

Stress Tests 2.0: Early Holiday Present for US Banks

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Late last week the Federal Reserve released results from two special stress tests for 33 large US banks. Said the Fed: “All firms' risk-based capital ratios would remain above the required minimum.” The Fed’s Vice Chair for Supervision, Randal K. Quarles, also remarked that: *“The banking system has been a source of strength during the past year and today's stress test results confirm that large banks could continue to lend to households and businesses even during a sharply adverse future turn in the economy.”* Spectrum notes, and the Fed agrees, that these large banks have been able to build their capital, even while strengthening loan loss reserves by around \$100 billion. This achievement, and passing these tough stress tests, highlight US banks’ strength, and help to demonstrate that COVID-19 is an earnings challenge (Not solvency), providing important comfort to preferred stock investors.

These special ‘Stress Tests 2.0’ were announced in June 2020, along with the positive results from annual Dodd-Frank Act stress testing (DFAST). The Fed decided to run these two additional stress tests – with the tougher, ‘Severely Adverse Scenario’ being even more stringent than the tests run in June – to take into consideration issues surrounding COVID-19. The Severely Adverse test resulted in average starting common equity tier 1 (CET1) of 12.2%, falling to 9.6% — well above the 4.5% minimums.

In addition, the Fed removed the prohibition on common share repurchases imposed in June 2020. That said, starting in 1Q21, banks’ dividends and share repurchases shall be limited to income earned over the prior four quarters, and common stock dividends will be capped at 2Q20 levels. Banks can also redeem and make scheduled payments on preferred stock and tier 2 debt. Spectrum views this loosening of payouts positively, as they indicate the Fed’s confidence in banks’ capacity to maintain financial strength, while also supporting the economy and providing a return to shareholders.

Spectrum has noted for some time that US banks are in good shape, and that despite stresses stemming from COVID-19 economic dislocations, today’s difficult economy is not a rerun of the Great Financial Crisis. The Fed’s stress tests in June 2020, and last week’s even tougher tests, support this conclusion. **Spectrum continues to view US banks’ preferred stock dividends as well supported.**

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