Banks Are Falling Short in Planning for the Worst, Fed Says

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By Peter Eavis

Most large banks appear to have been sailing through the annual "health checkups" they have had to undergo since the financial crisis.

But on Monday, the Federal Reserve described some significant shortcomings in the banks' responses to the so-called stress tests.

Despite the severity of the recent housing crisis, the Fed said some banks were not taking into account the possibility of falling house prices when valuing certain mortgage-related assets for the tests.

In other cases, banks assumed they would be strong enough to take business away from competitors in times of stress.

The Fed's findings are part of its efforts to improve the stress tests, which aim to ensure that banks have the financial strength to withstand shocks in the economy and markets.

The tests have created tension between the Fed and the banks. One reason is that the tests can determine how much a bank is allowed to pay out in dividends or spend on stock buybacks.

In March, the Fed announced that two out of 18 banks had effectively failed the latest tests. One was BB&T, a regional bank based in Winston-Salem, N.C. The other was Ally Financial, a consumer lender that has struggled to right itself since the financial crisis and still has not fully repaid its bailout money to the government. Also in March, JPMorgan Chase and Goldman Sachs passed the latest tests, but the Fed said their responses contained weaknesses, and the banks were required to resubmit their plans by the end of September.

"We continue to work with the Fed and will resubmit in September," Goldman Sachs said in a statement.

In its review released on Monday, the Fed appeared most concerned that banks were applying the tests too generally. In other words, banks did not pay enough attention to the risks that were particular to their assets and operations. Banks excluded material that was relevant to the bank's "idiosyncratic vulnerabilities," the Fed said.

Under the tests, the banks have to assume weakness in the economy and turmoil in the markets, and then calculate the losses they would suffer under such conditions. The banks then subtract those losses from capital, the financial buffer they maintain to absorb losses. If the assumed losses cause capital to fall below a regulatory threshold, the banks effectively fail the test.

As part of the stress tests, banks have to carefully lay out capital plans to show regulators that they would have the strength to operate through tough times.

But, again, some banks acted too formulaically, the Fed said.

The banks that showed weak responses based their capital plans solely on hitting regulatory requirements, rather than their unique risks, the Fed said.

One upshot of this is that banks may have to hold capital well above regulatory minimums to be considered properly capitalized in the Fed's eyes.

By making its expectations clearer, the Fed could sacrifice some of the unpredictability that could keep the banks on their toes when they apply the tests.

Perhaps anticipating that, the central bank warned that "designing an internal capital planning process that simply seeks to mirror the Federal Reserve's stress testing is a weak practice."

The Fed's review also contained hints that some banks still operate with some of the same hubris that got them into trouble during the crisis.

For instance, some banks "assumed that they would be viewed as strong compared to their competitors in a stress scenario and would therefore experience increased market share."

Bank of America acquired two large firms during the crisis that then burdened the bank with hefty losses.

JPMorgan's big acquisitions during the crisis caused less damage to its bottom line, and recently its chief executive, Jamie Dimon, promised, "We will be a port of safety in the next storm."

BB&T, which fell short in the last test, said in a recent securities filing that it had resubmitted its capital plan in June, adding that regulators had 75 days to review it. Ally is preparing to resubmit its capital plan, Gina Proia, a spokeswoman for the bank, said.

The Fed also said on Monday that 12 more banks would be included in the next stress tests, the results of which will be made public early next year. That group will not include the large nonbank financial firms, like the American International Group, that regulators recently designated "systemically important." Eventually, though, such firms will be subject to stress tests.

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