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Fed's Dodd-Frank Stress Test Results a Mixed Bag for Banks

by Victoria Finkle
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Correction: *The Federal Reserve Board has subsequently revised the stress test results that were initially released on March 20. In addition, an earlier version of this story also incorrectly characterized the level at which banks were deemed "well-capitalized." The Fed's only minimum capital level used for the test was 5%.*

WASHINGTON — The Federal Reserve Board released its second annual round of stress tests mandated by the Dodd-Frank Act on Thursday, providing a glimpse into how the country's biggest firms would fare under a hypothetical economic crisis.

In aggregate, the bank holding companies fared slightly better than last year's group, though year-over-year results across individual firms were mixed. Twenty-nine of the 30 institutions tested met the minimum capital threshold under the Fed's most dire economic scenario.

The tests are designed to evaluate how well the biggest firms would hold up under various financial shocks, and whether they would be able to maintain enough capital over a nine-quarter period to continue lending.

"The annual stress test is one of the Federal Reserve's most important tools to gauge the resiliency of the financial sector and to help ensure that the largest firms have strong capital positions," said Fed Gov. Daniel Tarullo in a press release. "Each year we are making substantial improvements, which have helped make the process even stronger than when we first conducted the stress tests in the midst of the financial crisis five years ago."

Two of the strongest banks last year again emerged at the head of the pack when tested under simulated "severely adverse" conditions: State Street came away with a minimum ratio of Tier 1 common capital to assets of 13.3%, and Bank of New York Mellon with a ratio of 13.1%. Discover Financial Services, new to the test this year, also held 13.1% capital.

Zions Bancorp., meanwhile, brought up the rear with just 3.5% Tier 1 capital under the same test conditions, well below the 5% threshold regulators use as the minimum.

The company announced in February that it would resubmit its capital plan to the Fed after regulators agreed to loosen a provision in the Volcker Rule related to collateralized debt obligations backed by trust-preferred securities. Zions owns more than $1 billion in the CDOs that it would have had to otherwise shed before the rule goes into effect in the summer of 2015.

The company said last month that it sold 35 such CDOs in part because it would have "contributed disproportionately to hypothetical projected losses" in the Fed's stress test models. (The Fed's stress test did take into account the January change to the Volcker Rule, according to the results release.)

"When you think about it, Zions was the most vulnerable because of its CDO portfolio. In times of stress it will lose value," said Paul Miller, an analyst at FBR Capital Markets. "Does that mean it will have to raise more capital? I don't know, but I think they'll find a way to work through it."

M&T Bank Corp. performed the second worst in the results, with a 5.9% Tier 1 common capital under the adverse economic scenario, but its results were well above the 5% minimum threshold. This is the first year both M&T and Zions participated in the test.

Overall, the 30 companies came away with an average ratio of 7.6%, slightly higher than last year's average of 7.4% among the 18 institutions tested.

"These firms, broadly speaking, have sufficient capital — they've spent years fixing their balance sheets and adjusting their behavior on risk," said Jason Ware, market strategist at Albion Financial Group. "It's a pretty encouraging commentary on the state of the financial system. It demonstrates that the industry is certainly more prepared and much healthier than it was five years ago."

The banks participating in the Dodd-Frank stress tests this year now cover $13.5 trillion of assets, or nearly 80% of domestic bank holding company assets.

The four biggest institutions reported mixed results. Wells Fargo performed the best with a ratio of 8.2%, up from 7% last year, while JPMorgan Chase held steady at 6.3%. Citigroup fell to 7% this year, from 8.3%, and Bank of America dropped to 6% from 6.8% last year.

"The onus is certainly going to be on the lower end of the spectrum. If you look at Bank of America or Zions or Morgan Stanley - they're not going to be paying back as much in dividends," said Ware. "If you want to boost returns to shareholders and you're barely keeping your head above water based on what you were doing last year, how are you going to increase returns to shareholders?"

Ally Financial, which last year had the lowest projected Tier 1 capital ratio of 1.5% under the severely adverse scenario, improved markedly this time. According to the 2014 test, its capital ratio would be 6.3% under the same scenario.

In addition to expanding the number of companies subject to the stress tests this year, the Fed made several adjustments to the 2014 analysis. It already included a hypothetical global market shock into its simulations for the largest six bank holding companies that "involve large and sudden changes in asset prices, rates, and spreads, reflecting general market stress and heightened uncertainty," according to the Fed's report. For those six institutions plus two more, however, regulators added the impact of a default to the company's largest trading counterparty.

Regulators also incorporated changes to the definition of capital under the Basel III agreement adopted in July. Fed officials told reporters that incorporating the Basel framework effectively increases the stringency of the tests over the years as different requirements take effect.

The release on Thursday is just the first of two Fed results concerning stress tests. The central bank is scheduled to release the second round of test results on March 26. The comprehensive capital analysis review, or CCAR, is arguably even more important to banks. It takes into account a company's annual capital plan for dividends and share buybacks. Accordingly, the Fed can use the results of the CCAR test to modify or reject a bank's plan.

The Dodd-Frank stress tests announced Thursday, meanwhile, simply assume the firms' capital distributions did not change.

"This is a cautionary tale for the distribution decisions next week. Seven of the original 18 CCAR banks passed Dodd-Frank with lower margins than they did last year. The test changes every year, but the banks are also still accumulating capital. Even if the test changes, if the banks are building capital, you would still expect them to fare better," said Jaret Seiberg, a policy analyst at Guggenheim Securities. "I'm not suggesting that any of the banks are going to fail CCAR, but this supports what I think is the broad view of banks, which is that there's no benefit to being aggressive in your distribution requests."

Regulators use both quantitative and qualitative factors to determine whether a company's capital plan will be accepted, and have recently offered a second chance to resubmit a plan, known as a mulligan, if the initial plan is rejected, though obviously that's a fate institutions seek to avoid.

"Even with the mulligan, you don't want to be rejected," Seiberg added. "If you are too aggressive in the distribution you're seeking, that could suggest you don't fully appreciate the risk that the bank is facing."
