



Stress Testing 101

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The Federal Reserve's stress test evaluates whether large banks in the U.S. can withstand economic shocks. Here's a quick look at stress tests' past, present and future.

The Federal Reserve conducts an annual stress test each year to determine whether banks are adequately capitalized to withstand adverse economic conditions. Stress testing is an important risk management tool for banks and supervisors. It helps identify potential vulnerabilities and ensures that banks have sufficient capital to withstand severe economic shocks.

How did stress testing start, and how has it evolved?

Banks are in the business of measuring and managing risk. While individual banks have historically gauged risk using their own internal stress tests, supervisory stress testing in the U.S. began with the Federal Reserve's 2009 Supervisory Capital Assessment Program during the Global Financial Crisis. This evolved into the annual Comprehensive Capital Analysis and Review (CCAR) program in 2011.

Today, the Federal Reserve conducts annual stress tests of the largest banks to determine if they hold enough capital to withstand severe economic shocks. The stress tests measure how much capital depletion a bank would experience in a worst-case hypothetical scenario, such as a severe recession featuring high unemployment, declining home prices, a decrease in real GDP, and a drop in the stock market. The results determine how much additional capital banks are required to hold in the following year as part of their ongoing capital requirements.

While the stress tests have evolved over the years, one aspect remains the same: the models used to project stress losses and revenues are kept secret. As a result, bank capital requirements can change significantly year-over-year due to undisclosed changes to stress testing models.

While stress tests serve a valuable purpose, **the lack of transparency violates the law, produces significant volatility, and imposes massive and unwarranted costs on the U.S. economy by ultimately decreasing market liquidity and the availability of credit, harming employment and reducing economic growth.**

The capital connection

Stress tests have evolved over the years and are now more tightly linked to each bank's ongoing capital requirements than they used to be.

The original stress tests included two parts: the Dodd-Frank Act Stress Test and the Comprehensive Capital Analysis and Review (CCAR). CCAR had a quantitative and qualitative segment within it that operated as an opaque "pass/fail" determination made in secret by the Fed. In 2020, the Fed changed this framework so that now, the stress tests continue to operate in secret but are used to determine each bank's additional capital requirements; these stress test capital requirements make more sense as part of the broader capital framework alongside minimum requirements and other capital surcharges.

Challenges

- ▶ **It produces inaccurate results.** While the goal of the test is to project how much a bank's capital would be depleted under a severely adverse scenario, the Fed's models perform this task poorly. Each year, the stress test produces counterintuitive and sometimes even nonsensical results that are inconsistent with more granular, and more accurate, bank models and recent market experience. The Fed argues the appeals process is sufficient to keep the results honest, but the appeals process is broken; nearly every public appeal has been denied with little explanation (the Fed granted an appeal for the first time ever in 2024).
- ▶ **Stress tests discourage certain lines of business.** Mortgages and small business loans, for example, are treated as riskier and can lead to higher capital requirements in the stress tests given their close link to the unemployment rate and resulting higher effective capital charges.
- ▶ **Standing in a dark room causes cautious movements.** The lack of transparency and volatility in the results makes it difficult for banks to plan and manage capital effectively, forcing them to hold an uncertainty buffer and leading to higher borrowing costs for their customers.
- ▶ **No crisis is alike.** The stress tests feature a single kind of crisis, typically a severe recession with high unemployment and low interest rates. The limitation of this approach is clear when considering the risks of rising rates, a global pandemic or other real-world disasters that have occurred in recent years. This is something the Fed is actively trying to address by adding multiple scenarios to its tests. One challenge thus far unaddressed is the one-size-fits-all and opaque nature of the Fed's own models, the conclusions of which suggest caution is necessary.

Common misconceptions

- ▶ **The stress test is not a college math exam. Banks do not "pass" or "fail"** the stress tests in the school sense; it is more akin to a test of a car crash dummy where regulators measure the outcome and identify the weaknesses. The results of the stress test have major implications for banks because the results determine their capital requirements and their ability to distribute dividends and engage in share buybacks.
- ▶ **The Fed is not the only one stress-testing banks.** Banks conduct their own stress tests regularly, evaluating their own resilience and risk management in a wide range of crisis scenarios.

What's happening now? BPI and its partners are challenging the opacity of the Fed's stress test models, which the public has a legal right to see, understand and comment on. BPI has told the Fed for years that its stress tests violate the law and petitioned the Fed to make them transparent; those efforts were ignored. While the Fed has taken steps to acknowledge problems with the current tests, the limitations period for challenging aspects of the current tests lapses soon, so this suit has been filed to preserve our ability to proceed in the event the Fed does not implement timely reforms, to preserve our legal options.

The stress test framework – effectively a binding rule with significant implications for banks' business decisions – creates uncertainty that hurts the economy and U.S. business growth. By challenging these practices, we hope to foster a more transparent and efficient financial system that better serves the needs of the U.S. economy.

For additional background, please see:

- [BPI Statement on GAO Report](#) (July 2024)
- [Stress Testing: A Response to Professor Daniel Tarullo's Recent Working Paper](#) (July 2024)

- [BPI's Stress Testing Testimony and 2024 Stress Test Results](#) (June 2024)
- [BPI Statement on Stress Tests](#) (June 2024)
- [BPI's Francisco Covas in Congressional Testimony: Stress Tests Need More Transparency](#) (June 2024)
- [Misunderstanding the Fed's Stress Test: Cost & Consequences](#) (July 2022)
- [BPI Statement on the Federal Reserve's Release of the 2022 Stress Test Results](#) (June 2022)
- [BPI Comments on Federal Reserve Implementation of Capital Assessments and Stress Testing Reports](#) (May 2022)
- [Fix Bank Leverage Requirements Now, in Advance of Upcoming Treasury Market Stress](#) (October 2021)
- [Estimating the Implicit Capital Charges in the Stress Tests](#) (August 2021)
- [Reserve Balances, Noninterest Expenses, and Bank Performance in the Stress Tests](#) (April 2021)
- [Reducing Spurious Volatility in the Federal Reserve's Supervisory Stress Tests](#) (October 2019)
- [The Global Market Shock and Bond Market Liquidity](#) (May 2019)
- [Stress Tests and Capital Surcharges Are Curtailing Lending to Small Businesses in LMI Communities](#) (December 2018)
- [A Proposal to Improve the Transparency of Stress Scenarios](#) (November 2018)
- [A Transparent Method for Judging the Severity of Macroeconomic Stress Scenarios](#) (August 2018)
- [Stress Tests and Improvements to the CCyB Framework](#) (July 2018)
- [Stress Test Dummies: A Fundamental Problem With CCAR \(and How To Fix It\)](#) (July 2018)
- [The Fed's Stress Tests May Have Left Banks More Exposed to Rising Interest Rates](#) (March 2018)
- [Fed's Versus Banks' Own Models in Stress Testing: What Have We Learned So Far?](#) (November 2017)
- [2016 Federal Reserve's Stress Testing Scenarios](#) (March 2016)