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Asset Management

US Banks Pass Fed's 2022 Stress Test

Banks Show Solid Capital Strength

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All 34 large US banks that were tested passed the Federal Reserve's 2022 stress test. According to the Fed: "Under the severely adverse scenario, the [banks'] aggregate common equity tier 1 (CET1) capital ratio falls from an actual 12.4 percent in the fourth quarter of 2021 to its minimum of 9.7 percent, before rising to 10.3 percent at the end of the projection horizon." This 9.7 percent level is "more than double the minimum requirement." The Fed goes on to say that: "The 2.7 percentage point aggregate decline this year is slightly larger than the aggregate decline of 2.4 percentage points last year." This change recognizes, in part, the reduction by banks in their loan loss reserves (which were boosted during the early stages of the Covid pandemic) in reflection of stronger economic conditions. This also "reflects design features of the severely adverse scenario that increase the hypothetical stress on economic and financial market conditions as current economic conditions improve, which result in a slightly higher loan loss rate this year. Despite the larger post-stress decline this year, the aggregate and individual bank post-stress CET1 capital ratios remain well above the required minimum levels throughout the projection horizon."

Spectrum also notes that the Fed's 2022 stress test's "hypothetical scenario is tougher than the 2021 test, by design, and includes a severe global recession with substantial stress in commercial real estate and corporate debt markets. The unemployment rate rises by 5-3/4 percentage points to a peak of 10 percent and GDP declines commensurately. Asset prices decline sharply, with a nearly 40 percent decline in commercial real estate prices and a 55 percent decline in stock prices." In effect, the Fed threw the kitchen sink at the banks, and they came out of the process well.

Spectrum views the Fed's bank stress test results positively, and they help provide assurance that large US banks have the capacity to continue to service their preferred dividends in a timely manner – even under difficult conditions. Spectrum notes that these stress test results are key inputs in banks' regulatory capital targets. This is important because it shows that such stress tests are not an academic exercise, but help ensure that individual banks maintain a prudent level of capital that reflects their particular strengths, risks and vulnerabilities.

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