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Fed Tells U.S. Banks to Test Capital Against Recession Scenario
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By Craig Torres and Hugh Son

Feb. 17 (Bloomberg) -- The Federal Reserve ordered the 19 largest U.S. banks to test their capital levels against a scenario of renewed recession with unemployment rising above 11 percent, said two people with knowledge of the review.

The banks stress-tested the performance of their loans, securities, earnings, and capital against at least three possible economic outcomes as part of a broader capital-planning exercise. The banks, including some seeking to increase dividends cut during the financial crisis, submitted their plans last month. The Fed will finish its review in March.

"They're essentially saying, 'Before you start returning capital to shareholders, let's make sure banks' capital bases are strong enough to withstand a double-dip scenario,' " said Jonathan Hatcher, a credit strategist specializing in banks at New York-based Jefferies Group Inc. Regulators don't want to see banks "come crawling back for help later," he said.

Executives at banks such as JPMorgan Chase & Co. in New York and PNC Financial Services Group Inc. in Pittsburgh have asked regulators for permission to increase dividends. The Fed has told banks that it expects dividends and share buybacks to be "conservative" and allow for "significant accretion of capital," according to a November notice. Some capital payout plans may be rejected as "inappropriate," the notice said.

The review "allows our supervisors to compare the progress made by each firm in developing a rigorous internal analysis of its capital needs, with its own idiosyncratic characteristics and risks, as well as to see how the firms would fare under a standardized adverse scenario developed by our economists," Fed Governor Daniel Tarullo said in an e-mail.

Dodd-Frank Act

The Fed also wants banks to consider how the Dodd-Frank Act overhauling financial oversight might affect earnings, and how they will meet stricter international capital guidelines, according to the November notice. Banks will also have to consider how many faulty mortgages investors may ask them to take back into their portfolios. Standard & Poor's Corp.
estimates mortgage buybacks could cost the industry as much as $60 billion.

The Fed's adverse economic scenario included a 1.5 percent decline in gross domestic product from the fourth quarter of last year through the end of 2011, said the people, who declined to be named because the Fed hasn't made the details of the review public. The scenario assumed growth resumes, with output rising 4 percent over the fourth-quarter 2010 level by the end of 2013. Unemployment would peak at more than 11

percent by the first quarter of 2012 and drop back to 9.5 percent by the end of 2013.

Federal Reserve spokeswoman Barbara Hagenbaugh declined to comment on the specifics of the Fed's parameters.

Growth Outlook

While Fed policy makers want banks to be prepared for a slump, they aren't predicting one. In January, members of the Federal Open Market Committee forecast growth of 3.4 percent or more annually over the next three years, with the jobless rate falling to 6.8 percent to 7.2 percent in the fourth quarter of 2013. Unemployment averaged 9.6 percent in the final three months of 2010.

As part of the most recent capital exam, regulators have made one of the largest data requests in Fed history, outside of normal regulatory reporting, asking banks for information about their securities, loans and other holdings. This will give the Fed the ability to check and even challenge the assumptions banks make about their portfolios.

Financial-Risk Unit

The tests are being overseen by a new financial-risk unit assembled by Chairman Ben S. Bernanke and Tarullo. Known as the Large Institution Supervision Coordinating Committee, or LISCC, the unit draws on the Fed's deep bench of economists, quantitative researchers, regulatory experts and forecasters and looks at risks across the financial system. The LISCC last year helped Bernanke respond to an emerging liquidity crisis faced by European banks.

"The current review of firms' capital plans is another step forward in our approach to supervision of the largest banking organizations," Tarullo said. "It has also served as an occasion for discussion in the LISCC of the overall state of the industry and key issues faced by banking organizations."

The Standard and Poor's 500 Financials Index is up 7.5 percent this year, compared with a 6.3 percent gain for the broader S&P 500 Index, as firms such as BB&T Corp. in Winston- Salem, North Carolina, and U.S. Bancorp in Minneapolis announced profit gains.

Dividend Plans

Bank of America Corp. Chief Executive Officer Brian T. Moynihan told analysts last month that he expects to "modestly increase" dividends in the second half of this year.

"We'd love to raise the dividend," James Rohr, chief executive officer of PNC, said in a Jan. 20 conference call.
"We're hopeful of hearing back in March from the regulators."

JPMorgan Chief Financial Officer Douglas Braunstein told investors Feb. 15 that the bank asked regulators on Jan. 7 for permission to raise the dividend to 30 percent of normalized earnings over time.

Braunstein's presentation showed that JPMorgan's own stress scenario was more severe than the Fed's, with U.S. gross domestic product declining more than 4 percent through the third quarter of this year. Unemployment peaks at 11.7 percent.

Other banks that may raise dividends early this year include Bank of New York Mellon Corp., San Francisco-based Wells Fargo & Co., U.S.

Bancorp and BB&T, according to research by Portales Partners in New York.

100 Fed Staff

The dividend increases, if they happen, will be one of the most carefully screened payouts in U.S. regulatory history, with more than 100 Fed staff working on the capital analysis of the banks.

Congress is also watching. The Fed should be cautious about allowing banks to reduce their capital through dividends or stock repurchases, House Democrats, including Representative Brad Miller of North Carolina, said in a Feb. 15 letter to Bernanke.

"We applaud your undertaking new stress tests on the banks," the lawmakers said. "It appears doubtful, however, that the stress tests alone can resolve the uncertainty facing those banks to justify reducing their capital."

The Fed's involvement in decisions normally reserved for boards shows how far the Dodd-Frank Act has pushed regulators into corporate governance.

"It is an uneasy balance between regulating an institution and running it," said Karen Shaw Petrou, managing partner at Federal Financial Analytics in Washington, a research firm whose clients include the nations' biggest banks. The Fed is moving "far more assertively" on bank oversight, she said.

2009 Stress Tests

As with the 2009 stress tests conducted by the Fed during the crisis, one of the goals is to assure that bank capital can support new loans to creditworthy borrowers. Loans and leases of banks in the U.S. contracted at a 10.3 percent annual rate in 2009, a 6.2 percent rate in 2010, and at a 2.6 percent rate in January.

The Fed's unprecedented exam of the 19 largest lenders in May 2009 concluded that 10 U.S. banks needed to raise an additional $74.6 billion in capital.

Banks were "destroying" value when they repurchased billions of dollars of stock in the years leading up to 2008, only to issue shares later at lower prices after they needed capital amid the crisis, said Jefferies Group's Hatcher, a former bank examiner for the Federal Deposit Insurance Corp.

"Whether it is liquidity, capital or earnings, banks are on a much better footing than they were a couple of years ago,"
said R. Scott Siefers, managing director at Sandler O'Neill & Partners LP in New York, a brokerage and research firm specializing in financial companies. "Still, you can pick your caveat. We are only in the early stages of an earnings recovery on the lending side and the legislative and regulatory framework is still in flux."

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