"I Swear the Sun Rose in the West": Denying the Obvious About Bank Performance in 2020

BPI Staff | October 18, 2021

The events of 2020 provided clear evidence of the resilience of U.S. banks. Banks funded the economy with extraordinary levels of lending and rode out the crisis without any major losses and with capital ratios rising, not falling. While the Federal Reserve provided unprecedented support for U.S. corporations by purchasing their bonds in both the primary and secondary markets, bank bonds were deemed uniquely ineligible for such support, and banks therefore were the only corporations issuing public debt without governmental backing.[1] Meanwhile, the Federal Reserve stress-tested all the major banks -- and did so on the counterfactual assumption that there was no governmental support for the economy (e.g., no PPP, stimulus payments or enhanced unemployment benefits); all major banks passed those stress tests with room to spare. One would have to work pretty hard to see this episode as anything other than a vivid demonstration that post-crisis reforms have left banks with more than ample capital and liquidity.

Yet there are some hard workers out there, and the political attraction of attacking banks has not subsided much. This note looks at one attempt -- fortunately, there have not been many -- to paint the history above as a bank bailout.

At least currently, the basis for the bailout canard is a relatively unremarkable research note published by the Federal Reserve Bank of Minneapolis.[2] That analysis uses the historical relationship between loan losses and the unemployment rate to estimate what loan losses for the banking sector would have been during 2020 in the absence of governmental support for the economy. The authors estimate additional loan losses under two different paths for the unemployment rate. First, using the actual path of unemployment in 2020, they find loan losses would have been $130 billion higher in the absence of governmental support. Second, the authors reasonably hypothesize that the unemployment rate was lower than it would have been absent the many programs Congress enacted; thus, they estimate that the unemployment rate would have reached 15.0 percent rather than the 6.8 percent registered at the end of 2020. In that scenario, they estimate that bank loan losses

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[1] Federal Reserve, Terms of Primary Market Corporate Credit Facility, July 2020, available here: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf. *See also* Federal Reserve, Terms of Secondary Market Corporate Credit Facility, July 2020, available here: https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf. We should add for completeness that banks did receive direct support from the government in the form of $51 billion in primary credit from the discount window. Any such borrowing came after specific encouragement from the Federal Reserve to do so, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200316a.htm; *see also* https://fsforum.com/news/financial-services-forum-statement-on-the-discount-window.

[2] Feldman, Ron J. and Schmidt, Jason, "Government fiscal support protected banks from huge losses during the COVID-19 crisis," *Federal Reserve Bank of Minneapolis*, May 26, 2021, available here: https://www.minneapolisfed.org/article/2021/government-fiscal-support-protected-banks-from-huge-losses-during-the-covid-19-crisis.

would have been $270 billion -- or $230 billion higher than the $40 billion in losses actually reported. (The subtitle of their note, which the authors may not have written, translates $230 billion into "as much as $300 billion.")[3]

And … so what? To absorb those $230 billion in hypothetical additional losses, the U.S. banking system entered the pandemic with $1.7 *trillion* in common equity tier 1 capital, the most loss-absorbing type of capital; in addition, the eight largest banks held an additional $1.8 *trillion* in bail-in debt, or gone concern capital.[4] In the first half of 2020, banks added reserves against estimated future loan losses of $120 billion. So far, a significant portion of those reserves proved unnecessary, and about $45 billion in reserves has been released.

So, in sum, the Minneapolis researchers estimate that in the absence of government support for the economy, the banking sector would have ended up losing a fraction of the amount of capital with which it entered the pandemic. Thus, in any common or rational usage of the term, banks would not have required a bailout, collectively or individually.

This analysis is fully consistent with the results of stress tests conducted by the Federal Reserve during 2020. Both stress tests neutralized the effects of governmental support, including unemployment insurance provided in the CARES Act and the support to small businesses through the Paycheck Protection Program. In addition, the Federal Reserve made model adjustments to maintain the historical sensitivity of projected losses to the stress scenarios akin to the changes made by the Minneapolis Fed researchers in their own exercise. And the stress test results demonstrated the covered banks had sufficient capital to absorb those losses.[5]

To be fair, the authors in no way characterize their research as demonstrating that banks required a bailout. Rather, they take aim at a small, straw man: "But ignoring the contributions these programs made to bank health is an important error of omission, in our view." There is no citation to identify who has ignored or denied that programs assisted bank health. Indeed, it seems inarguable that those programs assisted the health of every business in America. But this is a minor quibble, and no harm done from reaffirming the obvious.

But while the two Minneapolis researchers prudently refrain from using the B-word, their President, Rumpelstiltskin-style, did not wait long to spin their research straw into political gold.

> "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…"[6]

Note the sleight of hand here: because losses would have been larger, there was a bailout. But of course, as President Kashkari must remember from his time helping to administer an *actual* bailout in 2008-09,[7] a bailout

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[3] The summary states in full, "Federal relief payments and loans allowed people and businesses to stay current on loan payments, providing banks as much as $300 billion in indirect government support." If the "support" is losses that would otherwise have been incurred, the number suggested by the note is $230 billion.

[4] Data on total loss absorbing capacity is available on banks' 10-K and are as of 4Q/2019.

[5] In addition, after the release of the DFAST 2021 results, the Federal Reserve noted, "Consistent with previous stress tests, the model adjustments in DFAST 2021 do not directly account for an increase in government support programs. These programs—including expanded eligibility for unemployment insurance, larger unemployment insurance payments, and federal loan guarantee programs, such as the Paycheck Protection Program (PPP)—support credit access and improve credit quality for households and businesses." Federal Reserve, "Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Results," June 2021, available here: Federal Reserve Board Publication

[6] Kashkari, Neel, "Banks cannot expect government to bail them out of every crisis," Financial Times, June 28, 2021, available here: https://www.ft.com/content/760f8a05-d5be-4066-8f3d-802d78c33bce See also BPI's reply, "No, Banks Were not Bailed Out in 2020," July 13, 2021. https://bpi.com/wp-content/uploads/2021/07/No-Banks-Were-Not-Bailed-Out-in-2020.pdf

[7] Paulson Jr., Henry M., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, (February 2010) p. 334.

comes only when an impending failure requires taxpayers to absorb or guarantee losses that otherwise would have been absorbed by equity or debt holders. Flood insurance reduces bank losses but isn't a bank bailout. The same is true for Social Security, ordinary unemployment insurance, the actual bailout of the airline industry during 2020, the federal highway system and fire departments, to name a few.

The main point was made succinctly by the Fed Chairman when asked about the Minneapolis study.

> **Sen. Warren**: …. I'm looking at the Fed's own research, which says that, without the help that you had to put into the economy last year, they would have faced up to $300 billion in losses. So, look, I don't want to argue with you about…
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> **Chair Powell**: Which they would have met, which they would have been able to absorb without difficulty.

As the above colloquy indicates, other politicians have not gone as far as President Kashkari in labeling 2020 a bank bailout but have suggested that governmental action negates any favorable interpretation of the COVID crisis from a bank regulatory perspective.[8]

But what the actual Minneapolis research, as well as the Federal Reserve's stress tests, demonstrates is that the banking industry had ample capital to absorb not only the 2020 pandemic but even one where the government failed to act responsibly. As the Federal Reserve's November 2020 Banking and Supervision Report stated: "Unlike 2008, banking organizations have been a source of strength, rather than strain, to the economy, entering the COVID event with substantial capital and liquidity and improved risk management and operational resiliency."[9]

CONCLUSION

One problem with spending time denying the obvious is that it distracts (perhaps intentionally?) from some real lessons to be learned from 2020. First, banks were unwilling to use regulatory capital and liquidity buffers for fear of examiner or market censure, calling into question the utility of those buffers. This result was quite predictable – by definition, as we predicted it in 2019:

> The rationale for these buffers is that when stress occurs, banks will treat them as buffers, not legal or practical minimum requirements, and therefore allow their capital levels to drift down toward regulatory minimums in order to remain engaged in lending, market making, and other activities that support the economy…. This belief is an important foundation of post-crisis capital (and liquidity) regulation. Indeed, one could say that is the most important foundation of post-crisis capital (and liquidity) regulation. Unfortunately, I've never met a market participant who believes it. Rather, market participants universally believe that banks will never allow their liquidity and capital levels to drop, even if that means shrinking their balance sheets and turning away deposits." [10]

[8] *See* https://www.brown.senate.gov/newsroom/press/release/brown-powell-no-giveaways-wall-street ("To defend this reduction in capital *requirements*, Fed officials have misleadingly responded that current capital *levels* are relatively high. As the Federal Reserve Bank of Minneapolis has pointed out, this ignores the impact of the enormous interventions the Fed took during the pandemic to shore up credit markets and provide a backstop to the entire financial system, benefitting bank balance sheets despite the reduction in regulatory standards.")
[9] Federal Reserve, "Supervision and Regulation Report," November 2020, available here: Supervision and Regulation Report, November 2020 (federalreserve.gov)
[10] Baer, Greg, "The Next Financial Crisis and the Great Buffer Fallacy," *Banking Perspectives*, March 12, 2019, available here: https://www.bankingperspectives.com/the-next-financial-crisis-and-the-great-buffer-fallacy/.

Second, as recognized in two recent major reports, a Task Force formed by the Brookings Institution and the University of Chicago Booth School of Business and a Working Group of the Group of Thirty, leverage ratio requirements contributed to the breakdown of the Treasury market in March 2020.[11]

Third, with hindsight it is clear that the stress testing regime would have done its job of determining when to limit bank capital distributions well had the Fed not lost faith in its own program. Instead, researchers are now measuring how much banks' cost of equity (and with it, the cost of borrowing by consumers and businesses) was permanently increased by ad hoc restrictions imposed on capital distributions.[12]

These are certainly not the only lessons to be learned from the events of 2020. A first step in learning any of them is to start with a true rather than a false premise.

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[11] Group of Thirty Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience*, (July 2021), https://group30.org/images/uploads/publications/G30_U.S_._Treasury_Markets-_Steps_Toward_Increased_Resilience__1.pdf; Hutchins Center on Fiscal & Monetary Policy at Brookings and Chicago Booth Initiative on Global Markets, *Task Force on Financial Stability* (June 2021), https://www.brookings.edu/wp-content/uploads/2021/06/financial-stability_report.pdf; see also Liang, Nellie and Parkinson, Pat, "Enhancing liquidity of the U.S. Treasury market under stress," Hutchins Center Working Paper #72, (December 16, 2020), https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf (hereinafter *Task Force on Financial Stability*).

[12] Andreeva, Bochmann, Mosthaf and Schneider, "Evaluating the impact of dividend restrictions on euro area bank valuations," European Central Bank, July 2021, available here: https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202106_3~88f86aa6f1.en.html