Some Thoughts on the Bank Regulatory Picture: Dividends, CECL, Buffers and the Rest

By Greg Baer and Anna Harrington

May 15, 2020

Echoing moves by European and British regulators, a few commentators have urged the Federal Reserve Board to mandate a blanket halt to dividends by U.S. banks.1 While this idea has not taken hold, explaining why is a useful point of departure for assessing how a series of post-2010 regulatory and accounting changes are operating under their first wartime test. In short, a governmental ban on bank dividends would not produce additional lending, would undermine the credibility of a regulatory regime that thus far has worked well, and would do permanent damage to the banking industry by driving its already low market values still lower, with adverse consequences for its ability to support economic growth.

Calls for a government ban on dividends appear to have two goals. The first is to expand the lending capacity of banks in the midst of the current crisis. The second is to ensure that banks have sufficient capital to weather coming losses. As described above, both of those goals are already being well served by a myriad of post-crisis regulations, and thus a dividend ban would come with no marginal benefit; it would, however, come with significant costs.

BANKS’ LENDING CAPACITY

U.S. banks dramatically expanded their lending to U.S. businesses at the onset of the current health and economic crisis.2 In the first quarter alone, the largest banks extended more than $400 billion in lending, primarily by funding draws on lines of credit as large and small businesses sought to stockpile cash.3 While there has been much attention paid to Federal Reserve support for the economy, the fact is that to date Fed lending has risen $120 billion,4 while bank lending has risen by $800 billion.

This state of affairs is remarkable. The natural reaction of banks is to shrink when faced by bad economic news, market instability and uncertainty. Banks were able to expand lending significantly in recent months because they entered the crisis with extraordinarily high levels of capital which allowed them to fund massive draws on credit lines. This balance sheet capacity was also supported by each of the largest banks voluntarily deciding to halt share repurchases through the second quarter and update its capital plan accordingly.

---

The story on liquidity is much the same. U.S. banks entered the crisis with extraordinarily high liquidity levels, and the crisis has actually improved their liquidity position. As the Federal Reserve noted in its recent supervisory report, “Bank deposits and loans grew at extraordinary rates in March. Bank deposits surged as investors favored safe assets and pulled back from other short-term investments such as prime money market funds.” Furthermore, “While bank loans have grown sharply, deposits have grown just as rapidly, supporting banks’ healthy liquidity positions.”

The ability of banks to meet future demands for credit will be shaped by a variety of rules and regulations, including the allowance for loan and lease losses, risk-weighted capital measures, capital buffers, and stress testing—all of which have been ignored by those who see a government-mandated dividend halt as the only answer to maintaining lending capacity. Even then, there remain two equally important questions that depend not on regulation but on economic reality: whether there will be large demands for credit for banks to meet, and whether meeting them is consistent with safe and sound banking.

**CECL**

Beginning in the first quarter of this year, the current expected credit loss accounting standard (CECL) required banks to establish for each existing and new loan an allowance for the estimated future life of the loan, based on the current macroeconomic forecast and past loss history. This change was a major departure from the preexisting incurred-loss method of accounting, which required an allowance only for loans where a loss was probable and estimable. Now, every loan carries an allowance at all times; previously just a small percentage of loans—those that had actually shown signs of impairment—carried an allowance, and only then after default became probable and estimable. This accounting change went into effect for publicly traded companies in January, such that the transition to CECL has more or less coincided with the COVID-19 pandemic and its economic impacts.

An allowance is basically a reserve that the bank establishes by charging an expense against its income—in effect, it uses up capital to absorb all future forecasted losses. Thus, banks took large charges in the first quarter of 2020 as the crisis unfolded: first, because they were then having to reserve—for the first time and all at once—for life-of-loan losses both for existing loans and for the large volume of loans added in the first quarter; second, because the crisis had begun and their macroeconomic forecasts were amended to project dramatic increases in unemployment and GDP losses. (In practice, many if not most banks used a combination of various macro scenarios published by Moody’s Analytics. The most severe of Moody’s scenarios included an increase in the unemployment rate to 17%, and a 10% fall in real GDP in the second quarter of 2020. Moreover, in that scenario, the unemployment rate would stay above 10% until the first quarter of 2022.)

As a result, the largest banks (i.e., banks with over $100 billion in assets) collectively added about $60 billion to their allowances in the first quarter of 2020. And all banks that are public companies likely were required to take similar actions.7

It is a testament to just how much capital banks had built up before this crisis that the charges required by CECL, which reduced income and therefore capital, did not result in banks breaching the panoply of different regulations.8

---

5 Supervision and Regulation Report at 5.
6 Id. at 7.
7 For an entity that is not a PBE (non-PBE) and certain smaller reporting companies, the credit losses standard is effective in January 2023. See News Release, Financial Accounting Standards Board, “FASB Delays Certain Effective Dates for Credit Losses, Leases, Hedging, and Long-Duration Insurance Standards” (Nov. 15, 2019). https://www.fasb.org/cs/ContentServer?c=FASBContent_C6&cid=11761737763628d=0&pagename=FASB%2FFASBContent_C%2FNewsPage
capital buffers required by post-crisis regulation, let alone their regulatory minimum requirements. Notably, the federal banking agencies did mitigate the reduction in regulatory capital by issuing a final rule to allow firms to phase in the estimated impact of the CECL accounting methodology on capital for up to two years. At the end of the quarter, the average common equity tier 1 capital ratio (the ratio with the narrowest (strictest) definition of capital) for the largest banks was still 11.4 percent.

In any event, the key point to understand is that banks’ current loss absorbency now includes not only capital but also a reserve established explicitly to cover future expected losses from loans on bank books under the current macroeconomic outlook. Again, those who advocate a ban on bank dividends in order to maintain lending capacity have taken no account of this fact.

Of course, if the recession deepens, banks may need to build their allowances further. Banks continue to generate earnings that can be used for this purpose, as occurred in the first quarter. Furthermore, as discussed below, banks also hold large capital buffers that can be drawn down in the event that allowance builds exceed earnings.

**Risk-weighted Assets**

In the first quarter, banks saw an increase in risk-weighted assets. Naturally, a significant portion of the increase in risk-weighted assets was attributable to the simple fact that there was a larger volume of loans, increasing the denominator of capital ratios and thereby lowering them. At the same time, though, the nine banks subject to the advanced approaches calculate capital measures also became more bound by risk-weighted assets calculated using their own models. For those banks, part of the rise in risk-weighted assets was attributable to downgrades of borrowers, higher mark-to-market losses and increased requirements for counterparty credit risk. Thus, under risk-based capital requirements, there was an increase in the denominator because of the higher risk-weighted assets under the advanced approaches.

Again, at least for larger banks subject to risk-based capital measures, reduced but still high capital ratios already reflect some of the risk to banks in the current economic environment, yet still leave them substantial room to continue intermediation efforts.

**Buffers**

Those calling for dividend restrictions also ignore post-crisis regulations that require larger banks to hold massive capital buffers above their regulatory minimums expressly to allow them to continue lending under stress. The required buffers currently include a capital conservation buffer of 2.5 percent of risk-weighted assets applicable to all large and mid-sized banks, and a global systemically important banks (GSIB) surcharge applicable to the largest banks. The *entire point* of these capital buffers, established after years

---

8 Indeed, one debate that is beyond the scope of this note, but well worth having, is whether U.S. banks were *overcapitalized* going into this crisis—in other words whether the extra cushion in crisis came with sufficient benefit to offset the lower economic growth it cost in ordinary times. Going forward, that debate must include how CECL has changed how we think about bank capital. It is difficult to imagine how CECL and its life-of-loan reserving at the outset of a loan does not argue for a reduction in capital requirements.
9 *Supervision and Regulation Report* at 6 (stating “Strong growth in risk-weighted assets, the denominator of the CET1 capital ratio, rather than reductions in the actual amount of capital, was the main driver of lower capital ratios. The increase in risk-weighted assets was a result of increased lending in the first quarter.”).
10 For community banks that have elected to operate under the community bank leverage ratio, their reported ratios take no account of any increase in the risk of their assets, as leverage ratios by definition treat every asset as having the same risk at all times. It is unclear whether leverage ratio acolytes would view the present situation as a feature or a bug in that regime.
11 (“Under section 201(c) of Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), a qualifying community banking organization that exceeds the community bank leverage ratio, as established by the
of deliberation at the Basel Committee and more years of notice-and-comment rulemaking by the U.S. banking agencies, was to create an automatic rule set for determining at what capital level a bank’s dividends and other capital distributions should be reduced or eliminated. It is entirely unclear why the very clear product of that very deliberative process should now suddenly be ignored in favor of ad hoc government policy. And these buffers are no small rounding error: as of the end of the first quarter, the largest banks (those over $100 billion in assets) had more than $245 billion in capital buffers above their risk-based capital requirements including all applicable regulatory buffers, which translates into lending capacity of over $2 trillion. That’s a lot to ignore.

Recognizing the massive lending capacity embedded in these buffers, the federal banking agencies on March 17 issued a statement on their use:

These capital and liquidity buffers were designed to provide banking organizations with the means to support the economy in adverse situations and allow banking organizations to continue to serve households and businesses. The agencies support banking organizations that choose to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner. The agencies expect banking organizations to continue to manage their capital actions and liquidity risk prudently.

The effect of this statement has been muted, as it was hardly a full-throated endorsement of banks drawing down their buffers, at least in part because the agencies could not resist reminding banks that any drawdown must be done in a safe and sound and prudent manner, and requiring that a bank using its buffers immediately provide supervisors a remediation plan. Thus, substantial capital and liquidity buffers still remain undeployed. Put another way, further substantial lending capacity remains.

agencies, shall be considered to have met the generally applicable risk-based and leverage capital requirements in the capital rule (generally applicable rule), any other applicable capital or leverage requirements, and, if applicable, the ‘well capitalized’ capital ratio requirements for purposes of section 38 of the Federal Deposit Insurance Act.” See Regulatory Capital Rule: Temporary Changes to the Community Bank Leverage Ratio Framework, 85 Fed. Reg. 22,924, 22,925 (Apr. 23, 2020), https://www.govinfo.gov/content/pkg/FR-2020-04-23/pdf/2020-07449.pdf

The banking agencies explained that the capital conservation buffer was intended “to encourage better capital conservation by banking organizations and to enhance the resilience of the banking system,” and address how some banking organizations made capital distributions during the last financial crisis. The agencies explained “the capital conservation buffer is intended to provide incentives for banking organizations to hold sufficient capital to reduce the risk that their capital levels would fall below their minimum requirements during a period of financial stress.” Regulatory Capital Rules, 78 Fed. Reg. 62,018, 62,033 (October 2013). The GSIB surcharge is another buffer that is intended to mitigate the potential risk that a GSIB could pose to U.S. financial stability. See Regulatory Capital Rules, 80 Fed. Reg. 49,082, 49,083 (August 2015), https://www.govinfo.gov/content/pkg/FR-2015-08-14/pdf/2015-18702.pdf


Federal Reserve Board, SR 20-05, QSAs on Statement Regarding the Use of Capital and Liquidity Buffers (March 19, 2020) (“If a banking organization is subject to the liquidity coverage ratio and its liquidity coverage ratio is less than 100 percent, it must submit a plan to its supervisor.”). https://www.federalreserve.gov/supervisionreg/srletters/SR2005a1.pdf. Note that another reason banks may be reluctant to use their buffers is potential dividend restrictions. However, in recent testimony, the Vice Chairman for Supervision of the Federal Reserve noted “[b]anking organizations have used their capital buffers to support a sharp increase in lending . . . .” See Supervision and Regulation, at the Virtual Roundtable Discussion, Committee on Financial Services, Subcommittee on Consumer Protection and Financial Institutions, U.S. House of Representatives (May 13, 2020) (statement of Randal K. Quarles, Vice Chair for Supervision, Federal Reserve Board). https://www.federalreserve.gov/newsevents/testimony/quarter20200513a.htm.
**Stress Testing**

For most of the largest banks, their binding capital constraint has been one of the minimum post-stress capital requirements established through the Federal Reserve’s annual Comprehensive Capital Analysis and Review (CCAR) stress test. Thus, it is worth noting that under the stress test, banks are required not only to be able to weather a severely adverse stress scenario while maintaining high levels of capital, but also to do so while paying four quarters of dividends.\(^{15}\) So, bank capital requirements through stress testing effectively requires large banks to pre-capitalize the next four quarters of dividends they are scheduled to pay—previously, in order to pass CCAR, and going forward, as a component of their stress capital buffer. Thus banks subject to the Federal Reserve’s planned stress capital buffer (yet another buffer, this time based on stress test results) will be required to hold approximately $60 billion in capital buffers exactly for that purpose—a fact either missed or omitted by dividend opponents.

**Scope**

At least some of those calling for dividend cuts would only have the ban applied to large banks.\(^{16}\) This distinction is impossible to understand if the goal (however flawed its logic and execution) is actually to maintain credit to the economy. Large banks make about 37 percent of small business loans—a substantial amount but still a minority.\(^{17}\) The rest are made by small banks—banks that are not subject to some of these capital buffers, stress testing, in most cases CECL, and in many cases risk-based capital requirements altogether. Thus, there appears to be no case for arguing that large banks as a group currently have less lending capacity than small ones. Proposals to apply dividends bans only to large banks thus seem to be based more on political animus or ambition than on sound financial or economic analysis.

A further problem emerges. How are the parameters of the ban set? Is the government ban on dividends to apply to banks regardless of their capital levels and business lines? Should a bank that has substantial capital buffers cut its dividend in the same way as one barely above its regulatory minimums? And what about custody banks and other banks whose business models do not include substantial commercial lending, and thus have less lending to spur? What is the economic purpose of a dividend cut for those businesses?

**History**

It is true that in the 2008-09 financial crisis, many banks continued to pay dividends as the economy weakened and their own losses mounted; some of those banks subsequently needed government support. Indeed, preventing a recurrence of that situation was a key motivation for post-crisis reforms to capital requirements—narrowing what qualified as capital in the numerator, expanding the denominator to include off-balance-sheet exposures, and creating an automatic rule set in the form of capital buffers to determine


\(^{16}\) Kashkari, Neel, “Big US Banks Should Raise $200 Billion in Capital Now,” *Financial Times* (April 16, 2020). [https://www.ft.com/content/0b944cd4-7f01-11ea-a0fb-13524ae1056b](https://www.ft.com/content/0b944cd4-7f01-11ea-a0fb-13524ae1056b).

\(^{17}\) BPI member banks accounted for approximately 42 percent of loans to small businesses based on data provided in the Call Reports as of 12/31/2019.
when banks must cease paying dividends. It was also a key driver to the development of a stringent stress testing regime, to serve as a check on static capital measures. Now, each large bank’s quantity of high-quality loss absorbing capital is held to a standard based on both historical losses of the industry, as well as projections of that bank’s ability to keep lending in a severe crisis. Those seeking a blanket ban on banks dividends would thereby pronounce the post-past-crisis regulatory reforms a failure at precisely the time these reforms are being put to their first test, and thus far doing well.

In sum, all of the market data confirm that banks are lending, and a review of the applicable regulations and current balance sheets demonstrates that they have the capacity to lend still more. Thus, the relevant question appears not to be “Do we need to ban bank dividends to give them more lending capacity?” as the answer is clearly “No.”

**Demand**

While anecdotal, there are numerous reports that business demand for additional credit is currently low. First, as noted above, companies with committed lines of credit reacted to the onset of the crisis by drawing those down; banks also allowed draws on uncommitted lines. Thus, many businesses are sitting on a lot of liquidity. Second, for small businesses, the Paycheck Protection Program has provided forgivable loans to fund them for at least a few months. Third, larger companies have retained access to capital markets, which Federal Reserve programs have stabilized. Thus, large companies continue to issue both investment grade and high-yield debt, and even equity. Certainly, demand may grow over the next few quarters, and that brings us to our next topic.

**BANK SAFETY AND SOUNDNESS**

For businesses that lack liquidity and capital market access, banks likely are reluctant to lend not because they are capital constrained but rather because they do not want to lose large amounts of money. Lending is becoming increasingly risky, and the probability of default and loss given default more difficult to model. Here it is good to recall the equivocal statement from the banking agencies on the use of capital buffers. The regulators want to avoid large losses at U.S. banks — as assuredly so do the banks.

Indeed, it turns out that the public sector shares the private sector’s aversion to credit losses. Thus, the term sheets for the Main Street lending facilities have been constructed to limit those losses — both by disqualifying overly leveraged firms from borrowing and by establishing terms that will make lenders prudent in their participation. One can debate the policy, but it is worth noting that the terms of the Main Street facilities reflect many of the same concerns as our banks.

Thus, by all accounts, banks are maintaining or tightening credit standards in consumer and commercial lending in response to increasing credit risks.

So, the questions then arise: would a dividend ban cause them to relax their credit underwriting standards and make significantly more risky loans; if so, would that be a good policy? Put more pointedly, is the goal of a dividend ban to encourage banks to make unsound loans, given that there is no evidence that banks currently lack the capacity to meet the demand for sound credit?

Second, at the risk of stating the obvious, the general thrust of banking regulation has been to avoid banks incurring significant, potentially fatal losses. It is difficult to understand a policy whose effect (and perhaps goal) would be to head in the opposite direction. At the very least, it merits a vigorous debate, with a clear

---

vision of the types of credit for which there is likely to be demand but inadequate supply, and to what extent still greater surplus capital at banks would increase that supply.

COSTS OF GOVERNMENT-MANDATED DIVIDEND CUTS

Regardless of the motivation, a government-mandated dividend cut would come with substantial short-term and long-term costs.

First, in the medium- to long-term, there would be significant damage to the banking industry if investors knew that even a healthy bank, in compliance with all regulatory requirements (including a Fed stress test explicitly designed to assess dividend capacity) could have its board of directors divested of authority over the bank’s dividend without any regard to its financial condition or business model.

This point is worthy of emphasis. Bank holding companies are corporations that operate under a federal or state charter. Those charters come with significant restrictions on their lines of business (generally limited to financial activities) and with a plethora of capital and other regulations that limit their risk-taking and therefore their profitability — and appropriately so, given that banks operate with the benefit of a federal safety net (federal deposit insurance and discount window access), and the subsidy and moral hazard that attend it. However, banks in compliance with regulatory requirements are shareholder-owned corporations just like any other. And one of the key rights of a corporation is the power of its board of directors to determine whether to reinvest the company’s earnings or return them to shareholders in the form of a dividend.

A dividend ban imposed outside the established, robust regulatory construct would make it difficult for investors to value banks and thereby make them decidedly less investable. The market value to book value of banks’ equity fell in the post-crisis period due to a combination of factors including a loss in franchise value attributable to heightened regulation. At the end of 2019, U.S. banks included in the S&P 500 index were trading at 1.8x price-to-tangible book value (PTBV). Those banks are currently trading at 1.1x PTBV. Both numbers are low by long-run historical standards for the industry, and compare unfavorably to other sectors, represented by the PTBV of all companies included in the S&P 500 index (see Figure 1).

---

At this point, the major attraction to investors of highly regulated banks is the ability to produce a stable stream of dividends. If that ability is taken away arbitrarily, the short- and long-term impacts could be substantial. A fundamental tenet of finance is that investors want assets that provide income when times are lean, not just when times are fat. Consequently, and as noted above, a ban would raise banks’ costs of capital. Like all businesses, banks only make investments that provide returns in excess of their cost of capital. A higher cost of capital means less bank credit and therefore less GDP at all times.

Second, a policy of banning capital distributions in bad times is profoundly procyclical. Banks would respond by seeking to pay those funds out to investors when times are good, turbocharging the financial cycle by boosting investment in riskier, higher yielding, assets and running down capital reserves during boom times, then switching to safe investments in crisis times when credit is most needed.

Third, many Americans, including retirees and pensioners, rely on bank dividends as a source of income—particularly at a time when they, like the businesses that employ or employed them, are seeing less other income coming in. They also spend that money, which is helpful to the broader economy, and feel more secure in having received it. (Perhaps this is why their elected representatives generally have been keen to urge a cessation of buybacks—not just at banks, but across corporate America—but not dividends.)

Indeed, if there were a need for banks to halt dividends in order to fund companies seeking to borrow, it is hard to understand why those borrowing companies shouldn’t be ceasing their dividends. But again, there have been few calls for a dividend moratorium applicable to all corporations.20

THE LAW

There is a longstanding and well considered regime established precisely to govern when a bank holding company may pay a dividend to its shareholders. For starters, and as explained above, a centerpiece of the

---

post-crisis capital framework is an automatic rule set, based on capital buffers, for determining at what point a banking organization should be subject to restrictions on capital distributions, including dividends. Additionally, capital planning and stress testing also are key parts of the Fed’s capital framework for certain large bank holding companies.\textsuperscript{21}

Thus, if an individual bank is at or below any of these regulatory requirements, whether through credit losses or balance sheet expansion, then multiple rules require it to reduce or suspend its dividend. If the economy fails to recover quickly, we may reach that point at some or many banks, giving the rules a chance to work as drafted and intended.\textsuperscript{22}

Banking agencies also have the power to issue capital directives or to issue orders to individual banks to correct an unsafe or unsound practice at that bank.\textsuperscript{23} But it is not an unsafe or unsound practice for a board of directors to decide to pay an incremental dollar of earnings to the bank’s investors, assuming the bank is in compliance with the capital requirements that apply to it.

But far more importantly, each of these authorities requires a bank-specific determination. It does not allow for a blanket, industry-wide order to effectively raise capital by halting dividends.

**WHAT ABOUT EUROPE AND THE UK?**

The contrast with Europe is stark. With efforts for capital market union continually stalled, European corporates are far more reliant on bank lending than their U.S. counterparts. And while U.S. banks in 2019 accomplished approximately 73 percent of capital distributions through share repurchases and 27 percent through dividends, European banks distributed 4 percent through buybacks and 96 percent through dividends. Thus, in March, the European Central Bank mandated that European banks halt dividend payments to their shareholders as a means of ensuring that those banks retain the capital necessary to support European economic activity.\textsuperscript{24} Thereafter, the Bank of England took similar action.\textsuperscript{25}

More importantly, while the cases appear inapposite, the European and U.K. experiences may serve as a cautionary tale. The UK’s Prudential Regulatory Authority announced its dividend ban on March 31, which increased the book value of UK banks by £8 billion. Meanwhile, over the following day, the market value of the relevant UK banks fell by £35 billion, or £43 billion including the lost dividends, as equity markets were otherwise generally flat. So, eight steps forward, forty-three steps backward.

Of course, the dividend cut did increase book value, while the precipitous drop occurred in market value. But market value matters, because in both the short-term and certainly the long-term, a bank or any other company trading at a discount to book value has a motivation to shrink. Put another way, investors do not

\textsuperscript{21} Also, noteworthy, section 616 of the Dodd-Frank Act amended various banking law provisions to direct the banking agencies in establishing capital regulations to seek to make such requirements countercyclical, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company. Dodd-Frank Act, Pub. L. 111–203 § 616, 124 Stat. 1376 (2010).

\textsuperscript{22} Moreover, changing the rules of the road now, would mean it would become unclear on what basis banks would be able to pay dividends in the future.

\textsuperscript{23} See, e.g., 12 U.S. Code § 3907 ("In addition to, or in lieu of, any other action authorized by law, including paragraph (1), the appropriate Federal banking agency may issue a directive to a banking institution that fails to maintain capital[1] at or above its required level as established pursuant to subsection (a). ").


want to invest capital in companies that trade at a discount to book value and therefore invest elsewhere. When banks raise capital, they issue equity at market value, and when market value is depressed, banks' cost of capital is higher. The average PTVB of large U.K. and EU banks was already low going into this crisis and is currently about 0.4.

Thus, while much more analysis must be done, there is a good chance that the actions of UK and EU regulators have done significant, long-term damage to their banks. This will be an important focus of future research, but early signs certainly do not encourage similar, rash action on our shores.

CONCLUSION

In short, those advocating for government-mandated dividend halts for banks (and only banks) appear to have adopted an “if it ain’t broke, let’s break it” approach to bank regulation. While perhaps politically appealing, such an approach is bad policy and a repudiation of the good work that both banks and their regulators have done since the last financial crisis.

Disclaimer: The views expressed in this post are those of the author(s) and do not necessarily reflect the position of the Bank Policy Institute or its membership, and are not intended to be, and should not be construed as, legal advice of any kind.