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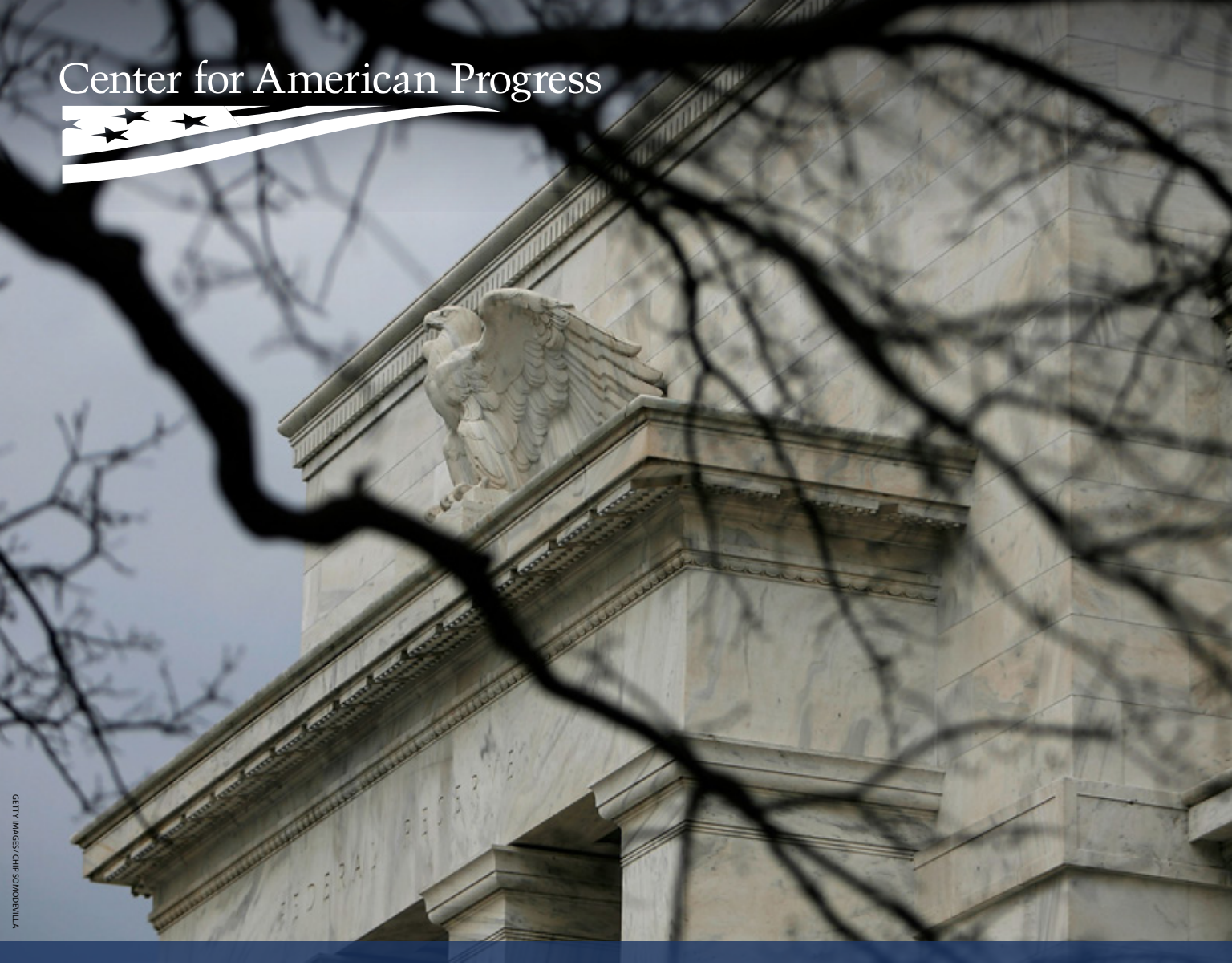

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Bank Capital and the Coronavirus Crisis

4 Ways the Federal Reserve Can Improve the Resilience of the Banking System

By Gregg Gelzinis May 2020

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Introduction and summary

The COVID-19 outbreak has sparked a serious economic downturn that is placing increasingly severe stress on the banking system. Many households and businesses are likely to face grave difficulties meeting their financial obligations in the coming months. Jobless claims have increased by more than 30 million in the past six weeks, and gross domestic product (GDP) is expected to shrink drastically in the near term.[1] Former Federal Reserve Chair Janet Yellen estimates that GDP could drop by 30 percent in the second quarter of 2020, and Federal Reserve Bank of Minneapolis President Neel Kashkari believes that the current unemployment rate could be as high as 23 percent.[2]

As a result, banks' loan, securities, and derivatives portfolios are likely to face serious downward pressures. Other sources of bank income have begun to dry up as well. In the first quarter of 2020, the six major Wall Street banks announced sharp profit declines, driven by large provisions for loan losses.[3] Executives at these banks expressed extreme uncertainty regarding the depth and timeline of the economic downturn. Michael Corbat, CEO of Citigroup, stated, "No one knows what the severity or longevity of the virus' impact on the global economy will be."[4] They were similarly unsure about the extent of the strain that the intensifying crisis will place on bank balance sheets. JPMorgan Chase & Co. CEO Jamie Dimon bluntly stated, "If the economy gets worse, we'll bear additional loss."[5]

In the wake of the 2007-2008 financial crisis, policymakers improved the suite of safeguards that mitigate the chances of instability in the banking system. These efforts have contributed to the banking system's initial resilience to this crisis, unlike large segments of the shadow banking sector that required immediate government intervention.[6] But the Federal Reserve's bank capital decision-making over the past several years, in conjunction with the Federal Deposit Insurance Corp. (FDIC) and the Office of the Comptroller of the Currency (OCC), has needlessly increased the vulnerability of the banking system. This is especially relevant as the economic fallout from the coronavirus crisis is set to escalate in the coming weeks and months.

Regulators should have required banks to continue building their loss-absorbing capital buffers while profits were high and the economy was booming. Instead, they moved in the opposite direction, chipping away at the resiliency of banks large and small. And regulators have continued to erode bank capital requirements during the coronavirus crisis. Regulators' emergency changes have permitted banks to pay out more capital to shareholders and to proceed with concerningly low levels of capital.

This report outlines the general importance of bank capital requirements, and it details the failures of the Federal Reserve's capital policy both before and after the onset of the coronavirus. It offers four recommendations that would allow the Fed to correct its mistakes. Rather than enact changes that benefit shareholders and executives or endanger the financial system, the Fed should suspend all capital distributions; temporarily delay and reformat the annual stress tests; be willing to require banks to turn to equity markets to raise additional capital if necessary; and indefinitely suspend implementation of an ill-conceived package of capital changes—the stress capital buffer (SCB) rule—which is set to increase the fragility of big banks. These actions would bolster the resilience of the financial system and ensure that banks are able to safely support the real economy during this period of severe stress.

The importance of bank capital

Bank failures can severely harm the economies they serve.[7] Businesses and households rely on banks for credit, payment, and other financial services. When enough struggling or failed banks are unable to perform these critical economic functions, businesses shed jobs, consumers pull back their spending, and families suffer the hardships that inevitably accompany an economic downturn. It is therefore critical for policymakers to design a regulatory and supervisory regime that mitigates the chances of distress in the banking system. The bank capital framework is the most important element of such a regime.

Bank capital refers to the portion of a bank's funding, such as common stock and retained earnings, that does not have a contractual requirement to be repaid and can absorb losses when a bank's assets lose value.[8] Contrary to popular nomenclature, capital is not held in a bank vault.[9] Just like debt, it is used to fund the bank's assets. Banks prefer to fund their assets with debt because the tax code, subsidies, and guarantees make it a cheaper source of funding.[10] Executive compensation structures tied to a bank's return on equity and the desire to shift risk to creditors also help fuel this debt reliance.[11] Regulators use capital requirements as a primary tool to limit the chances of bank failures. The more capital funding a bank employs, the higher the losses it can withstand while continuing to provide the financial services the economy needs to grow sustainably. Research shows that an increase in capital is associated with an increase in loan growth and that better capitalized banks expand lending more quickly coming out of a financial crisis.[12] Well-capitalized banks can serve as a source of strength for the economy in good times and bad.[13]

Dangerously low capital was one of the major vulnerabilities in the banking system in the lead-up to the 2007-2008 financial crisis.[14] Banks were unable to safely withstand mounting losses as the subprime mortgage market collapsed and their excessive risk-taking went south. More than 500 banks failed during the crisis.[15] Policymakers bailed out large banks for fear that their failure would completely destroy the economy. Even with the extensive support provided directly to banks,

unemployment increased to 10 percent, 10 million homes were lost, and $19 trillion in wealth evaporated.[16] Between 2007 and 2010, the real wealth of the average middle-class family dropped by nearly $100,000, or 52 percent.[17] The Great Recession made clear what should have already been obvious: Financial crises are catastrophic, and safeguards must be drastically improved to mitigate the risks of a future crisis.

After the crisis, policymakers worked to improve the quality and quantity of required capital in the banking system. Between the first quarter of 2009 to the first quarter of 2017, the 34 largest bank holding companies increased their common equity capital-to-risk-weighted assets ratio from 5.5 percent to 12.5 percent.[18] Despite this significant improvement in bank capital levels heading into the Trump administration, there was still much work left to be done. A strong body of research demonstrated that capital requirements were still below the socially optimal levels.[19] The research on socially optimal bank capital seeks to identify the level that maximizes the economic benefits of reducing the likelihood of financial crises, while accounting for the slightly higher lending costs associated with higher capital requirements. At the start of 2017, banks were at or below the low end of the optimal capital range.[20]

Given the catastrophic economic impacts of instability in the financial system, the data show that the risks of undershooting capital requirements far outweigh the risks of overshooting them. As former Fed regulatory czar Dan Tarullo stated in his farewell address in 2017:

> *In fact, one might conclude that a modest increase in these [capital] requirements--putting us a bit further from the bottom of the range--might be indicated. This conclusion is strengthened by the finding that, as bank capital levels fall below the lower end of ranges of the optimal trade-off, the chance of a financial crisis increases significantly, whereas no disproportionate increase in the cost of bank capital occurs as capital levels rise within this range.*[21]

In addition to improving overall bank capital levels, policymakers wanted the postcrisis bank capital framework to lean against a concerning dynamic that was once again laid bare during the crisis: deregulation in positive economic times. In the years leading up to the crisis, policymakers had chipped away at many financial industry safeguards and refused to implement new rules to curb emerging risks.[22] This deregulatory agenda, advanced while the economy was strong, diminished the resiliency of the financial system. This procyclical dynamic—deregulat-

ing when times are good—was not new. In fact, it has been a common thread in many financial crises throughout history.[23] When things are going well, there is a tendency to assume that "this time is different" and that the financial system has evolved beyond catastrophic crises. That notion—coupled with heavy pressure from the financial industry—fuels a boom, deregulation, and bust cycle.[24] After the most recent iteration of this cycle, policymakers vowed to embed some countercyclicality in the bank capital framework.[25] As the old saying goes, "[T]he worst loans are made during the best of times."[26] Instead of eroding financial safeguards, policymakers should strengthen them during economic expansions. This approach would require financial firms to improve their resiliency while profits are high and the economy is healthy, so they can continue to serve businesses and households when the economy inevitably faces the next downturn.

One tool developed with this goal in mind was the countercyclical capital buffer (CCyB).[27] The CCyB is an additional buffer of loss-absorbing equity capital that can be built up during positive economic times. The CCyB can then be released when the economy faces a downturn and the banking system takes on higher losses as a result. The added layer of protection enables banks to withstand losses, while continuing to serve the real economy.

Building up a layer of added protection when times are good is intuitive: Banks that build capital buffers are able to take on higher losses without failing. But the related dynamic behind allowing a buffer to decrease during a period of stress is not as clear. Banks that experience a decline in capital levels, and face regulatory penalties or otherwise flirt with insolvency, may seek to increase those capital levels by selling assets at fire-sale prices and reducing their debt levels. This occurrence is often referred to as deleveraging or shrinking to safety.[28] While it may be a prudent decision for an individual bank to make, if many large banks do it all at once, it would exacerbate a credit crunch—and businesses and households would suffer the consequences. The CCyB would be lowered during times of stress, so banks would not have to deleverage to increase their capital ratios since the required capital ratio would be reduced.

It is critical to note, however, that there is risk involved with lowering capital during periods of stress. The less capital a bank funds itself with, the more likely it is to fail. Bank failures can have a devasting impact on their communities and, when it comes to the largest banks, the broader economy. The utility of lowering capital ratios during periods of stress, therefore, depends on how high the capital requirements are to begin with. If capital ratios are robust heading into periods of stress,

then regulators can safely reduce them without fear of permitting banks to operate with overly fragile balance sheets. If capital ratios are too low, however, lowering capital during a downturn could cause more harm than good. The Fed finalized the policy framework for activating the CCyB in 2016, setting the stage for its potential use in the next administration.[29]

The capital policy failures of the banking regulators

At the start of the Trump administration, bank capital levels were improved relative to pre-2007-2008 but were still too low. Instead of using tools such as the CCyB to raise capital to safer levels while the economy was strong, Trump-appointed financial regulators spent the last three years moving in the opposite direction—leaving the U.S. banking system vulnerable in the face of the coronavirus pandemic. Regulators have also responded poorly during the crisis, authorizing misguided rule changes that exacerbate their precrisis mistakes.

Precrisis capital errors

The Federal Reserve voted against activating the CCyB in March 2019, despite the emerging vulnerabilities of an economy in the 10th year of an expansion.[30] Federal Reserve board member Lael Brainard dissented from that decision.[31] She had previously pointed to the high levels and poor quality of corporate debt, stretched asset valuations, and other risks as reasons to justify activating the CCyB.[32] Brainard was not the only one calling for the activation of this tool. Former Federal Reserve Chair Janet Yellen, former FDIC Chair Sheila Bair, several regional Federal Reserve Bank presidents, members of Congress, and other policy analysts supported activating the CCyB.[33] With the CCyB at 0 percent heading into the period of economic turmoil triggered by the spread of COVID-19, the Federal Reserve does not have a ready-made tool to prudently relieve banks from the pressure to deleverage through asset fire sales in times of stress. Many other countries, including the United Kingdom, France, and Sweden, did activate the CCyB for banks under their jurisdiction over the past several years.[34] The CCyB is just one tool that could have been used to further improve bank capital positions and move U.S. banks more comfortably into the optimal capital range. Regulators could have also raised the core capital requirements that remain static throughout the economic cycle. Instead of deploying any number of mechanisms to raise bank capital to more prudent levels, however, regulators have spent the last several years chipping away at key requirements.

Last year, the Federal Reserve, OCC, and FDIC finalized a series of regulatory rollbacks for banks that generally have between $100 billion and $700 billion in assets. One change allowed banks with between $250 billion and $700 billion in assets to opt out of an important postcrisis capital requirement that required capital levels to reflect the unrealized gains and losses of available-for-sale (AFS) securities portfolios. AFS portfolios consist of securities that a bank has not designated as trading assets that will be sold in the near term, or as hold-to-maturity investments that will be held until the security is repaid. This requirement was a direct response to a vulnerability that manifested during the 2007-2008 financial crisis. Market participants had little confidence in the regulatory capital ratios that banks reported, in part because those ratios did not incorporate the real-time losses that banks were experiencing on a range of securities investments.[35] The 2019 regulatory rollback was projected to decrease required capital by $9 billion that year, but the impact may be significantly higher now due to recent COVID-19-related price declines in securities markets.[36]

Also last year, the Federal Reserve decided to release detailed information on its own internal models for the annual bank stress tests.[37] This decision, advanced in the name of "transparency," provides banks with the opportunity to reverse-engineer the stress tests. As a result, banks can tailor their balance sheets over time to limit their projected losses in the stress tests, lowering the capital required by the tests.[38] This also fosters "model monoculture": Large banks will tailor their balance sheets in similar ways to game the stress tests, increasing the correlation of risks in the banking system.[39] This dynamic would increase the chances of many banks experiencing stress at once if a particular shock were to expose a common vulnerability. Former Federal Reserve board member Tarullo recently stated, "I suspect quite strongly that the effective amount of capital the banks have to have for a given portfolio is lower because they have so much more information about the stress tests."[40]

In addition, the Federal Reserve recently finalized the SCB rule, a major change to the bank capital framework.[41] The policy decisions embedded in the SCB final rule, adopted in February, would lead to reduction in capital levels and an increase in the fragility of big banks. As Brainard stated in her dissent, "[The] rule gives a green light for large banks to reduce their capital buffers materially, at a time when payouts have already exceeded earnings for several years on average."[42] The final rule drives capital down by watering down two important assumptions used in the stress tests.[43] The SCB rule would also remove all leverage measures from the annual stress tests. Leverage capital requirements do not factor in the real or per-

ceived riskiness of assets and complement the more complex set of risk-weighted capital requirements. They were the binding capital constraint for several big banks in recent stress tests. The rule would reduce the capital requirements for the nation's largest banks by $100 billion or roughly 7 percent.[44]

As a result of these deregulatory changes, capital has started to decline at large banks—exactly when it should be increasing. In its November 2019 financial stability report, the Fed noted that "several large banks have announced plans to distribute capital to their shareholders in excess of expected earnings, implying that capital at those banks will decrease."[45] Similarly, the minutes for the January 28–29 meeting of the Fed's Federal Open Market Committee state, "Several participants noted that planned increases in dividend payouts by large banks and the associated decline in capital buffers might leave those banks with less capacity to weather adverse shocks—which could have negative implications for the economy—or that lower bank capital ratios could be associated with greater tail risks to GDP growth."[46]

Banking regulators also provided capital relief to community banks. Congress directed regulators to establish a community bank leverage ratio (CBLR) between 8 percent and 10 percent in the Economic Growth, Regulatory Relief, and Consumer Protection Act.[47] Eligible banks with less than $10 billion in assets that satisfy this one capital requirement are effectively exempted from the risk-weighted capital requirements that would otherwise apply to them. Risk-weighted capital requirements and leverage requirements complement one another. Risk-weighted assets can be gamed and rely on the fallible judgements of regulators; leverage requirements do not. But leverage rules incentivize banks to load up on riskier assets. Risk-weighted requirements lean against such higher-risk exposures. Instead of prudently opting for the top of the CBLR range—given the risks associated with relying so heavily on just one type of capital requirement—regulators adopted a 9 percent CBLR.[48] The CBLR final rule also provides banks with a two-quarter grace period if a bank's ratio drops below 9 percent but stays above 8 percent. Setting the CBLR at 9 percent means that roughly 83 percent of eligible banks with less than $10 billion in assets can opt into this framework, and avail themselves of the risk-weighted capital exemption, without increasing their capital levels.[49]

Capital mistakes during the coronavirus crisis

Over the past several weeks, financial regulators have made decisions that weaken the banking system's ability to respond to the coronavirus. In March, the Fed,

OCC, and FDIC made technical rule changes that enable large banks to make higher shareholder payouts and reduce the amount of loss-absorbing equity on their balance sheets.[50] These misguided changes were an attempt to realize the policy benefits that would have come with reducing the CCyB, had it been enacted. The regulators amended the conservation capital buffer and total loss-absorbing capacity (TLAC) rules to permit big banks to make higher capital distributions as they dip into their capital buffers during this period of stress.

Over the past year, many large banks have distributed most or all of their profits through dividends, share buybacks, and discretionary bonus payments to executives.[51] If they were to dip into their capital buffers as they experience losses or increase borrowing to fund additional lending, they would be automatically restricted on how much capital they could distribute. The permitted capital distributions are restricted to a certain percentage of a bank's eligible retained income. Essentially, banks that breach their capital buffers can distribute a percentage of their net income from the past four quarters, net of the capital distributions they made over that period. Therefore, banks that have been paying out most or all of their net income over the past year are more restricted than other banks as they dip into their capital buffers, as their eligible retained income is small or nonexistent.

This structure effectively embeds an incentive for prudent capital planning during good times. Regulators' recent rule changes alter the definition of eligible retained income in the conservation capital buffer and TLAC rules so that banks that had been distributing a lot of capital recently are not as restricted as they would be under the old definition. Practically speaking, these changes enable large banks to pay out more money to shareholders and executives. The idea behind this change is similar to the justification for lowering the CCyB. The Fed wants to disincentivize banks from deleveraging to stay above their capital buffers in order to continue distributing capital. The critical difference, however, is that capital was not previously raised to high enough levels to justify a relaxation of capital requirements during this period of stress. This change permits banks to more easily and rapidly deplete capital, increasing their likelihood of failure as they provide short-term benefits to shareholders and executives. Importantly, the Fed could have instead suspended capital distributions for all banks to limit their incentive to stay above their capital buffers. Allowing banks to make larger payouts to shareholders and executives runs counter to the stated goal of supporting lending to businesses and households.

A week after making these rule changes, the Fed, OCC, and FDIC announced an interim final rule that further reduced loss-absorbing equity.[52] The rule does this by carving out reserves held at the Fed and Treasury securities from the denomi-

nator of an important leverage capital requirement, the supplementary leverage ratio (SLR). This decision lowered the capital requirements for the largest banks by $17 billion immediately and by up to $76 billion over time.[53] Notably, the final rule did not restrict the ability of banks to distribute that capital to shareholders and executives; it merely cautioned banks against doing so and encouraged them to increase lending for businesses and households.

Regulators gave two primary reasons for this change.[54] The first reason mirrored the justification provided for the change to the definition of eligible retained income: to reap the benefits of countercyclical capital policy. Regulators argued the change would prevent banks from deleveraging in a crisis and would permit them to take on more leverage generally to increase lending.

The second reason was to relieve a different, but interrelated, pressure that banks claim has intensified. As institutions withdraw cash from investment funds or liquidate securities, they may move that cash quickly into bank deposits. Banks will then take the influx of deposits and park them, at least temporarily, in safe assets such as central bank reserves or Treasury securities. The Fed's monetary policy decision to significantly expand its balance sheet has also contributed to the increase in bank reserves.[55] A rapid crisis-related influx of deposits can quickly increase the denominator of bank leverage ratios, thus decreasing the ratios. If banks then bump into their regulatory leverage limits as a result, they may turn away customer deposits or take other steps to deleverage.

It is clear, however, that difficulties caused by rapid deposit increases can be handled without meaningfully reducing bank equity. In 2014, regulators anticipated this crisis dynamic and adjusted the leverage ratio calculation accordingly. At the time, regulators stated:

> *The agencies believe that using daily average balance sheet assets, rather than requiring the average of three end-of-month balances in the calculation of the supplementary leverage ratio under the 2013 revised capital rule would be an appropriate way to address the commenters' concerns on the impact of spikes in deposits and, in the 2014 NPR [notice of proposed rule-making], are proposing changes to the calculation of total leverage exposure that would incorporate this concept.*[56]

Moreover, Congress carved out reserves held at the Fed from the denominator of the leverage ratio for custody banks in 2018 legislation.[57] Custody banks focus on custodial and administrative services for large investors.[58] They are arguably

the class of banks that face the most acute version of this dynamic. That decision, itself concerning due to its impact on capital requirements for three major custody banks, should have mitigated this pressure and eliminated the need for broader regulatory action during the coronavirus crisis.[59] If Congress had wanted the Fed to make this change for noncustody banks, it would have done so in that legislation or in the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

However, even if both the original 2014 adjustment to the capital rules and the additional 2018 legislative change were insufficient to address this dynamic, the Fed could have made narrower changes that would not have decreased capital and exposed the banking system to serious risks. The Fed could have limited the exemption to central bank reserves and Treasury securities above current levels, tied directly to a bank's demonstrated increase in deposits. In short, the level of central bank reserves and Treasury securities on a bank's balance sheet prior to the COVID-19-induced stress would not be exempted. And the increase in Treasury securities and central bank reserves going forward would only be exempted to the extent that bank deposits increased above precrisis levels. An alternative option would be for the Fed to simultaneously increase the leverage ratio proportionally to the expected decrease in capital. That approach would keep capital levels flat, instead of allowing banks to operate with lower capital. It is also important to note that the Fed's decision, in one way, actually decreases banks' incentives to lend. By exempting central bank reserves and Treasury securities from the SLR, the Federal Reserve made those assets more financially attractive for banks than before. In turn, lending to businesses and households is now more expensive in relation to these exempted assets.

Larger banks have not been the only beneficiaries of reduced capital requirements during this crisis. Congress temporarily lowered the CBLR from 9 percent to 8 percent in the CARES Act until the end of 2020 or until the disaster declaration is lifted, whichever is sooner.[60] The banking regulators went even further than Congress directed when implementing this provision. Under the banking regulators' interim final rule, the CBLR will not reach 9 percent again until January 2022 and banks are provided with a two-quarter grace period if their ratios drop below 8 percent but stay above 7 percent.[61] If the CBLR had been set at 10 percent, then more banks would have had to increase their capital levels to take advantage of the risk-weighted capital exemption.

In making these capital changes, for large banks and small, regulators have not restricted banks' ability to make capital distributions to shareholders and make

discretionary bonus payments to executives. It is wholly unacceptable that regulators are facilitating the enrichment of shareholders and executives as a deeply uncertain economic crisis looms. The next section will expand on this topic.

Regulators should rescind these changes and pursue a regulatory agenda that ensures banks remain resilient as this crisis worsens. As a bare minimum step, they must ensure the changes will be truly temporary. There will be immense pressure from the banking industry and their allies in Congress to make these changes permanent when the crisis ends.

Policy recommendations

In addition to rescinding the concerning decisions it has made over the past several weeks, the Federal Reserve should take the following four steps to bolster the resiliency of the banking system: suspend all bank capital distributions; perform robust crisis stress tests; be willing to require banks to turn to equity markets to raise additional capital if needed; and indefinitely delay the implementation of the SCB rule.

Suspend all bank capital distributions

Although Wall Street banks have announced that they are suspending share buybacks for the first two quarters of this year,[62] the Fed should step in and enforce a full suspension of all bank capital distributions during the coronavirus crisis, including dividends and discretionary bonus payments. The suspension should at least cover banks with more than $50 billion in assets, not just the largest Wall Street banks. Such a suspension should be considered for community banks as well.[63]

As the economic fallout of the COVID-19 pandemic intensifies in the coming weeks and months, the banking system may face increasingly severe stress. Despite the economic support provided by Congress and the Federal Reserve, businesses and households could still face significant difficulties meeting their financial obligations. Banks must be prepared to withstand the losses associated with this economic turmoil, while continuing to provide the credit and financial services upon which the real economy depends. Suspending dividends would preserve roughly $40 billion of capital per year and preventing banks from restarting share repurchase programs could preserve an additional $75 billion in capital during the final two quarters of this year.[64]

Suspending capital distributions would increase equity funding that could be used for supporting businesses and households instead of shareholders and executives. It is important to reiterate that every dollar of capital distributed to shareholders

and executives is a dollar of capital unavailable to withstand losses and support lending to businesses and households. Assuming banks maintain their capital ratios as distributions are suspended, that extra dollar of capital can support more than $15 in additional lending.[65] This step would also disincentivize deleveraging. In March, the Fed changed the eligible retained income definition to prevent banks from fighting to stay above their capital buffer thresholds by selling off assets at fire-sale prices in order to continue making capital distributions. That same incentive to deleverage to avoid restrictions on capital distributions—the penalty for breaching capital buffers—is relieved if all banks have to suspend capital distributions. A bank that breaches its capital buffer is treated the same as a bank hovering above the buffer. Moreover, banks would be incentivized to dip into their leverage capital buffers for the same reason, diminishing the need for the recently implemented SLR carveout. The Bank of England effectively required a suspension in capital distributions for the banks within its jurisdiction.[66]

Acting early to suspend capital distributions is a critical lesson that policymakers should have learned in the 2008 financial crisis. The Federal Reserve Bank of Boston found that if policymakers had suspended distributions at the start of the recession, the largest banks could have retained $80 billion in capital—about half of the value of the bailout capital that was ultimately injected into them.[67] Janet Yellen recently stated, "We learned that we let way too much money out the door in that crisis."[68] Sheila Bair, the FDIC chair during the 2008 crisis, described the Fed's current reluctance to suspend distributions a "mystery."[69] A chorus of other former policymakers have also called on the Fed to suspend capital distributions.[70] The richest 10 percent of U.S. households own 84 percent of the total stock market, so the argument that temporarily suspending bank capital distributions would materially harm middle-class investors is woefully unconvincing.[71] The social economic benefits of limiting the chances of COVID-19-induced bank failures far outweigh any inconvenience cost for bank shareholders and executives.

Banks themselves cannot be expected to do this on their own for several self-interested reasons, including a clear collective action problem. Even if one bank wanted to take the prudent long-term action of suspending capital distributions, the market would view it as a sign of weakness and exacerbate any stress at the bank as creditors try to limit their exposure. In the future, policymakers should consider embedding strict automatic capital distribution suspensions into the regulatory framework. The automatic restrictions could be tied to metrics of economic or financial sector stress, including the Fed's invocation of its emergency lending authority.[72]

Regulators must step up and act immediately. It is unconscionable to allow banks to distribute capital to shareholders and executives given this immense economic uncertainty and the enormous downside risks that would come with a wave of bank failures.

Perform robust crisis stress tests

The Fed should also provide stress-test results that are based on the current state of the financial system. The results of the most recent stress tests are scheduled to be announced in June. However, the test outcomes will be based on the effects of hypothetical shocks on bank balance sheets as of December 31, 2019. Bank balance sheets have changed substantially since then, and with respect to several macroeconomic variables, the current stress in the financial system has already surpassed the levels of the hypothetical severely adverse scenario for this year's stress tests.[73] Moreover, a key assumption used in the test—that bank balance sheets remain flat during a crisis—has already proven to be drastically off base.[74] Bank balance sheets have grown substantially during this crisis. JPMorgan Chase & Co. alone has grown by about 20 percent.[75]

Lightly stressing, relatively speaking, bank balance sheets as they stood on December 31 has limited utility. At best, the overly rosy results will be broadly ignored due to their lack of credibility. At worst, the results will provide regulators, policymakers, and the public with a false sense of confidence. If the Fed has not suspended distributions by this point, banks would undoubtedly use the positive results as strong ammunition to push for even greater capital distributions. Instead, regulators should briefly delay the tests and then stress the already stressed balance sheets of banks to determine whether they can safely handle a deepening crisis. The first stress-testing exercise in 2009, the Supervisory Capital Assessment Program (SCAP), was taken seriously because it was credible.[76] The tests were not shocking the precrisis balance sheets of banks with a less stressful scenario than what was likely to occur. SCAP robustly tested battered bank balance sheets to determine if they had sufficient capital levels to withstand an intensifying crisis.

Moreover, this period of stress should be a wake-up call for the Fed regarding the weaknesses of the current stress-testing regime. Any time actual stress threatens to far exceed the hypothetical stress in the supposedly severely adverse scenario, it calls for some self-reflection. It is inherently difficult to predict the precise nature

of future shocks, and stress tests only use one of thousands of potential scenarios. Moreover, the current tests do not fully capture certain financial crisis dynamics that exacerbate losses.[77] Going forward, the Fed must either develop novel stress-testing approaches that better approximate a crisis and use more imaginative scenarios, or make the current assumptions and models far more severe to account for those present shortcomings.

Be willing to require banks to turn to equity markets for additional capital

The Fed should be prepared to require that banks turn to equity markets to raise additional capital if the stress tests indicate that they lack sufficient loss-absorbing capacity to weather further economic deterioration. The decision to do this in 2009 helped stabilize the financial system, and it would have a similar effect today.[78] Banks are healthy enough at this point that equity markets are still a viable option to raise capital if necessary.[79]

Federal Reserve Bank of Minneapolis President Neel Kashkari, a senior staffer to Treasury Secretary Hank Paulson during the 2008 crisis, has already called on big banks to turn to equity markets to increase their loss-absorbing capital cushions now.[80] He argues that raising capital today "would ensure that large banks can support the economy over a broad range of virus scenarios."[81] If it turns out that banks do not need the extra capital funding preserved through distribution suspensions or stress-test-linked equity issuances, Yellen and Kashkari have both rightly noted that banks would be free to return that capital to shareholders after the crisis.[82]

Indefinitely delay the implementation of the SCB rule

Finally, the Fed should indefinitely delay the implementation of the SCB rule. The Fed should not be lowering capital requirements right now. The SCB rule would permit banks to lower their capital ratios and would undermine leverage requirements in particular. There is no compelling justification for only requiring banks to meet risk-weighted capital requirements as part of the stress tests.[83] In fact, leverage requirements are the more important measure of capital adequacy during periods of stress.[84] During the 2007-2008 financial crisis, market participants lost faith in risk-weighted capital ratios due to regulators' fallibility in setting the weights and the vulnerability of these requirements to financial engineering.[85] It

is financial stability malpractice to erode this type of capital requirement as the financial system undergoes stress. Moreover, suspending the SCB rule would enhance the credibility of the delayed stress-testing exercise because the exercise would not include the SCB rule's newly adopted—and deeply flawed—assumption that bank balance sheets would remain flat during a crisis.

Conclusion

The postcrisis improvement to the quality and quantity of bank capital is one reason banks have not yet teetered during this crisis, unlike nonbank financial institutions and markets that required immediate support. But the decisions executed by the Federal Reserve and other banking regulators over the past several years have meant that the banking system is more fragile than it should be in the face of the coronavirus crisis. Furthermore, their decisions during the crisis have increased the risk that the pandemic-induced financial stress will evolve into a banking crisis over time.

The Fed can still change course, but time is running out. It must quickly take the four steps described in this report to improve the likelihood that banks can weather this economic catastrophe and serve as a source of strength to a struggling economy.[86]

About the author

Gregg Gelzinis is a senior policy analyst for Economic Policy at the Center for American Progress. Gelzinis focuses primarily on financial institutions, financial markets, and consumer finance policy. His analysis has been quoted in *The New York Times*, *The Washington Post*, *The Wall Street Journal*, and other publications. Gelzinis graduated summa cum laude from Georgetown University, where he received a bachelor's degree in government and a master's degree in American government and was elected to the Phi Beta Kappa Society.

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