

Dean Croushore Blog About Monetary Policy

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Dodd-Frank Has Teeth

The Dodd-Frank banking regulation, which passed into law in 2010, gave bank regulators important new powers to ensure the safety and soundness of major banking organizations, as discussed in M&B Chapter 9. One of the key tools that the Federal Reserve uses is stress testing of banks and the authority to pass judgment on their capital plans.

In the most recent set of stress tests, 30 large financial institutions were required to provide data to the Fed on their assets and how they would respond to a severely adverse economic situation, in which the economy would fare slightly worse than it did in the recession from 2007 to 2009. In the scenario, real GDP declines nearly 5 percent, the unemployment rate rises to over 11 percent, stock prices fall by almost 50 percent, and house prices decline by 25 percent. The banks and the Fed each independently conducted the stress tests and the Fed analyzed both sets of tests and the differences between them.

The good news from the tests is that 29 of the 30 banks were able to withstand the severely adverse scenario while maintaining capital levels exceeding over 5 percent of their risk-weighted assets. Only one bank, Zions Bancorp, failed the tests and will need to improve its capital position going forward. In fact, the aggregate ratio of capital to risk-weighted assets would fall to only 7.6 percent in the severely adverse scenario, significantly higher than was the case in the stress tests performed one year earlier, when the ratio would have fallen to 5.5 percent.

Having a large amount of capital in difficult economic times helps banks to survive without needing a bailout from the government or an emergency loan from the Federal Reserve. Thus, requiring banks to have substantial capital helps to reduce the chances that banks will fail, which could lead to a financial crisis, as it did in 2008.

In addition to the stress tests, banks must also comply with other regulations, including the Fed's qualitative assessment of their capital planning process. If a bank does not operate in a safe and sound manner, or if it has delinquencies in its planning and control processes, the Fed may decide to not allow the bank to issue dividends, or buy back shares of its stock in the market.

In the latest approval process, the Fed agreed to allow the plans of 25 of the 30 banks to proceed. However, 5 banks were denied the ability to pursue their capital plans. Zions Bancorp failed the stress test and must now change its plan to increase its level of capital so that it can pass the stress test. Four other banks, including one of the largest in the country (Citibank), had their capital plans denied on qualitative grounds. The Fed cited problems in Citibank's planning process that the bank had not fixed despite earlier warnings from the Fed.