Banking and Finance Law Daily Wrap Up, TOP STORY—Fed releases stress test results, including coronavirus hypotheticals, (Jun. 26, 2020)

Banking and Finance Law Daily Wrap Up

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The Fed responds to stress testing results by making changes to ensure that large banks maintain their resiliency despite coronavirus pandemic.

The Federal Reserve Board has released the results of the annual Dodd-Frank Act stress tests for 2020. In addition to its normal stress test, the Fed conducted a sensitivity analysis to assess the resiliency of large banks under three hypothetical recessions, or downside scenarios, which could result from the coronavirus event. The scenarios included a V-shaped recession and recovery; a slower, U-shaped recession and recovery; and a W-shaped, double-dip recession. After considering the stress test results, the Fed took several actions following its stress tests to ensure large banks remain resilient despite the economic uncertainty from the coronavirus event.

Results. In the aggregate, the 33 firms subject to the supervisory stress test would "experience substantial losses under the severely adverse scenario but could continue lending to businesses and households, due to the substantial buildup of capital since the financial crisis." Loan losses for the 34 banks ranged from $560 billion to $700 billion in the sensitivity analysis and aggregate capital ratios declined from 12 percent in the fourth quarter of 2019 to between 9.5 percent and 7.7 percent under the hypothetical downside scenarios.

In the three downside scenarios, the unemployment rate peaked at between 15.6 percent and 19.5 percent, which is significantly more stringent than any of the Fed's pre-coronavirus stress test scenarios.

Under the U- and W-shaped scenarios, most firms remain well-capitalized, but several would approach minimum capital levels, according to the Fed. The sensitivity analysis did not incorporate the potential effects of government stimulus payments and expanded unemployment insurance.

The results of the Fed's full stress test designed before the coronavirus are comparable to the V-shaped downside scenario in the sensitivity analysis, in aggregate, and show that all large banks remain strongly capitalized. The Fed plans to use the results of this test to set the new stress capital buffer requirement for these firms, which will take effect, as planned, in the fourth quarter. Additionally, the Board will not be objecting to five foreign banks whose capital planning practices were evaluated as part of the stress tests.

Fed actions. For the third quarter of this year, the Fed is requiring large banks to preserve capital by suspending share repurchases, capping dividend payments, and allowing dividends according to a formula based on recent income. The Fed is also requiring banks to re-evaluate their longer-term capital plans. All large banks will be required to resubmit and update their capital plans later this year to reflect current stresses, which will help firms re-assess their capital needs and maintain strong capital planning practices during this period of uncertainty. The Fed plans to conduct additional analysis each quarter to determine if adjustments to this response are appropriate.

During the third quarter, no share repurchases will be permitted. In recent years, share repurchases have represented approximately 70 percent of shareholder payouts from large banks. The Fed is also capping dividend payments to the amount paid in the second quarter and is further limiting them to an amount based on recent earnings. As a result, a bank cannot increase its dividend and can pay dividends if it has earned sufficient income.

The banking system "has been a source of strength during this crisis," the Fed's Vice Chair for Supervision, Randal K. Quarles said, "and the results of our sensitivity analyses show that our banks can remain strong in the face of even the harshest shocks." Quarles called the Fed's action "an acknowledgement of both the

strength of our largest banks as well as the high degree of uncertainty we face." The coronavirus pandemic and the drastic measures taken to contain it "have roiled global markets and the U.S. economy, where the unemployment rate has soared to a post-war high, and where households and businesses continue to face tremendous challenges." Quarles pointed out that "the banking system remains well capitalized under even the harshest of these downside scenarios—which are very harsh indeed." He stated that for the first time in the ten years of stress testing, "we are exercising the option that has always been in our capital framework of requiring all large banks to reassess their capital needs and resubmit their capital plans to the Federal Reserve later this year."

Quarles stated that the Fed will use the results to make an assessment of the banks' financial conditions and risks." He explained that the Fed is "taking two actions to preserve capital among the large banks subject to the supervisory stress test: requiring banks to suspend their share repurchase programs and limiting dividend payments, each for at least an additional quarter.

Fed Governor Lael Brainard issued a separate statement noting that she does not support "giving the green light for large banks to deplete capital, which raises the risk they will need to tighten credit or rebuild capital during the recovery." According to Brainard, this policy "fails to learn a key lesson of the financial crisis, and I cannot support it." Instead, she supports "asking the banks to update and resubmit their capital plans." Brainard stated that "the strong capital buffers associated with Dodd-Frank reforms have enabled banks to play a constructive role in responding to the COVID-19 pandemic. It is a mistake to weaken banks' strong capital buffers when they are clearly proving their value in the first serious test since the global financial crisis."

Industry Reaction. The American Bankers Association issued a statement by President and CEO Rob Nichols that the "latest stress test results affirm that the nation's largest banks continue to be a source of strength for the economy and remain well prepared to handle a range of potential economic shocks. Their strong balance sheets and capital levels have allowed these institutions to provide critical support to the U.S. economy during the very real economic shock caused by the coronavirus. As the results make clear, even under the most adverse hypothetical scenarios banks will continue to help the nation overcome the economic challenges posed by the pandemic."

Nonprofit group Better Markets also responded to the results. Dennis M. Kelleher, Better Markets President and Chief Executive Officer stated "While the Fed is right that 'the banking system has been a source of strength during this crisis,' it failed to mention that is only because they were forced by the Dodd-Frank Act and regulators to increase their capital, liquidity and resiliency."

Americans for Financial Reform warned that "for years, the Federal Reserve has systematically weakened stress test modeling practices and assumptions used to forecast bank losses in a recession. This has the effect of allowing banks to reduce their reserves of risk-reducing capital and distribute these reserves to shareholders and executives." The advocacy group says that the reality of a major recession has made this practice "unsustainable." "The experience of the past decade should lead policymakers to reconsider the wisdom of basing critical bank risk controls like capital requirements on an opaque and technocratic stress testing process subject to political manipulation. Instead, we need strong basic requirements that will ensure the soundness of banks through even a significant recession."

Companies: American Bankers Association; Americans for Financial Reform; Better Markets

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