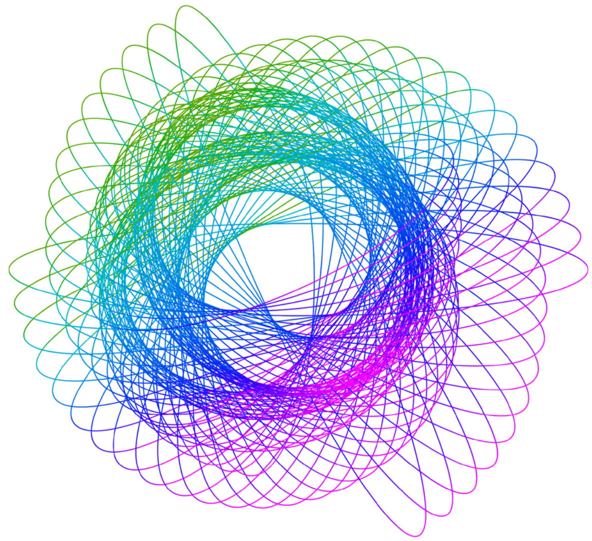
Deloitte.



The Federal Reserve Board releases hypothetical scenarios for its 2021 bank stress tests amid lingering uncertainty on the path of the pandemic and its impact on the financial system and broader economy

Introduction

On February 12, 2021, the Federal Reserve Board (FRB) released its hypothetical scenarios for the 2021 stress tests, examining how large banks would fare if the US economy were to enter into a recession during Q1 2021 and experience “substantial stress in commercial real estate and corporate debt markets.”[1]

Last year, the FRB required two different stress tests for the first time due to the shock and uncertainty over the pandemic’s impact on the financial system.[2] The FRB found that large banks were well-capitalized under a range of hypothetical adverse scenarios. More recently, in December 2020, the FRB extended limits on capital distribution until Q1 2021 to preserve the banking sector’s strength; however, the FRB allowed both dividends and share repurchases to proceed based on certain criteria.[3]

2021 hypothetical scenarios

In announcing the hypothetical scenarios, FRB Vice Chairman for Supervision Randal Quarles said, “[t] he banking sector has provided critical support to the economic recovery over the past year. Although uncertainty remains, this stress test will give the public additional information on its resilience.”[4]

For 2021, the FRB set forth two hypothetical economic and financial market scenarios -- baseline and severely adverse. In the severely adverse scenario, the hypothetical recession begins in Q1 2021 and features a severe global downturn with substantial stress in commercial real estate, corporate debt markets, and equity markets. These downturns reflect impacts from COVID-19 on the US and global economies.

- The decline in commercial real estate prices--40% in the 2021 Federal Reserve severely adverse scenario--is the largest such decline in the last three scenario cycles.
- The corporate debt markets are stressed through a dramatic widening of spreads between yields on investment-grade corporate bonds and yields on 10-year Treasury securities and the mortgage rates and the yields on 10-year Treasury securities.
- The substantial decline in equity prices--55%, in the 2021 Federal Reserve severely adverse scenario--is the largest such decline in the last three scenario cycles.
- The US unemployment rate rises by 4 percentage points in the severely adverse scenario, reaching 10.75% percent by the third quarter of next year. At the same time, economic growth shrinks 4 percent over the same period. Compared to the Fall 2020 cycle, this cycle’s unemployment rate has a 1% percentage point larger decrease but ends at a level 1.75% percentage points lower. This exercise demonstrates a more severe move to a lower unemployment level than the Fall 2020 scenario.

The FRB noted that “the severely adverse scenario is significantly more severe than most current baseline projections for the path of the US economy.”[5]

Notably, nineteen of the country's biggest banks will face the tests this year, rather than the 34 required to submit last year. Some banks with more than $100 billion in assets now only face the tests every other year. Smaller banks[6] can still elect to "opt in" to participate in the tests by April 5, 2021.[7]

Key considerations

- Even while working through this cycle, all CCAR (Comprehensive Capital Analysis and Review (CCAR) banks (even those not submitting this cycle) should be prepared for the potential of additional regulatory requests similar to what was experienced in 2020.

- Given the severity of this cycle's scenarios, and the difficulties in loss forecasting given the current levels of uncertainty, banks should continue to ensure key capital estimates and decisions are thoroughly supported through analysis and documentation, particularly as it goes through the various stages of the internal challenge and review process, including senior management and board review.

- Even as banks address the current cycle, they should also consider synergies to enable more strategic transformation of their CCAR/stress testing frameworks to unlock additional efficiencies and value in their capital management processes going forward.

Summary Takeaways

While the firms cleared the stress tests in 2020, the FRB continues to exercise caution given the pandemic's uncertainty and rapidly evolving nature. The significant levels of uncertainty associated with the course of the pandemic, vaccine rollouts, and the corresponding medium-term economic impacts and effectiveness of government stimulus programs, will continue to make this stress test submission both critically important and challenging for participating CCAR banks.

This point-of-view is part of an ongoing series analyzing the liquidity and capital conditions of financial institutions in the current environment. Like you, we will continue to monitor developments as requirements evolve to reflect current stresses related to the pandemic's longer-term impact on the financial services industry.

Contacts

Alex Brady
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Craig Brown
Managing Director | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Courtney Davis
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Andrea DiGiovanni
Managing Director| Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Irena Gecas-McCarthy
FSI Director, Deloitte Center for Regulatory Strategy, Americas
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Austin Tuell
Manager| Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Kyle Cooke
Senior Consultant | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Endnotes

1. Federal Reserve Board (FRB), "Federal Reserve Board releases hypothetical scenarios for its 2021 bank stress tests," accessed on February 12, 2021.
2. Ibid.
3. Provided the firm's capital ratio is above the total capital requirement, it can pay common stock dividends and make share repurchases that, in the aggregate, do not exceed average of the firm's net income for the preceding four calendar quarters (for ICHs, FBR references Q2,Q3,Q4 2020 and Q1 2021). The payout cannot be larger than the payout in Q2 2020. It can make share repurchases that equal the amount of share issuances related to expensed employee compensation as well as redeem and make scheduled payments on additional tier 1 and tier 2 capital instruments.
4. Federal Reserve Board (FRB), "Federal Reserve Board releases hypothetical scenarios for its 2021 bank stress tests," accessed on February 12, 2021.
5. Ibid.
6. Ibid. This year banking organizations subject to Category IV standards are not subject to a supervisory stress test, but they may elect, by April 5, 2021, to participate in the Federal Reserve's 2021 supervisory stress test.
7. Ibid.