First take

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Ten key points from the Federal Reserve's 2015 Dodd-Frank Act Stress Test (DFAST)

For the first time all banks passed DFAST this year, but this unfortunately tells us nothing about their chances of passing next week's CCAR qualitative assessment.

The DFAST results published yesterday are the Federal Reserve's (Fed) first stress test results released in 2015. On March 11th, the Fed will release the more important Comprehensive Capital Analysis and Review (CCAR) results which will tell us whether the banks passed the Fed's qualitative and quantitative assessments in order to return more capital to shareholders.[1]

1. **All banks pass DFAST's classroom test; next week is CCAR's road test:** All institutions remained above minimum capital ratios under the Fed's stress models (applying the banks' existing dividend payout rate). The test that matters, however, is next week's CCAR which impacts shareholders. Although we do not believe any of the 31 banks' capital plans will be rejected for quantitative reasons (based on the DFAST results), it is a near certainty that some plans will be rejected for qualitative reasons. The Fed has not let up on raising its standards for banks' stress testing processes.
2. **More post-stress capital exists today than did *pre*-stress capital during the financial crisis:** The 31 banks' post-stress Tier 1 Common ratios (T1C) average 8.2% under the severely adverse scenario, which is higher than the same banks' *pre*-stress T1C average of 5.5% at the beginning of 2009. Average pre-stress T1C is also up again this year from last year (11.9% versus 11.5%) as is post-stress T1C (8.2% versus 7.6%).
3. **Industry capital ratios improve faster overall than at the largest banks:** The six largest banks accounted for about half of the total increase in industry Tier 1 common equity. However, these institutions make up 70% of industry-wide RWA, demonstrating that the other 25 banks are disproportionately accounting for the increase in industry-wide capital.
4. **Leverage ratio appears binding for many of the largest banks:** The leverage ratio is the binding constraint for many large banks as they remain close to the 4% minimum. The leverage ratio is particularly punitive for banks with significant capital markets activities. However, as the proposed G-SIB capital surcharge comes into play, these banks will further increase their common equity, lessening the impact of the leverage ratio in the future.[2]

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[1] The primary difference between DFAST and CCAR is that under CCAR the Fed assesses the quantitative impact of the bank's capital plan and the quality of the bank's capital planning processes. DFAST does not assess processes and assumes historical dividends, so DFAST can only be used to help anticipate CCAR's quantitative results.

[2] See PwC's *Regulatory brief, G-SIB capital: A look to 2015* (December 2014).

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5. **High analyst capital payout expectations have likely caused a few banks to overshoot in their proposed capital actions:** Like last year, this year's improved DFAST stressed ratios (T1C, leverage, etc.) indicate that space exists for increased capital distributions to shareholders. However, given the significantly greater payout expectations by equity analysts, we believe that some banks' capital plans have tested the Fed's boundaries and will result in a few banks having to quickly adjust their proposed capital actions – i.e., "take the mulligan" (these banks know who they are and are currently making adjustments that will be disclosed as part of next week's CCAR results). Even banks with significant capital flexibility may be restrained from greatly increasing dividends due to relatively high payouts in prior years – regulators still look less favorably on dividends versus buybacks given the difficulty in ratcheting down dividends in future years.

6. **Fed models seem to be maturing and becoming more predictable:** For the first time, the Fed disclosed the degree to which its stress models have changed, indicating that there were only incremental changes to most models. This model stability (and the fact that the Fed's economic scenarios have been held fairly constant over time) should allow banks to better anticipate the Fed's projected capital losses in the future. Banks can integrate this information into their future capital distribution plans in order to maximize their distributions to shareholders without having to raise regulatory flags by taking the mulligan.

7. **Loan loss rates improve due to fewer legacy problem portfolios and improved underwriting standards:** Total loan loss rates continued their march downward, reaching 6.1% under the severely adverse scenario (down from 6.9% in 2014 and 7.5% in 2013). This decline is driven by improvements in first lien loans, junior liens, and credit cards, as legacy problem portfolios are being removed from balance sheets and improved underwriting standards are taking hold (as alluded to above, Fed models and scenarios in these areas have remained stable). First lien and junior lien loss rate declines are particularly impactful, with decreases of 2.1 and 1.6 percentage points respectively. Commercial and industrial loan loss rates remained stable from last year, but were generally higher for banks with significant leveraged lending businesses (which the Fed has been expressing concern about in recent years).

8. **Banks overall are positioned well under the adverse scenario's rising interest rate environment:** Firms have generally prepared for the prospect of rising rates, as reflected in the adverse scenario results that show 27 of the 31 firms posting a pre-tax profit over the nine quarters. The average T1C falls only 110 bps from start to minimum, and 80 bps of that erosion is recouped by the end of the nine quarters through an increase in PPNR for these banks, largely due to asset-sensitive balance sheets more than offsetting unrealized AFS losses over time.

9. **Minimum capital ratios look worse than reality:** A few banks that heavily trade in the capital markets have post-stress minimum capital ratios close to the 8% requirement. However, we do not believe these banks will be as constrained in their capital distributions as it may appear. The trough in their ratios comes very early in the nine-quarter stress horizon, due to the market shock component which disproportionately impacts these firms, but rises in subsequent quarters.

10. **DFAST (and CCAR) will likely be tougher in the future:** The Fed indicated late last year that it may add all or a portion of the proposed G-SIB capital surcharge to post-stress capital ratios. Although we would not expect a proposed rule in this regard until at earliest the second half of this year, it is possible that such a rule could be finalized in time for DFAST 2016 given that stress testing deadlines will occur three months later.[3] Timing aside, in our view the G-SIB capital surcharge will ultimately factor into stress testing. At a minimum for 2016, Fed expectations will be higher as a result of the extra three months for banks to prepare.

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[3] See PwC's *First take: CCAR Guidance and final Capital Plan amendments* (October 2014).

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