Americans for Financial Reform Education Fund

Massive Payoffs to Shareholders Laid the Groundwork for the Current Bailout

The third, just passed Coronavirus stimulus bill contains provisions for a massive financial assistance program to major corporations and Wall Street. It is backed by a $500 billion appropriation that could be levered up through the Federal Reserve to encompass over $4.5 trillion in total loans to corporations and the financial sector. This is an extraordinary level of financial support – representing almost a quarter of total U.S. economic output – that will directly or indirectly provide financing for the entire corporate sector. It's crucial to put this new flood of cash in context by looking at the behavior of corporations and – especially – the nation's largest banks during the years before this unexpected crisis.

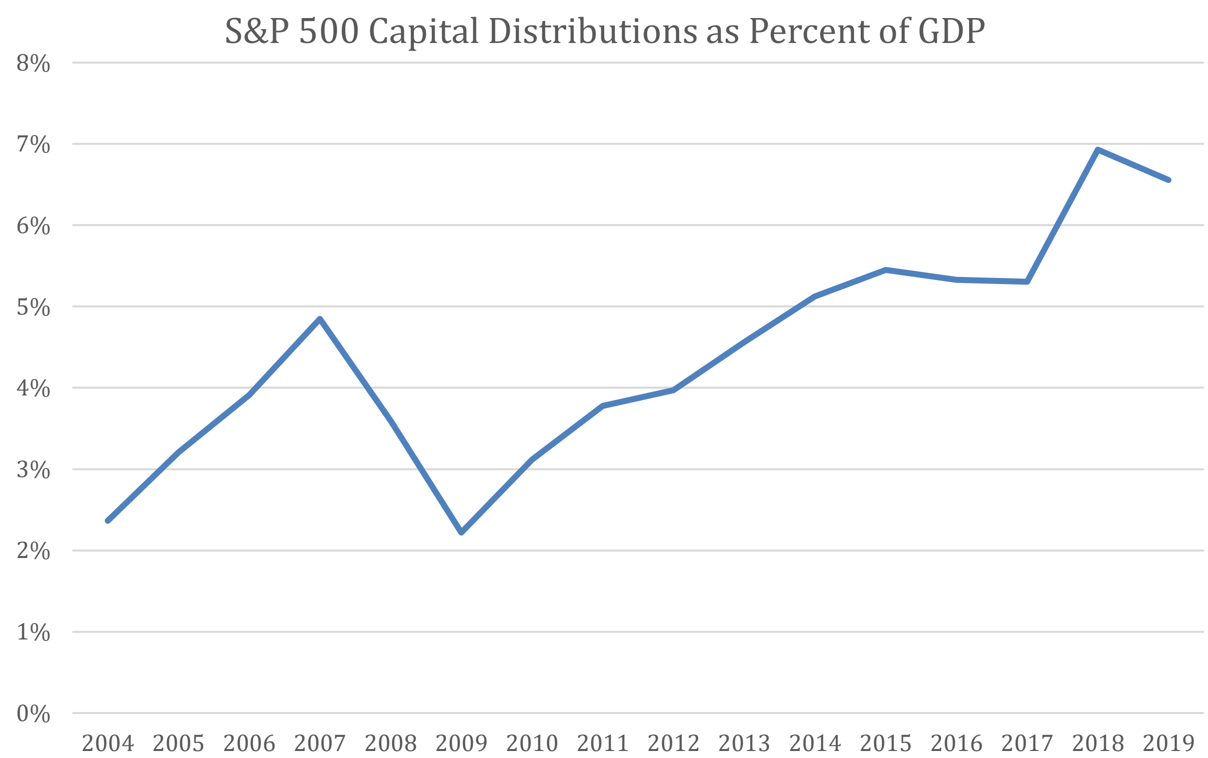
This lending program, particularly the $454 billion portion of the program that is not specifically directed at supporting the airlines, has few, if any, real restrictions on corporate behavior. Large corporations getting government financing are permitted to lay off workers, even as they receive public assistance. Under Section 4003(c)(3)(A) of the stimulus bill, only companies that receive support in the form of loans directly from the government are restricted in their distributions to shareholders or in their top executive pay packages. Other forms of government financing that are likely to make up the majority of support under the program, including direct purchases of corporate bonds and government support for bank loans to large corporations, won't carry any restrictions.

In this way, the stimulus continues a pattern of permissive regulation of large corporations that has enabled them to channel their income to providing capital payouts to wealthy shareholders and top executives, rather than support for workers or investment towards the long-term stability and success of the firm. These payouts have contributed to a steady increase in wealth inequality that has driven the proportion of wealth held by the top 1% to the highest level on record – about a third of all wealth in the economy.

The pattern is most striking in the case of the largest banks. Big banks occupy a privileged position among corporations in the United States. Because of their centrality to the financial system they are in some respects considered a crucial public utility. They receive a significant public backstop even in normal times, and in recent years have also received massive public support in periods of financial instability.

Over the past decade, and especially since the passage of major corporate tax cuts in 2017, both corporations and big banks have made unprecedented payouts to shareholders. Permitting banks to pay out their capital to shareholders in good times means that they do not have capital available to support lending and loan forbearance during crisis periods like the one we face today. Yet in recent years banks have been permitted to pay out over 100% of their profits directly back to shareholders – setting the stage for the large-scale public assistance to the financial sector that we are seeing now.

The chart below shows total capital distributions (stock buybacks and dividends) by all S&P 500 companies as a percentage of U.S. GDP from 2004 to 2019.



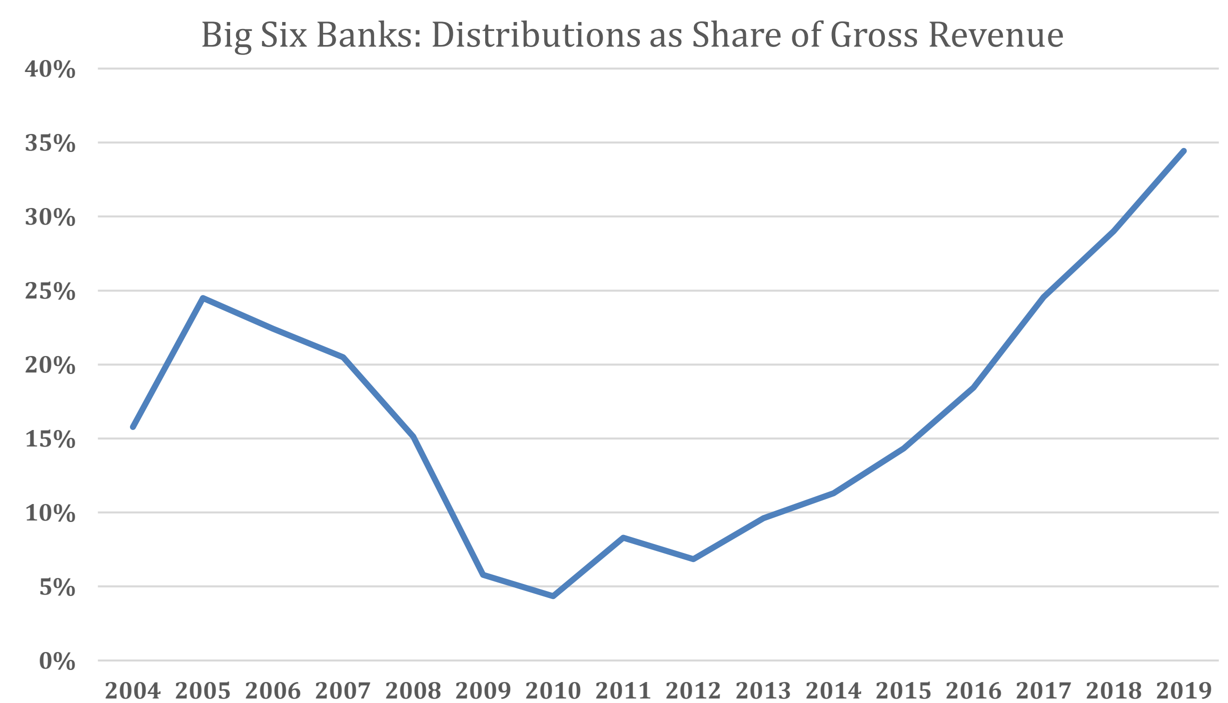
SOURCE: S&L Financial and AFR calculations. S&P 500 represent firms in the index during the year.

In 2018 and 2019 alone, when shareholder payouts reached record levels of close to 7% of GDP, corporations returned over $2.5 trillion to shareholders. This torrent of cash overwhelmingly benefited the wealthiest Americans. According to Federal Reserve distributional accounts, the top 1% of wealth holders own over half of equity wealth, and the top 10% hold about 90% of equity wealth. Along with the top executives of the firms themselves, who are often compensated with equity shares, these wealthiest households were the major recipients of shareholder payouts. The recent stimulus bill sets up the framework for corporations to receive an enormous amount of public support. A significant share of this public support will compensate for resources distributed to the wealthy through those transfers to shareholders and executives.

Shareholder payouts, especially stock buybacks, also had a large effect on pushing up stock market valuations. In 2019 Goldman Sachs analysts called share buybacks the "dominant" source of stock market demand. Inflated valuations set the stage for the stock market roller coaster ride at the opening stages of the current pandemic crisis, adding to perceptions of financial fragility. Before Reagan-era legal changes in 1982, regulators considered stock buybacks a form of illegal market manipulation. AFR, and many other policy analysts and organizations, have called for the pre-1982 ban on stock buybacks to be restored.

Perhaps the most striking area of excessive capital distributions in recent years has been the shareholder payouts made by the largest banks. Because of their privileged position in the financial system and the public support they receive, large banks, unlike other corporations, *are* subject to regulation explicitly designed to restrict shareholder payouts. The goal of this regulation, known as the "Comprehensive Capital Analysis and Review" (CCAR), or simply stress testing, is to ensure that major banks preserve adequate capital to continue lending during an economic downturn when revenues decline. Without effective capital regulation, big banks have powerful incentives to pay out their funds to shareholders in good times and rely on government bailouts to replenish their capital during severe recessions, when the risk of financial disruption due to bank failure may lead government to support the banks.

But despite this obvious issue, in recent years regulation has completely failed to restrict bank capital distributions to shareholders. As the chart below shows, distributions by the largest systemically significant U.S. banks have soared to unprecedented heights, far exceeding the levels seen before the 2008 financial crisis.



Source: S&L Financial and AFR calculations. The "Big Six" banks are the six largest systemically significant U.S. banks -- JP Morgan Chase, Bank of America, Morgan Stanley, Goldman Sachs, Citigroup, and Wells Fargo

In 2018 and 2019 alone, large banks returned over $265 billion to their shareholders – capital that would otherwise have been available to support trillions in additional lending to aid the economy during the current pandemic crisis. In fact, over the last several years banks have been returning over 110% of their *net income* to shareholders, including top executives, meaning that they have paid out all of their free cash flow plus drawn down their pre-existing capital stocks that were accumulated in anticipation of a crisis. According to the Federal Reserve Bank of New York, leverage ratios (the broadest measure of capital availability to back lending) at the largest banks have dropped by 10% since 2016.

The major banks stand to be some of the largest recipients of public support through the recently enacted stimulus measures. The Federal Reserve lending programs to be supported by the public financing from the Treasury already include special facilities for "primary dealers," the major

Wall Street financial companies that include the largest systemically significant banks. Other Federal Reserve financing facilities created in the coming weeks will likely also benefit banks, either as direct beneficiaries or as key intermediaries that will profit from on-lending public funds. Banks are also benefiting from numerous examples of regulatory forbearance by the Federal government in order to ensure their stability. In addition, the stimulus package included a provision that would allow the Federal government to guarantee all bank debt for the rest of 2020 – something that will greatly reduce bank funding costs.

The overnight switch from permitting big banks to pay out record levels of capital distributions to wealthy shareholders to providing broad public support to those same banks, underlines that the dynamic of privatized gains and socialized losses that we saw in the 2008 crisis is still operative. During good times banks were permitted to pay out all their profits and more to their owners, while in the crisis they receive public support from the rest of us. Neither the specific post-crisis reforms to bank regulation in the Dodd-Frank Act, nor what seemed at least for a moment like elite consensus that more substantial capital buffers were a basic necessity of a more stable and resilient financial system were enough to change this pattern.

The current pandemic is obviously neither the creation of the big Wall Street banks nor of large corporations. But they would have been in a better position to be a source of stability rather than fragility in the crisis if had not been allowed to reward their equity owners so lavishly during good times. Not only were insiders allowed to profit through lavish capital distributions, but the consequences of that activity then served as additional ammunition for their demand for a Wall Street and corporate bailout.