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# What to Know About Bank Stress Tests

By PETER EAVIS MARCH 4, 2015, NYTimes.

Wall Street is on edge as it awaits the release of the results of the Federal Reserve's stress tests, starting on Thursday.

The tests, which occur annually, and were mandated by the Dodd Frank Act of 2010, aim to assess whether large banks can withstand a deep recession, a severe market shock – and, in the case of some large institutions, a default by another Wall Street firm. In all, 31 banks, including giants like JPMorgan Chase, Bank of America and Goldman Sachs, will be subject to the stress tests this year.

Bank executives and investors take the tests seriously because failing them bars a bank from paying out money to their shareholders in the form of dividends or stock buybacks. Citigroup, for instance, failed last year, raising lingering questions about the performance of its management team.

## How to Stress Out a Bank

To do their job, the tests have to try to quantify the damage that a financial and economic storm might do to a bank's financial strength. The tests do that by focusing on capital, a financial metric that reflects a bank's capacity to absorb losses. The financial crisis of 2008 showed that banks had too little capital, prompting the taxpayer bailouts that injected billions of dollars of capital into scores of lenders.

Capital is typically expressed as percentage of a bank's assets, which consist primarily of its loans and trades. At the end of last year, for instance, a regulatory measure of Bank of America's capital was equivalent to 10 percent of a regulatory tally of its assets.

A bank's losses eat away at its capital. The stress tests therefore add up all the putative losses that might occur on loans and trades during scenarios that include harsh recessions and market collapses. The tests then subtract those estimated losses from regulatory measurements of capital, along with some other adjustments. The Federal Reserve's 2014 test of big banks' capital. One of the capital ratios that is applied to the banks in the stress tests is the tier one common ratio. The banks have to end up with capital that is equivalent to at least 5 percent of assets, using this measure.

## How Does a Bank Pass or Fail?

Strictly speaking, a bank fails if the Fed objects to its proposed plans to pay out capital to shareholders. That objection can happen for two reasons. The first is if a bank has too little capital left after suffering the losses projected in the stress tests and after paying out capital to shareholders.

After applying the stress tests and capital payouts, the Fed wants banks to end up with capital that exceeds minimum levels, expressed as a percentage of their assets. The Fed, for instance, did not sign off last year on the capital payout plan of Zions Bancorporation, because its capital, measured by the so-called tier 1 common ratio, fell below 5 percent minimum under the stress test. The minimum thresholds are different for other ways of measuring capital.

But the Fed may say no to a capital plan even if a bank's capital ends up above all the stipulated minimum levels.

**Table 4. Projected minimum tier 1 common ratio, Q4 2013 to Q4 2015: All bank holding companies**
Federal Reserve estimates in the severely adverse scenario

| Bank holding company | Stressed ratios with DFA stress testing capital action assumptions |
|---|---|
| Ally Financial Inc. | 6.3 |
| American Express Company | 12.1 |
| Bank of America Corporation | 5.9 |
| The Bank of New York Mellon Corporation | 13.1 |
| BB&T Corporation | 8.4 |
| BBVA Compass Bancshares, Inc. | 8.5 |
| BMO Financial Corp. | 7.6 |
| Capital One Financial Corporation | 7.8 |
| Citigroup Inc. | 7.2 |
| Comerica Incorporated | 8.6 |
| Discover Financial Services | 13.2 |
| Fifth Third Bancorp | 8.4 |
| The Goldman Sachs Group, Inc. | 6.9 |
| HSBC North America Holdings Inc. | 6.6 |
| Huntington Bancshares Incorporated | 7.4 |
| JPMorgan Chase & Co. | 6.3 |
| KeyCorp | 9.2 |
| M&T Bank Corporation | 6.2 |
| Morgan Stanley | 6.1 |
| Northern Trust Corporation | 11.7 |
| The PNC Financial Services Group, Inc. | 9.0 |
| RBS Citizens Financial Group, Inc. | 10.7 |
| Regions Financial Corporation | 8.9 |
| Santander Holdings USA, Inc. | 7.3 |
| State Street Corporation | 13.3 |
| SunTrust Banks, Inc. | 8.8 |
| U.S. Bancorp | 8.2 |
| UnionBanCal Corporation | 8.1 |
| Wells Fargo & Company | 8.2 |
| Zions Bancorporation | 3.6 |

Note: The capital ratios are calculated using capital action assumptions provided within the Dodd-Frank Act stress testing rule. These projections represent hypothetical estimates that involve an economic outcome that is more adverse than expected. These estimates are not forecasts of capital ratios. The minimum stressed ratios (%) are the lowest quarterly ratios from Q4 2013 to Q4 2015 in the severely adverse scenario.
Source: Stressed ratios with Dodd-Frank Act capital action assumptions through Q4 2015.

The banks also have to perform their own internal stress tests, to get them in the habit of planning for dire scenarios. These tests provide the basis for the bank's internal plans to have sufficient capital. If the Fed judges that the internal tests and the related capital plans are deficient, it may object to the bank's proposed payouts to shareholders. Last year, this happened to Citigroup and the United States units of three foreign banks.

## When Do We Find This All Out?

The results come out in two stages. First, on Thursday afternoon, the Fed will release materials showing what the stress tests did to the banks' capital. The exercise then is to see whether any banks ended up with capital close to the minimum levels. Those banks are at risk of failing.

The actual pass-or-fail day is March 11, when the Fed announces whether it has objected to the capital payout plans of any banks. The banks privately find out on Thursday this week whether the Fed has approved their capital payout plans. If a proposed payout takes capital below minimum levels, the bank can offer to reduce it, to bring the stress-tested capital above the minimum, in the hope that the Fed will then sign off. A bank that fails because its own tests and capital planning were judged by the Fed to be deficient will have to resubmit their payout requests at a later date.

**Table 2. Summary of the Federal Reserve's actions on capital plans in CCAR 2014**

| Non-objection to capital plan | Objection to capital plan |
| --- | --- |
| Ally Financial Inc. | Citigroup Inc. |
| American Express Company | HSBC North America Holdings Inc. |
| Bank of America Corporation | RBS Citizens Financial Group, Inc. |
| The Bank of New York Mellon Corporation | Santander Holdings USA, Inc. |
| BB&T Corporation | Zions Bancorporation |
| BBVA Compass Bancshares, Inc. | |
| BMO Financial Corp. | |
| Capital One Financial Corporation | |
| Comerica Incorporated | |
| Discover Financial Services | |
| Fifth Third Bancorp | |
| The Goldman Sachs Group, Inc. | |
| Huntington Bancshares Incorporated | |
| JPMorgan Chase & Co. | |
| KeyCorp | |
| M&T Bank Corporation | |
| Morgan Stanley | |
| Northern Trust Corporation | |
| The PNC Financial Services Group, Inc. | |
| Regions Financial Corporation | |
| State Street Corporation | |
| SunTrust Banks, Inc. | |
| U.S. Bancorp | |
| UnionBanCal Corporation | |
| Wells Fargo & Company | |

The Federal Reserve rejected the capital plans of five banks in 2014.

## What Should We Expect This Year?

In recent years, the stress tests have presented nasty surprises for some large banks. It is hard to tell ahead of time which firms are going to fail or fall short in some way. The American operations of some foreign banks may fail this year, according to media reports. The reason is most likely going to be that these banks' internal tests and capital planning fell short in the Fed's eyes.

Overall, as the banks undergo more tests, they are in theory less likely to fail. Still, the Fed does not want the stress testing process to become predictable. That sense of the unknown is what has Wall Street sitting on the edge of its seat right now.