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The Federal Reserve's 2021 Stress Test Results: All Bark and No Bite[1]

June 28, 2021

Introduction

The Federal Reserve released the results of its 2021 Dodd-Frank Act stress test (DFAST) on June 24, 2021. The stress tests covered 23 of the largest banks. The results included aggregate and bank-by-bank loss estimates by broad asset category, loss rates for various loan types, and pre- and post-stress capital ratios. In aggregate, the 23 firms are projected to have losses of $474 billion under the so-called "Severely Adverse" scenario and a relatively small 2.4 percentage point decline in the common equity tier 1 (CET1) ratio (a key measure of regulatory capital) to a minimum under stress of 10.6%. In summary, all the banks passed the tests comfortably.

While these results still provide insight into risks at the banks subject to the test, the de-regulatory efforts of the last four years have resulted in a less meaningful public assessment of the strength of the banking system under stress. Key assumptions have been changed from the Fed's longstanding practices of running the stress test, resulting in less robust results and an easier test for the banks. In addition, the Fed's $4+ trillion of pandemic-related support has materially facilitated the large banks increase in capital, liquidity, revenue, and profits. Because the stress test results are used as triggers for capital ejections, it is therefore no surprise that the Fed lifted the remaining pandemic-related restrictions on dividends and share buybacks, effective June 30, in light of these results. There is no doubt now that the Fed has lifted the pandemic-related restrictions that a flood of dividends and share buybacks from the largest banks will follow, reportedly as much as $200 billion, which will exceed bank earnings by more than 100% on average and as much as 167% for some.

As proved during the 2008 Global Financial Crisis (2008 GFC) and since, stress tests were one of the most important and successful ways the Fed robustly tested the banking system. They materially reduced the threat of a financial crash and increased the ability of the banks to serve their public function of supporting the real economy through the business cycle. Unfortunately, as detailed below, the Fed is on the verge of snatching defeat from the jaws of victory by deregulating and weakening the stress tests since 2018.

The once-informative DFAST exercise used to be the bark before the CCAR bite, but deregulation has materially reduced the stress of the stress tests

Stress tests have been one of the most successful and important tools the Fed has used since the 2008 crash to identify and address risks at the most dangerous banks in the country, including those that failed or almost failed in 2008, all of which required and received massive taxpayer bailouts and support. Stress tests, along with other financial reforms,

[1] Better Markets issued a press release regarding the 2021 results on Thursday, June 24, 2021, which is available here: https://bettermarkets.com/newsroom/fed-s-increasingly-toothless-stress-tests-no-longer-stress-or-test-banks-are-cover-wall

were critical in attempting to ensure that these banks were never again so vulnerable and, most importantly, never again had to be bailed out by taxpayers.[2]

The DFAST exercise always has been intended to provide the public, shareholders, depositors, and policymakers with an understandable view of the potential losses the largest banks could face in a severely stressful environment and the potential impact on their capital levels. The public has a right to be informed of the resiliency of the largest banks and their ability to withstand severe stress without requiring another bailout and while continuing to lend to the productive economy, particularly after the taxpayer-funded bailout of the banking system during the 2008 GFC. If banks have enough capital to continue to lend during a period of severe stress, an economic downturn will be less severe, and the upturn will be quicker.

To this end the Dodd-Frank Act requires the stress test results to be published every year. The Federal Reserve shares aggregate and bank-by-bank loss estimates by broad portfolio type as well as minimum capital ratios under the stress scenario so the public can see at a high level where the most material risks are for each bank. The structure of the exercise also allows banks' resilience to stress to be compared to one another by using the same scenarios and common assumptions across banks.

The assumptions used in the stress test matter a great deal to the final results and some of the key assumptions have been materially weakened by the Fed.[3] The stress test used to provide a more robust assessment by assuming that (1) banks continue to pay dividends in stress, as was the case during the 2008 GFC and the 2020 pandemic, and (2) balance sheets grow to support the economy and market activity. Both of those assumptions have been removed as part of the de-regulatory effort under the Powell chairmanship. Starting with the 2020 DFAST, banks' balance sheets are assumed to not grow at all and it is assumed banks will not be paying dividends, which greatly increases the banks' post-stress capital ratios and overstates the strength of the banks being tested. For example, had they continued to include growth of risk-weighted assets and payments of dividends throughout the nine quarter scenario time horizon, it would have resulted in a further reduction of 1.7 percentage points from the CET1 ratio for the group of firms under this year's stress test.[4]

Even if these changes had not been made (i.e., if those assumptions were still included in the tests), the results this year still would not reflect the full risks to the banking system. As with the second run of the stress test last year, adjustments were made to the data and modeling processes to account for the special circumstances created by the pandemic, such as the forbearance of mortgages. However, these adjustments are likely to obscure the true risks underlying banks' assets.

Additionally, the breadth and scale of the unprecedented Fed support provided to financial markets and the economy since March 2020 -- $4 trillion and counting -- has helped to bolster bank balance sheets and allowed banks to raise capital levels. For example, this led to a buildup of CET1 capital ratios across the 23 firms in this year's stress test from 12.1% to 13.0%, a higher starting point that resulted in a comfortable post-stress minimum of 10.6%. This support, and

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[2] See Better Markets blog post *Stress Tests Are Vital Tools to Protect Taxpayers & Our Economy* (July 3, 2019) https://bettermarkets.com/blog/stress-tests-are-vital-tools-protect-taxpayers-our-economy#12%20Resources; also see opening remarks by Dennis Kelleher from the Federal Reserve Board of Governors conference "Stress Testing: A Discussion and Review" Panel One "Stress Tests as a Policy Tool" (July 9, 2019) https://www.bostonfed.org/-/media/Documents/events/2019/stress-testing/stress-tests-and-policy-paper-kelleher.pdf?la=en

[3] For more detail, see the Better Markets white paper *Federal Reserve Actions Under the Trump Administration Have Significantly Weakened Post-Crisis Banking Protection Rules*, Tim Clark and Dennis Kelleher (December 3, 2020) https://bettermarkets.com/sites/default/files/Better_Markets_WhitePaper_Fed_Actions_Under_Trump_Administration_12-03-2020.pdf

[4] Risk-weighted assets were assumed to grow at the 6 percent average growth from the DFAST 2016-2019 exercises. The common stock dividends from Q4 2020 were used to represent dividend payments in all nine projection quarters.

its eventual unwinding, is not mentioned in the scenario documentation or the framework adjustments. Estimates of what the banks' losses might have been without this Fed support, which would almost certainly be significant, were apparently not considered in the test scenario design or modeling.

The Fed nonetheless trumpeted – in an unqualified fashion - the false comfort from this year's stress test results to justify removing all of the remaining pandemic-related restrictions on the banks' capital distribution. However, its failure to acknowledge the role of its own actions over the last year in supporting the banks raises serious questions as to the value of the results of these stress tests and the weight they should be accorded.

The end of the CCAR "object/non-object" assessment and the transition to the SCB has removed the bite from the Fed's oversight of bank capital

The CCAR and capital planning processes have also been weakened to the point of near irrelevance through de-regulatory efforts and the transition from the CCAR-related capital buffer to the stress capital buffer (SCB).[5] Notably, this marks ***the first time*** the Fed will not consider the Comprehensive Capital Analysis and Review (CCAR) "object/ non-object" assessment of capital plans, including planned dividends and buybacks, and risk management practices for any bank.

Since its inception, the CCAR assessment could result in a quantitative and/or qualitative objection to a bank's capital plan, both of which could lead to restrictions on the banks' dividend and share buybacks. After an objection, the Fed could then limit dividends and stock buybacks to ensure banks held sufficient capital to account for the stress scenarios or any weaknesses identified through the supervisory process. This was all made transparent in a CCAR disclosure that publicized not only the plan-adjusted post-stress capital ratios but also a description of the firm-specific deficiencies that led to any qualitative objections.

The qualitative objection was used when a bank exhibited fundamental weaknesses that pointed to critical deficiencies in its capital planning process. The Fed regrettably has eliminated this qualitative objection completely, substantially weakening incentives for bank boards and senior management to prioritize their risk management and governance practices. This tool provided the Fed with a direct link between supervisors' qualitative assessments of key bank practices, resulting in meaningful consequences when large banks had dangerously bad practices. Its removal effectively moves the supervisory process back towards the pre-2008 GFC approach that had mistakenly assumed that banks, acting in their own supposedly well-informed self-interest and constrained by the discipline of market forces, would not take on excessive risks. Also, with no CCAR disclosure document, there is no disclosure of banks' deficiencies, keeping the public in the dark about the Fed's assessments of the banks' practices. That lack of transparency prevents public oversight and accountability not only of the banks, but of the Fed itself, as was the case before the 2008 GFC.

One of the unique aspects of CCAR was that it utilized the stress test and the possibility of a quantitative objection to planned capital distributions to ***create an effective post-stress capital requirement***. That is, if a bank fell below any of the post-stress minimums, the Fed's Board could require that bank to adjust its capital plan—e.g., reduce or stop dividends and buybacks—to stay above those minimums. This process was outside of the formal, point-in-time capital requirements and gave the Fed more flexibility and direct impact over a bank's capital plan.

The post stress minimum capital requirements from CCAR, and therefore the quantitative objection, were purportedly replaced by the SCB starting in October 2020. In a sign of the Fed's own de-prioritization of the CCAR program and the material reduction of information provided to the public, the annual instructions to banks for the CCAR program were not published this year.

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[5] For more detail, see Better Markets white paper Id at 4; also see Tim Clark, *Is the Fed in Retreat?*, Politico (April 9, 2019) https://www.politico.com/agenda/story/2019/04/09/federal-reserve-stress-tests-banks-000889/

The SCB removes stress-related capital requirements from the CCAR program and force-fits it as a buffer to the real-time capital requirements for those large banks subject to the stress test—those with assets of over $100 billion. The SCB now fills the role of what would otherwise have been a 2.5% capital conservation buffer (CCB) and reflects a bank's performance under the stress test. The SCB has a floor of 2.5%, so it cannot be weaker than the CCB. However, it does not seem the SCB is in practice materially different from the CCB. Nearly half of the firms subject to the SCB had their buffers floored at 2.5% last October, the same level as the CCB. Of the eight US GSIBs, only three had SCBs above the floor, with only the two former investment banks—Goldman Sachs and Morgan Stanley—materially so. In light of this year's DFAST results, we can likely expect similar or even weaker SCBs.

The final SCB requirement made dangerous, unnecessary changes that materially reduce capital requirements and undermine the forward-looking nature of the original CCAR program by:

- including only four quarters of dividends, rather than 9 quarters of dividends and buybacks,
- changing the stress-test assumptions to include no growth of banks' balance sheets,
- eliminating the requirement that banks meet the minimum leverage ratio on a post-stress basis,[6]
- making any automatic restrictions on bank capital distributions take effect more slowly,[7] and
- allowing banks to increase their capital distributions without prior approval as long as they remain above their real-time SCB capital requirement.

Under CCAR banks were required to fully capitalize for all nine future quarters of stress losses and planned capital actions, including a potentially growing balance sheet. The reduction to four quarters of planned capital actions and transition to a flat balance sheet results in a material reduction of post-stress capital requirements. Additionally, the removal of the post-stress leverage requirement was misguided. The leverage ratio is intended to serve as a backstop to risk-adjusted capital requirements, since it does not risk weight assets and only considers how much capital a bank holds relative to its assets (and off-balance sheet exposures). Such a backstop is critically important under stress when financial conditions and bank positions are changing rapidly.

While the capital planning process from CCAR is not dead, it has been severely gutted. Banks still must submit their nine-quarter capital plans, but the SCB's inclusion in real-time requirements all but eliminates the Fed's ability to impact those plans regardless of deficiencies, since banks are no longer restricted from materially deviating from planned capital actions without Fed approval.

Loosening these restrictions on capital planning and distribution has dramatically changed the focus of the stress testing process: it has shifted from "what if" to "what now." This incentivizes banks to be planning more to their next quarter than their next nine and has made it dangerously easy for banks to deplete their capital even in times of stress. Banks do not need any incentive in this regard, as they did not even hesitate to continue their dividends at the onset of the unprecedented pandemic-induced economic shutdown and extreme financial stress last year. That is exactly what they did in 2008, ejecting capital even after the collapse of Lehman Brothers and the receipt by some of TARP bailout money.[8]

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[6] The leverage ratio is not risk-adjusted, simply capital divided by on- and off-balance sheet exposures and is intended to be a backstop to the risk-adjusted capital ratios. Inclusion in the CCAR stress testing process ensured this backstop was also considered on a post-stress basis.

[7] Better Markets Comment Letter on Eligible Retained Income (May 11, 2020) https://bettermarkets.com/sites/default/files/Better_Markets_Comment_Letter_on_TLAC_of_Systematically_Important_Bank_Holding_Companies_and_Foreign_Banking_Corporations.pdf

[8] See Better Markets blog post *Stop Wall Street Payouts That Produce TARP Bailouts* (October 3, 2018) https://bettermarkets.medium.com/https-medium-com-bettermarkets-stop-wall-street-payouts-that-produce-tarp-bailouts-7647792b3246

While the CCAR stress results were published one week after DFAST, the SCBs for each of the banks in the stress test are likely to be made public in roughly six weeks. Nevertheless, insights about the banks' capital requirements under the SCB can be drawn from this year's DFAST losses and post-stress capital ratios. The losses from the stress test show little change from last year. This is an indication that the Fed is reducing the volatility and uncertainty of stress test results. Reduced variation undermines the very nature of the stress test, which is intended to be dynamic and capture risks that are exposed or highlighted by different scenarios. Indeed, this year's stress scenario is materially similar to last years. The banking industry has been seeking a reduction in uncertainty of the test for years because it will allow banks more easily to manage to each year's capital requirement. Additionally, reduced volatility may lead to banks structuring their positioning explicitly to reduce the Fed's loss estimates and new risks being missed due to little scenario variation.

Stress Test Results Will Unleash Massive Capital Ejections Via Dividends and Stock Buybacks

Considering this new weakened stress testing and capital planning regime, the largest banks are poised to issue over $100 billion and perhaps as much as $200 billion through dividends and share buybacks. Across the six largest banks this would amount to about 122% of earnings on average and up to 167% of earnings at the top end (Wells Fargo).[9] While this will please banks' shareholders, millions of America's workers, homeowners, renters, and Main Street businesses are left waiting for the recovery.

Importantly, capital payouts above 100% of bank earnings imply a reduction in capital, making the banking system less safe. The economy is still in a precarious state; no one knows what the future will bring; the Fed is still engaged in unprecedented emergency actions to support the financial system and the economy; given all that, it is not difficult to conclude that such payouts would be premature and irresponsible. History may judge the Fed's decisions to deregulate and weaken the stress tests as to allow such outsized, capital-depleting payouts to be as dangerous as many of the Fed's actions were before the 2008 GFC, which made that financial crash much worse, if not inevitable, and all but guaranteed the need for taxpayers to bailout Wall Street's biggest banks.

Conclusion

The Fed should take the continued lesson from the pandemic (and the 2008 GFC) that the largest banks will not self-regulate in any meaningful way. The only thing standing between a failing bank, a taxpayer bailout and an economic and human catastrophe is loss absorbing capital. The Fed's recent actions, as illustrated by the most recent results, risk snatching defeat from the jaws of victory in terms of the effectiveness of stress tests. At the very least, the Fed should restore the stress in the stress test, particularly through full dividend assumptions and a growing balance sheet, make full use of the qualitative objection, which is all the more important after the transition to the SCB, and reinstate the post-stress leverage requirement.

That will reinvigorate the stress tests and restore them to their original purpose, which served the country well during the darkest days of the 2008 GFC and since.

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[9] Joshua Franklin, Imani Moise, *US banks gear up for buyback bonanza after passing stress tests*, Financial Times (June 25, 2021); David Henry, Pete Schroeder, *U.S. Fed bank stress tests pave way for stock buyback, dividend bonanza*, Reuters (June 22, 2021)

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1825 K Street, NW | Suite 1080 | Washington, DC 20006 | 202-618-6464 | www.bettermarkets.com