FedFin Client Report

Thursday, February 15, 2024

FedFin Assessment: New Fed Stress Tests are a lot Like the Old Fed Stress Tests

Client Report: STRESS32

Executive Summary

In this report, we assess the strategic and policy implications of the Fed's new stress-test regime. Released today, it incorporates new "exploratory" scenarios previewed by Vice Chair Barr as a response to the significant stress-test omissions laid bare in the March banking crisis. However, these exploratory tests will not directly factor into the SCB, which will also be calibrated to current capital rules since the banking agencies are now most unlikely to finalize these in time for SCB calculations later this year. We nonetheless expect bank supervisors to run bank results against internal models premised on new capital requirements, using supervisory discretion to address any capital shortfalls they feel warrant distribution restrictions regardless of formal test results. Similarly, we think supervisors will take near-term action if any of the exploratory scenarios points to near-term risk. Banks with large hedge-fund exposures will be at particular risk for supervisory orders to reduce exposures, as this report details.

Analysis

Binding Stress Tests

The relatively unchanged nature of these tests is likely to make it still easier for covered banking organizations to have structured their exposures ahead of the test to ensure remaining capital-distribution capacity under it. This could of course also increase correlation risk if any of the Fed's scenarios are ill-designed or fail to anticipate actual macroeconomic or market activity, as proved the case in 2023. Key points in the severely-adverse stress scenario include:

- continuing reliance on macroeconomic GDP, unemployment stresses and market-volatility parameters roughly in line with those in past exercises. Inflation measured by the CPI at the end of 2025 falls to 1.3 percent due to the forecast severe recession, rising to 1.6 percent at the end of the scenario. As in past tests, the interest-rate shocks are to the downside, with an inverted yield curve and ten-year Treasuries hitting 0.8 percent by the second quarter of 2024 and then

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

gradually rise;

- house-price declines of 36 percent, slightly less severe than the 2023 test. Losses are to be assumed concentrated in areas of rapid house-price hikes;
- an unchanged forty percent CRE test assumed for property types at greatest risk;
- regional shock scenarios that lead to dollar value declines and depreciation in all major currencies but the yen;
- a global market-shock scenario for the largest trading banks that this year assumes inflationary pressures and rising rates despite the inflation assumptions noted above for credit risk; and
- an unchanged approach to testing counterparty risk.

Exploratory Tests

These are to cover the largest and most complex banks according to the Fed's release, but how these will be determined is not made clear. The exploratory tests will judge:

- funding stress leading to deposit repricing under moderate and severe stress scenarios. These tests are not looking for funding resilience in the face of runs, but rather for bank balance-sheet strength if deposit rates go up. The test must also assume diminished earnings from mortgage originations, refis, and MBS; and
- market shocks due to moderate and severe changes in expectations of global economic activity. The bank must assume failure of the hedge funds to which it has the five largest counterparty exposures under both scenarios, but the more severe one also assumes sharp dislocations such as higher Treasury and commodity prices.

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com