Insight

U.S. Banks Sufficiently Capitalized Even Against Worst-Case Coronavirus Scenarios

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Executive Summary

- In the Federal Reserve's (Fed) 2020 bank stress testing exercise, all participating banks were deemed to have sufficient capital to weather a crisis, even when judged against a separate, more extreme coronavirus sensitivity analysis.
- Despite this positive result, the Fed will prevent banks from performing stock buybacks and capped dividends that could be paid in the third quarter.
- S. banks have been central to the coronavirus response and to stabilizing the economy; it is undesirable to interfere with their business in ways not supported by the results of the Fed's own testing.

Introduction

It is not an exaggeration to say that the economy is suffering near-unprecedented strain in the wake of the disruption caused by the coronavirus pandemic. From wild swings in the stock market, to an unemployment rate not seen since the Great Depression, to forecasts that the U.S. economy will shrink 8 percent this year, these circumstances clearly invite comparison to the previous financial crisis of 2007–2008. Although some of the end results will likely be and are already similar, the root causes could not be any more different in that this economic crisis did not originate in the housing and finance sectors. That is not to say that these industries are immune to the impacts of the coronavirus, just that the crisis did not begin there and circumstances have not revealed major systemic structural weaknesses.

At least for now. Widescale distress in the economy necessarily adversely impacts the safety and soundness of U.S. banks and housing finance actors. If either sector were sufficiently imperiled, in the worst case scenario, the current economic downturn could evolve the same distinguishing features of the previous crisis, be they widespread defaults on mortgages or runs on banks, either of which would severely worsen the recession and make the road to recovery that much longer.

All of which begs the question – how safe are banks? Fortunately, that answer has been addressed in the most comprehensive way possible with the release of this year's stress testing results. The Federal Reserve (the Fed) has concluded that all 33 banks involved in testing are well capitalized and "a source of strength" to the economy. Despite this conclusion, the Fed announced that in the third quarter banks could not perform stock buybacks and that dividends repaid to shareholders would be capped. The Fed also announced, for the first time in 10 years, that it would exercise its authority to require banks to resubmit their 2020 capital plans, indicating the Fed's concern about the lack of certainty in the economic outlook.

The role of stress testing

The 2007–2008 financial crisis, and the failure and subsequent bailout of some of the world's largest financial services firms, indicated a need for widescale reform. The Comprehensive Capital Analysis and Review (CCAR) is an annual exercise performed by the Fed that seeks to determine whether banks (or, slightly more specifically, bank holding companies with greater than $50 billion in assets, operating in the United States) hold sufficient capital to appropriately manage the unique risks each bank faces and be able to absorb losses in the event of unforeseen crises. Note that the CCAR exercise is distinct from the Dodd-Frank Act stress testing process (DFAST), which is a similar exercise with more of a forward-focus, performed separately (although, in a break from tradition, the Fed also released DFAST results on the same day as CCAR).

Annual stress testing is made up of two phases. The first phase, considered a lower hurdle, measures whether banks are holding sufficient capital in the event of hypothetical catastrophic losses. The second phase is considered more stringent and focuses on a bank's capital plan, including cash the bank intends to return to shareholders. The results of stress tests are closely followed as the Fed uses them, as seen above, to determine which firms it allows to issue dividends and share buybacks.

The 2020 CCAR results

The 2020 CCAR process was unusual in two regards. First, for the first time in the history of the CCAR individual firms did not pass or fail on the basis of their capital adequacy. This is a result of a regulatory CCAR program change where the Fed will from this year going forward use CCAR results to determine a bank's capital requirement for the following year. This is as opposed to allowing banks to make this assessment themselves and providing oversight (a regulatory change that eliminates autonomy from the banks, neuters the Fed's most effective oversight tool, and removes a vital layer of checks and balances).

Second, the scenarios used by the Fed in the exercise were published in February, before the impacts of the coronavirus had begun to be felt (the worst-case scenario envisaged unemployment at 10 percent, significantly below the current 13.3 percent). Recognizing the need to address these unique challenges, the Fed also required banks to undergo a supplementary "sensitivity" analysis that modelled the impacts on bank capital of three different recovery scenarios: V-shaped (a sharp decline and a sharp recovery); U-shaped (a sharp decline and a gradual recovery); and W-shaped (a double recession). Unlike the normal CCAR, the Fed did not release individual data for the sensitivity analysis, simply noting that all firms in aggregate would meet minimum capital requirements (for a primer on bank capital requirements, see here). Bank capital would, however, decline from the 12 percent of Q4 2019 to between 9.5 and 7.7 percent in the most adverse scenarios. Results of the sensitivity analysis will not impact bank capital requirements in 2021.

At the most fundamental level the 2020 CCAR results represent a win for the banking industry, with Fed Vice Chair Randall Quarles noting that banks have "served as a source of strength, not strain, in the current crisis" and that "[t]he banking system remains well capitalized under even the harshest of these downside scenarios—which are very harsh indeed." This statement appears to address fears that weaknesses in bank capital could have similar implications as in the previous financial crisis, at least in the near term.

This result was not an unqualified victory for the banks, however, as the Fed also announced that for Q3 banks would not be able to perform stock buybacks, and that the dividends banks could return to their shareholders would be capped. In her dissenting statement, Federal Reserve Governor Brainard went further, arguing that banks should be outright prevented from issuing dividends, not merely capped. In addition, all banks involved in the exercise are also required to resubmit their capital plans later this year. The actual impact of these decisions will vary from bank to bank, rendering it difficult to say precisely how dramatic this decision is. Certainly, eight of the largest banks in the United States had already voluntarily suspended buybacks for the first two quarters of the year. By contrast, a restriction on dividends will hit many banks keenly, perhaps none more so than Wells Fargo. The new rule requires that a bank's dividend not exceed average quarterly earnings for the previous year, something that may outright prevent some banks from issuing a dividend for the rest of the year.

The broader context

These results are best assessed with a view to the wider policy context, and in particular the role of banks in emergency relief to businesses and recent moves at the Fed to relax bank capital restrictions.

The most significant legislative response to the coronavirus pandemic to date, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, set aside (an initial) $349 billion to the Small Business Administration (SBA) to guarantee loans to small businesses and $500 billion for the use of the Fed and Treasury for emergency lending programs aimed at key businesses and larger firms. The Fed has moved extremely slowly on its portion of funds provided by CARES, but the SBA's Paycheck Protection Program (PPP) has by contrast been quite successful, providing over $500 billion dollars to small firms across the country, an enormous outlay of funds at rapid speed. The PPP has been the single most effective aspect of the CARES legislative package, and singlehandedly was the largest support for the economy for the month of April. Getting over $500 billion to businesses in need in a matter of weeks is a significant achievement of Congress, Treasury, and the SBA. Perhaps the most credit, however, goes to the U.S. banking system, without which these loans would not have been possible. Just four banks have to date provided over 10 percent of all PPP loans by value, and the average size of PPP loans has decreased without exception for weeks. Congress put U.S. banks front and center in the government's response to the coronavirus, and did so in a manner that at least initially exposed banks to high degrees of risk, a significant portion of which remains in the program today. There is no doubt that without the involvement of U.S. banks, a far higher percentage of small businesses would have gone under.

These efforts are paralleled by continuous efforts at the Fed to decrease the capital requirements placed on banks, from allowing banks to use otherwise impermissible capital reserves to adjusting supplementary leverage ratios. The Fed's exertions have an obvious motivation – to enhance the ability of banks to lend to those who need the capital. The perhaps unintentional result of these efforts, however, has been to almost incidentally roll back a number of Dodd-Frank provisions governing bank safety. That banks were all deemed to be meeting minimum capital requirements in not only the standard CCAR test but also in the most adverse supplementary sensitivity test has the (presumably unintentional) result of demonstrating that the reactionary restrictions of Dodd-Frank are not only unnecessary but doubly unnecessary in times of economic health. That is an aside, however; the key takeaway is that the Fed has used its powers to encourage banks to shed capital to the fullest extent safely possible. Strange, then, to penalize banks for not holding sufficient capital – which in and of itself isn't the case; banks are to be prohibited from their normal course of business even though they meet all the requirements of the CCAR.

Conclusions

Fed Vice Chair Quarles noted, “Today’s actions by the Board to preserve the high levels of capital in the U.S. banking system are an acknowledgement of both the strength of our largest banks as well as the high degree of uncertainty we face.” This is a perfect encapsulation of the dual nature of the CCAR results. Banks remain not only strong but an invaluable source of strength to the economy. That the Fed is preventing banks from making buybacks and capping dividends is a reflection of economic uncertainty, not a lack of safety at the banks.

It remains slightly troubling, however, that banks should be at the very center of Congress’s legislative efforts to provide emergency relief to businesses and yet have their ability to provide a return to their shareholders restricted. Private banking is not an arm of government. If the Fed is concerned about the safety of banks, penalizing them for having lower capital reserves while doing everything possible to reduce capital buffers to encourage lending seems counterintuitive; likewise, if Congress requires banks to keep the economy afloat, it makes little sense to discourage private industry and investment. All that in addition to showing scant gratitude to the providers of the single most effective emergency lifeline to the economy.