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Stonebridge F.A.Q. on the Preferred and Hybrid Securities Market Following the Fed Stress Test Results, July 6, 2020

In light of the release of the Federal Reserve's 2020 stress test results on June 26th, we would like to reiterate Stonebridge's comfort level with our positions in U.S. bank preferred securities. Overall, we believe that the results were favorable for preferred securities dividends.

How has the U.S. Preferred and Hybrid Securities Market reacted to the Fed Stress Test Results?

The preferred and hybrid securities market had a fairly muted reaction to the stress tests across all market segments, with the broad market (P0P1) off less than a quarter point since the results were announced. Looking forward, we believe the positive results of the stress tests coupled with attractive valuations should be supportive of the market. The current yield spread of the broad preferred market (P0P1) versus 10-year Treasuries (GA10) has widened during the quarter by 35 bps despite returning 7.21% through 6/29/2020, as the entire Treasury curve moved sharply lower. The preferred and hybrid securities market is trading at a current yield spread of 482 bps (source: ICE BofA as of 6/29/2020), which represents the widest yield spread in over 7 years. We believe this combination of solid credit quality and attractive valuations provides a solid foundation for future returns.

Why is the Fed stress test important?

The Federal Reserve (Fed) runs an annual stress test on the largest U.S. banks to assess their ability to remain above minimum capital requirements during a severe economic shock. This stress test is part of the Comprehensive Capital Analysis and Review (CCAR) process which assesses the capital adequacy of the banking sector. Each bank submits a capital plan as part of the process which the Fed reviews in the context of the bank's stress test numbers. This year, the Fed added a new component to set each bank's minimum capital requirements for the next year based on their capital depletion under the stressed scenario.

What did the Fed implement for capital actions across banks in the third quarter of 2020?

For the third quarter of '20, the Fed announced:

- the suspension of share repurchases (majority of banks had already suspended buybacks)
- a restriction on dividend growth to 100% of last quarter's amount
- a limit on the maximum common dividend payout using the average quarterly net income from the four preceding calendar quarters
- the authorization that banks make scheduled payments on additional tier 1 and tier 2 capital instruments[1] (which includes preferred securities)

[1]Additional Tier 1 capital – a component of Tier 1 capital for the banks made up primarily of preferred-like securities.
Tier 2 capital – a component of total capital for the banks made up primarily of subordinated debt securities.

What are the implications for preferred securities dividends?

In our view, this outcome was favorable for preferred dividends because the Fed ensured meaningful capital retention through the continued suspension of share buybacks and capping of common dividends, while communicating their view that banks are in a strong position to continue paying common dividends. The decision against banning common dividends shows how preferred dividends are not even close to be called into question, in our opinion.

How does the Fed's stress test compare to Stonebridge's internal stress test?

We view the overall results as supportive of the internal stress test that we ran two months ago. On average, Stonebridge's internal stress test had total losses of each bank at ~50% of those reported in the Fed stress test, which makes sense since we forecasted four quarters of losses vs. nine quarters in Fed stress test. While some of the Fed's economic assumptions were more harsh than our assumptions, the Fed also did not incorporate the potential effects of government stimulus payments and expanded unemployment insurance. Leaving out government stimulus plans calls into question the probability that the Fed's scenarios would actually come to pass.

What impact could the CCAR results have for preferred securities?

Stonebridge believes the regional banks will continue to issue new preferred securities to build up their Tier 1 capital requirement. This is supported by the recent wave of preferred securities issuance we witnessed leading into the CCAR process and think this trend will continue during 3Q20.

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Please note: All opinions expressed constitute judgements as of the date of release and are subject to change without notice. There can be no assurance any forecasts will be achieved.

Index Definitions:

P0P1 – ICE BofA Fixed Rate Preferred Securities Index – tracks the performance of fixed-rate US dollar denominated preferred securities issued in the US domestic market. All holdings are investment-grade rated.

GA10 – ICE BofA Current 10-Year US Treasury Index – is a one-security index comprised of the most recently issued 10-year US Treasury note.