The results of the 2020 Comprehensive Capital Analysis and Review (CCAR) stress tests of the largest US banks have revealed that despite COVID-19 and the prospect of pandemic-led loan losses, the sector remains in good shape. In this investment note, our US bank portfolio management team takes a closer look.

# Assessing the impact of the Comprehensive Capital Analysis and Review on US banks

On Thursday 25 June, the US Federal Reserve Board (the Fed) announced the results of the 2020 CCAR stress test of the country's largest banks, which this year included additional analysis given the ongoing pandemic[1]. The supplementary analysis sought to assess how resilient banks are to the current downturn, as it differs from a more typical business–cycle-led-recession. All of the banks passed the stress test; however, the initial market reaction was negative, given investor caution about the recent increase in global coronavirus cases.

Although there will be a range of opinions, the outcome was largely in line with our expectations. Fed Vice Chairman for Supervision Randal Quarles observed that "the banking system has been a source of strength during the crisis and the results of our sensitivity analyses show that our banks can remain strong in the face of even the harshest shocks."[1] This is an important differentiator from the global financial crisis when the banking system was at the heart of the downturn. After the first round of Fed stress tests in 2009, the banks were collectively told to raise US$75 billion in additional capital.

As expected, the Fed kept its share buyback restrictions in place. The Street does not anticipate this will start again until 2021 when the economic recovery is expected to be more firmly established[2].

Prior to the Fed's release of results, investors appeared to be more concerned about how the Fed would treat dividends, which were subsequently capped at second-quarter levels and below recent earnings. However, most of the banks should be able to maintain their current dividends under this framework. That said, it could be a limiting factor for a small group of banks. After the market close on Monday 29 June, we received clarity as individual banks announced their capital plans and the majority reaffirmed their dividends going forward, which has been positively received by the markets.

To reflect the current stress tests, an additional requirement this year is for the banks to resubmit and update their capital plans in the third quarter. We view this as appropriate, given the dynamic nature of the recovery.

We would note that the COVID-19 scenario analysis showed that the banks could suffer significant pandemic-driven loan losses. However, we believe that revenue, capital, and loan-loss reserves are sufficient to absorb these potential losses. Additionally, the stress tests scenarios were extremely severe relative to the current situation. For example, one parameter assumed that US unemployment would peak at 19.5% – meaningfully worse than today's levels. Moreover, the Fed excluded the mitigating effects of government stimulus payments and expanded unemployment benefits that have provided significant support to the economy. Therefore, we think it is unlikely that loan losses will approach these worst-case scenarios.

What the stress-test process has shown is the strength of the banks' balance sheets, even under extreme stress. Furthermore, valuations remain historically low on both a relative and absolute basis. As such, we believe that US banks offer long-term investors a compelling opportunity.

[1] Press release of the Board of Governors of the Federal Reserve System, 26 June 2020.
[2] Manulife Investment Management, June 2020

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