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Asset Management

US Bank Stress Test: Good News

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On Wednesday, June 28, 2023 the Federal Reserve released results of its annual stress test on large US banks. All 23 tested banks passed – money center banks, large foreign-owned banks, the trust banks, large investment banks, and several regional banks. According to Fed Vice Chair for Supervision Michael S. Barr, "Today's results confirm that the banking system remains strong and resilient."

All 23 banks exceeded their minimum capital levels after being put through the 'severely adverse scenario' that envisions a deep global recession, generating $541 billion in aggregate bank losses. Key factors in the stress test included a 6.4% rise in unemployment – peaking at 10% -- a 40% decline in commercial real estate (CRE) prices, and a 38% decline in house prices. These losses of over half a trillion dollars would decrease the banks' aggregate CET1 capital by 2.3%, resulting in a minimum CET1 ratio of 10.1% -- still a healthy double-digit level, and more than twice the minimum regulatory capital ratio. This 2.3% CET1 drop is less than the 2.7% drop experienced in the 2022 stress test. All other stressed capital and leverage ratios were also comfortably exceeded.

Many investors are concerned about the possible adverse effects falling CRE prices would have on banks' health. The Fed is equally concerned. Although the large banks tested would experience heavy losses from their CRE loans, "they would still be able to continue lending." Furthermore, the 23 banks in the 2023 test hold around 20% of the office and downtown CRE loans held by banks; these are the CRE sectors of highest investor concern. According to the Fed, "The large projected decline in commercial real estate prices, combined with the substantial increase in office vacancies, contributes to projected loss rates on office properties that are roughly triple the levels reached during the 2008 financial crisis." Spectrum takes comfort from large US banks' demonstrated resilience in the face of a particularly onerous CRE credit crunch. Spectrum also believes that large bank resilience to CRE value declines, with heavy stresses on more vulnerable CRE segments, provides a positive indicator for smaller regional banks, which have been a particular investor focus.

The individual stress test results for each bank are important inputs into the capital requirements to be set for each bank. This helps create individually tailored large bank capital minimums and avoids a 'one size fits all' regulatory approach. Spectrum views this positively.

What Next?

US bank regulators are considering a range of actions to further strengthen the financial system, with the publication of some Advanced Notices of Proposed Rulemaking beginning this summer. Potential actions could include:

- Banks with assets from $100 billion to $250 billion undergoing the stress test every year (currently every other year)
- New operational risk requirements
- Regulatory capital adjustments for market value deficits on available-for-sale securities for more banks
- Requiring more banks to issue long-term debt that would incur losses before depositors in the event of severe distress.

Spectrum would expect any final rules to be supportive of preferred stock due to the higher levels of common stock, and to have long phase-in periods to avoid market disruptions.

Spectrum believes these stress test results demonstrate the robust creditworthiness of US banks.

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