Washington Examiner

Biggest US banks ace stress tests, a good omen for dividends

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June 21, 2019

The largest U.S. banks have more than enough capital to withstand a major economic shock, based on annual Federal Reserve stress test results released Friday that help determine how much the lenders can pay in dividends and spend on stock buybacks.

Under the harshest test scenario, a severe recession with unemployment spiking to 10% and the Dow Jones Industrial Average falling by more than 50% to about 12,800, evaluators projected that the banks examined this year would lose just 5.7% of assets, or $410 billion. That's a decrease from 7.5% six years ago.

Only 18 were evaluated, a product of Congress' decision last year to grant a break to smaller financial institutions from some of the regulatory scrutiny that followed the 2008 financial crisis.

Together, the firms hold about 70% of all banking assets — including mortgages, credit card portfolios, and commercial loans — in the U.S.

“The results confirm that our financial system remains resilient,” said Randal Quarles, the central bank's vice chairman for supervision. “The nation’s largest banks are significantly stronger than before the crisis and would be well-positioned to support the economy even after a severe shock.”

Core capital, including common stock and retained earnings, fell from 12.3% of outstanding loans and other assets to 9.7%, well above global minimums, Fed officials said. The ratios were all higher, and included stronger forms of capital, than the banks held heading into the last recession, the officials said.

For the fifth straight year, credit cards and commercial and industrial loans were the two largest categories of losses, at $107 billion and $73 billion, respectively. Together, they accounted for 44% of total losses.

"We consider this exercise as a very robust health check of the banks’ capital resilience," said Rita Sahu, a vice president at Moody's Investors Service.

Friday's results are a critical part of broader findings, slated to be reported next week, that will affect bank payout plans from July 1 through June 30, 2020, a period in which the U.S. presidential campaign will be heating up and the Fed may respond to indications of slowing economic growth by trimming U.S. interest rates.

On average, the banks are likely to plan dividends and stock buybacks totaling 8% more than net earnings during the period, Goldman Sachs analyst Richard Ramsden predicted. A survey conducted by the investment bank showed participants expected that beleaguered Wells Fargo might lead the way with a total payout of 124%.

That compares with a median payout ratio of 73% for large banks as recently as three years ago and shows the progress lenders have made in meeting Federal Reserve expectations since the financial crisis and, consequently, returning some of the capital amassed during the past 11 years to investors.

Yearly stress tests began in 2010 as the government worked to prevent a repeat of the 2008 crisis, which forced Congress to spend billions in bailouts to keep lenders from collapsing after the failure of Lehman Brothers, the fourth-largest U.S. investment bank at the time. Its bankruptcy was the largest in U.S. history.

Some of the bailed-out lenders had raised their dividends before the crisis, leaving them with weakened reserves, even though defaults were surging in the $15 trillion U.S. mortgage market, and economists were warning that recession risks were rising.

A decade later, the public resentment lingering from a rescue that Bush-era Treasury Secretary Henry Paulson said "worked very well economically but was a disaster politically" leaves a significant risk to big banks, especially if Democrats gain more power in Washington next year.

Wall Street's net-favorable rating of 21% as of May 2017 ranked below Congress, at 23%, and used car dealers, at 26%, according to an online survey by the libertarian Cato Institute.

Approval measures of industry firms, the people who run them, and financial regulators are not only less than 50% today, they're beneath even the lows to which they had tumbled before the crisis, according to a September report by the conservative-leaning American Enterprise Institute that examined public opinion polls covering a period of decades.

Sen. Elizabeth Warren, D-Mass., one of the candidates vying for the chance to unseat President Trump, has tapped into the ire. She has long advocated forcing the largest banks to split their trading and consumer-deposit businesses, as they were required to do from the Great Depression through the 1990s.

Such discontent helps explain why the biggest banks have been largely excluded from changes to the Dodd-Frank finance reform law, passed two years after the crisis.

The law imposed heightened supervision on financial institutions with more than $50 billion in assets, subjecting them to annual stress tests, and banned proprietary trading under the Volcker Rule, a provision named for former Fed Chairman Paul Volcker.

In the spring of 2018, Trump signed a compromise bill engineered by Senate Banking Committee Chairman Mike Crapo that raised the level at which banks are considered "systemically important" and have to undergo the yearly reviews to $250 billion, giving the Fed the option to exempt others.

Friday's results "offer political protection to the biggest banks as they show extraordinary levels of capital even after an economic shock," said Jaret Seiberg, an analyst with Cowen Washington Research Group, which has tracked federal policy for 40 years.

"Banks can point to these results to contest charges" that loosening some stress-testing rules is "leaving the system more vulnerable to attack," he added. "It is hard to make that case when overall capital levels are still above 9% when there are $410 billion in losses."