw on during times of stress."[57] Furthermore, the Fed should immediately clarify that it will eliminate the temporary restrictions on capital distributions once the Fall 2020 stress test is complete and the results are publicly released. The Fall 2020 stress test will provide sufficient information as to the resiliency of the banking system that such temporary restrictions will no longer be necessary and the Fed can rely on the capital framework to make any determinations about capital distributions.

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[53] *See, e.g.*, COMMITTEE ON CAPITAL MARKETS REGULATION, *Roadmap for Regulatory Reform*, 14 (May 2017), https://www.capmktsreg.org/wp-content/uploads/2018/10/Roadmap-for-Regulatory-Reform.pdf; COMMITTEE ON CAPITAL MARKETS REGULATION, *Comment Letter to the Federal Reserve System re: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules* (June 25, 2018), https://www.capmktsreg.org/wp-content/uploads/2018/06/CCMR-Fed-Capital-comment-letter22.pdf.

[54] Til Schuermann and Oliver Wyman, *Stress Testing Banks*, WHARTON FINANCIAL INSTITUTIONS CENTER, 2 (Feb. 2013), https://www.capmktsreg.org/wp-content/uploads/2018/10/Capital-Study-Report.pdf.

[55] FEDERAL RESERVE SYSTEM, *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event* (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm. FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces it will extend for an additional quarter several measures to ensure that large banks maintain a high level of capital resilience* (Sept. 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200930b.htm.

[56] Resubmission Q&A, *supra* note 43, at 3.

[57] https://www.federalreserve.gov/publications/ccar-resubmission-qas.htm

The Purpose of the Fall 2020 Stress Test

In our view, the purpose of the Fed's Fall 2020 stress test should be to determine whether capital requirements need to be adjusted to take into account the real economic situation. However, the adverse economic scenarios in the Fall 2020 stress test include projections for unemployment that are consistently outside of the range of projections for unemployment by the Federal Open Markets Committee and quarterly GDP projections that are also often outside of the range of economist forecasts.[58] While such stress scenarios are an appropriate focus for the Fed's annual stress test, we do not believe they should be the focus of the interim Fall 2020 stress test. Although the economic scenarios for the Fed stress test are not as severe as the W-shaped recovery in the COVID-19 sensitivity analysis,[59] and certain industry estimates find that the aggregate effects on capital will be similar to the DFAST scenarios,[60] our view is that the economic scenarios should be consistent with the median forecasts for economic measures such as unemployment and GDP.

Specifically, the FOMC projects that unemployment will steadily decline from 7.5% in Q4 2020 to approximately 5.6% by the end of 2021.[61] On the other hand, under the severely adverse scenario in the Fall 2020 stress test, unemployment will *rise* to a peak of 12.5% at the end of 2021.[62] As for GDP, the FOMC projects that GDP growth will be approximately 4.89% over the next five quarters from Q4 2020 through Q4 2021.[63] However, the severely adverse scenario in the Fall 2020 stress test has GDP declining by about 3.11% over that same period.[64] The severely adverse scenario also includes the Dow Jones Total Stock Market Index ("**DWCF**") falling by 50% by Q2 2021.[65] However, in reality, the DWCF fell by only 35% during the most severe stage of the COVID-19 crisis, and it has almost fully recovered its losses since then.[66] Although the link

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[58] *See* FEDERAL RESERVE ECONOMIC DATA, *FOMC Summary of Economic Projections for the Growth Rate of Real Gross Domestic Product, Median* (last accessed Sept. 25, 2020), https://fred.stlouisfed.org/series/GDPC1MD; FEDERAL RESERVE ECONOMIC DATA, F*OMC Summary of Economic Projections for the Civilian Unemployment Rate, Median* (last accessed Sept. 25, 2020), https://fred.stlouisfed.org/series/UNRATEMD; FEDERAL RESERVE ECONOMIC DATA, *Release Tables: Summary of Economic Projections* (last accessed Sept. 25, 2020), https://fred.stlouisfed.org/release/tables?rid=326&eid=783029&od=2020-01-01#.

[59] *Compare* FEDERAL RESERVE SYSTEM, *Supervisory Scenarios for the Resubmission of Capital Plans in the Fourth Quarter of 2020*, 16 (Sept. 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200917a1.pdf; FEDERAL RESERVE SYSTEM, *Assessment of Bank Capital during the Recent Coronavirus Event* (June 2020), https://www.federalreserve.gov/publications/files/2020-sensitivity-analysis-20200625.pdf.

[60] Francisco Covas, *Assessing the Severity of Mid-cycle Stress Tests*, BANK POLICY INSTITUTE (Sept. 22, 2020), https://bpi.com/assessing-the-severity-of-mid-cycle-stress-tests/.

[61] FEDERAL RESERVE ECONOMIC DATA, *FOMC Summary of Economic Projections for the Civilian Unemployment Rate, Central Tendency, Midpoint* (last accessed Sept. 25, 2020), https://fred.stlouisfed.org/series/UNRATECTM.

[62] FEDERAL RESERVE SYSTEM, *Supervisory Scenarios for the Resubmission of Capital Plans in the Fourth Quarter of 2020*, 16 (Sept. 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200917a1.pdf ["**Fed Scenarios (Sept. 2020)**"].

[63] FEDERAL RESERVE ECONOMIC DATA, *Release Tables: Summary of Economic Projections* (last accessed Sept. 25, 2020), https://fred.stlouisfed.org/release/tables?rid=326&eid=783029&od=2020-01-01# (based on central tendency midpoint projections for the change in real GDP from 2020-2021).

[64] Fed Scenarios (Sept. 2020), *supra* note 62, at 16 (based on the variable for real GDP growth by quarter).

[65] Fed Scenarios (Sept. 2020), *supra* note 62, at 16.

[66] Michael Wursthorn, *S&P 500 Sets First Record Since February, Erasing Its Coronavirus Plunge*, THE WALL STREET JOURNAL (Aug. 18, 2020), https://www.wsj.com/articles/the-s-p-500-sets-first-record-since-february-

between the stock market performance and performance of the real economy is weak, the performance of the stock market affects banks' trading activities. Indeed, rather than incurring trading losses thus far in 2020, banks have instead experienced very strong trading revenues.[67] For example, the six largest banks earned trading revenues of $34 billion in the second quarter of 2020 alone.[68]

Although it is too late for the Fed to revise its scenarios, the Fed should take into account the unnecessary severity of its scenarios by exercising extreme discretion when determining whether to increase firms' SCBs based on the stress test results. Indeed, there is precedent for the Fed exercising discretion when there are issues with the stress test design. In 2018, the Fed was criticized for designing unreasonably severe stress test scenarios and the Fed ultimately issued "conditional non-objections" to the capital plans of Goldman Sachs, Morgan Stanley and State Street.[69] The conditional non-objections for Goldman Sachs and Morgan Stanley were related to one-time capital reductions from the tax law changes apparently inaccurately taken into account in the Fed's stress test design while State Street's conditional non-objection was due to issues with the design of the Fed's stress test.[70] More recently, errors in the Fed's stress test model resulted in a revision by the Fed to the SCB for Goldman Sachs and Morgan Stanley.[71] So, there is clearly precedent for adjusting the effects of the stress test to address possible issues with the Fed's model or scenarios.

Encouraging the Use of Capital Buffers

As noted earlier, the Fed and banking regulators have sought to encourage banks to use their capital buffers, which have been clearly defined to include the SCB and GSIB surcharge.[72] Indeed, the purpose of stress testing banks is to ensure that banks have sufficient capital to continue

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erasing-its-coronavirus-plunge-11597781130#:~:text=The%20benchmark%20U.S.%20stock%20index,now%20up%204.9%25%20this%20year.. WALL STREET JOURNAL MARKETS, *Dow Jones U.S. Total Stock Market Index (DWCF): Historical Prices* (last accessed Sept. 30, 2020), https://www.wsj.com/market-data/quotes/index/DWCF/historical-prices (showing that the DWCF closed at 34,631 on February 19, 2020, fell to 22,463 on March 23, recovered to 36,434 on September 2, and closed at 34,044 on September 29).

[67] *See, e.g.*, Declan Harty, *In trading results, Wall Street's big banks find some relief from tumultuous Q2*, S&P GLOBAL MARKET INTELLIGENCE (July 16, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/in-trading-results-wall-street-s-big-banks-find-some-relief-from-tumultuous-q2-59430160.

[68] Greg Baer, *What Is Next for Capital Regulation? Hard Choices About Dynamism and Procyclicality*, BANK POLICY INSTITUTE, fn. 19 (July 24, 2020), https://bpi.com/what-is-next-for-capital-regulation-hard-choices-about-dynamism-and-procyclicality/#_ftnref19.

[69] FEDERAL RESERVE SYSTEM, Fed*eral Reserve releases results of Comprehensive Capital Analysis and Review (CCAR)* (June 28, 2018), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180628a.htm.

[70] FEDERAL RESERVE SYSTEM, *Comprehensive Capital Analysis and Review 2018: Assessment Framework and Results*, 11 (June 2018), https://www.federalreserve.gov/publications/files/2018-ccar-assessment-framework-results-20180628.pdf. See also Liz Hoffman and Lalita Clozel, *Goldman Sachs, Morgan Stanley Dinged in Fed Stress Tests*, WALL STREET JOURNAL (June 28, 2018), https://www.wsj.com/articles/fed-stress-tests-deutsche-bank-fails-goldman-sachs-morgan-stanley-are-limited-on-payouts-1530217924.

[71] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200904a.htm

[72] FEDERAL RESERVE SYSTEM, *Federal Reserve Board announces individual large bank capital requirements, which will be effective on October 1* (Aug. 10, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm.

lending during market stress.[73] The Committee therefore supports allowing banks to use their capital buffers during the COVID-19 pandemic. However, using these buffers would mean that banks are subject to limitations on their ability to return capital to shareholders.[74] We think that such restrictions will strongly discourage banks from using their capital buffers to lend to businesses and households. We therefore support allowing banks to use a portion of their capital buffers to lend to households and businesses without subjecting banks to restrictions on their capital distributions, similar to the countercyclical buffers that were released in the UK[75] and another recent recommendation.[76] Banking regulators should determine the extent to which banks may use their capital buffers, such as 10% or 15%, during the COVID-19 pandemic. The effective SCB (plus G-SIB capital surcharge) should therefore be temporarily relaxed to 85-90% of their full levels.

Enhancing Model Transparency

The Committee has long supported full disclosure of the Fed's stress testing models because such disclosure would allow for public participation and market discipline that would enhance the quality of the Fed's models and ensure that the banking system is well-capitalized.[77] As we have noted in the past, the Committee does not believe that banks could "game" the stress test if the models were public,[78] as the Fed has remediation measures that it could adopt to prevent regulatory arbitrage[79] and given that the Fed collects data throughout the year from the banks, the Fed is well positioned to determine whether a bank is attempting to game the test.[80] Furthermore, we are not concerned that the disclosure of the Fed's model could result in model monoculture—whereby all banks adjust their internal models and effectively adopt the Fed's model instead.[81] This concern ignores the fact that the Fed has the supervisory authority to prevent banks from

[73] FEDERAL RESERVE SYSTEM, *Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results*, ix (June 2020), https://www.federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf; 85 FED. REG. 15576, at 15588.
[74] *Id.*
[75] *See, e.g.*, BANK OF ENGLAND, *Bank of England measures to respond to the economic shock from Covid-19* (March 11, 2020), https://www.bankofengland.co.uk/news/2020/march/boe-measures-to-respond-to-the-economic-shock-from-covid-19.
[76] https://www.oliverwyman.com/our-expertise/insights/2020/oct/restructuring-basel-s-capital-buffers.html
[77] COMMITTEE ON CAPITAL MARKETS REGULATION, *The Administrative Procedure Act and Federal Reserve Stress Tests: Enhancing Transparency*, 21 (Sept. 2016), https://www.capmktsreg.org/wp-content/uploads/2019/05/The-Administrative-Procedure-Act-and-Federal-Reserve-Stress-Tests-Enhancing-Transparency.pdf ["**CCMR on the Model Transparency**"]; COMMITTEE ON CAPITAL MARKETS REGULATION, *Comment Letter to Federal Reserve System*, 2 (Jan. 19, 2018), https://www.capmktsreg.org/wp-content/uploads/2018/01/1_19_18_CCMR-FINAL_Comment_Letter_Fed-Stress-Test-Proposals.pdf.
[78] CCMR on the Model Transparency, *supra* note 77, at 8.
[79] CCMR on the Model Transparency, *supra* note 77, at 19.
[80] CCMR on the Model Transparency, *supra* note 77, at 19.
[81] BROOKINGS INSTITUTION, *The Future of Financial Regulation: Q&A Panel*, 26-27 (Nov. 9, 2018), https://www.brookings.edu/wp-content/uploads/2018/11/es_20181109_quarles_financial_regulation_transcript.pdf; Jeremy Newell, *Fed's Quarles Outlines Needed Adjustments to Stress Testing Framework*, BANK POLICY INSTITUTE (Nov. 9, 2018), https://bpi.com/feds-quarles-outlines-needed-adjustments-to-stress-testing-framework/; Ryan Tracy, *Quarles: Fed to Propose More Transparent Bank Stress Tests*, THE WALL STREET JOURNAL (Dec. 1, 2017), https://www.wsj.com/articles/quarles-fed-to-propose-more-transparent-bank-stress-tests-1512176369.

effectively adopting the Fed's model.[82] Moreover, banks have a self-interest in adopting the best models for their own risk management purposes and no one-size fits-all regulatory model could do a better job of forecasting revenues and expenses than the models that firms use for their own strategic purposes.[83] The Committee continues to support full transparency of the Fed's model and increased use of bank's own models in determining stress test losses.[84]

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Should you have any questions or concerns please do not hesitate to contact the Committee's President, Emeritus Prof. Hal S. Scott (hscott@law.harvard.edu), or the Committee's Executive Director, John Gulliver (jgulliver@capmktsreg.org).

[82] Andrew Kuritzkes, Chief Risk Officer of State Street, *A Case for CCAR Transparency*, PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS (2019), https://www.pifsinternational.org/wp-content/uploads/2019/11/CCARwhitepaperfinal-footnotes.pdf

[83] Andrew Kuritzkes, Chief Risk Officer of State Street, *A Case for CCAR Transparency*, PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, 4 (2019), https://www.pifsinternational.org/wp-content/uploads/2019/11/CCARwhitepaperfinal-footnotes.pdf

[84] CCMR on the Model Transparency, *supra* note 77; COMMITTEE ON CAPITAL MARKETS REGULATION, *Roadmap for Regulatory Reform*, 23-25 (May 2017), https://www.capmktsreg.org/wp-content/uploads/2018/10/Roadmap-for-Regulatory-Reform.pdf; COMMITTEE ON CAPITAL MARKETS REGULATION, *Comment Letter to Federal Reserve System*, 2 (Jan. 19, 2018), https://www.capmktsreg.org/wp-content/uploads/2018/01/1_19_18_CCMR-FINAL_Comment_Letter_Fed-Stress-Test-Proposals.pdf; COMMITTEE ON CAPITAL MARKETS REGULATION, Comment Letter to Federal Reserve System, 6-7 (June 25, 2018), https://www.capmktsreg.org/wp-content/uploads/2018/06/CCMR-Fed-Capital-comment-letter22.pdf.

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