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Fed Change Should Make Tests Less Stressful For Most Banks

By **Evan Weinberger**

Law360, New York (June 21, 2017, 6:53 PM EDT) -- A change in the way the Federal Reserve will evaluate most banks' ability to withstand a financial shock should make the central bank's stress testing process for this year much less harrowing than in previous years, experts say.

Banks with $50 billion or more in assets are subject to two separate rounds of stress testing: the bank-run Dodd-Frank Act Stress Tests and the more rigorous Comprehensive Capital Analysis and Review. The Fed has the power to reject banks' proposed share buybacks and dividend payments if it finds problems under the CCAR.

Where banks have in the past run into the most trouble is not on the review of the numbers in the CCAR but in a qualitative review of their risk management and other procedures. The Fed said in January that it no longer will subject banks with $250 billion in assets or less to the qualitative part of the CCAR, likely making it easier for those banks to pass.

That means the results of the Dodd-Frank stress tests, which will be released Thursday, should provide a clearer picture of whether banks under $250 billion in assets will see the Fed curtail their planned capital distributions when the CCAR results are released next week, said Randy Benjenk of Covington & Burling LLP.

"The quantitative results of DFAST this year will be a better indicator of whether the regional banks will have objections to their capital plans," he said.

Most banks undergo two separate rounds of stress tests each year, the bank-run DFAST and the more rigorous CCAR.

Both examinations involve the Fed providing banks with three separate stress scenarios of increasing severity, but the DFAST is a quantitative review of their capital levels during all three projections. On the other hand, the CCAR is more demanding, with the Fed taking a close look at banks' capital in response to the scenarios and, if the central bank's examiners aren't happy, can force them to hold off on planned share buybacks and dividend payments.

Where many banks have been tripped up in the past has been on the Fed's review of the risk management and other processes banks have in place that cannot be measured by strict numbers. Last year, the Fed flunked Santander Holdings USA for the third time based not on the numbers in its capital levels but on those risk management processes.

This year, all but nine of the 34 banks that undergo the Fed's stress testing regime — CIT Group Inc. joins those undergoing the exams for the first time — will avoid dealing with those worries over their risk management procedures when the CCAR results come. That's because the Fed determined in January that doing those qualitative reviews for regional and midsize banks was not worth the cost and effort that those banks undertook to comply with them.

The Fed said at the time that it would judge purely on the numbers banks that have between $50 billion and $250 billion in total consolidated assets, have less than $75 billion in total nonbank assets such as an insurance arm, and are not designated as globally systemic important banks by the Financial Stability Board, a panel of global regulators.

Removing the primarily large, regional banks from the more rigorous qualitative review of their capital management systems will reduce the "significant burden on these firms and [focus] the qualitative review in CCAR on the largest, most complex financial institutions," the Fed said in a statement at the time.

And that has investors bullish.

"Those banks deemed large and noncomplex will not be subject to the qualitative portion of the CCAR, and this should reduce most of the uncertainty surrounding CCAR for these banks," analysts at investment bank Keefe Bruyette & Woods said in a May research note. "The large and noncomplex still have to pass the stress test and remain above stressed minimums once the capital plan is incorporated, but investors should think of the large and noncomplex banks as having the ability to increase capital return faster, in our view."

But just because the Fed is not going to evaluate the midsize banks' risk management procedures on the first glance of their qualitative stress test results, that does not mean that they will be ignored completely.

Stress testing has been a key part of the post-financial crisis regulatory structure, and any inkling that the Fed is taking it easy on banks where the numbers do not add up could lead to a loss in confidence in the examinations, according to Kevin Petrasic, a partner at White & Case LLP.

"You still have to look at the integrity of the numbers, though. I don't know how you can get away from that," he said.

If a midsize bank's math does not add up, the Fed is going to take a close look at the math that was used and the place where the institution started, Petrasic added.

“To fail an institution that’s under the $250 billion threshold for the CCAR process now will require some significant analytics and digging,” he said.

A strong showing Thursday could provide a clearer picture of whether the Fed is going to have to do that digging.

--Editing by Christine Chun and Emily Kokoll.

Correction: An earlier version of this story misspelled the name of an attorney. The error has been corrected.

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