April 10, 2018

Dear Representative,

On behalf of Americans for Financial Reform, we are writing to urge you to vote in opposition to H.R. 4293, the “Stress Test Improvement Act,” which is being considered on the House floor this week.\(^1\) This bill would significantly weaken stress testing, a crucial element of bank supervision, by preventing regulators from assessing the capacity of big banks to perform adequate data analysis or risk management as part of the stress testing process. Since the Federal Reserve only assesses these issues for the largest and most complex banks in the country, H.R. 4293 would benefit only these banks.

Specifically, H.R. 4293 would ban regulators from failing banks based on “qualitative” objections to their stress test processes, meaning that regulators could not withhold assent to bank capital plans based on their assessment that banks had inadequate data management or risk measurement. Since regulatory stress test results are crucially dependent on data supplied by banks, these “qualitative” elements are critical to the effectiveness of stress testing as a whole. The need for proper data analysis and risk management as part of forward-looking stress tests was a key lesson that came out of the 2008 financial crisis. Former Federal Reserve official Nellie Liang has described the failures of banks in this area before the crisis:\(^2\)

“…good risk management is not cheap. It takes well-organized data and expertise, and the attention of senior officers, to conduct rigorous and credible analysis. Banks and supervisors learned the hard way during the crisis that many banks had not structured their data in ways to project losses under alternative scenarios. … banks could not consolidate their loans across subsidiaries, evaluate total exposures to an asset class, and might not have known if they held both the first and second liens on the same house. Other banks recorded mortgages with the billing address of the investor rather than the property address, making it impossible to evaluate the value of the home backing the mortgage. … Without strong incentives from the stress tests, banks would almost surely backslide on data and risk management as they face constant pressure to boost profits by cutting back-office operations.”

\(^1\) Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

Former Federal Reserve vice-chair for supervision Daniel Tarullo has similarly emphasized the importance of the qualitative element of stress tests.³

“While, understandably, many focus on the quantitative side and its implications for capital distributions, the importance of the qualitative component has been perhaps underappreciated. We saw during the 2009 stress test that many large financial institutions were unable to marshal the data necessary to gauge their own exposures accurately or to project the adverse effects they would suffer in a tail event, as opposed to a more ordinary cyclical downturn. CCAR has required the firms to steadily improve their risk management and capital planning processes.”

By banning regulators from assessing the capacity of big banks to perform these crucial data management and risk assessment tasks as part of the stress testing process, H.R. 4293 would severely undermine the effectiveness of stress testing for the largest and most complex banks. The Federal Reserve has already voluntarily removed this “qualitative” assessment from stress testing of non-complex banks below $250 billion in size.⁴ H.R. 4293 would therefore benefit only the largest and most complex banks in the country, while increasing risk to the general public.

Eliminating the qualitative element of stress tests is not the only way in which H.R. 4293 would weaken stress tests. Other provisions would reduce the number of stress test scenarios from three to two, reducing the capacity of regulators to test alternative assumptions about how financial markets might weaken in the future. H.R. 4293 would also reduce the number of self-conducted stress tests mandated at large banks from two to one per year, eliminating part of the early warning system for upcoming financial stress.

Former Chair Janet Yellen has stated that stress testing “improves public understanding of risks at large banking firms, provides a forward-looking examination of firms’ potential losses … and has contributed to significant improvements in risk management.”⁵ Former Chair Ben Bernanke has praised stress testing for playing a crucial role in the recovery of the economy and creating a more resilient post-crisis U.S. banking system.⁶ The deceptively named “Stress Test Improvement Act” severely weakens this key element of bank oversight and must be rejected.

Thank you for your attention to this matter. For more information please contact AFR’s Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform