Congressional Oversight Panel

June 9, 2009

JUNE OVERSIGHT REPORT*

Executive Summary

*Submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

Executive Summary[*]

Across the country, many American families have taken a hard look at their finances. They have considered how they would manage if the economy took a turn for the worse, if someone were laid off, if their homes plummeted in value, or if the retirement funds they had been counting on shrunk even more. If circumstances get worse, how would they make ends meet? These families have examined their resources to figure out if they could weather more difficult times – and what they could do now to be better prepared. In much the same spirit, federal banking regulators recently undertook "stress tests" to examine the ability of banks to ride out the financial storm, particularly if the economy gets worse.

Treasury recognized the importance of understanding banks' ability to remain well capitalized if the recession proved worse than expected. Thus, Treasury and the Federal Reserve announced the Supervisory Capital Assessment Program (SCAP) to conduct reviews or "stress tests" of the nineteen largest BHCs. Together these nineteen companies hold two-thirds of domestic BHC assets. As described by Treasury, the program is intended to ensure the continued ability of U.S. financial institutions to lend to creditworthy borrowers in the event of a weaker-than-expected economic environment and larger-than-estimated losses.

The Emergency Economic Stabilization Act of 2008 (EESA)[1] specifically requires the Congressional Oversight Panel to examine the Secretary of the Treasury's use of his authority, the impact of the Troubled Asset Relief Program (TARP) on the financial markets and financial institutions, and the extent to which the information made available on transactions under the TARP has contributed to market transparency. In this report, the Panel examines the steps Treasury has taken to assess the financial health of the nation's largest banks, the impact of these steps on the financial markets, and the extent to which these steps have contributed to market transparency. Understanding the recently completed stress tests helps shed light on the assumptions Treasury makes as it uses its authority under EESA. As Treasury uses the results of these tests to determine what additional assistance it might provide to financial institutions, the tests also help determine the effectiveness of the TARP in minimizing long-term costs to the taxpayers and maximizing taxpayer benefits, thus responding to another key mandate of the Panel.

As part of their regular responsibilities, bank examiners determine whether the banks they supervise have adequate capital to see them through economic reversals. Typically, these bank supervisory examination results are kept strictly confidential. The stress tests built on the

[*] The Panel adopted this report with a unanimous 5-0 vote on June 8, 2009.

[1] Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110-343 (hereinafter "EESA").

existing regulatory capital requirements, but, because the stress tests were undertaken in order to restore confidence in the banking system, they included an unprecedented release of information.

The stress tests were conducted using two scenarios: one test based upon a consensus set of economic projections and another test using projections based on more adverse economic conditions. The only results that have been released are those based on the adverse scenario. These test results revealed that nine of the nineteen banks tested already hold sufficient capital to operate through 2010 under the projected adverse scenario; those banks will not be required to raise additional capital. Ten of the nineteen banks were found to need additional capital totaling nearly $75 billion in order to weather a more adverse economic scenario. Those banks that need additional capital were required to present a plan to Treasury by June 8, 2009, outlining their plans to raise additional capital. All additional capital required under the stress tests must be raised by November 9, 2009, six months after the announcement of the stress test results. Some BHCs have already successfully raised billions in additional capital.

Like the case of the family conducting its own stress test of personal finances, the usefulness of the bank stress test results depends upon the methods used and the assumptions that went into conducting the examinations. To help assess the stress tests, the panel engaged two internationally renowned experts in risk analysis, Professor Eric Talley and Professor Johan Walden, to review the stress test methodology.

Based on the available information, the professors found that the Federal Reserve used a conservative and reasonable model to test the banks, and that the model provides helpful information about the possible risks faced by BHCs and a constructive way to address those risks. The criteria used for assessing risk, and the assumptions used in calibrating the more adverse case, have typically erred on the side of caution and avoided many of the more dangerous simplifications present in some risk modeling.

The professors also raised some serious concerns. They noted that there remain unanswered questions about the details of the stress tests. Without this information, it is not possible for anyone to replicate the tests to determine how robust they are or to vary the assumptions to see whether different projections might yield very different results. There are key questions surrounding how the calculations were tailored for each institution and questions about the quality of the self-reported data. It is also important to note that the stress test scenarios made projections only through 2010. While this time frame avoids the greater uncertainty associated with any projection further in the future, it may fail to capture substantial risks further out on the horizon. Based on the testimony by Deutsche Bank at the Panel's May field hearing, the projected rise in the defaults of commercial real estate loans after 2010 raise concerns.

In evaluating the useful information provided by the stress tests, as well as the remaining questions, the Panel offers several recommendations for consideration moving forward:

- The unemployment rate climbed to 9.4 percent in May, bringing the average unemployment rate for 2009 to 8.5 percent. If the monthly rate continues to increase during the remainder of this year, it will likely exceed the 2009 average of 8.9 percent assumed under the more adverse scenario, suggesting that the stress tests should be repeated should that occur.

- Stress testing should also be repeated so long as banks continue to hold large amounts of toxic assets on their books.

- Between formal tests conducted by the regulators, banks should be required to run internal stress tests and should share the results with regulators.

- Regulators should have the ability to use stress tests in the future when they believe that doing so would help to promote a healthy banking system.

The Federal Reserve Board should be commended for releasing an unprecedented amount of bank supervisory information, but additional transparency would be helpful both to assess the strength of the banks and to restore confidence in the banking system. The Panel recommends that the Federal Reserve Board release more information on the results of the tests, including results under the baseline scenario. The Federal Reserve Board should also release more details about the test methodology so that analysts can replicate the tests under different economic assumptions or apply the tests to other financial institutions. Transparency will also be critical as financial institutions seek to repay their TARP loans, both to assess the strength of these institutions and to assure that the process by which these loans are repaid is fair.

Finally, the Panel cautions that banks should not be forced into counterproductive "fire sales" of assets that will ultimately require the investment of even more taxpayer money. The need for strengthening the banks through capital increases must be tempered by sufficient flexibility to permit the banks to realize full value for their assets.