



Building a better working world

Capital management: Navigating through economic uncertainty

June 2020

Results by the numbers

210 bps

CET1 ratio depletion from actuals to stress trough, in aggregate, under the Severely Adverse scenario

250 bps

CET1 ratio depletion from actuals to stress trough, in aggregate, under the "V" shaped recovery path

390 bps

CET1 ratio depletion from actuals to stress trough, in aggregate, under the "U" shaped recovery path

430 bps

CET1 ratio depletion from actuals to stress trough, in aggregate, under the "W" shaped recovery path

4.8%

Projected minimum CET1 under the "W" shaped recovery path for firms in the 25th percentile

The Federal Reserve Board (Fed) released this year's Dodd-Frank Act Stress Test (DFAST) and Comprehensive Capital Analysis and Review (CCAR) results on June 25, 2020. Thirty-three firms, each with greater than \$100 billion in total consolidated assets, were subject to supervisory stress tests this year. This includes the Category IV firms under the Fed's tailoring rule that are subject to supervisory stress tests every other year.

All participating firms are subject to the new Stress Capital Buffer (SCB) requirement, finalized in March 2020. Per the capital and stress test rules, the SCB requirements and firm-specific disclosures will be released by 8/31, based on the Supervisory Severely Adverse results (pre-COVID Scenario), and incorporating firms' planned dividends.

In light of the economic deterioration and uncertainty caused by the COVID-19 pandemic, the Fed conducted additional sensitivity analysis based on alternative economic recovery paths (V, U, W). The Fed will use the results of the sensitivity analysis to inform its views of the appropriateness of capital distributions and ongoing supervision of firms.

Overall highlights

- ▶ Firms face a cap on capital distributions through the third quarter of 2020, at a minimum, and will be required to resubmit capital plans within 45 days of receiving revised Fed scenarios later this year, in response to ongoing uncertainty surrounding the recovery
- ▶ Firms exhibit a range of practice with regards to their ability to adequately plan and forecast capital in a rapidly changing economic environment, with many firms relying more heavily on qualitative approaches due to limitations in their models
- ▶ No firms breached the regulatory minimums under the Supervisory Severely Adverse Scenario under DFAST
- ▶ Aggregate CET1 ratio depletion from actuals to stress trough is 210 bps, which does not include common dividend distributions, unlike prior years
- ▶ Given CET1 ratio minimums and assuming dividends consistent with prior year, implied SCB levels by bank category range from 310 bps for Large and Complex to 420 bps for Large and Complex Foreign Banking Organizations (FBOs)¹; while ranges look similar across categories, individual firms range from 250 bps to 779 bps
- ▶ Several large FBOs that were subject to a potential qualitative objection did not receive an objection to their capital plans
- ▶ Sensitivity Analysis showed aggregate declines in CET1 ratios of 250 bps, 390 bps, 430 bps under the V-, U-, and W-shaped recovery paths, respectively, at stress trough, with peak unemployment reaching between 15.6% and 19.5% across the three recovery paths
- ▶ The Fed did not disclose nor did it provide to firms the firm-specific results under the sensitivity analysis, but did emphasize that some firms would fall below minimum capital requirements under the W-shaped recovery path
- ▶ There is a wide dispersion in the mean CET1 results under the sensitivity analysis, with several firms potentially facing basis point impacts well in excess of the aggregate industry losses

¹ Based on a weighted average by four bank categories: G-SIB, Large & Complex FBO, Large and Complex Other, Large and Non-complex

Stress Capital Buffer

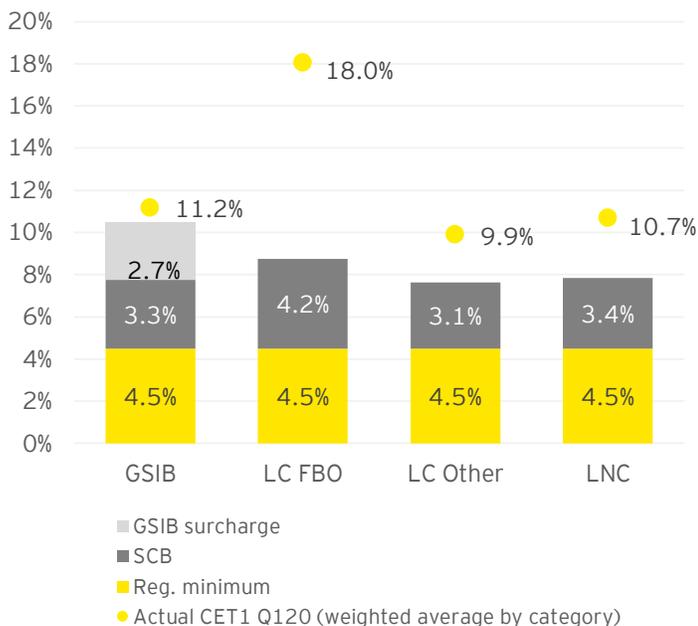
Firms will start to manage capital under new SCB requirements beginning in October 2020. Based on DFAST results under the Severely Adverse Scenario, G-SIBs have the smallest excess capital relative to minimum requirements.

In March 2020, the Fed finalized the new SCB requirement for all banks with \$100b+ in total consolidated assets. The SCB combines forward-looking elements of the capital plan and stress testing rule with the spot buffer requirements of the regulatory capital rule. The buffer is intended to be more risk-sensitive, forward-looking and firm-specific based on the difference between the firm's starting and minimum projected CET1 capital ratios under the supervisory severely adverse scenario, as well as four quarters of planned common stock dividends as a ratio of risk weighted assets (RWA).

Firms are required to maintain risk-based capital ratios above the regulatory minimum plus their SCB, global systematically important bank (G-SIB) surcharge and any countercyclical buffer requirements, to avoid restrictions on capital distributions and discretionary bonus payments.

Implied weighted average SCBs by category range from 310 bps to 420 bps across G-SIBs, Large and Complex (FBOs and other) and Large and Non-complex firms, based on CET1 ratio minimums under DFAST 2020 and assuming dividends consistent with the prior four quarters (Q2'19 through Q1'20). while ranges look similar across categories, individual firms range from 250 bps to 779 bps.

Figure 1: Estimated Stress Capital Buffer (Weighted Average by Category)



G-SIBs display the smallest excess capital relative to minimum requirements. If the Fed revises the SCB higher in response to further deterioration in the economy, the GSIBs could be most at risk relative to the other groups of firms for having to revise their capital actions.

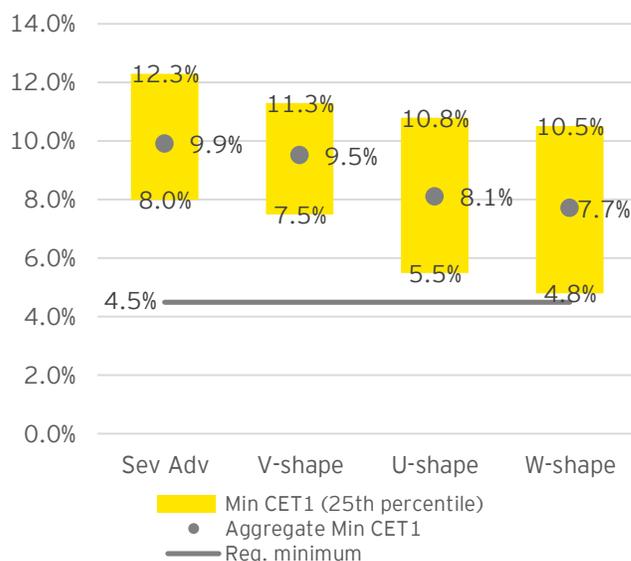
"COVID event" sensitivities

CET1 minimums under COVID sensitivities, relative to implied SCB levels, suggest that the 25th percentile of firms would be operating within their stress capital buffers leading to payout ratios limited to 0-60% of eligible retained income.

Recognizing the importance of ensuring banks' capital requirements reflect recent economic deterioration and the significant uncertainty due to the COVID-19 pandemic, the Fed supplemented its approach to the stress test this year. While the SCB will be calibrated on the hypothetical stress scenario released in February (pre-COVID scenario), the Fed performed additional sensitivity analysis to inform its views of the appropriateness of capital distributions and ongoing supervision of firms.

The Fed's sensitivity analysis is based on a range of possible outcomes, including three different economic recovery paths (as opposed to full scenarios), which are U-, V- and W-shaped. Peak unemployment reaches between 15.6% and 19.5% across the three recovery paths. The V-shaped recovery is comparable in severity to the pre-COVID scenario. The analysis also includes targeted adjustments to reflect material changes in bank balance sheets including drawdowns on corporate credit lines. Under these sensitivities, resulting loan losses are 1.3x to 1.6x the result of the pre-COVID scenario.

Figure 2: Firm-level minimum CET1 Capital ratios, interquartile range and aggregate minimum





Aggregate sensitivities show potential incremental declines in CET1 ratio minimums by 40 bps, 180 bps, and 220 bps under the V, U, and W recovery paths, respectively, compared to the decline under the pre-COVID scenario. Furthermore, when evaluating the projected minimum ratios in the 25th percentile under the

three paths (Figure 2) against capital conservation restrictions (Figure 1), payout ratios for firms in this quartile would be limited to 0-60% of eligible retained income, depending on the size of their buffer relative to required levels.

What's next for banks

- ▶ **Banks face a cap on capital distributions through the third quarter of 2020, at minimum.** Specifically, the Fed will suspend share repurchases except for issuances relating to employee stock ownership plans; cap the growth of dividends by imposing a limit that does not exceed the average of the firm's prior four quarter net income; allow only scheduled payments on additional tier 1 and tier 2 capital instruments.
- ▶ **Banks will resubmit capital plans later in the year.** Per the capital plan rule, the Board has determined that the changes in financial markets or the macro-economic outlook could have a material effect on each firm's risk profile and financial condition and require updated capital plans. Hence, the Board is requiring each firm to update and resubmit its capital plan within 45 days after the Board provides updated scenarios.
- ▶ **Banks should continue to progress towards implementing more dynamic planning and forecasting capabilities.** The COVID-19 pandemic has introduced new complexities into financial planning and forecasting toolsets, and firms are adapting to be more flexible and dynamic. Moreover, the Fed indicated that it will "remain focused on certain firms that are particularly sensitive to the current economic outlook, whose outlooks are more optimistic than appropriate given current conditions, whose credit cost forecasts have not considered a range of possible outcomes, or whose planning has not been thoughtful".
- ▶ **Banks should plan for redevelopment of capital planning models in the long run and use analysis that is well-supported and documented in the near term.** The severe macroeconomic conditions and the resulting fiscal and monetary response have presented challenges as existing capital models are developed based on data that is not any more reflective of current risk drivers and/or do not capture the effects of the economic stimulus and customer forbearance programs. As a result, firms have relied upon qualitative approaches, including management judgment, assumptions, and overlays.

In conclusion

Since 2009, the build up of capital buffers across the largest bank holding companies, coupled with investments in capital planning and stress testing capabilities, have thus far helped the banking industry withstand the severe economic downturn caused by the COVID-19 pandemic. However, this latest crisis has highlighted the need for more flexible and dynamic capabilities to react to rapidly evolving conditions. Given the ongoing uncertainty around the economic recovery, the Fed has instituted caps on capital distributions in upcoming quarters, while requiring firms to resubmit their capital plans based on updated scenarios to be provided later this year.

While firm-specific SCB levels will not be disclosed until later this year, preliminary analysis shows G-SIBs in particular have the smallest excess capital relative to

minimum requirements. The Fed's sensitivity analysis suggests that there are firms at risk of falling below minimum requirements in the W-shaped recovery path. To date, there has been no change to the incoming SCB final rule. While the Fed's sensitivities will not directly inform capital buffers under SCB, the Fed will conduct sensitivity analysis on a quarterly basis when assessing the need for future policy actions, including revisions to SCB requirements, as necessary.

Looking ahead, firms must ensure they have the proper tools and capabilities in place to effectively navigate through the ongoing economic uncertainty. Capital management must continue to evaluate alternative scenarios in allocation and risk management decisions, and in assessing distributions relative to both the SCB and the possibility of further Fed actions.

Notes:

Bank categories used in Figure 1:

- ▶ **G-SIBs:** Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup Inc.; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; Wells Fargo & Company
- ▶ **Large and complex – FBOs:** Barclays US LLC; Credit Suisse Holdings (USA), Inc.; DB USA Corporation; HSBC North America Holdings Inc.; RBC USA Holdco Corporation; TD Group US Holdings LLC; UBS Americas Holding LLC
- ▶ **Large and complex – others:** Capital One Financial Corporation; Northern Trust Corporation; The PNC Financial Services Group, Inc.; Truist; U.S. Bancorp
- ▶ **Large and non-complex:** Ally Financial Inc.; American Express Company; BMO Financial Corp.; BNP Paribas USA, Inc.; Citizens Financial Group, Inc.; Discover Financial Services; Fifth Third Bancorp; Huntington Bancshares Incorporated; KeyCorp; M&T Bank Corporation; MUFG Americas Holdings Corporation; Northern Trust Corporation; Regions Financial Corporation; Santander Holdings USA, Inc.

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