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THE FED TRIES TO BOOST BANKS WITH A STRESS TEST

The Federal Reserve sought to bolster confidence in the U.S. banking systems as concerns over the European sovereign-debt crisis roil financial markets and pose risks to the economic expansion. Yesterday, the Fed told the 31 largest U.S. banks to test their loan portfolios against a deep recession to ensure they have enough capital to withstand losses. Banks with large trading operations will also test against a European market shock. The most severe scenarios that were outlined by the Fed include an unemployment rate of as much as 13 percent, an 8 percent drop in gross domestic product and a 52 percent plunge in the stocks from the third quarter of 2011 to the fourth of 2012. ''This is a daunting test,'' said Karen Shaw Petrou, who is a managing partner at Federal Financial Analytics, a Washington regulatory research firm whole clients include some of the largest banks. ''The Fed's credibility as a tough guy can't be challenged based on this.'' The stress tests, that the Fed said don't represent its outlook for the economy, aim at making the banks' capital adequacy more transparent by demonstrating whether they can handle a deeper downturn and financial market shock. The Fed helped to clear away all the uncertainty from the surrounding banks in May of 2009, when it published stress tests showing that 10 U.S. firms needed to raise a total of &75 billion, giving the investors a little more clarity. ''Transparency is very important to enhancing global stability,'' and ''helps with the overall confidence of the banking system,'' said Sabeth Siddique, who is a director at Deloitte & Touche LLP and a former assistant director on the Fed's supervision and regulation staff. The KBW Bank Index (BKX), which includes shares of 24 companies, including Bank of America Corp. and Capital One Financial Corp., is down 31 percent this year, which is compared with a 5.5 percent drop for the Standard & Poor's 500 Index. The Fed aims to prevent the kind of capital depletion that occurred both before, and during, the financial crisis, when the firms bought back stock and paid dividends even as their loan portfolios soured and the economy deteriorated. ''One of the central components of prudential regulation is capital adequacy,'' said Federal Reserve Governor Daniel Tarullo, in an interview. ''We saw in the years preceding the crisis the floodgates open and capital flow out of firms whose ability to weather a storm was actually diminishing.'' On June 15 of this year, Patrick Parkinson, who is the director of the Fed's Division of Banking Supervision and Regulation, said that the 19 largest banks paid out more that $43 billion in dividends in 2007 and an additional $39 billion in 2008. The goal ''is to ensure that institutions have robust, forward-looking capital planning process that account for their unique risks, and to help ensure that institutions have sufficient capital to continue operations throughout times of economic and financial stress,'' the Fed said in one of their statements.