

The Importance of Moving to the Stress Capital Buffer

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EXECUTIVE SUMMARY

Banks entered the COVID-19 event extremely well capitalized and with highly liquid balance sheets. The strength of banks' balance sheets was evident in their ability to respond to the demand for credit at the onset of the pandemic and also from the results of several 2020 stress tests. Those results showed that almost all large banks could withstand a significant economic shock and be able to continue offering credit to businesses and households.

The Federal Reserve finalized the stress capital buffer (SCB) framework in March 2020, just as the financial shocks associated with the COVID-19 event emerged. The SCB integrates the results of the stress tests with banks' point-in-time capital requirements. This is an important step to make the current capital requirements more dynamic. However, because of unprecedented uncertainty, the SCB framework was put on hold in October 2020. In this post, we summarize evidence that demonstrates the SCB effectively limits capital distributions in stress, so further delaying implementation risks undermining the credibility of a regime that is highly effective. Therefore, as the level of uncertainty subsides, we urge the Federal Reserve to fully implement the SCB framework to avoid undermining its credibility with market participants and the public more generally. Further, a delay of the SCB implementation could send a message that banks need more capital than is implied by their current SCBs and the Federal Reserve's capital regime.

In this blogpost, we present an overview of the SCB framework and demonstrate that under the SCB framework banks are well equipped to deal with severe economic conditions. We end the post by describing some of the potential costs of further delaying the implementation of the SCB framework.

THE STRESS CAPITAL BUFFER EFFECTIVELY GOVERNS CAPITAL DISTRIBUTIONS IN STRESS

The Federal Reserve finalized a rule last year that represented a culmination of its capital framework.¹ The stress capital buffer or SCB rule uses the results of the Federal Reserve's conservative stress test to size a stress capital buffer based on stress test losses, plus pre-funding of four quarters of dividends (see right-hand bar, SCB Regime, in Exhibit 1). The SCB is floored at the level of the internationally agreed-upon capital conservation buffer (CCB) of 2.5 percent (which it replaces at the holding-company level). Based on the June 2020 stress results, the SCB ranges between 2.5 percent and 7.8 percent.²

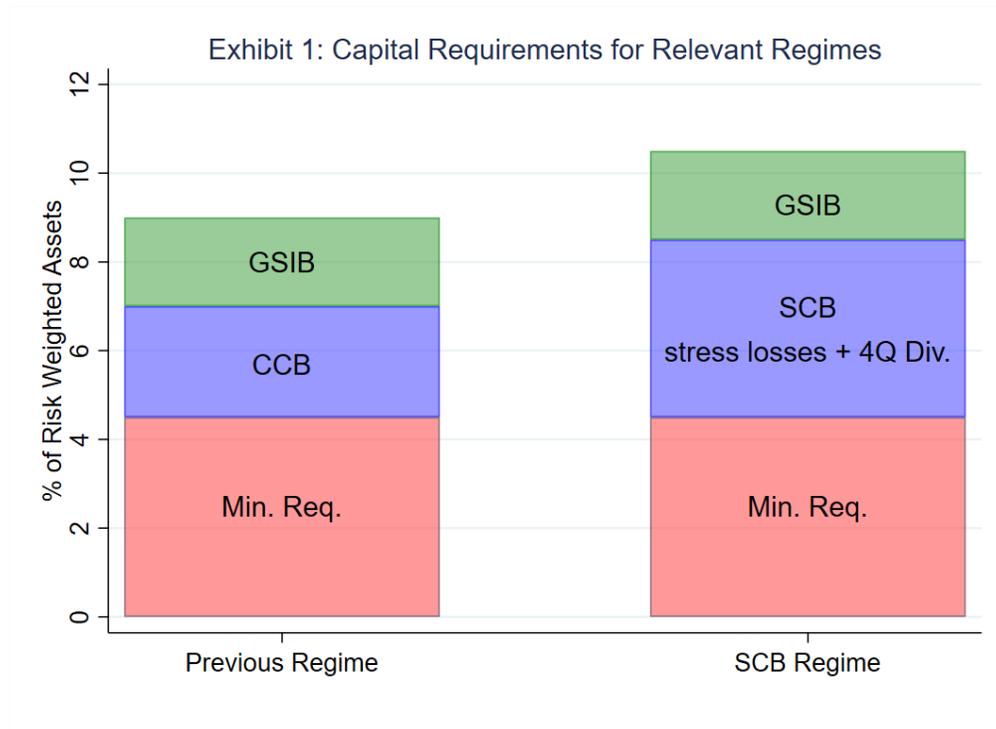
The *entire point* of the SCB is to govern capital distributions in stress. The purposes of the capital buffers including the SCB are to "help ensure that a firm maintains an adequate amount of loss-absorbing capital to stay above minimum regulatory requirements during stress" and "restrict a firm's ability to distribute capital as the firm's actual capital levels approach minimum ratios."³ According to the Federal Reserve, "[t]hese requirements

¹ 85 Fed. Reg. 15,576 (March 18, 2020).

² See Federal Reserve Board, Press Release, "Federal Reserve Board announces individual large bank capital requirements, which will be effective on October 1" (August 10, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm>.

³ 83 Fed. Reg. 18,163 (April 25, 2018).

therefore strengthen the ability of individual firms and the banking system to continue to function and serve as financial intermediaries in times of stress.”⁴ The largest U.S. banks, the U.S. global systemically important banks or GSIBs, are subject to additional capital requirements. This accounts for their systemic risk, and the GSIB surcharge sits atop the SCB.



The capital buffers offer an automatic and gradual mechanism that places restrictions on capital distributions and discretionary bonus payments. Specifically, when a bank’s estimated regulatory capital ratio under stress is less than its regulatory capital minimums plus all of its regulatory buffers added together, capital distributions and bonuses cannot exceed a certain percentage of average profits over the prior year.⁵ Thus, the amount of capital firms can distribute to shareholders is tied to each firm’s profitability when it moves inside its regulatory capital buffer. If profits are already negative when that happens, shareholder payouts and discretionary bonus payments are automatically set to zero. In a [prior blog post](#), we have shown that this mechanism is highly effective in restraining capital distributions in stress.

LARGE BANKS BEGAN THE COVID-19 EVENT IN A POSITION OF STRENGTH UNDER THE REGULATORY REGIME PUT IN PLACE OVER THE PREVIOUS DECADE, AND THEY REMAIN QUITE STRONG.

The largest banks have proven during the COVID-19 event that they are extremely well equipped to deal with unexpected and severe stresses that may have an impact on the U.S. economy, largely because of the regulatory regime enacted over the past decade. These safeguards include increases in the quality and quantity of regulatory capital, regulatory capital buffers to govern capital distributions, and a rigorous stress testing regime used to calibrate the size of each bank’s SCB. Moreover, throughout the course of the COVID-19 event, the Federal Reserve has repeatedly emphasized that U.S. banks are well capitalized.

⁴ See id.

⁵ 85 Fed. Reg. 63,423 (October 8, 2020).

For example, in the May 2020 *Supervision and Regulation Report*, the Federal Reserve stated: “. . . the banking industry entered the current crisis well positioned to support continued lending. Strong capital positions enable institutions to absorb higher credit losses while continuing to lend through times of stress. The aggregate bank common equity tier 1 (CET1) capital ratio ended 2019 at a high level, close to 12 percent.”⁶ A similar message was shared in the November 2020 *Supervision* report⁷ and in connection with the disclosure of the second-round stress test results in December 2020.⁸ Likewise, the November 2020 *Financial Stability Report* indicated that “banks’ strong capital positions at the onset of the pandemic may have mitigated some of the disruption in credit availability relative to during the 2007–09 financial crisis.”⁹

The CET1 capital ratio of banks subject to the stress tests is at its highest level in five years. The aggregate capital ratio is higher than it was even a year ago, when the CET1 capital ratio was already deemed elevated by the Federal Reserve’s own standards. As shown in Exhibit 2, the CET1 ratio of large banks subject to the stress testing framework increased from 12 percent at the end of 2019 to 12.8 percent at the end of 2020.¹⁰ In CET1 terms, this represents an increase of nearly \$100 billion in aggregate common equity tier 1 capital. At the same time, those banks increased their allowance for credit losses by approximately \$90 billion, or more than 1 percentage point in risk-weighted asset terms.¹¹ As we discuss below, the higher level of allowances for credit losses at the start of the stress tests, dampen the maximum decline of banks’ capital ratios under the stress tests and therefore result in a lower stress capital buffer.

⁶ Federal Reserve Board, *Supervision and Regulation Report* at 3 (May 2020), available at <https://www.federalreserve.gov/publications/files/202005-supervision-and-regulation-report.pdf> (emphasis added).

⁷ Federal Reserve Board, *Supervision and Regulation Report* at 1, 3–5, 22, and 24 (November 2020), available at <https://www.federalreserve.gov/publications/files/202011-supervision-and-regulation-report.pdf>.

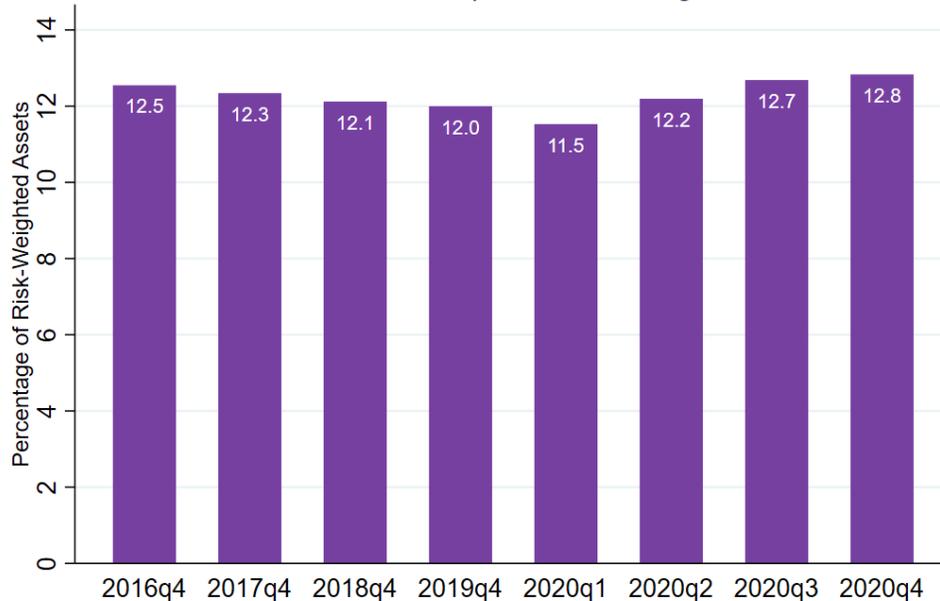
⁸ Federal Reserve Board, Press Release, “Federal Reserve Board releases second round of bank stress test results,” December 18, 2020, available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201218b.htm>.

⁹ Federal Reserve Board, *Financial Stability Report*, at 42 (Nov. 2020), available at <https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf>.

¹⁰ The CET1 capital ratio of 12.8 percent includes the CECL add-back to retained earnings. Without the add-back, the CET1 capital ratio would be 12.5 percent.

¹¹ Almost all banks subject to the stress tests have implemented the current expected credit losses or CECL accounting standard by the U.S. banking agencies at the start of 2020.

Exhibit 2: CET1 Capital Ratio of Large Banks



Source: Federal Reserve Board, FR Y-9C, BPI calculations.

THE SCB, WHICH WAS FINALIZED IN 2020, WAS PAUSED BECAUSE IT BECAME EFFECTIVE AT A TIME OF UNPRECEDENTED UNCERTAINTY.

The SCB, which would have taken effect last October, was paused during a time of unprecedented uncertainty. The Federal Reserve chose to put the SCB framework on hold after the release of the first set of sensitivity analysis results in June 2020. There was still substantial uncertainty then about the path of the economic recovery, and the risk of a severe second wave of the virus was still possible. In abandoning the SCB last June, the Federal Reserve explained it was doing so “to ensure large banks remain resilient despite the economic uncertainty from the coronavirus event.”¹² But now, almost a year later, the recovery seems much more certain.

[As we recently described](#), uncertainty is no longer unprecedently high. Now is the time to implement the SCB or risk it losing credibility—not least because not doing so could appear to be sending a message that banks need more capital than what is implied by the SCB framework. Moreover, it is not clear that the SCB ever really needed to be paused. Its very purpose is to ensure banks have enough capital to withstand severe stress, and in retrospect it would have served that purpose very well.¹³

THE SCB IS DERIVED FROM A STRINGENT STRESS TEST, WHICH DEMONSTRATES THAT THE LARGEST BANKS ARE RESILIENT UNDER EXTREMELY SEVERE ECONOMIC CONDITIONS.

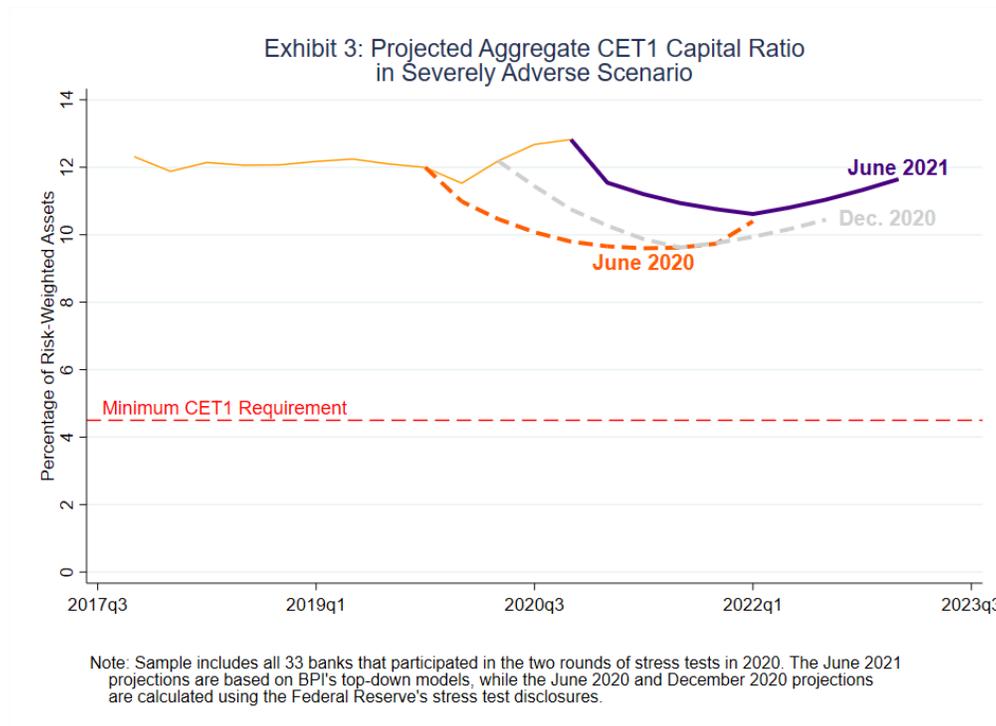
The Federal Reserve has been using the stress tests as a key supervisory tool to update information about the resilience of large banks during the COVID-19 event. In two rounds of stress tests last year, large banks faced six

¹² Federal Reserve Board, Press Release, “Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event” (June 25, 2020), available at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm>.

¹³ See Victoria Guida, “Quarles Says Big Banks Could Have Weathered 2020 Without Payout Restrictions,” *Politico*, February 25, 2021, <https://login.politicopro.com/?redirect=https%3A%2F%2Fsubscriber.politicopro.com%2Farticle%2F2021%2F02%2Fquarles-says-big-banks-could-have-weathered-2020-without-payout-restrictions-3987255>.

downside scenarios. The stress test results in both rounds in 2020 and in all six downside scenarios demonstrated that large U.S. banks are highly resilient. The average maximum decline of regulatory capital ratios in the second-round stress tests in December exceeded the decline of capital ratios in the June exercise, and two banks approached (but did not fall below) minimum risk-based requirements. However, we estimate that the average stress capital buffer would have remained unchanged if the Federal Reserve had recalculated SCBs based on these results, largely because of higher allowances for credit losses.¹⁴

The biggest banks thus have demonstrated resilience in the face of severe shocks through multiple stress scenarios in two rounds of stress tests, with a third round currently in progress. In February, the Federal Reserve released the scenarios of the June 2021 stress tests. The stress scenarios are quite stringent, and the degree of severity is in line with last year’s stress scenarios. For instance, the path of CRE prices and the BBB spread—two of the four most important determinants of loan losses—are more severe relative to the June and December 2020 stress scenarios. The severity in the June 2021 scenario is somewhat attenuated by a lower increase in the unemployment rate under stress, and by a less severe decline in the House Price Index. Based on the projected level of loan losses over the nine-quarter planning horizon, we expect the June 2021 stress scenario to be tougher than the one used in the original stress test of 2020 last June, but slightly less severe than the severely adverse scenario from the December 2020 stress tests.



Once more, the massive additional loss reserves that banks had already set aside at the jumping-off point of the exercise offset the further increase in loan losses and the decline in PPNR over the planning horizon, relative to the June 2020 stress test. As shown in Exhibit 3, BPI projects the aggregate CET1 capital ratio to decline from 12.8 percent in the fourth quarter of 2020 to a minimum of 10.6 percent, or a 2.2-percent maximum decline in the

¹⁴ In addition, banks with substantial trading and investment banking operations showed strong performance relative to other banks, and these banks tend to report higher peak-to-trough declines in their capital ratios in the stress tests. By contrast, banks with significant concentrations in CRE loans saw larger peak-to-trough declines in their CET1 capital ratios under stress because of the expected impact of the COVID-19 event on CRE loss rates.

aggregate capital ratio. Further, all banks would remain well above the 4.5-percent minimum. As a reference for comparison, in the severely adverse scenario of the December and June 2020 stress tests, the peak-to-trough declines were 2.6 percent and 2.1 percent, respectively.

The COVID-19 event has created further challenges for certain sectors (e.g., travel and entertainment) reflected in the December 2020 stress test results that will likely be reflected again in the June 2021 test. For instance, the CRE loss rate was the highest ever in the December stress tests (twice as high as the June 2020 test). BPI's own projection also shows an elevated loss rate for CRE loans in the June 2021 stress test. In addition, the Federal Reserve will also apply an extra layer of stress to commercial and industrial (C&I) loans, and uncertainty lingers about the treatment of loans still under deferral programs. Our projections include an extra layer of loan losses to account for the additional downside risk.

In addition, in their loan-loss projections, the Federal Reserve does not take into account the impact of government actions to support the economy, and our forecast follows the Federal Reserve's assumptions. Lastly, our analysis also projects that net interest income will remain subdued over the projection horizon because of low interest rates. Overall, taking into account the improvement in the economic outlook at the start of the stress tests and the elevated level of allowances for credit losses, the maximum decline in CET1 capital ratios in this year's stress tests most likely will not exceed the 2.6-percent registered in the December stress test. The lowest level of the CET1 ratio under the nine-quarter planning horizon of each bank would remain well above the 4.5-percent minimum requirement.

NOW IS THE TIME TO IMPLEMENT THE SCB, BECAUSE NOT DOING SO INAPPROPRIATELY UNDERMINES THE CREDIBILITY OF THE SCB AND PROMPTS BANKS TO TIGHTEN CREDIT UNNECESSARILY

Given the high levels of capital and the similarly high expectations that banks will continue to show a strong performance in the upcoming stress tests, the Federal Reserve should move to the SCB framework to avoid undermining it. As we have noted, the capital framework (particularly the SCB) was designed to govern capital distributions based on the results of a severe stress test and does so effectively.

Moreover, the continued departure from the stress capital buffer framework has significant implications, given the strength of the banking system. First, the recent experience of overriding the framework for an extended period sends a confusing message and could undermine public confidence in the SCB framework. If the regulatory regime is not transparent, it effectively raises capital requirements, because the lack of predictability hinders how banks could efficiently manage capital. A consequence of higher capital requirements is tighter credit availability, which could be meaningful when credit demand returns. Similarly, uncertainty about the rules governing capital distributions to shareholders permanently raise banks' cost of capital, and also reduces credit availability and output. Lastly, the public needs to have confidence in the SCB framework for the next crisis, and that confidence is built by demonstrating the effectiveness of the framework during a stress event.

The longer the SCB is kept on hold, the more its credibility is undermined, and the more cautious banks are likely to be in meeting credit demands when the economy rebounds. In the SCB, the Federal Reserve has created a highly effective framework for limiting capital distributions to the extent necessary to ensure that banks can continue to function effectively, even under severe stress. It needs to demonstrate its confidence in the efficacy of its creation.

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