**Submission for the Record by the Securities Industry and Financial Markets Association**

**before the U.S. House of Representatives'**

**Financial Institutions and Monetary Policy Subcommittee**

**Hearing entitled "Stress Testing: What's Inside the Black Box?"**

**June 26, 2024**

**Executive Summary**

- Large banks are critical intermediaries in our capital markets, which fund roughly three quarters of all economic activity in the U.S. The small businesses, consumers, and savers who benefit directly and indirectly from bank involvement in U.S. capital markets are negatively affected by excessive capital requirements, including those resulting from the Global Market Shock ("GMS") component of the stress tests that the Federal Reserve Board (the "Board") uses to determine large banks' Stress Capital Buffers ("SCB"), which would be compounded by the market risk component of the Basel III Endgame proposal, known as the Fundamental Review of the Trading Book ("FRTB").
- The Board's stress testing policy statement requires the GMS to be "hypothetical but plausible"; however, it does not specify any quantitative thresholds for plausibility. And it is not clear how the Board designs the GMS scenarios annually. This lack of transparency makes it difficult for regulated firms and the public to fully understand how the Board arrives at its stress test results.
- A 2019 SIFMA study demonstrated that the GMS scenarios were practically implausible, which leads to excessive GMS loss estimate resulting in excessive and volatile capital requirements for large banks – severely constraining large banks' ability to support the U.S. capital markets. The proposed FRTB framework under the Basel III Endgame would further exacerbate the negative effects of the GMS.
- SIFMA believes that the Board should either eliminate the GMS component of the supervisory stress test or significantly adapt it with the following three solutions that would take into account the FRTB framework and reflect severe but plausible market shock scenarios: (1) remove the GMS from the SCB; (2) recalibrate the GMS scenarios to ensure it is practically plausible; and (3) apply the GMS and the FRTB sequentially.

**Introduction**

The Securities Industry and Financial Markets Association ("SIFMA")[1] and its member firms appreciate the opportunity to submit our perspectives on the supervisory stress tests conducted by the Board as required by Section 165 of the Dodd Frank Act. We are writing specifically to express our concerns regarding the negative effects on credit availability of the GMS component of the stress testing framework and the FRTB framework in the Basel III Endgame proposal. In particular, the GMS scenarios are empirically implausible and result in excessive levels of capital for large U.S. banks' capital markets activities. The proposed FRTB framework would further and severely constrain large banks' ability to intermediate U.S. capital markets, leading to higher costs and reduced availability of capital markets products and services to businesses and consumers.[2] Thus, SIFMA believes that the Board should re-propose the Basel III Endgame considering holistically the role of the GMS and the FRTB.

**GMS Shocks Are Empirically Implausible**

The GMS scenario is a set of hypothetical severely adverse shocks to a large set of risk factors reflecting general market distress and heightened uncertainty. Banks with significant trading activity must consider the GMS in their stress tests as a part of the supervisory severely adverse scenario.

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] The conceptual and practical overlaps between the FRTB and the GMS are discussed in this SIFMA blog, *Explaining the Overlap Between the FRTB and the Global Market Shock* (May 30, 2023), https://www.sifma.org/resources/news/explaining-the-overlap-between-the-frtb-and-the-global-market-shock/.

As a key component of the projected total stress losses that are used to determine SCB requirements, the losses associated with the GMS are recognized in the first quarter of the scenario and are carried through all subsequent quarters.

For the GMS scenarios, the Board's Policy Statement on the Scenario Design Framework for Stress Testing requires that the Board consider "hypothetical but plausible outcomes."[3] However, the Board has not adopted any quantitative thresholds for determining what severely adverse scenario shocks are "plausible" in the GMS component.

In 2019, SIFMA conducted a study to assess the plausibility of the GMS shocks.[4] The study evaluated the probability of various GMS shocks in the prior years and found that, in many cases, the statistical probability of a GMS shock is extremely low. For example, the statistical probability of 2019 GMS spreads for certain corporate bonds occurring was 0.001%. Since the Board generally calibrates the GMS shocks based on the assumption of a holding period of three months or longer (see the 2024 Stress Test Scenarios document for details[5]), the probability of 0.001% corresponds to at least a one-in-forty thousand-year event. Should this type of event be deemed to be "plausible" within the meaning of the Board's scenario design standard? Such events generally would be considered implausible, at least in a statistical sense.

[3] 12 C.F.R. § 252, Appendix A 5.2.3 (c), https://www.ecfr.gov/current/title-12/chapter-II/subchapter-A/part-252/appendix-Appendix%20A%20to%20Part%20252.

[4] *Global Market Shock and Large Counterparty Default Study: Recommendations for Reforms Based on a Statistical Analysis of Stress Testing Scenarios* (August 2019), https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-GMS-LCD-Study-FINAL.pdf.

[5] https://www.federalreserve.gov/publications/files/2024-stress-test-scenarios-20240215.pdf

**Practical Implications of Implausible GMS Shocks**

In the United States, capital markets fund approximately three quarters of all economic activities, and large banks play a crucial role in intermediating those markets. The design of the GMS has not been reviewed or adapted by the Board since late 2010 when the supervisory market risk stress test was formalized as the GMS under the CCAR process. It has been a major source of volatility in the projected stress losses largely because of its wildly implausible, arbitrary scenarios (e.g., all markets heading in one direction at the same time), which could give rise to misleading results in terms of the plausible, real world market risks that banks face – raising doubts about whether it performs any appropriate supervisory function.

The implausibility of GMS shocks and the variability from one year to the next results in both excessive levels of capital and excessive volatility in the resulting capital requirements for large U.S. banks from year-to-year.[6] For instance, the Board's 2023 stress test exercise indicates that the GMS losses accounted for nearly one fifth of total projected stress losses.[7]

The GMS losses estimate is a key driver of the resulting SCB requirements for large banks. The SCB was designed to replace the Capital Conservation Buffer ("CCB") in the Basel international standards. But the SCB went above and beyond the CCB; while the latter is fixed at 2.5%, the former can be *no lower* than 2.5%. Under the current U.S. capital rule, the SCB is applicable to the U.S.

[6] For more details, see SIFMA blogs, *Explaining the Overlap Between the FRTB and the Global Market Shock*, https://www.sifma.org/resources/news/explaining-the-overlap-between-the-frtb-and-the-global-market-shock/, and *US Stress test Capital Requirements Are Excessively Volatile and Overestimate Losses*, https://www.sifma.org/resources/news/u-s-stress-test-capital-requirements-are-excessively-volatile-and-over-estimate-losses-identifying-the-problem-and-how-to-solve-it/.

[7] https://www.federalreserve.gov/publications/files/2023-dfast-results-20230628.pdf

standardized approach, which is the binding capital constraint for many large U.S. banks. Therefore, as a result of the GMS, large banks' ability to support U.S. capital markets is already severely constrained.

**The Proposed FRTB Framework Would Further Exacerbate the Negative Impacts of the GMS**

The proposed FRTB framework contained in the banking agencies' Basel III Endgame Proposal is expected to increase capital requirements for large banks' trading activities by roughly 75% to over 100%, depending on whether the bank is using a modelled approach or the standardized approach. The combined effect of the GMS component and the proposed FRTB framework would lead to capital requirements exceeding the maximum possible economic losses on many positions, e.g., securitization positions. This is a clear indication that the capital requirements are not commensurate with risks and are overly conservative. The securitization market is a crucial funding source for American consumers.[8]

**Recommendations**

To mitigate the above impacts, SIFMA recommends that the Board either eliminate the GMS component of the supervisory stress test or significantly adapt it with the following three solutions that would approach the GMS and the FRTB in a holistic manner and ensure that capital requirements for large banks' capital markets activities are commensurate with their risks:

1. **Remove the GMS from the SCB**. Because the potential losses on trading activities under severe market stress are already capitalized adequately by the FRTB, the GMS component becomes

[8] For more details, see SIFMA blog, *How the Basel III Endgame Could Impair Securitization Markets and Harm US Businesses and Consumers*, https://www.sifma.org/resources/news/how-the-basel-iii-endgame-could-impair-securitization-markets-and-harm-us-businesses-and-consumers/.

duplicative and redundant. As a result, the most effective way of addressing this problem would be to remove the GMS component from the SCB altogether.

2. **Redesign the GMS to be reasonably plausible**. If the Board insists on retaining the GMS, the Board should make the GMS shocks reasonably plausible and ensure that they are supported by empirical evidence.
3. **Apply the GMS and the FRTB sequentially**. Instead of applying the FRTB and the GMS separately and summing up the resulting capital requirements as envisaged by the U.S. Basel III Endgame Proposal, the Board should apply the GMS and the FRTB sequentially. This approach is consistent with the SCB's objective that banks' capital levels still exceed the minimum requirement even after sustaining a severe market downturn.

**Conclusion**

In conclusion, we applaud the House Financial Services Committee's Subcommittee on Financial Institutions and Monetary Policy for holding this critical hearing on improving the Board's stress testing framework. We appreciate your review of our suggested proposals, which would mitigate the negative consequences of the stress testing framework, especially its GMS component, on the U.S. capital markets and American businesses and households that depend on them for access to affordable credit.