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Bank Capital Plans and Stress Tests

2014 Stress Test Results Demonstrate the Strong Capital Position of U.S. Banking System

Yesterday, the Federal Reserve announced the summary results of the Dodd-Frank Act 2014 supervisory stress tests for the 30 largest U.S. banking organizations. The results demonstrate the sharply enhanced capital strength and resiliency of the U.S. banking system. Under an “extreme stress scenario”, these U.S. banking organizations could absorb an extraordinary downturn in “pre-provision net revenues” and an unprecedented level of loan losses and still maintain capital levels well above minimum regulatory requirements and almost 40% above the actual capital ratios in 2009.

The stress test results are particularly impressive in view of the high level of conservatism employed by the Federal Reserve in conducting the stress tests. The Federal Reserve’s macro-economic assumptions in the severely adverse scenario included a deep recession involving a sharp rise in the unemployment rate to 11.25%, a drop in real gross domestic product of nearly 4.75%, a nearly 50% decline in equity prices, and a 25% decline in housing prices. Many of the Federal Reserve’s macroeconomic assumptions are worse than actual conditions experienced during the 2007-2009 period. For some of the largest banking organizations, the applicable scenario contained an additional instantaneous global market shock on the value of their trading positions which was also, in some respects, more severe than that experienced in 2008, as well as the hypothetical default of each such institution’s respective largest counterparty.

The effect of such macroeconomic assumptions were then made more draconian in their impact by the Federal Reserve’s econometric models and other supervisory stress testing criteria which embody several layers of cumulative conservatism, including assuming no new issuances of capital instruments, no reductions in dividend payouts and no other management actions, in each case, over the entire planning horizon in the face of the deep recession scenario.

The Federal Reserve's models project (in the aggregate) in the severely adverse scenario:

- $501 billon aggregate credit losses and credit impairments, representing an astounding 5.98%[1] of total risk-weighted assets;
- $366 billion (of the total $501 billion) in accrual loan portfolio losses, representing a loss rate "more severe than any U.S. recession since the 1930s" of 6.9%;
- $151 billion in "operational-risk losses", which appear to be predominantly litigation-related, and reflect the Federal Reserve's concern about "elevated litigation risk";
- pre-provision net revenue of only $316 billion (which is net of operational risk), over the entire nine-quarter planning horizon; and
- net risk-weighted asset growth over the planning horizon of 3.3% (applying the previously applicable general risk-based capital approach to determining risk weighted assets) or 12.63% (applying the newly finalized U.S. standardized approach), which is a departure from prior years and considerably above the asset level that a number of observers believe would actually occur in the severely adverse macro-economic environment postulated by the Federal Reserve's scenario.

These stress test results will presumably inform the current debate about both new regulatory capital and other safety and soundness requirements.

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[1] Based on total aggregate risk-weighted assets of approximately $8.374 trillion for the period ending September 30, 2013. *See* Federal Reserve, *Dodd-Frank Act Stress Test 2014: Supervisory Stress Test Methodology and Results* (Mar. 2014), at 27.

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