TFA Monthly Newsletter

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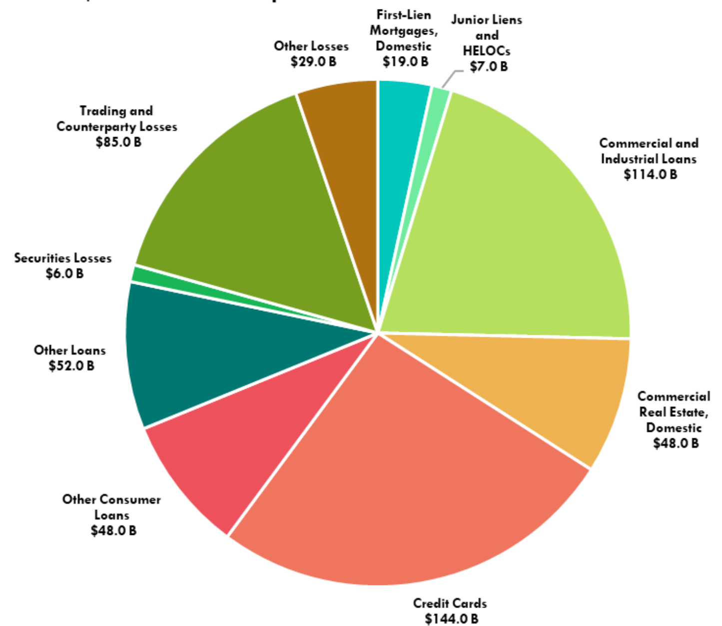
Stress Testing: The Fed's Forecast on Bank Capital

By David Howard

As the COVID-19 pandemic forced tribes to shut down their gaming operations in mid-March, lenders were concerned about many tribal casinos' ability to weather the storm. Over the past several months, tribes have participated in ongoing conversations with their banks, securing waivers and amendments to cure various defaults and avoid future issues with their debt agreements and covenant levels. With a combination of cash reserves, tribal grants & loans to the casino, bank lines of credit, and disaster relief funds (PPP, CARES Act funding, etc.), it appears that most tribal casinos have weathered the shut-down. Cash coffers are slowly beginning to refill as properties have thankfully started to re-open across the country (817 of 989 open as of 7/1/20 per the AGA). We may again see the need for additional amendments and covenant resets once the "new normal" levels of cash flow are tested – but for now many are breathing a sigh of relief.

Now, let's look at how the banks stack up in their ability to weather the storm. Not only have banks been worried about tribal casino loans, they have concerns with multiple business sectors under stress, including commercial casinos, hotels, restaurants, real estate, credit cards, home mortgages, and other businesses across the country. To the right are the projected losses by sector in a severely adverse scenario from the 1st Quarter of 2020 through the 1st Quarter of 2022.



Source: Federal Reserve

Last Thursday, the Federal Reserve released the initial results of its annual bank Stress Test as part of the Dodd-Frank Act. The Fed tested 33 banks to see how their regulatory capital would handle various downturn scenarios. The purpose of the stress test is to ensure banks maintain adequate liquidity to lend to customers and businesses, even under extremely unfavorable economic conditions.

Through these tests, one of the key ratios the Federal Reserve monitors is the Common Equity Tier 1 Capital Ratio. It is the base level of capital a bank needs to maintain when stressed from potential losses during an economic downturn,

(Continued on Page 2)

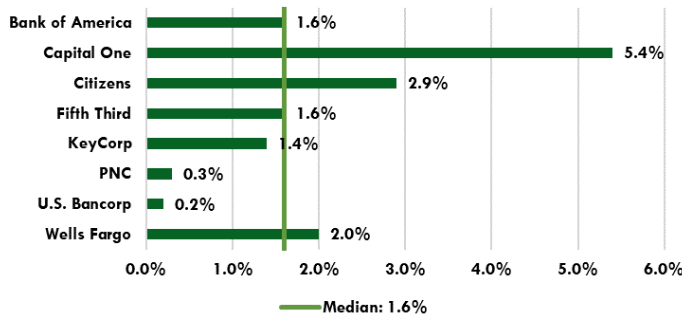
(Continued from Page 1)

while also maintaining the ability to extend credit to borrowers. Below are the latest capital ratios of several banks which are regular lenders to Indian Country. Included are capital ratios for the 4th Quarter of 2019, as well as the capital ratios for the ending period (1Q22) and minimum requirement throughout a severely adverse scenario (with 10% peak unemployment and -8.5% peak-to-trough GDP change).

Firm	Common Equity Tier 1 Capital Ratio		
	Actual 4Q19	Ending Period	Minimum Requirement
PNC	9.5%	10.0%	9.2%
Bank of America	11.2%	9.8%	9.6%
Wells Fargo	11.1%	9.7%	9.1%
U.S. Bancorp	9.1%	9.3%	8.9%
Fifth Third	9.7%	8.1%	8.1%
KeyCorp	9.4%	8.1%	8.0%
Citizens	10.0%	7.1%	7.1%
Capital One	12.2%	6.8%	6.8%

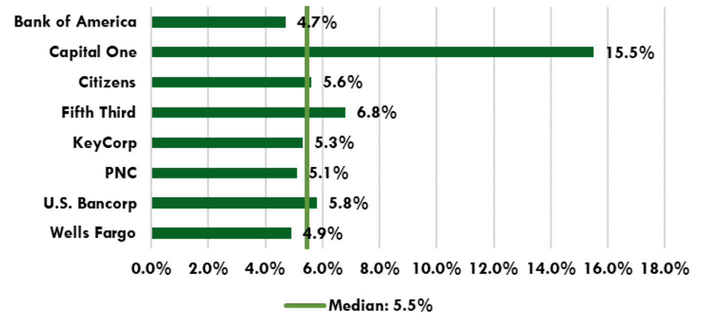
Source: Federal Reserve

The chart below illustrates the change in the banks' equity requirements from pre-recession 4Q19 to what will be required in the period that is likely at the end of the recession (1Q22) in a stressed scenario. For example, the Federal Reserve expects that US Bank will see little change in their overall required capital levels given the characteristics of their current loan portfolio. On the other hand, the Fed expects Capital One to have more loans committed and/or more loan losses by the end of the period, and further, that they will be right on top of their required level (which is 5.4% lower than the cushion they had at the end of 2019).



Source: Federal Reserve

As of the latest actuals from the 4th Quarter of 2019, the majority of banks were well capitalized before shutdowns began. Though none of the listed banks are expected to drop below the minimum capital ratio requirement, many are fairly close to breaking minimum covenant levels by the end of the forecasted period. Furthermore, the below chart demonstrates the estimated amount of loan losses throughout the projected period, expressed as a percentage of the average loan balance within the respective bank's loan portfolio. Provisions for loan losses decrease a bank's net income, possibly causing banks' capital ratios to shrink closer to the required minimum levels.



Source: Federal Reserve

To maintain strength within banks' balance sheets, the Federal Reserve has suspended share repurchases and placed a cap on dividend growth through the 3rd Quarter of 2020. Additionally, banks are expected to re-assess their capital needs, submit updated capital plans, and undergo further stress testing later this year. Overall, banks are expected to experience upwards of $552 billion in losses, however, will maintain the ability to continue lending during this economic contraction.

Why is this all important? We need lenders in Indian Country to remain as strong as possible. Stress on banks' capital ratios and liquidity due to loan losses will likely result in tighter lending parameters and increased pricing to tribal borrowers, even if casinos and other tribal economic enterprises are performing well.

If you have any questions or comments, please feel to reach out to the members of our team. We hope you are all staying safe!

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