No, Banks Were Not Bailed Out in 2020

Bill Nelson | July 13, 2021

As unanimously concluded in official sector reports, banks were a source of strength at the depth of the COVID crisis last year. In a few weeks in March and April 2020, before the government could provide meaningful support, U.S. commercial banks increased their lending by $700 billion. (By comparison, Fed lending went up $130 billion.) They did so even as new accounting rules required them to add $100 billion to their loan and lease loss allowances in order to reflect a worsened economic forecast, reducing their capital by a corresponding amount.

More remarkably, there were no market concerns about bank liquidity or solvency, even as they expanded their balance sheets to support the economy. Large banks passed two Fed stress tests and one sensitivity analysis that examined six severe stress scenarios. Banks received no government capital injections; furthermore, when the Fed established two unprecedented programs to purchase corporate debt at issuance and in the secondary market, it excluded bank debt (and only bank debt) from eligibility and therefore government support. Fed lending to banks barely increased, and most of the increased lending to banks that occurred was in the PPPLF and the MMMLF, two lending programs that used banks as conduits to get liquidity to small businesses and money funds.

Why were banks so resilient to a financial shock that was roughly the same size as the Lehman failure as measured by the initial market reaction?[1] Because they have much more capital, much more liquidity, and were much less reliant on short-term funding. Banks' fortress balance sheets are the result of both greater prudence on the part of banks and a massive overhaul of the bank regulation and stress testing regime following the global financial crisis.

Furthermore, 2020 was the first at least partial test of a revolution in the recovery and resolution process applicable to banks, designed to ensure that they were not too big to fail. A crucial component of the new process was the issuance of more than a trillion dollars of bail-in debt in the United States (referred to, along with equity, as TLAC or total loss-absorbing capacity). While no large bank came close to failing, the pandemic offered an opportunity to observe market pricing of that debt. Notably, spreads on that debt widened considerably – indicating that markets were pricing for risk, and on the presumption that there would be no government support for banks.[2] (This presumption was likely enhanced when the Fed excluded only bank debt from its corporate-bond facilities.)

In the face of all this evidence, a few observers have suggested that banks were actually bailed out last year. For example, Neel Kashkari, President of the Minneapolis Federal Reserve Bank, recently wrote:

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[1] *See* table 1 in Nelson, B., Covas, F., Fernandez Dionis, G., & Freedman, A. (2021). *How Strong and Liquid Banks Helped the Federal Reserve Prevent a Financial Crisis This Spring*. The Euro in 2021, Instituto Espanol de Analistas Financieros. https://www.ieaf.es/images/Publicaciones-FEF/Anuarioeuro2021/15_How_strong_and_liquid_banks_helped_the_federal_reserved_prevent_a_financial_crisis_this_spring.pdf

[2] Covas, F., & Fernandez-Dionis, G. (2020, September 9). *Putting "Too Big to Fail" to Rest: Evidence from Market Behavior in the COVID-19 Pandemic*. Bank Policy Institute. https://bpi.com/wp-content/uploads/2020/09/Putting-Too-Big-to-Fail-to-Rest-Evidence-from-Market-Behavior-in-the-COVID-19-Pandemic.pdf

> The losses in the banking sector were much smaller than expected because governments were so aggressive in providing fiscal support for families and businesses affected by the crisis…Fiscal authorities were right to be so forceful and proactive in supporting the economy during the Covid downturn. But this was also a banking bailout. Absent these fiscal interventions, losses in the banking sector would have been much larger…We now face some fundamental policy questions. What economic shocks should banks be able to handle on their own? And for which shocks is it appropriate to depend upon taxpayer support?[3]

The only possible logical conclusion is that banks should hold capital and liquidity on the assumption that the government will not act to defend the economy in a crisis. Applying this logic to 2020, bank capital and liquidity levels would have needed to have been sufficient to buffer the banks against the global meltdown that would have occurred had governments not provided fiscal and monetary support – if there had been no PPP, no special unemployment insurance, no economic impact payments, no Fed support for fixed income markets, no changes to Fed monetary policy. Indeed, there is no logical reason why the counterfactual should just encompass government spending or Fed programs; medical support and vaccine research helped as well; thus, the same logic would dictate that banks capitalize themselves on the assumption that future epidemics will not be contained.

Two questions arise. First, does this make any common sense? Second, as this would obviously argue for banks holding extraordinarily high levels of capital and cash, is there a cost from proceeding from this counterfactual?

The answer to the first question is clearly “No.”

Imagine being required by the government to drive a vehicle that could handle the terrain without roads, arm yourself heavily to be prepared for total lawlessness, prepare your house with generators to replace the power grid, and stockpile food to handle a breakdown in the distribution system. Would those be sensible policies if the government planned to continue to provide roads, utilities, and a reliable system of government?

There are important lessons to be learned from 2020 about bank safety and bank regulations.[4] Large amounts of loss-absorbing capital and liquidity were why banks were able to support the economy despite a massive shock to financial markets. At the same time, key elements of how capital and liquidity regulations are designed worked poorly, and requiring banking organizations to hold capital against essentially riskless assets discouraged banks from providing liquidity to the U.S. Treasury and Treasury repo markets. Now is not the time for complacency – but there is a tremendous amount to learn from what *actually* happened in 2020, and much to be done to ensure that the Federal Reserve does not have to continue to play as large a role in markets next time. We shouldn’t be distracted and misguided by contemplating what could have happened if the government hadn’t done what any well-functioning government should.

The answer to the second question was answered succinctly and cogently by Fed Vice Chair Randal Quarles. "We shouldn't solve for March 2020. If you create a system that actually can shrug that off, you don't have an efficient system for the other 100 years of the century." Put less succinctly, the calibration of capital and liquidity requirements is done by comparing the benefit of a reduced chance of financial crisis to the cost of reduced bank credit and therefore GDP all the time.[5] If capital and liquidity requirements were calibrated to encompass

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[3] Kashkari, N. (2021, June 28). *Banks cannot expect government to bail them out of every crisis*. Financial Times. https://www.ft.com/content/760f8a05-d5be-4066-8f3d-802d78c33bce

[4] *See* “Basel Committee on Banking Supervision. (2021, July). *Early Lessons From the COVID-19 Pandemic on the Basel Reforms*. Bank for International Settlements. https://www.bis.org/bcbs/publ/d521.pdf

[5] *See* Nelson, B. (2020, July 15). Should We Take Estimates of the Optimal Level of Bank Capital Ratios Seriously or Not. Bank Policy Institute. https://bpi.com/should-we-take-estimates-of-the-optimal-level-of-bank-capital-ratios-seriously-or-not/

extremely severe events that could never occur, GDP would be lower year in and year out without a corresponding compensating increase in safety.

Put another way, if one assumes that the next pandemic will be met with no government reaction and that the economy will effectively cease to exist and combine it with an expectation that banks must be prepared to continue lending no matter what, and you pretty quickly get to the conclusion that banks should be 100 percent equity funded and should hold only Treasury securities and central bank reserves as assets – materially reducing economic activity for perpetuity. As Mervyn King famously put it, these kinds of measures would provide the "stability of the graveyard."[6]

[6] Jenkins, P. (2012, July 17). *Growth Demand Splits Bank Committee*. Financial Times. https://www.ft.com/content/2196b248-b884-11e1-82c8-00144feabdc0