

Peterson Institute for International Economics

Fed Governor Michael S. Barr on stress testing over time: Insights for future reform

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[00:05:16.05] - Caroline Atkinson

Hello, everybody. I'm Caroline Atkinson, a member of the board at the Peterson Institute. I want to welcome you all here for what I think will be an interesting discussion about a topic that we all hope is being managed. But often don't spend so much time talking and thinking about it. We're going to speak with Governor Michael Barr, Federal Reserve Governor Michael Barr, whom I have to refer to as Michael because many years ago we worked together in the US Treasury. And it's wonderful to see his career, which I'll mention in a minute. This conversation with Governor Barr is part of a series of events that Peterson— that has brought governors, presidents of regional banks, of the Fed to talk about how they see things at what is really a very critical time in monetary policy, but also in financial policy. And tomorrow, there will be a conversation with Tom Barkin, who is the president of the Federal Reserve Bank of Richmond, in the morning from 9:00 to 9:45.

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I understand.

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So, Michael, he took office as a member of the Board of Governors on July 19th, 2022, for a term that goes for 10 years. He served as the Vice Chair for Supervision of the Board of Governors from July 19th, when he came, to February 28th, 2025. And that, as you may remember, was a very interesting and stressful time for the Fed as we'd had the collapse, near collapse of Silicon Valley Bank, which seemed to take supervisors and regulators as well as the world more generally by surprise. And Michael had to dig right into figuring out, well, how do we make the system more resilient? Before his appointment to the Board, I mentioned that Michael had worked at Treasury, but just before the Board, he was in academia. As the Joan and Sanford Weill Dean of the Gerald R. Ford School of Public Policy. This is a very long title, uh, the Frank Murphy—

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because he was doing a lot of things—

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the Frank Murphy Collegiate Professor of Public Policy and the Roy F. and Jean Humphrey Professor of Law at the University of Michigan Law School. And he also worked in in the University of Michigan Center on Finance, Law and Policy and taught financial regulation and international finance in Michigan. I think one thing that's really interesting about Michael's background is that he is obviously in one sense has been like a Washington insider, but also has deep roots in the Midwest or in the heartland of the US. And I was speaking to him earlier, was, interested to hear that he spends a fair bit of time going around the country and talking to small businesses, community banks, others to get a sense of how people are in America. Of course, he also has to deal with the deep issues of stress testing, bank regulation, how do we make the system safe, safe enough, because I think we can't have a system that is never allows for failure of banks because that's also dangerous, but we certainly want to have a system that is systemically safe even if not for individual institutions. Before going to Michigan, Michael served in the Treasury as the Assistant Secretary for Financial Institutions for 2009, 2010 under President Obama, and then before that, he'd been a special assistant in the Treasury Department under Bill Clinton, it says here, but I remember it as being under Bob Rubin and then Larry Summers.

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He was before that a law clerk to David Souter on the Supreme Court. So he has really an excellent background in both financial regulation, law, his Yale law degree, and in the real world of those who rely on banks and the banking system to get the economy to move.

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So, over to you, Michael.

[00:09:57.16] - Michael S. Barr

Thanks very much, Caroline, for that warm introduction. It's great to be with you all here today, and those of you here in the room and those of you online, thank you for being here to join for this conversation. Good afternoon. Today I would like to discuss a vital tool for supervising the safety and soundness of the largest banks and preserving the stability of our financial system.

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I was there at the Treasury Department in 2009 when stress testing was first used in the United States in the heat of battle, an ad hoc measure to reverse a loss of confidence in U.S. banks that was a major force then driving the—

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the Great Recession.

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By examining how the balance sheets of banks would be affected by a worsening of financial and economic conditions, this process was intended to reveal weaknesses that could threaten the solvency of banks and prevent them from playing their central role in the economy. Stress testing ultimately succeeded in helping to restore confidence during the crisis, and in the aftermath of this battle-tested tool became a formal an integral part of the effort to repair the ensuing damage and strengthen the banking system. Stress testing has continued to evolve in the years since then to maintain that strength and help limit the chances of another devastating financial crisis. Stress testing changed as its purpose changed from wartime to peacetime, from mitigating the crisis to preserving the safety, soundness, and stability of the financial system. It has changed as banks and regulators learn more about how stress testing works in practice, and is part of an otherwise evolving supervisory and regulatory framework for banks that must necessarily adjust as finance itself evolves. Adjusting regulation in this dynamic environment is challenging, and one of those challenges is dealing with unintended consequences. The Federal Reserve made changes to stress testing in 2020 intended to make it more predictable and to better integrate it with overall capital regulation, but those changes are now at the center of litigation brought by large banks.

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The Fed responded in April by proposing more changes intended to address these criticisms. But as I explained in voting against those measures, I believe these steps will substantially impair stress testing, concealing rather than revealing crucial weaknesses in the risk management —of individual banks and in the stability of the financial system. As the Federal Reserve Board considers these changes, I believe we should focus on how best to address the original purpose and preserve the effectiveness of stress testing. As I will explain, I believe that the best way to further these goals is to separate stress testing from capital requirements in order to maximize the informative value of the tests— and their results— and untangle them

from the larger and complex task of setting capital requirements. I will lay out that alternative approach toward the end of these remarks, but first I believe it is helpful to take a step back and recall how stress testing has evolved to this point, and then turn to where it might go from here. It all began during the Global Financial Crisis. Capital markets froze, resulting in business failures and prompting the need for unprecedented public sector intervention. Credit to households and businesses slowed to a trickle, and millions of people were losing homes and jobs.

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By the fall of 2008, there was a broad-based lack of confidence in the banking system, as large banks faced questions about their exposures to losses related to real estate and other assets. These were questions that large banks in many cases could not credibly answer, because of the complexity and opacity of their direct and indirect exposure to mortgages at the center of the crisis. Without this information, investors assumed the worst, driving down equity prices of banks, which complicated efforts by banks to bolster their balance sheets. Restoring confidence in the banking system required credible information. From a reliable source. Treasury worked with the Federal Reserve to design the Supervisory Capital Assessment Program, or S-CAP, to test the capital adequacy of what were determined to be the 19 most systemically important banking and financial institutions. In addition, Congress had provided a backstop in the form of the Troubled Asset Relief Program. The FDIC had backstopped bank funding through guarantees., and the Federal Reserve had stepped up in significant ways to bolster the financial system and the economy. The existence of a government backstop played a big role in the success of the first stress test. With the use of public funding on the line, the rigor and transparency of the stress test was doubly important.

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There were 5 aspects of the S-CAP that are elemental to stress testing. Have been present in different tests since then. First, there was the use of a severe but plausible scenario for macroeconomic conditions. The scenario assumed a deeper and more prolonged recession than forecasters expected. Because of the focus on housing-related losses, the scenario's assumption of a further severe decline in house prices was essential to rebuilding confidence. Second, there was the use of economic models— to translate a given scenario into quantified losses for each bank. The banking regulators worked together to develop models to map the stress scenario into a range of associated loss rates for different loan categories and iterated with the banks to assess their specific exposures. Third, based on the extent of these projected losses, the test arrived at a firm-specific amount of capital that each bank would need in order to withstand this stress and keep lending to customers. A fourth aspect of the S-CAP and

subsequent stress tests was the public disclosure of the scenario, the basic testing methodology, and most importantly, firm-specific results. And lastly, in addition to the balance sheet data and other numbers related to the stress test, the Federal Reserve produced a qualitative supervisory assessment of the bank's capital planning decisions— and processes.

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One essential element of that first test is that the supervisors reviewed and assessed the data and modeling assumptions used by the banks, which helped to provide credibility for the loss estimates. The result of the S-CAP was that 10 of the 19 tested institutions were required to raise capital sufficient to keep them above regulatory minimums if the scenario were to materialize. A total of \$75 billion. The 10 were given 6 months to develop capital plans to meet their stress test minimums. The S-CAP was remarkably successful. There was skepticism that the tests would be sufficiently severe or transparent to be credible. And bank stock prices were volatile due to speculation about what the stress test results would reveal. But bank stocks recovered after the results were announced in May. Most banks that had been struggling to raise capital were able to do so, with 9 of the 10 able to find private sector sources of funding by the 6-month deadline. Credit default swaps for large banks returned to levels seen before the acute stage of the crisis. Bank lending was slower to recover, but stabilizing the banks helped stop the crisis and the U.S. economy started the long process of recovery.

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That July. I have compared the S-CAP to a battlefield campaign, and while the financial crisis certainly felt like combat at the time, my point is to emphasize the unique challenge of making financial regulatory policy in an emergency. The goal was to restore public trust in banks that were under fire, and as the job shifted to preserving that trust, it was apparent that there should be an ongoing role for stress testing in peacetime,— as well. Starting with the yearly stress tests established in 2010 with the Dodd-Frank Act and continuing with the integration of stress testing into the Federal Reserve's annual Comprehensive Capital Analysis and Review, or CCAR, the peacetime approach focused on institutionalizing bank resilience and risk management practices. The Federal Reserve conducted the first CCAR exercise in 2011. CCAR was an overall assessment of the capital planning process of banks, which included quantitative and qualitative components. Either of those components could form the basis for an objection by the Fed to firm plans to distribute capital to shareholders—distribution which would reduce the capital available that the firm could use to buffer its losses. The quantitative evaluation of a firm's capital adequacy was driven by the results of the Dodd-Frank Act stress tests, or DFAST.

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It departed from the SCAAP in at least two important ways. First, rather than making the severe scenario just a more negative version of the current consensus forecast, the Fed built a process to develop thematic, forward-looking scenarios using macroeconomic models calibrated to historical data. Some parts of the scenario design framework are purposefully countercyclical under normal conditions—for instance, the minimum peak unemployment rate is set at 10%. The countercyclicality of stress test scenarios is an attempt to lean against the pro-cyclical effects that can make borrowers appear overly resilient in good times, something which could cause the model to significantly understate the magnitude of borrower defaults when the economy turns. The second way that the Dodd-Frank stress tests departed from CCAR is that most losses under that test are projected by applying models developed and operated by the Federal Reserve, based on data provided by the banks. Using Fed-developed and validated models provides for independent risk assessment. The granular data provided by banks has been valuable in ensuring that the stress tests are truly risk-sensitive and in understanding broader trends and interconnections in the financial system. —In addition to this quantitative test, CCAR assesses the ability of banks to determine their capital needs in the future.

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Supplementing the DFAST model administered by the Fed, each bank projects its income over the stress scenario using internal models, providing supervisors with a view of governance and risk management of the bank's capital planning process. If a bank did not pass either the qualitative or quantitative evaluation, the Board of Governors was able to object to the capital plan and restrict the firm's shareholder distributions. Over time, several criticisms of CCAR's approach emerged. The first, that was CCAR was wholly separate from the process used to set a bank's basic risk-based capital requirements. Large banks also criticized CCAR for a lack of transparency and predictability that resulted in them pre-committing to lower capital distributions and higher levels of capital. In 2020, the Federal Reserve Board addressed these bank criticisms by creating the Stress Capital Buffer, or SCB. I know there's a lot of acronyms. To address the criticism that CCAR was additive and wasn't integrated into capital planning, the SCB combined the basic capital requirement for banks with one equal to a bank's projected capital ratio decline during the stress period plus a year's worth of planned dividends, linking components of the capital framework. To address the claim that CCAR lacked transparency and predictability, the SCB requirement set for each participating bank at a level that reflected its losses in the stress test and provided banks with flexibility to change their dividends in real time.

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Another bank criticism was that CCAR's use of its qualitative assessment was subjective. The, the SCB dropped the qualitative objection and moved that assessment of capital planning

practices into the traditional supervisory process. By more directly integrating stress testing into capital regulation, the SCB increasingly moves stress testing away from supervision and toward the regulatory arena—a consequential decision. While this change was intended to promote consistency and predictability, In retrospect, it may have reduced some of the value of the exercise, in that it reduced the range of facts and circumstances the Board would take into account when evaluating an individual firm's capital adequacy. As a result, the Board's flexibility to adjust capital adequacy determinations based on the unique features of different firms, including different business models and risk profiles, was constrained. When I became Vice Chair for Supervision in 2022, we continued the process of evolving the stress test. In particular, the Fed conducted multiple scenarios not directly connected to setting banks' capital requirements. Using additional scenarios has helped us to understand how a broader range of risks might affect the banking system. For example, we've explored a stagflation scenario and looked at the failures of large non-bank counterparties.

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Using multiple scenarios has helped keep our risk assessments dynamic. Before turning to the legal challenges to the current stress test framework, I would be amorous— amorous— not to emphasize the value of the framework we have. The stress test has been a critical element that led to strengthening both the quantity of capital in the banking system and the risk management capabilities of large banks. Since the Global Financial Crisis, large banks have more than doubled their risk-based common equity capital ratios. —from roughly 5% to 12% or more. At the same time, they have made meaningful improvements in their ability to measure, monitor, and manage their own risks. The stress test has directly contributed to both. Despite this success, some have argued for what they term "full transparency" of the test. But the criticism can be misleading because two important points are often omitted. First, the Federal Reserve already provides substantial information about the design of the test and has expanded these disclosures over time. Banks are far from uninformed. They receive substantial information about the models in annual model methodology disclosures, and any material model changes are phased in over 2 years with full explanation. Second, what critics call transparency is not disclosure of basic information about the rigor and methodology of the test essential for its credibility.

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Instead, it is the equivalent of handing out the questions to the test in advance. That would fundamentally undermine the rigor of the test, which is intended to assess resilience under conditions not fully known in advance, just as in a financial crisis. In short, the framework strikes a deliberate balance, providing banks with enough information about scenarios and models to

ensure fairness and accountability, but preserving the rigor that makes the stress test an effective safeguard. In December 2024, bank trade associations brought suit against the Board of Governors, challenging the role of stress testing in setting SCB requirements for large firms. The trade associations have challenged what they contend is the opacity of certain elements of the stress testing process, and have argued that the models and scenarios should be released— in proposed form to promote transparency and facilitate public comment. In anticipation of and in response to this litigation, the Board announced that it would disclose and seek public comment on all the models that determine the hypothetical losses and revenue of banks under stress, as well as the annual stress scenarios. The Board also proposed to change its rules to average stress testing results over 2 years, to reduce the year-over-year volatility in the capital requirements that result from annual stress testing.

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These proposed changes represent a policy choice to respond to the litigation by enhancing transparency and promoting public participation, and they are not intended to materially affect overall capital requirements. But, in my judgment, they are a mistake that will make stress testing less rigorous and nimble. Subjecting the stress testing models to the notice and comment process could lead them to ossify, and their dynamism and effectiveness may fade. Stress testing models are inherently complex and require adjustments to maintain accuracy and relevance, to appropriately account for quickly developing risks. Changes in the model would require new notice and solicitation of comment, and the time lag and burden in making changes would be significantly extended. We saw this type of ossification play out before the Global Financial Crisis, when supervisory stress testing of Fannie Mae and Freddie Mac became formulaic and failed to capture escalating risks, with dire consequences. An additional problem is that the comment process may have an uneven effect since banks have an incentive to object to aspects of the models that result in higher capital requirements, and not to highlight the areas in which the models underestimate downside risk. Responding to these comments could create a one-way ratchet that successively weakens capital requirements.

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Knowing the details of the stress test in advance will also increase the likelihood that banks are able to game the results to lower their capital requirements. We've seen examples of how firms have been able to game stress tests in the past. For instance, some firms started to use so-called macro hedges. Many of these macro hedges were hedges against a deep recession, similar to a stress test scenario, and these short-term hedges were cheap because investors assumed these scenarios as extremely unlikely. They were far out of the money, in option terms. The hedges project— reduced projected capital losses in the stress test by billions of

dollars for some banks. But they weren't really credible protection from the effects of a recession because maintaining these hedges would become prohibitively expensive as the economy moved into an actual downturn. This is just one example of attempts to game the stress tests that were eventually addressed through the supervisory process. But this example underscores how full disclosure of the Fed's stress test models and scenarios would enable banks to optimize stress test results by, among other things, adjusting their balance sheets based on their knowledge of where the models underprice risk in order to reduce their capital requirements without materially reducing their actual risks.

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Banks are likely to change their behavior in other ways that increase risk. Banks may invest less in their own risk management framework if the test becomes too predictable. Full disclosure of the Board's models may encourage concentration across the banking system— in assets that receive comparably lighter treatment in the test, which could create risks to financial stability. And banks are likely to reduce their management buffers, making it more likely that they would breach their required buffers and minimums in the event of stress. The upshot is that a so-called full transparency stress test can increase systemic risk because risk is underestimated and capital is too low.

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The stress tests could lose their credibility. A loss in credibility is bad for the banks, bad for the banking system, bad for financial stability, and ultimately bad for American families and businesses. As an alternative path to these proposed changes, I would favor prioritizing the rigor of the stress testing framework by separating stress testing from binding regulatory capital requirements., which would instead be increased commensurately. The Dodd-Frank Act requires that the Board conduct stress tests on large banks to evaluate whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. While these results can and should still play a role in informing supervisory and managerial assessments of the appropriate capital level for particular banking organizations, Decoupling the stress test results from the preliminary FCB would enable the Board to preserve essential aspects of stress testing, including the generation of credible and detailed information on the risk exposures of banks and how their capital levels would be affected by a stress event. Such information would be valuable in the supervision of banks in the normal times and especially important for banks and the financial system if they are again threatened by crisis.

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If the stress tests are no longer used to inform the calculation of a firm's preliminary SCB requirement, the legal justification for publishing the models and scenarios for comment would be eliminated. And I've already discussed the policy grounds for not publishing them. So the Board could abandon the notice and comment proposal. The Board could instead approach these statutory required tests primarily as a supervisory exercise, and could thereby retain flexibility to design and adjust the models and scenarios as appropriate to ensure their rigor and robustness. Moreover, as authorized by the Dodd-Frank Act, the Board could run multiple scenarios to provide greater dimension to the assessment of risks. As history teaches us, shocks and crises can manifest through a range of channels,— and testing a large bank's unique profile under a range of risks is more likely to yield high-value information about a bank's likely resilience to potential stress events. The net result of these changes would be to increase the nimbleness, dynamism, and effectiveness of our current stress testing framework. The Board's continued publication of firm-specific results would promote transparency and market discipline. So that this change does not reduce overall capital in the system, SCBs could instead be set entirely by regulation.

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For most non-GSIBs subject to the SCB requirement, the current 2.5% buffer floor likely remains an appropriate level. For GSIBs with a lot of trading, past stress tests have routinely indicated that SCBs should likely be set higher than the 2.5% floor, and any regulatory capital measure designed to replace the current SCB framework would need to account for this gap. While further analytical work is required, the shortfall generated by decoupling the stress tests from the SCB may be largely addressed by a regulatory capital requirement baked— like, linked to the risks in the trading book, with perhaps some other adjustments as required to maintain appropriate capital levels.

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If over time stress testing results indicate that this replacement regulatory capital measure routinely exceeds or falls short of the capital levels required to provide adequate resilience to stress conditions, the Board could revise the regulatory measure through a notice-and-comment process, informed by data gathered in the stress testing process. This proposed approach of decoupling the stress test from regulatory capital and increasing regulatory capital to make up the shortfall in the SCB appears to me to be the best way to retain the value of stress testing as a supervisory exercise while maintaining appropriate levels of capital in the system. However, replacing the current framework of individualized SCBs informed by firm-specific stress test results with broadly applicable formulaic regulatory capital requirements would result in a diminution of the risk sensitivity reflected in the, the SCB requirements. That is, capital levels for

firms that are subject to the stress tests would be relatively less tailored than they currently are, and less reflective of the unique business models, exposures, and risk profiles of a particular firm. To address this loss in risk sensitivity, I would propose that, in exceptional circumstances, The Board could use its capital directive authority to impose individualized capital requirements on specific firms to account for a firm's particular circumstances, including its capital structure, riskiness, complexity, financial activities, and other appropriate risk-related factors.

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This would be similar to the United Kingdom's Pillar 2B requirements and those of other jurisdictions. While these requirements could be informed by the stress test results in part, They would also take into account qualitative factors and supervisory judgment. Because these individualized requirements would consider the specific risks of a firm, they would be adjusted to reflect a firm's specific risk profile. While I don't believe it would be advisable for this type of exercise to become the default manner for setting capital requirements, in exceptional cases it would preserve some of the tailoring benefits of the current SCB regime in a manner that comports with the changes I have discussed. Furthermore, it would preserve the ability for banks to address stress results that demonstrate significant deficiencies in capital adequacy under a stress scenario, when the firms are otherwise in compliance with regulatory capital requirements. With these changes, stress testing could maintain its flexibility and adaptability, and therefore could retain its value as an effective tool for identifying idiosyncratic risk in a major bank and ensuring that capital is sufficient to address that risk. Among the benefits would be the space this approach would allow for continued innovation in stress testing.

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Such innovation is vital as finance evolves and banks continue to seek ways to reduce supervisory and regulatory requirements. This approach could allow for scenario design and modeling advancements unencumbered by the limitations I have spoken of imposed by the notice-and-comment process.

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In conclusion, I believe it is critically important to maintain the dynamism and rigor of stress testing so that supervisors, banks, and the public understand the underlying vulnerabilities in the banking system and at the largest banks, and understand that these firms are holding sufficient capital to address these vulnerabilities. I have deep concerns that the set of changes the Board is now considering risks resilience— risks reliance on a stress test that can no longer effectively

assess the resilience of the largest banks and lacks credibility, thus putting our financial system and the economy at risk.

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Thank you very much.

[00:37:43.07] - Caroline Atkinson

Well, that was not uplifting, at least at the end. And so I want to go straight into asking you, what do you think is the chance of your recommendation gathering support and maybe even gathering support sufficient to, you know, to become— for the board to turn back from where they were and for other voices to join in and argue for more flexibility. I have also to confess that having first dealt with or learned about supervision and regulation when I was at the Bank of England, where supervisory rather than regulatory approach was very much in the way of doing things. It does seem attractive to me to think of holding the flexibility and relying more on supervisory challenges— on supervisory oversight. But of course, that does raise the question of, are the supervisors up to the task? So first question is, is this— is your approach have a chance?

[00:38:56.13] - Michael S. Barr

I think there's, I think there's time for the board to think about it. We haven't had a formal proposal yet before the board. There's time for the board to assess that. There'll be time if the board moves forward with this first stage of the notice and comment process for us to receive comments from the public and to take those comments into account. And my experience has been in serving on the board and as an observer of it for for many decades now that the Board is open to different ways of thinking about things and isn't locked into any predetermined strategy. So the reason for giving these remarks and for encouraging the public to engage in this process is that I hope that the Board will be open to an alternative way of getting out of the box that we're currently in.

[00:39:46.11] - Caroline Atkinson

I was in a discussion with another supervisor just recently who was commenting that As far as money is concerned, there's nothing new under the sun. And— but as far as IT— with the developments in information technology, IT people come up with ideas and they don't understand about money. Money people don't understand about IT. Do you see that as a problem in this issue of stress testing, that there are all sorts of clever ways for the IT people to figure out new models and— and so on. And we know that fundamentally there are cycles and

bad loans are made in good times. And during the good times, there's tremendous pressure to release— you've written about this or spoken about this— to relieve pressure on capital. And then in the bad times, the government might— It's not there. So how do you see that interplay of the development of new technologies and the work that is in one sense the same as it's been for decades of trying to make banks take account of risk?

[00:41:09.15] - Michael S. Barr

Well, there are kind of 3 elements in the questions that you've raised. One is this cycle of history that we see and that you referred to— I gave remarks on not that long ago— we do see these cycles repeat over time. In periods where the economy seems to be doing well and memories of the last financial crisis have faded, there's this tendency to reduce regulation. Or not to keep up with the changes by making sure regulation keeps apace. And that failure to keep pace or to even reverse regulation that is there in good times ends up feeding the next financial crisis. And as you said, oftentimes it's the case, first of all, that that financial crisis causes enormous harm to families and to businesses. We certainly saw that in the global financial crisis in spades. And then the second thing that often happens is the government then has to step in and support the financial sector so that the financial sector can once again support the economy. And the whole point of getting regulation right in advance was that you make it less likely that firms will get themselves into such trouble that they harm the real economy, and government is required to step in.

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And I do worry that we're in the beginning of one of these deregulatory processes, deregulatory cycles now. You can see it in lots of different areas— stress testing, supervision, capital, to name a few. The second, you know, theme you raised is this question about regulation versus supervision. And I think both are really important. It's good to have strong regulation that goes through the notice and comment rulemaking process that everybody can rely on and see as a base level of resilience in the system. And then it's also really important to have supervisors who are poking and prodding. Stress testing is a great tool for poking and prodding when it's done right. And that brings me to your third theme, which is, you know, you know, this question of technology and can the regulator keep up. And that's one of the reasons that I'm really worried about the path we're on on stress testing, making it subject to this notice and comment process, because technology will keep going, and banks' modeling processes will keep going, and people will invent new ways to take on risk that the stress tests don't pick up. And it will become harder and harder for the stress tests to keep up.

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I really worry that the gears of the system will slow down and that friction will make it harder for the stress test to stay dynamic and innovative. This is not through any fault of anybody at the Fed. I'm sure that the teams who are working on stress testing are going to do their utmost to keep the stress test dynamic and relevant and accurate. But they're going to be having this push against them of the bank lobby and the notice and comment rulemaking process that the bank lobby uses. And that will make it hard for them to stay dynamic. And that's the worry that I have, that we'll end up with a stress testing process that sort of blesses the banking system as being safe when it's not.

[00:44:51.20] - Caroline Atkinson

Right. So it's interesting that there's an arc of the US inventing stress testing essentially after the global financial crisis. And in a sense, banks submitting to it, maybe not always happily, but also they wanted, and non-banks became banks in order to be kind of embraced by the system and embraced by the safety net. —then it becomes more and more annoying for the banks to have this safety net which they feel is unnecessary and so on. When you— as I was listening to you, I was thinking it's like a kind of cat-and-mouse game between the banking firms that want to take on risk in order to make profits and the regulators who are trying— who are looking at it from a systemic point of view and want to limit that risk. And is that just the nature of the beast, that it will always be this cat-and-mouse game with periodic crises necessary to, I don't know, knock some sense into the risk-takers, but at a big economic cost? So how do you see that?

[00:46:13.05] - Michael S. Barr

No, I do worry about that. I mean, there is this cat-and-mouse aspect to the game. I mean, banks respond to a set of incentives in the world, and regulation attempts to adjust those set of incentives, and then banks respond to the regulatory incentives themselves. And drawing those lines is super difficult. We don't want— as you said in your introduction— we don't want a banking system without risk. We want banks to take on risk. That's their function in society. They take on a set of risks that help our economy grow. But we want them to manage those risks, and we want them to have enough capital against those risks so that if they get into trouble, they bear the economic consequence, not taxpayers, not society at large. We want them, in economic terms, to internalize those costs. And that's what the battle is about in capital regulation. Banks never like capital. They would prefer to hold as little capital as the market would let them get away with. And the reason we have bank regulation is so that banks have sufficient capital to take society's costs into account in thinking about their risk management. And stress testing is part of that conversation, if you will, about what the appropriate way to manage risk is.

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And I worry that the path that we're on will result in less of that balance. And if things get out of whack and banks start taking on more risk for which they inadequately capitalize themselves, then that's when farmers get hurt and small businesses get hurt and families lose their home and people can't find a job. That's what that's about. And so getting that balance right, I think, is crucially important for the American economy, and that's why I care so deeply about what we're talking about today.

[00:48:15.14] - Caroline Atkinson

Yes, I think that's really well said, and I liked your— the way that you were talking about stress testing as a way to poke at risks and poke at and reveal risks that may not be captured by a system that regulation is necessarily a slower one. I want to ask about the edges of regulation in two different ways. One, as I referred to SVB, and of course that SVB, when Silicon Valley Bank got into trouble, the common refrain was, well, they weren't, you know, there'd been a mistaken lowering of, for a while, of the regulatory boundary within the US or within the banking system. And then separately, there are the non-banks We were talking earlier about private credit, private equity, all of these mechanisms of providing financing to the real economy through institutions or mechanisms that don't involve the banking system. Is that a problem, or is the fact that they're outside the banking system kind of fine because at least regular depositors are not going to be affected. How do you see those two issues?

[00:49:38.03] - Michael S. Barr

Well, there's always this problem. You know, I've taught financial regulation for many years, and one of the key themes of the classes that I've taught are this question of the regulatory perimeter. Who's in regulation? Who's not in regulation? Who's covered? Who's not covered? There's no way to get away from that problem completely. But I will say on SVB, you know, one of the problems that happened with SVB was that there was legislation that was passed by Congress to lower the burden on banks that were large banks but not super large banks. And SVB was omitted then from supervision as a large bank, and they were taken out of the stress testing program, and there were other changes to its capital and liquidity requirements. And they were sort of treated like a large community bank for quite a while as they were growing fast. And that led examiners to miss some of the key growing risks in the bank. You know, I testified on this bill back before it passed saying that one of the risks that you have is that if you let a series of these institutions that are large but not super large get out of this regulatory perimeter, they might all behave in a similar way that we wouldn't know, and then they could create stress in the financial system.

[00:51:02.04]

And that's basically what happened in 2023. You know, now when you look at the broader issues that you raised about the non-bank sector, the United States has a very vibrant, very dynamic financial system, some of which involves banks and some of which involves lots of different kinds of other entities. And not all those entities should be regulated like banks. We have different kinds of regulation for different kinds of institutions. But there is this risk that risk will float from one part of the system to another without people understanding what that risk is and without being able to measure and manage that risk. And that's what you want to look out for. So we, you know, at the Fed, We have a process we use to try and look across the financial system, not just at the banking sector, and say, where are the other potential sources of risk? How do we manage its intersection with the banking system? What could happen if that set of problems, you know, blew up? You know, at various times, we've looked at things like the role of hedge funds in the Treasury market, and— What do we think about the rise of private credit?

[00:52:16.28]

And what's the structure of non-bank mortgage origination and servicing? There are lots of these kinds of topics we're looking at all the time to try and say, okay, do we have our handle on the risk for the system as a whole, not just in the banking sector?

[00:52:33.02] - Caroline Atkinson

And do you feel that that's enough, or which of the areas outstripped just on the edges or the other side that worry you the most, if you are happy to, ready to talk about that.

[00:52:47.00] - Michael S. Barr

Well, I guess by disposition I'm always worried about— Everything, yeah. Risk in the system. That's your job. You and I have spent enough time together to know, you never know, we were talking about this just now over lunch, you never know where the shock is gonna come from. People who were, in the wake of the global financial crisis, one of the things that people did, very smart people did, was to build agent-based models to understand the transmission of risk in finance. And agent-based models, people know, come out of epidemiology. That's sort of where it's commonly used. And then it was brought into the financial sector analytic toolbox. But nobody doing agent-based modeling and using these advanced sophisticated techniques thought, well, what happens if we have a once in 100 years global pandemic? What would that do to the financial system? So you just don't know where the shock is going to come from, so you have to focus on resilience in the system as a whole. And that's why capital is so important, and that's why stress testing is so important. You just don't know where the shock is going to

come from. You want there to be sufficient resilience that the system can withstand those kinds of shocks.

[00:53:54.09] - Caroline Atkinson

So it's interesting that you mentioned the pandemic, because of course that was a massive crisis, shock, and all the rest of it that did not lead to a sustained financial crisis. I mean, there were moments of extreme stress. So what was it that went right?

[00:54:11.29] - Michael S. Barr

Well, there was massive government intervention to prevent the pandemic from becoming an economic and financial catastrophe. And in the absence of that government intervention, things would have been terrible. There was huge intervention to save money market mutual funds. There was a lot of support for the corporate bond market. There was support for municipal bonds. There was support for the housing market. There was economic aid that went to communities. There was economic aid that went to individuals. And all of that worked together in both the financial sector and the economic sector to keep the economy from plummeting and actually to help it recover much more quickly than countries in other parts of the world. Of course, all of that support together with the, you know, once in a lifetime or once in every 3 generation shock to our economy from the pandemic, plus Russia's assault on Ukraine, a series of supply shocks hitting the economy, plus the support for demand, Fed inflation that we're now continuing to work on addressing. So let me turn—

[00:55:25.16] - Caroline Atkinson

I mean, I think all of that is interesting, especially because there's a question about whether the financial sector actually learned that risk didn't matter so much because it was rescued. So that's always the balance. It's always the worry. Right. But you mentioned inflation. Let's turn— of course, you know, as a Fed governor, you also have to worry about interest rates, and we've had, as I mentioned, a series of Fed policymakers talking about how they see the economy. We don't have that much time left, but before I see if there are questions from the audience, I really would like to hear your view on this balance of risks, or maybe the risks are not balanced but rather in tension with each other.

[00:56:11.24] - Michael S. Barr

Well, you know, let's just take a step back and remember we had, you know, inflation rise up extremely steeply. And since that time, it's come down gradually. And we're now at a point where inflation is running under 3%. And it had been doing this long kind of gradual reduction in

inflation while the labor market remained solid and the economy was growing at a good rate. And that— it's a very unusual set of circumstances to have experienced. Without a significant recession. And now we're looking at a situation where inflation is starting to rise again slowly, and that is largely because of tariffs. So we're seeing services inflation and housing inflation continue with a bumpy path, but continue to come down. But goods inflation is moving from negative, which is its normal state in the world, to positive and growing. And the question is, what's going to happen to inflation over time as it moves away from our target? We need to watch that and be careful about it. Because it is largely related to tariffs, a reasonable base case is that it will continue to rise over time through 2026., but then will stop rising and will go back to its normal path.

[00:57:46.01]

That's a reasonable base case. But there's a risk that those price increases could be more embedded in the way we think about prices, and then inflation could spread to the services sector or to, to other parts of the economy. And we have to guard against that risk vigilantly to be sure that tariff increases in prices don't become embedded in the economy and that we return towards our target. On the labor side of our mandate, we have a dual mandate to care about inflation and maximum employment. On the labor side of the mandate, many indicators suggest that the labor market is doing okay. So, if you look at the unemployment rate, It's held quite steady in a narrow band for a while. The vacancy to unemployment rate, the quits rate, the new claims rate, you can think of as all showing positive signs. But there are heightened risks now on the employment side of the mandate. So one, you know, important example is if you look at the payroll data and you make certain adjustments to it, you can think of it as basically being in a band around zero growth. In payroll for the last several months.

[00:59:06.26]

Now, part of that is labor supply has shrunk a lot because immigration is no longer providing new workers to the labor force, but labor supply is also— labor demand has also come down. And so whenever you're operating in an economy with zero, effectively zero net job growth, a negative shock could cause a more significant decline in the labor market. So, we have to be attentive to that. And that's, I think, why you saw us— I'll just speak for myself— I thought, you know, our move to reduce rates by 25 basis points at our last meeting was an appropriate risk-management acknowledgment of that increased risk to the employment side of the mandate. So, we have to take both these things in mind.

[00:59:52.22]

They're in tension.

[00:59:54.08]

The inflation side of our mandate would suggest that we hold still or raise rates. The employment side of our mandate suggests that we would lower rates as a risk management exercise. So we have to be careful as we're moving forward. We're making adjustments to make sure that the employment side of the mandate is doing okay, that we also are keeping a watchful eye on inflation. And that's, I think, what you're going to see us trying to weigh in the coming months.

[01:00:22.20] - Caroline Atkinson

And is that—

[01:00:23.14]

well, I'll turn to the audience in case there are questions. Yes, thank you.

[01:00:28.15]

Please say who you are and ask your question.

[01:00:33.01] - Audience

Good afternoon. Is this— OK, great. Thank you very much for that presentation. I agree that you can't distribute the test.

[01:00:39.29] - Caroline Atkinson

Sorry, can you just tell us who you are?

[01:00:41.20] - Audience

Excuse me. Sorry, I think I probably did that while it was off. I'm Cullen Hendricks. I'm with the Institute. I do hope that you get your wish. But I want to make sure I understand this correctly. If you're able to separate these two processes and be able to devise the best possible stress suite of stress tests that you can imagine, and then that information is made public, and then you have a disclosure of the capital requirements that does not directly correspond to what you have said is the best mousetrap for assessing this, how do you think markets or the public generally is going to respond to any discrepancies that might arise? Thank you.

[01:01:18.27] - Michael S. Barr

It's a good question. I mean, I think one of the reasons that I think it's quite important for the stress test to be made public and to have individual results is that that market discipline will matter, and if the markets view the stress test as credible, they will look to the banks to make sure that they can withstand the stress of that stress test. I think that's a totally appropriate thing.

[01:01:45.07] - Caroline Atkinson

Thank you.

[01:01:47.24]

Are there other questions from the audience? And I'm sorry for those online that we can't take questions online, or we're not taking questions online at the moment, I just want to finish off perhaps with another monetary policy question to you, Michael, which is this balancing of the risks doesn't sound like actually we're restarting an easing cycle. We know that's the way to go and we've done one 25 basis point. We expect, as the dot plots seem to suggest, we expect another couple in the next 2, 3 months and maybe even more in 2026. So, what's your view on that?

[01:02:34.05] - Michael S. Barr

You know, I do think that the most likely direction of travel, the base case, is that it will be appropriate to reduce rates over time. I just think we need to be cautious about how we do that. I think there's too much focus on what are we going to do between now and December and not enough looking over 2025 and 2026 and thinking what is going to be the sequence and timing of rate cuts over that longer period of time. And I, I think the direction of travel is towards lower rates, but I think we need to be cautious about it.

[01:03:10.01] - Caroline Atkinson

Okay, well, on that note, thank you very much. Thanks for the interesting discussion about and Thank you for coming here and putting out that view about let's think differently about stress tests because they were an essential tool in helping the US economy to recover so quickly from the global financial crisis and a tool that we want to stay active and useful.

[01:03:35.28]

So thank you all. Thank you, Michael. Let's all join.