Fed rosier than banks on revenue amid negative rates

By Zach Fox and Venkatesh Iyer   *July 20, 2016*

When the Federal Reserve released the results from the most recent Dodd-Frank Act stress tests, the regulator's findings differed materially from company-specific results. While the Fed's results were more dour than banks' on the all-important capital ratios, the central bank actually projected significantly better revenue performance in a negative-rate environment.

An inability to reconcile the Fed's stress-test findings with their internal models has been a source of frustration for bankers, and this year's results proved no different.
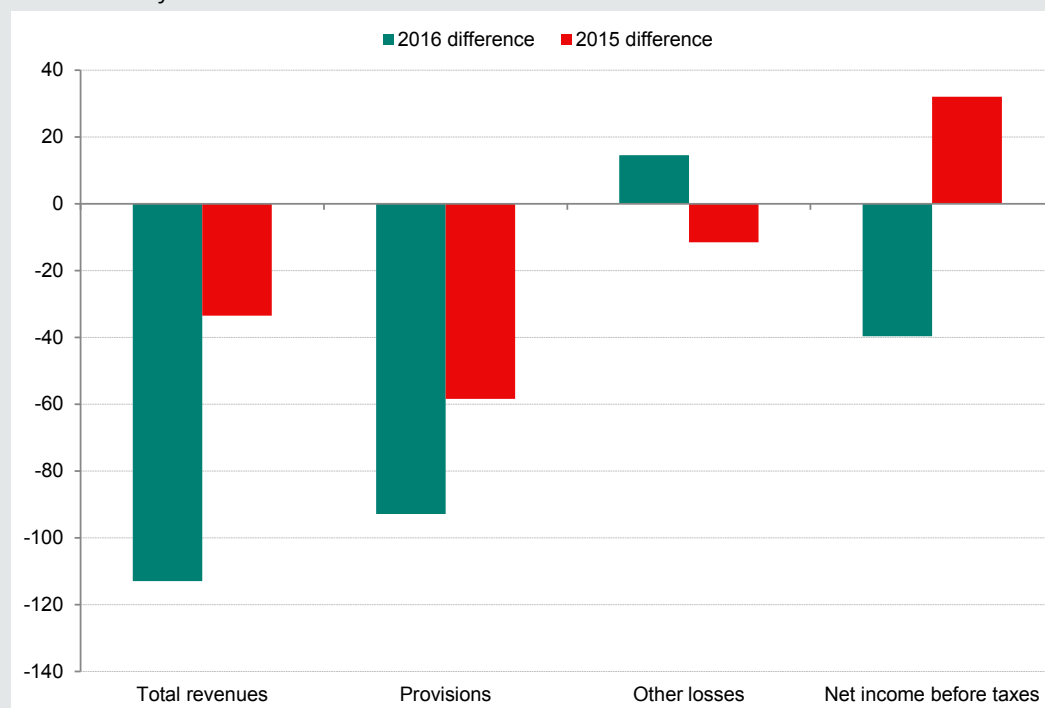
"I always joke, it's a stress test and it's effective because we are stressed the whole time," said U.S. Bancorp CEO Richard Davis during the bank's second-quarter earnings call. He added that banks had not yet received letters from the Fed detailing the results — not that those letters will have answers.

"We will never know exactly how the model works," Davis said.

The disconnect between banks and the Fed is, arguably, a feature of the stress tests. The Fed encourages banks to devise idiosyncratic stress tests specific to their case. Also, banks can apply an assumption — such as reduced lending in a recession — that the Fed does not apply to all banks. Further, the opacity ensures that banks cannot manipulate the system. If a bank could reproduce the Fed's methodol-

Aggregate difference between company-run and Fed-run DFAST income projections ($B)
Under severely adverse scenario

Data compiled July 13, 2016.
The aggregate Fed-run results are subtracted from the aggregate company-run results for select income statement metrics.
The Dodd-Frank Act stress test, or DFAST, severely adverse scenario utilizes hypothetical estimates that are representative of an economic outcome that is more adverse than expected.
The results from the company-run tests and the Federal Reserve-run tests may include different assumptions and methodologies.
TD Group US Holdings LLC and BancWest Corp. participated in the 2016 Dodd-Frank Act stress test for the first time. Both banks are accounted for in the differences calculated for 2016.
2015 aggregate values are for the severely adverse scenario beginning in the first quarter of 2015 through to the first quarter of 2017.
2016 aggregate values are for the severely adverse scenario beginning in the first quarter of 2016 through the first quarter of 2018.
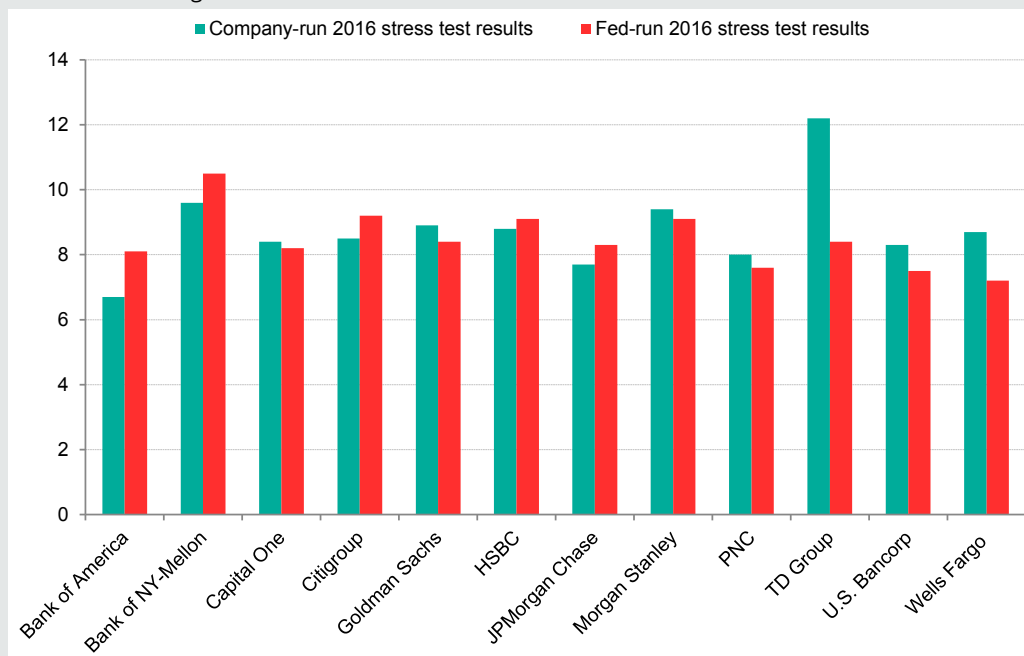Total revenue is a summation of pre-provision net revenue and other revenue.
Other losses is a summation of realized losses/gains on available-for-sale and held-to-maturity securities, trading and counterparty losses, and other losses/gains.
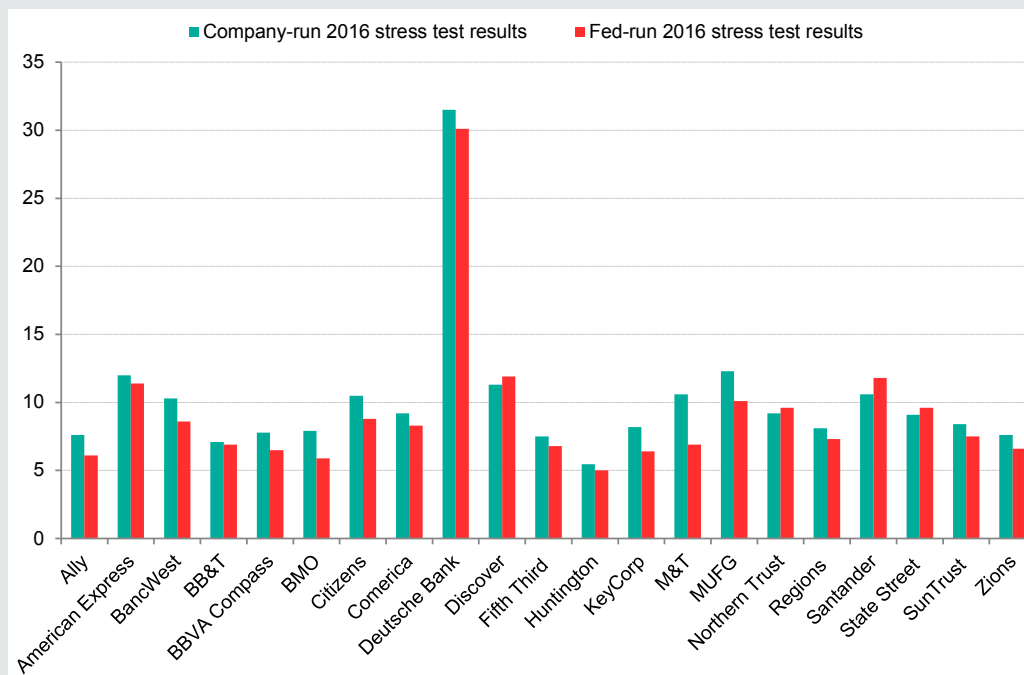Sources: Federal Reserve, company disclosures and SNL Financial, an offering of S&P Global Market Intelligence

DFAST projected minimum CET 1 ratio (%)
BHCs with assets greater than $250B

Legend: ■ Company-run 2016 stress test results ■ Fed-run 2016 stress test results

BHCs with assets less than $250B

Legend: ■ Company-run 2016 stress test results ■ Fed-run 2016 stress test results

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CET 1 ratios shown are the lowest quarterly ratios from the first quarter of 2016 to the first quarter of 2018.
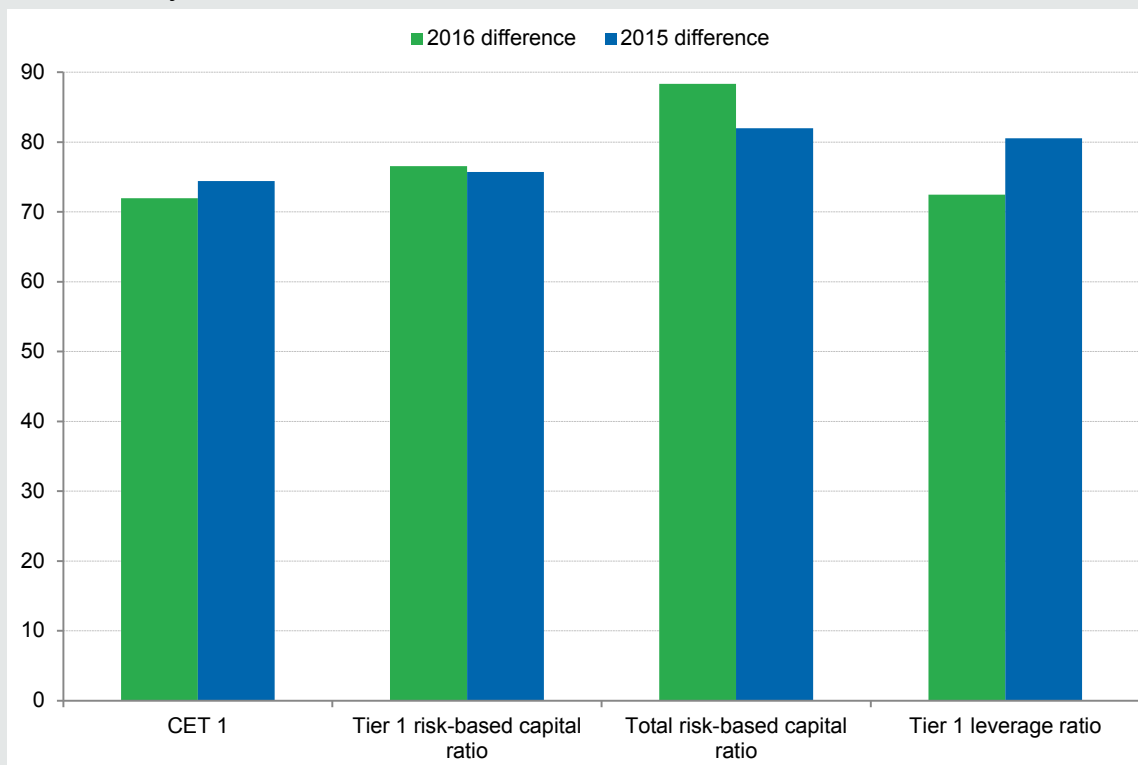Companies are grouped based on asset sizes disclosed for the first quarter of 2016.
CET 1 = common equity Tier 1; BHC = bank holding company
Sources: Federal Reserve, company disclosures and SNL Financial, an offering of S&P Global Market Intelligence

Difference between company-run and Fed-run DFAST average minimum capital ratios (bps)
Under severely adverse scenario

Data compiled July 13, 2016.
Analysis shows the basis-point difference, with the average Fed-run result subtracted from the average company-run result.
The Dodd-Frank Act stress test, or DFAST, severely adverse scenario utilizes hypothetical estimates that are representative of an economic outcome that is more adverse than expected.
TD Group US Holdings LLC and BancWest Corp. participated in the 2016 Dodd-Frank Act stress test for the first time. Both banks are accounted for in the differences calculated for 2016.
The results from the company-run tests and the Federal Reserve-run tests may include different assumptions and methodologies. For 2015, minimum capital ratios are the lowest quarterly ratios from the fourth quarter of 2014 to the fourth quarter of 2016 under the severely adverse scenario. For 2016, they are the lowest quarterly ratios from the first quarter of 2016 to the first quarter of 2018.
CET 1 = common equity Tier 1
Sources: Federal Reserve, company disclosures and SNL Financial, an offering of S&P Global Market Intelligence

ogy, it could target the lowest possible capital ratio while still passing. With a black-box methodology, banks need to build in a buffer to ensure their capital ratios do not fall below the regulatory minimum.

This year's results featured a very large gulf between the Fed's assumptions on revenue and the banks'. However, it was the Federal Reserve with the more optimistic outlook.

Last year, the Federal Reserve estimated revenue for banks subject to the stress test would total $309.8 billion over the nine-quarter period, compared to the banks' aggregate estimate of $276.4 billion — a difference of $33.4 billion. In this year's stress test, the banks estimated aggregate revenue of $272.3 billion over the nine-quarter period,
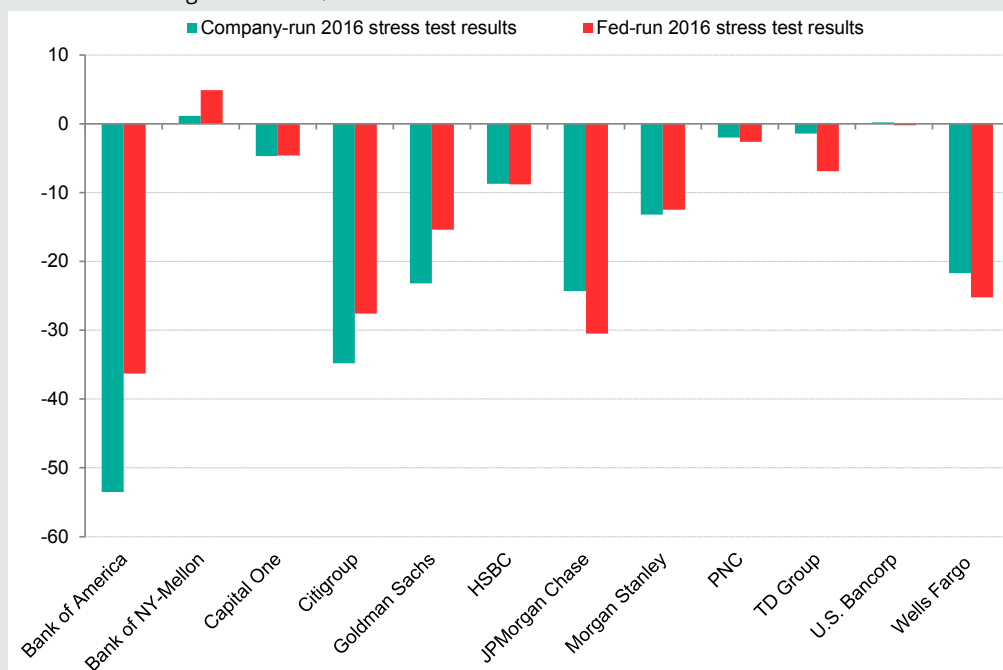
compared to an estimate of $385.3 billion from the Fed — a difference of $113.0 billion.

"When you talk about revenue, negative rates are a big question mark, so that could be a big reason for the divergence," said Joe Breeden, founder of Prescient Models, a company that offers banks consulting services on stress testing.
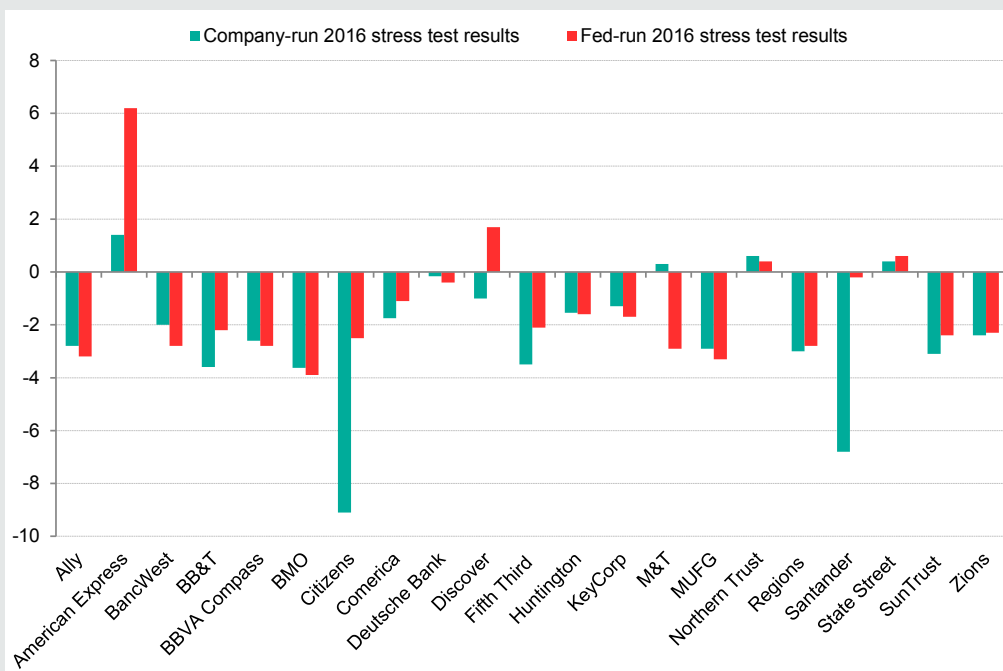
The Fed included negative rates in this year's stress tests, a first for the exercise. The severely adverse scenario included a drop in the three-month Treasury yield to negative-50 basis points, whereas the low point in earlier stress tests was positive-10 basis points. It appears banks, weary from years of low rates, were more pessimistic about the revenue implications of negative rates.

DFAST projected net income before taxes ($B)
BHCs with assets greater than $250B

BHCs with assets less than $250B

Data compiled July 13, 2016.
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The results from the Federal Reserve-run test and the company-run tests may include different assumptions and methodologies.
TD Group US Holdings LLC and BancWest Corp. participated in the 2016 Dodd-Frank Act stress test for the first time. Both banks are accounted for in the differences calculated for 2016.
Net income before taxes 2016 are shown for the severely adverse scenario beginning in the first quarter of 2016 through the first quarter of 2018.
Companies are grouped based on asset sizes disclosed for the first quarter of 2016.
BHC = bank holding company
Sources: Federal Reserve, company disclosures and SNL Financial, an offering of S&P Global Market Intelligence

The DFAST capital ratios are perhaps the most important part of the process, as banks must meet minimum ratios or face regulatory sanction. The differences between Fed-run and company-run capital projections were relatively similar in this year's test when compared to last year's. Whereas the Fed was more optimistic on revenue, banks continued to be rosier on their capital ratios in the stressed environment.

Across the 33 bank holding companies in this year's stress test, the average minimum common equity Tier 1 ratio was 9.6%, compared to a Fed-run average of 8.9% — a difference of 72 basis points. A year ago, when 31 banks reported results, the difference was 74 basis points.

Breeden said the stress tests remain on the same trajectory of improvement seen over the last few years. As banks better their internal models, they can reduce the amount of "model risk" they build into assumptions. He said an emerging area of concern — now that models are getting better and better — emanates from the role of the validator. Banks employ various individuals to work on stress tests, including a model developer, an auditor of the model and a validator of the model. In some cases, the validator will reject a useful model.

"It's a process with a lot of checks but not a lot of balances," Breeden said. "The person builds the model, and then you put it to these lines of defense, but sometimes you're defeating things that are actually pretty good."