The Daily Dish

Stress Tests Demystified

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Eakinomics: Stress Tests Demystified

The financial crisis is far enough in the rear view mirror that relatively little scrutiny is given to the ongoing, enhanced monitoring of the largest banks. One of those enhanced tools is a stress test. The Federal Reserve imposes a simulated stressful economic environment each year to see if (a) the banks can withstand the shock at all, and (b) if they can withstand the shock and continue "normal" activities like paying dividends. As detailed by AAF's Gordon Gray and Tom Wade, this year's stress test meant a hypothetical 9.6 percent downturn in the economy, double-digit unemployment, and the collapse of home prices. The Federal Reserve estimated this would generate losses of about $578 billion in the banks examined.

There were three major takeaways from this year's stress test. First and foremost, all 35 banks that the Fed examined passed the basic test of survival. Second, 31 of the 35 passed the second test of normal operations. Deutsche Bank AG — the U.S. subsidiary of Deutsche Bank — was cited for "widespread and critical deficiencies across the firm's capital-planning practices," while State Street was cautioned — but passed — for inadequate internal counterparty risk recognition. Goldman Sachs and Morgan Stanley also got conditional passes because they fell under the minimum capital required, but for a surprising reason: the impact of the Tax Cuts and Jobs Act (TCJA).

Critics have labeled the TCJA a giveaway to big corporations like Goldman and Morgan Stanley, so this third finding is the most surprising. How can the TCJA be "bad" for banks?

The Tax Cuts and Jobs Act (TCJA) had three impacts on the measured capital of banks. First and foremost, it reduced the tax rate from 35 to 21 percent. While that is good news for firms making profits, it also reduces the value of losses. Each dollar of loss now saves only $0.21 instead of $0.35 in taxes. Not only were net operating losses (NOLs) made less valuable, the TCJA eliminated the ability of banks to use current losses to offset past gains (and thus get a tax rebate) and limited their ability to carry current NOLs forward to offset future gains. Finally, the TCJA also imposed a one-time tax on the accumulated overseas earnings of U.S. multinational firms. These provisions hit just as the stress test did and caused a transitory failure at the two banks. In recognition of the fact that it was the policy environment — and not bank management — that caused the failure, the Federal Reserve did not stop the banks from paying their normal dividends.

The stress test should be viewed as a very successful regulatory tool that should be kept central to the prudential regulatory strategy in the future.