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The Federal Reserve Board's 2024 Stress Test and the Comment Letter that Never Was: How the 2024 Macroeconomic Scenario Violates the Board's Own Guidance

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Each year the Federal Reserve imposes a binding capital charge on the nation's largest 32 banks, based on a stress test. The stress test estimates how much each bank would lose under two hypothetical shocks: a macroeconomic shock and (for nine trading banks only) a market shock. Each year, in violation of the Administrative Procedure Act,[1] the Federal Reserve establishes its shocks without providing prior notice and the opportunity for public comment. Below is the comment we would have filed if provided the opportunity.

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Dear Secretary Misback:

We are writing to demonstrate that the 2024 stress testing scenarios are inconsistent with historical experience and the Board's own self-imposed rules, and therefore should be modified substantially.

Background

The Board's Policy Statement on the Scenario Design Framework for Stress Testing states, "The Board intends to use a recession approach to develop the severely adverse scenario.[2] In the recession approach, the Board will specify the future paths of variables to reflect conditions that characterize post-war U.S. recessions, generating either a typical or specific recreation of a post-war U.S. recession."[3]

With respect to the unemployment rate, the policy statement notes, "The unemployment rate used in the severely adverse scenario will reflect an unemployment rate that has been observed in *severe* post-war U.S. recessions, measuring severity by the absolute level of and relative increase in the unemployment rate." It then identifies the severe recessions as those occurring in 1957-58, 1973-75, 1981-82, and 2007-09.[4] The Policy Statement also specifies that the unemployment rate should increase by either (1) 3 to 5 percent or (2) the percentage required to reach a 10 percent unemployment rate, whichever is higher.

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[1] https://bpi.com/bpi-and-aba-seek-transparency-around-fed-supervisory-models-and-stress-scenarios/

[2] The policy statement was first issued in 2014 and underwent relatively minor changes in 2017. While the macroeconomic shock includes a baseline and severely adverse scenario, it is the severely adverse scenario that generates the binding capital requirement, so it is the focus of this comment.

[3] 12 CFR 252 Appendix A, 4.2.1 (a).

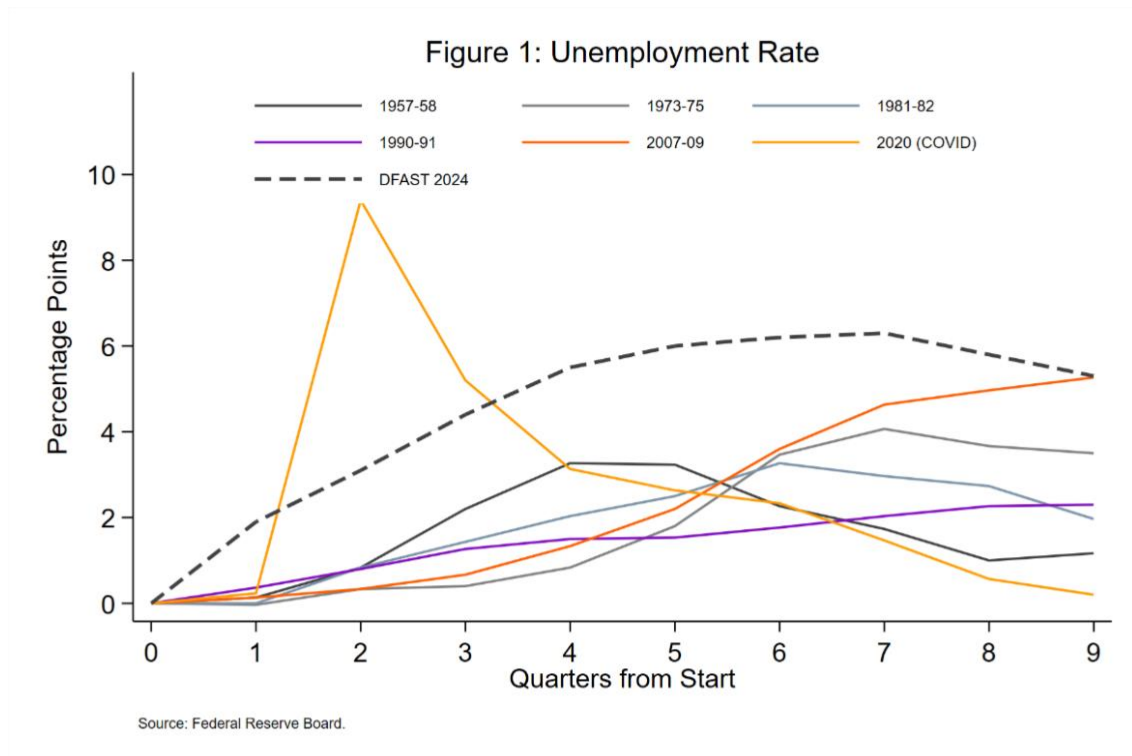
[4] Id. at Table 1, p.37

Following the trajectory of the unemployment rate, the Federal Reserve then determines the path of the remaining macroeconomic and financial variables. This determination is based on the underlying structure of the scenario and is consistent with the empirical relationships between those macroeconomic variables.

The 2024 Scenarios

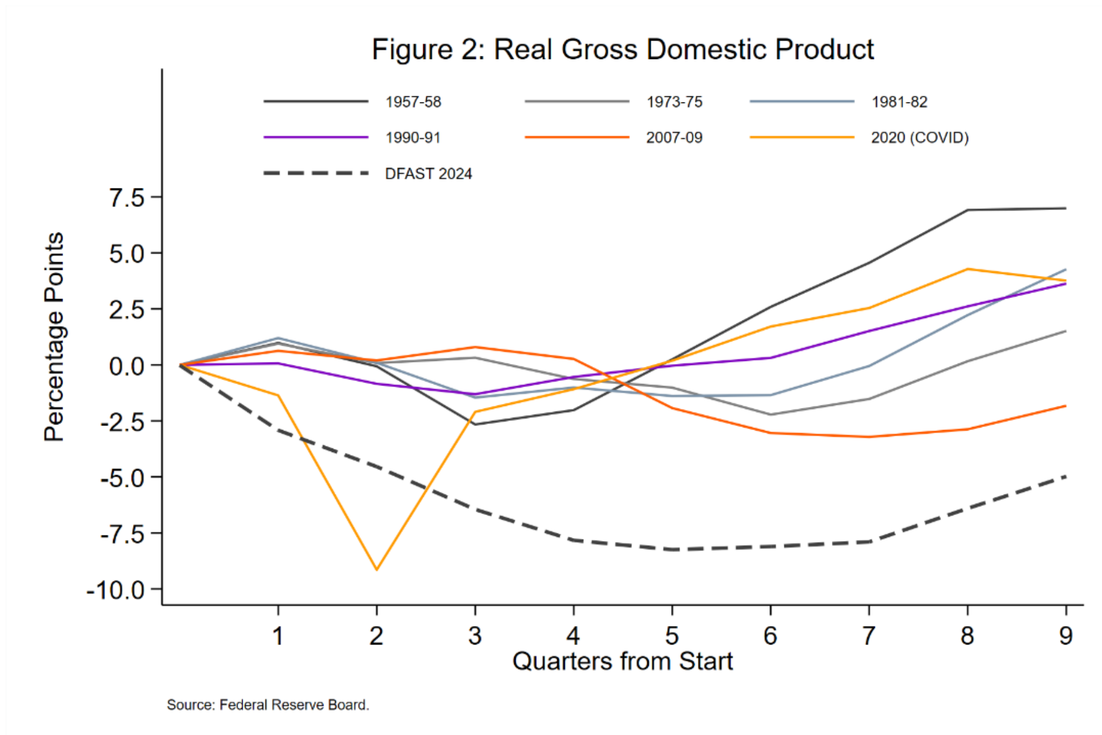
This year's stress scenarios do not align with historical experience or the Fed's own guidance and should be modified substantially.

First, with respect to unemployment, the increase in the unemployment rate is substantially more sudden than was experienced during the 2007-2009 financial crisis and any prior severe recession, with the exception of the pandemic-induced recession. The sudden jump in unemployment is expected to result in projected losses accumulating rapidly and in greater amounts over the stress test planning horizon. Furthermore, while the increase to 10 percent is consistent with the Policy Statement, that requirement is inconsistent with all post-war recessions save for the first quarter of the pandemic-induced recession of 2020.[5]

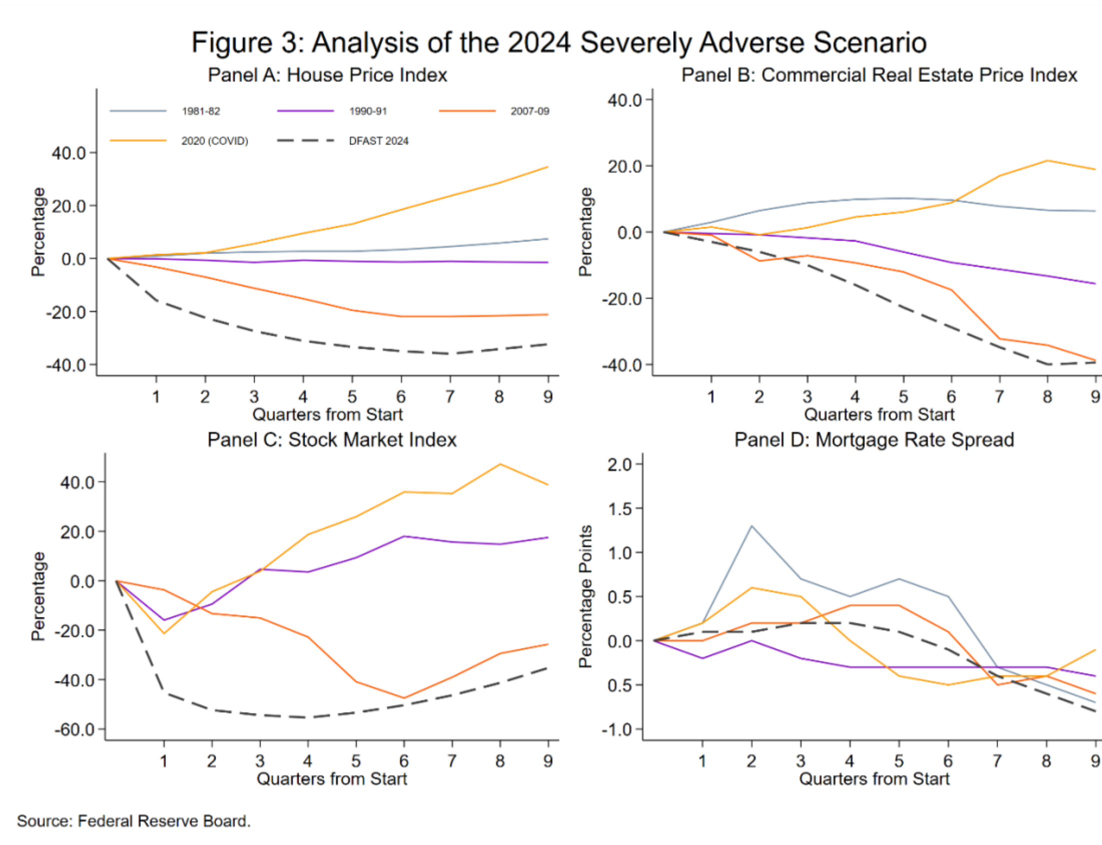


Second, the decline in real GDP is dramatically worse than all of the six recessions, including the 2020 pandemic-induced recession, except for one quarter.

[5] During the pandemic-induced recession, the unemployment rate reached 13 percent in the second quarter of 2020.



See below for other macroeconomic series comparing post-war recessions with the 2024 scenario.



While they speak for themselves, and clearly illustrate the Board's failure to comply, we would elaborate:[6]

- The housing price index is dramatically worse than all recessions, including the 2007-2009 global financial crisis.
- The decline in commercial real estate prices is close to the most severe path across all recessions. (We note that while some might consider a more dramatic downturn here appropriate given projections of trouble in this sector, that view assumes, counterfactually, that those projections have not affected the reserves that banks hold against such a downturn. In fact, under the CECL accounting standard, banks are already required to set aside reserves based on these projections in a probabilistic sense, even in the absence of any current impairment.)
- The stock market drop in DFAST 2024 is worse than all recessions, and considerably more frontloaded.
- The spread of the mortgage rate to the 10-year Treasury rate is the one variable that is generally consistent with the prior recessions.

Conclusion

We urge the Board to amend the macroeconomic scenarios to be consistent with the path of post-war U.S. recessions. Conforming to administrative law and its own guidance would enhance the credibility of the process, and the appropriateness of the resulting capital charge.

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[6] Since some macroeconomic series are not available prior to 1977, we have excluded the 1957-58 and 1973-75 recessions from Figure 3.