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Stress Testing Is Changing Bank Supervision

JULIUS L. ("JERRY") LOESER

Stress testing is an estimation by bankers and bank regulators of potential losses at each covered bank in each major asset category, as well as revenue, under a worse than expected economic scenario over the forthcoming two years. The author discusses the bank supervision developments that have been suggested by the recent stress testing experience of 19 major banks, and how the experience will have consequences for all banks.

Federal Reserve Chairman Ben Bernanke recently spoke on the occasion of the first anniversary of the public release of the stress test results for the 19 largest banking organizations in the midst of the recent financial crisis.[1]

Under the House version of the pending financial regulatory reform legislation, H.R. 4173, systemically significant firms would be required to perform quarterly stress testing, and all financial companies with assets of $10 billion or more would be required to undergo annual stress testing. In the Senate, the Dodd Bill, S. 3217, would also subject systemically important firms to stress testing, but not every large financial company, although it would require stress testing of all large (at least $50 billion in assets) bank holding companies. Chairman Bernanke did not go so far as to suggest that all banks should have to undergo stress testing, but did suggest that bank

Julius L. ("Jerry") Loeser is Of Counsel to Winston & Strawn LLP in Chicago where he focuses his practice on banking regulation. He was formerly on the legal staff of the Federal Reserve Board in Washington, D.C. He may be contacted at jloeser@winston.com.

regulators learned lessons from last year's stress testing exercise and that those lessons are applicable to efforts to improve bank supervision generally.

THE NATURE OF THE STRESS TESTS

Before explaining the longer term effects of the stress tests on bank supervision in general, it makes sense to explain in a bit more detail exactly what the stress tests entailed.[2] Stress testing is simply an estimation by bankers and bank regulators of potential losses at each covered bank in each major asset category (i.e., loan, investment, and trading securities portfolios, including off balance sheet commitments, and contingent liabilities and exposures), as well as revenue, under a worse than expected economic scenario over the forthcoming two years. However, the actual work itself is not simple at all, of course, requiring considerable complex effort to ensure that data from different banks is comparable and to minimize examiner subjective judgment by using model-based estimates of losses and revenues.

The more adverse scenario assumed a decline in home values of 22 percent in 2009 and seven percent in 2010, a GDP growth rate of -3.3 percent in 2009 and 0.5 percent in 2010, and an unemployment rate of 8.9 percent in 2009 and 10.3 percent in 2010. The participating banks were provided with a common set of indicative loss ranges for 12 specific loan categories, but could deviate from those ranges if they could provide evidence justifying deviation.

The conclusion of the exercise was that the 19 largest banking organizations would lose approximately $600 billion in 2009 and 2010 and that 10 of the 19 would need to raise $75 billion in common equity.[3] Most raised that capital through new issues or converting preferred stock into common stock.

DEVELOPMENTS IN BANK SUPERVISION

There are at least five bank supervision developments that have been suggested by the stress testing experience, and all may be expected to have ongoing consequences for all banks.

Even Stronger Preference for Common Equity

Basel capital requirements have long treated preferred and even subordinated debt as capital to some extent. However, the bank regulators have always preferred common equity. Unfortunately, increasing capital by issuing new common equity in these difficult economic times seriously dilutes the investment of existing common shareholders. The pain of dilution compounds the pain felt by existing common stockholders who have had their dividends substantially reduced or even eliminated altogether.

However, the financial crisis has validated the regulators' preference for common equity, and that was reflected in the stress test exercise. It can be expected to steel regulators' resolve in demanding that new capital be in the form of common stock. Common equity, of course, is available to absorb losses and also provides flexibility in the timing and amount of dividend payments, features lacking in preferred stock and debt, which is why it is strongly preferred by regulators.

Interdisciplinary Effort

The Federal Reserve has historically been divided between the bank regulatory staff and the economics staff, and rarely did the two ever meet.[4] Indeed, the separation could be noted on agendas of Board meetings; most Board meetings being devoted either exclusively to supervision or economics, but often not both.

In his speech, Chairman Bernanke noted the interdisciplinary effort that went into the stress testing last year, bringing together the skills of economists, financial market specialists, payment systems experts, and others with those of bank examiners.[5] That interdisciplinary approach was echoed in the recent selection of Patrick M. Parkinson, an economist with 30 years of service at the Board, as the Board's new Director of Bank Supervision and Regulation, the first time that an economist has been tapped to lead the Board's bank supervisory effort.

The significance of all of this is that the bank regulators, in their regulatory efforts, may be expected to devote more attention to the systemic consequences not only of supervision of individual institutions, but also of regulatory initiatives.

Incorporation of Elements of Stress Testing into Capital Adequacy Assessments

Chairman Bernanke said that the Board is incorporating elements of stress testing into its ongoing supervision of capital adequacy, beginning with the largest banks. Apparently, examiners at these banks will be assessing whether the banks are able to estimate effectively their capital needs. The Chairman suggested that banks need to conduct their own stress tests, a suggestion that he made two years ago. The belief is that such tests force bankers to think more thoroughly about scenarios that may be unlikely and thus may be otherwise dismissed cursorily by bankers. Theoretically, whenever a bank assesses its future capital needs, it undertakes some form of stress test, even if it is just a crude mental one. Larger firms would be expected to have systems in place that can quickly and accurately assess risks under alternative scenarios. Chairman Bernanke even suggested that such stress testing serves as a check on the quality of a bank's information systems.

Increased Public Disclosure

The Board released publicly the results of the stress tests of the 19 largest banks (holding two-thirds of the nation's banking assets and more than half of the loans in the U.S. banking system) last year. Doing so was unprecedented and risked creating runs on the 10 banks that the test results suggested would need more capital. Traditionally, bank regulation has assumed the need for confidentiality in order to avoid shaking public confidence in depository institutions.[6] Despite the warnings of many, the Board's public release of the stress test results last year had exactly the opposite effect. Rather than frightening analysts, depositors, and investors, it provided the market certainty that the market apparently craved. Disclosing the results enabled analysts to do their own analyses and confirm the results, spreading public confidence in the exercise and in the banking system.

Horizontal Examinations

The stress tests apparently taught the bank regulators that much can be learned by comparing the practices of different banks, instead of following the usual practice of simply focusing on one bank at a time. Chairman Bernanke, in his speech, advised that the Board will increase its use of cross-firm horizontal examinations. Last fall, the Board proposed guidelines for incentive compensation at banking organizations and, in doing so, indicated that in order to learn more about bank incentive compensation practices it would conduct horizontal examinations of the largest banking organizations. That was the first public announcement of its intent to undertake horizontal examinations. According to the Chairman's speech, this may be considered to be an increasingly frequent practice in bank supervision.

CONCLUSION

While the stress tests directly affected only the 19 largest banks, the tests provided bank regulators with experience that they will apply to all banks.

NOTES

[1] Chairman Bernanke's speech was given May 6, 2010, at the Federal Reserve Bank of Chicago's 46th Annual Conference on Bank Structure and Competition in Chicago.

[2] While conventional short hand for this is "stress testing," the formal name of the program is the Supervisory Capital Assessment Program, or SCAP.

[3] Of course, it would be instructive to compare the stress testing's worse than expected scenario results with actual results. However, that is not yet possible as the stress test reflected predictions over a two year period and was not more finely tuned than that, and the two year period has not elapsed yet. However, at the end of the first year, 2009, revenues were at 60 percent of those estimated for the two years of the stress testing, and loan losses were only 40 percent of the two year estimate.

[4] The only exception would be the involvement of Federal Reserve economists in the analysis of competitive effects of bank mergers and acquisitions.

[5] An April 24, 2009, Federal Reserve paper "The Supervisory Capital Assessment Program: Design and Implementation" indicates that the evaluations drew on the expertise of more than 150 senior supervisors, onsite examiners, analysts, and economists from the banking agencies.

[6] The traditional notion of the need for confidentiality was also tested and proven overly conservative when bank regulators made the decision several years ago to

make public enforcement actions against banks, many of which now contain express findings that the banks engaged in unsafe and unsound banking practices. Public release of such actions and findings has not created runs on banks subject to such enforcement actions.