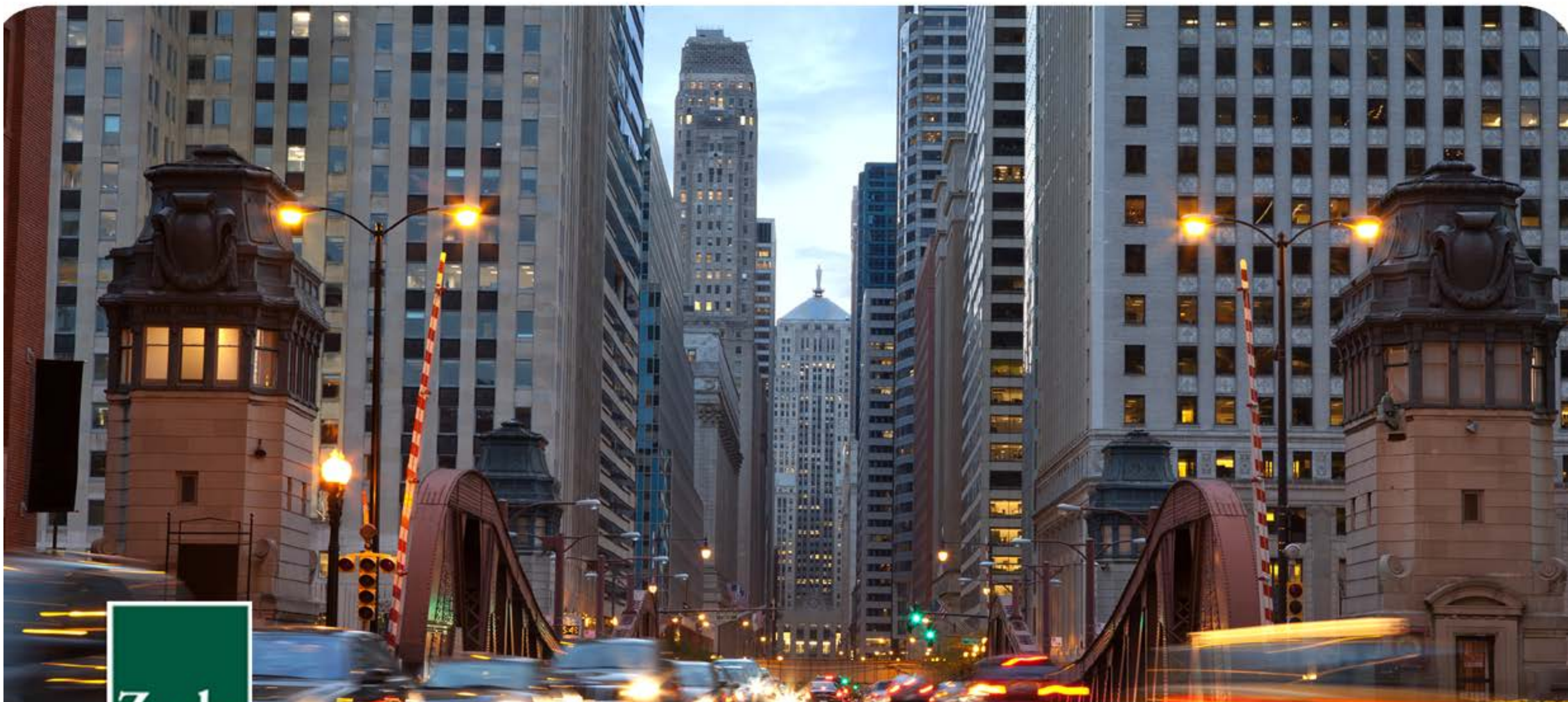

# The Great Irony of the Fed's "Stress Test"

By Mitch Zacks,
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Results of the Fed's latest "stress tests" are in, and to little surprise and with little fanfare all 31 banks passed. Simply put, the results signify that the country's biggest banks are adequately capitalized to absorb another severe economic crisis, at least according to the Fed's established standards.

In other words, if doomsday descended (which we do not think will happen this year or next), GDP were to fall by -4.5%, unemployment increased by 4% and inflation were to tick up 3% from these levels, banks would still be healthy enough to lend. This means too that, theoretically, the American taxpayer would not be burdened by another bailout. By and large, this is positive news that investors should feel good about it.

Does this mean that it is a good time to go long Financials? Not necessarily.

**Over-Regulation and Unintended Consequences**

What few investors realize is that the Fed actually runs a second set of tests, known as the Comprehensive Capital Analysis and Review [CCAR]. These tests aren't concerned with surviving the next financial crisis. Instead, they are subjectively testing banks to determine if they are healthy enough to return capital to shareholders in the form of dividends and share buybacks.

With both sets of tests taken together, the Fed is essentially doing what the public wants – taking the hard line on Wall St. and taking action to curb excessive risk. The 'anti-big bank' sentiment is prevalent enough in Washington and across the country that the government understands the political gains made through regulation.

What we are missing, however, is economic growth. And that, in my view, is precisely what's being choked off as a result of these stress tests. It happens in two ways:

1) Banks are constantly looking over their shoulder and must adhere to the Fed's fairly tough standards, as a result they're hoarding capital. Sure, the Fed is ensuring that they're healthy, but doing so also ironically means impairing the way banks take risks and do business. We want banks to take risks and make loans, which in my view has been "over-stifled" by excessive regulation.

2) Banks now have to spend exorbitant amounts of money on compliance, which is good in theory, however it also detracts from funds that could be used to create economic activity.

I'm not arguing against the stress tests altogether. They've achieved positive results and have boosted confidence in the banking system. Since 2009, the common equity capital ratio – which compares high-quality capital to risk-weighted assets – of the 31 bank holding companies tested has more than doubled from 5.5% in the first quarter of 2009 to 12.5% in the fourth quarter of 2014, which is good.

It is the CCAR tests that are the issue. Fed officials say they don't want the CCAR tests to be predictable, because firms should plan for unforeseen risks. Because the tests are subjective and banks can't prepare, it forces the banks to become overly-cautious and leaves them in a state of uncertainty – which markets loathe.

Bank of America Corp., for example, passed the first round of stress tests but was considered one of the "failures" of CCAR tests. The Fed found "certain weaknesses" in Bank of America's ability to measure losses and revenue in other internal controls. The bank can temporarily boost dividends or share buybacks, but it must submit a revised plan addressing its shortcomings by September 30. The reality is that Bank of America is likely in great shape, but the "subjective" CCAR tests deem otherwise. This, in my opinion, is harmful to the bank's image and its shares. It also creates another layer of uncertainty for Bank of America's peers, which is the opposite of what the economy needs.

**Weighing the Economic and Investment Implications**

The government bailed out many of these banks with taxpayer dollars, so it seems justified that they monitor balance sheets and risk-taking in the spirit of preventing another crisis, which is fair enough.

However, when the government bailed out the auto industry from January 2009 – December 2013, they invested a total of around $80 billion (mostly in GM). Towards the end, the government exited all positions, and as a result, cost the taxpayer around $10 billion.

Yet, once TARP (auto + bank bailouts) was complete, the government profited approximately over $15 billion as a result of the formidable profits generated through bank bailouts. The irony is that the government does not meddle in the affairs of auto companies, and companies like Ford, GM, and Chrysler (which net cost the taxpayer money) are free to raise dividends or buyback shares as they wish. The country's biggest banks have to answer to the Fed, to this day. Is this fair? Political views aside, this in my opinion, seems restrictive, and an over-extension of power.

Furthermore, it is affecting the way banks do business, which ultimately can prevent them from taking risks – or making loans – that they might otherwise make if they had more control over their balance sheets. I'm not arguing to let banks run hog-wild and take excessive risks like they did pre-crisis, However, the irony of excessive oversight is that we could be inhibiting the very activity we need to generate more economic growth.

-Mitch

**About Mitch Zacks**

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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