SPECTRUM
Asset Management

DFAST Stress Test: Good Results Overall

26 June 2020

On 25 June 2020 the Federal Reserve released the results of its periodic Dodd-Frank Act Stress Test (DFAST) for 33 large US banks, which includes US-based subsidiaries of foreign-owned banks. **Results are positive overall, as they have been in prior years**. In the words of Fed Vice Chair for Supervision Randal Quarles: *"As demonstrated in our public disclosure of the sensitivity analysis, the banking system remains well capitalized under even the harshest of these downside scenarios—which are very harsh indeed."*

In addition, this time the Fed ran a separate stress test to reflect the economic challenges posed by the COVID-19 health crisis. This stress test was particularly onerous, and consisted of three scenarios in rising order of difficulty: a V-shaped (quick) recovery, a U-shaped (slow) recovery and a W-shaped (double dip) recovery. While noting that *"the banking system has been a source of strength,"* and that *"all large banks are sufficiently capitalized at present,"* the COVID-19 crisis presents all banks with unique revenue and credit challenges. Reflecting this, the Fed *"will require banks to re-assess their capital needs and resubmit their capital plans later this year, and conduct additional stress analyses later this year as data from banks become available and economic conditions evolve."*

Furthermore, the Fed will be altering its way of computing large banks' individual capital requirements, and this new approach is to be rolled out in 4Q20. In a nutshell, the new bank-specific "stressed capital buffers" to be incorporated into banks' capital minimums will reflect each bank's unique stress test losses, as well as dividend payments. Most banks are likely already in excess of these new minimums, with those below more than able to get there. These stressed capital buffer figures should be released on 29 June.

For 3Q20, the Fed has suspended common stock repurchases (which have essentially been halted already by large banks), capped the growth of dividends, and imposed a dividend limit such that dividends cannot exceed the average of a bank's net income for the preceding four quarters. This dividend limit as a percentage of rolling net income could be extended. However, in the DFAST report, *the Fed states that "scheduled dividend, interest, or principal payments that qualify as additional tier 1 capital [preferred stock] or tier 2 capital [subordinated debt] are assumed to be paid"* during the test period. **And even with preferred stock dividends and subordinated debt coupons being paid in full, stress test results were good overall.** Furthermore, in the COVID stress test report, the Fed specifically said that banks may *"make scheduled payments on additional tier 1 and tier 2 capital instruments."*

Spectrum agrees with the Fed that large US banks are well capitalized, and a source of strength for the economy. That said, the COVID-19 crisis poses a material challenge – but one which we think banks are more than capable of meeting. Spectrum is also encouraged by the Fed's support of continued preferred dividend payments by healthy banks.

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