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# Highlights

Highlights of GAO-10-861, a report to congressional committees

September 2010

# TROUBLED ASSET RELIEF PROGRAM

## Bank Stress Test Offers Lessons as Regulators Take Further Actions to Strengthen Supervisory Oversight

## Why GAO Did This Study

The Supervisory Capital Assessment Program (SCAP) was established under the Capital Assistance Program (CAP)—a component of the Troubled Asset Relief Program (TARP)—to assess whether the 19 largest U.S. bank holding companies (BHC) had enough capital to withstand a severe economic downturn. Led by the Board of Governors of the Federal Reserve System (Federal Reserve), federal bank regulators conducted a stress test to determine if these banks needed to raise additional capital, either privately or through CAP. This report (1) describes the SCAP process and participants' views of the process, (2) assesses SCAP's goals and results and BHCs' performance, and (3) identifies how regulators and the BHCs are applying lessons learned from SCAP. To do this work, GAO reviewed SCAP documents, analyzed financial data, and interviewed regulatory, industry, and BHC officials.

## What GAO Recommends

This report recommends that the Federal Reserve complete a final 2-year SCAP analysis, and apply lessons learned from SCAP to improve transparency of bank supervision, examiner guidance, risk identification and assessment, and regulatory coordination. The Federal Reserve agreed with our five recommendations and noted current actions that it has underway to address them. Treasury agreed with the report's findings.

View GAO-10-861or key components.
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## What GAO Found

The SCAP process appeared to have been mostly successful in promoting coordination, transparency, and capital adequacy. The process utilized an organizational structure that facilitated coordination and communication among regulatory staff from multiple disciplines and organizations and with the BHCs. Because SCAP was designed to help restore confidence in the banking industry, regulators took unusual steps to increase transparency by releasing details of their methodology and sensitive BHC-specific results. However, several participants criticized aspects of the SCAP process. For example, some supervisory and bank industry officials stated that the Federal Reserve was not transparent about the linkages between some of the test's assumptions and results. But most of the participants in SCAP agreed that despite these views, coordination and communication were effective and could serve as a model for future supervisory efforts. According to regulators, the process resulted in a methodology that yielded credible results. By design, the process helped to ensure that BHCs would be capitalized for a potentially more severe downturn in economic conditions from 2009 through 2010.

SCAP largely met its goals of increasing the level and quality of capital held by the 19 largest U.S. BHCs and, more broadly, strengthening market confidence in the banking system. The stress test identified 9 BHCs that met the capital requirements under the more adverse scenario and 10 that needed to raise additional capital. Nine of the 10 BHCs were able to raise capital in the private market, with the exception of GMAC LLC, which received additional capital from the U.S. Department of the Treasury (Treasury). The resulting capital adequacy of the 19 BHCs has generally exceeded SCAP's requirements, and two-thirds of the BHCs have either fully repaid or begun to repay their TARP investments. Officials from the BHCs, credit rating agencies, and federal banking agencies indicated that the Federal Reserve's public release of the stress test methodology and results in the spring of 2009 helped strengthen market confidence. During the first year of SCAP (2009), overall actual losses for these 19 BHCs have generally been below GAO's 1-year pro rata loss estimates under the more adverse economic scenario. Collectively, the BHCs experienced gains in their securities and trading and counterparty portfolios. However, some BHCs exceeded the GAO 1-year pro rata estimated 2009 losses in certain areas, such as consumer and commercial lending. Most notably, in 2009, GMAC LLC exceeded the loss estimates in multiple categories for the full 2-year SCAP period. More losses in the residential and commercial real estate markets and further deterioration in economic conditions could challenge the BHCs, even though they have been deemed to have adequate capital levels under SCAP.

SCAP provided a number of important lessons for regulators about the benefits of increased transparency, the need for regulators to strengthen bank supervision, the need for regulators and BHCs to improve their risk identification and assessment practices, and the need for regulators to improve coordination and communication. First, SCAP underscored the potential benefits that increased transparency about the financial health of the nation's largest BHCs can provide. Many experts have said that the lack of transparency about potential losses from certain assets contributed significantly to the instability in financial markets during the current crisis. But transparency in the banking supervisory process is a controversial issue. Some observers say that publicly disclosing sensitive bank information without a federal capital backstop could have unintended negative effects, such as runs on banks, that would disproportionately affect weaker banks. However, other observers believe that more transparency about banks' asset valuations and losses could help the public better understand the risk exposures of BHCs, increase market discipline, and improve the oversight of these institutions. A final analysis by the Federal Reserve of BHCs' performance during the full 2-year SCAP period can help in this regard. The Federal Reserve and other banking regulators could benefit from developing a plan to improve the transparency of bank supervision. Second, SCAP showed that more robust regulatory oversight of bank stress tests was necessary to better understand banks' capacity to withstand downturns in the economy. Regulators and BHC officials commented that internal bank stress tests prior to SCAP did not comprehensively stress their portfolios. The Federal Reserve is finalizing examiner guidance for assessing capital adequacy, including stress testing, but it has not established criteria for assessing the rigor of the BHCs' stress test assumptions. Without more robust guidance, ensuring that stress tests are being evaluated thoroughly and consistently is difficult. Third, the SCAP exercise highlighted opportunities to enhance both the process and data inputs for conducting future stress tests. The Federal Reserve has started to build a plan to enhance its risk identification and assessment infrastructure in response to the financial crisis, but further planning is needed to reflect recent changes under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Finally, SCAP demonstrated the need for robust coordination and communication among regulators in examining complex institutions. While SCAP promoted coordination and communication, further efforts are needed to ensure the participation of relevant regulators in multiagency examinations of banks.

**Table 1: Indicative Loss Rates Estimates and Actual SCAP BHCs and Banking Industry Average Loss Rates, December 31, 2009**

Percentage

| | SCAP indicative loss rate estimates | | 2009 actual loss rates | |
|---|---|---|---|---|
| Loan category | Federal Reserve's more adverse 2-year loss rate[a] | GAO's more adverse 1-year pro rata loss rate[b] | SCAP BHCs average loss rate | Banking industry average loss rate[c] |
| First-lien mortgage | 7-8.5% | 3.5-4.25% | 1.9% | 1.7% |
| Second/junior lien mortgages | 12-16 | 6-8 | 4.4 | 3.9 |
| Commercial and industrial | 5-8 | 2.5-4 | 2.5 | 2.3 |
| Commercial real estate | 9-12 | 4.5-6 | 2.3 | 2.4 |
| Credit cards | 18-20 | 9-10 | 10.1 | 10.2 |
| Other consumer | 8-12 | 4-6 | 4.1 | 4.4 |
| Other loans | 4-10 | 2-5 | 1.4 | 1.1 |

Sources: Federal Reserve SCAP results report and GAO analysis of SNLFinancial Y-9C regulatory data.

[a]Data as of December 31, 2010.

[b]GAO calculated the more adverse 1-year pro rata loss rate by dividing the SCAP more adverse 2-year loss rates by 2. A key limitation of this approach is that it assumes equal distribution of losses, revenues, expenses, and changes to reserves over time, although these items were unlikely to be distributed evenly over the 2-year period. Another important consideration is that actual results were not intended and should not be expected to align with the SCAP projections.

[c]Data are for BHCs with greater than $1 billion in total assets.