Americans for Financial Reform Education Fund

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Backdoor Bailout: Pandemic-Related Assistance to Biggest Banks

Overview

Unlike in the 2008 financial crisis, the Coronavirus crisis does not so far appear to have threatened the solvency of major banking institutions. While it's true that the largest banks currently look solvent in the face of economic stress, this is in significant part because they have benefited greatly from regulatory forbearance and from Federal Reserve intervention in financial markets. This important part of the story has been frequently overlooked or played down. Further, their continuing solvency over an extended recession is considerably more doubtful than is currently acknowledged — and much more dependent on continued help from the government.

This report, based on analysis of regulations and bank financial reports by Americans for Financial Education Fund and Risky Finance, lays out some of the clearest ways in which the nation's six largest banks have benefited from regulatory forbearance and the Federal Reserve's financial market interventions.[*] Key conclusions include:

- During the second quarter of 2020, major banks were permitted to remove almost $2 trillion from their balance sheets for the purposes of calculating compliance with key leverage capital thresholds.

- Banks also benefited from $20 billion in direct capital relief due to a two- year moratorium on counting new loan loss reserves against their retained earnings for capital purposes. This impact is moderate currently but will increase in significance if there is in an extended recession.

- The revival of bond and equity markets thanks to Federal Reserve assistance have also driven tens of billions in additional trading and investment banking profits at the nation's largest banks. These profits, which are so large that they seem clearly connected to the extraordinary levels of public support from the Fed for trading markets, also function to boost big bank solvency.

- When these factors are taken into account, the nation's six largest banks are already much closer to statutory leverage limits than is generally acknowledged. For example, if not for supernormal trading profits and regulatory exemptions, Citibank would have had a supplementary leverage ratio of 5.3% as of June, 2020, just 30 basis points above the legal limit of 5%, as opposed to the 6.7% it reported.

Below, we discuss these issues in more detail.

Regulatory Forbearance — Treasuries and Central Bank Deposits

On April 14, 2020, regulators issued a rule that exempted U.S. Treasuries and central bank cash deposits for a period of one year from measurements of the bank's size

[*] Americans for Financial Reform Education Fund is a coalition working for stronger financial regulation that includes consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. A list of AFR Education Fund member organizations is available at https://ourfinancialsecurity.org/about/coalition-members/. Risky Finance (www.riskyfinance.com) is a market data analysis and visualization platform that analyzes banking and financial market data.

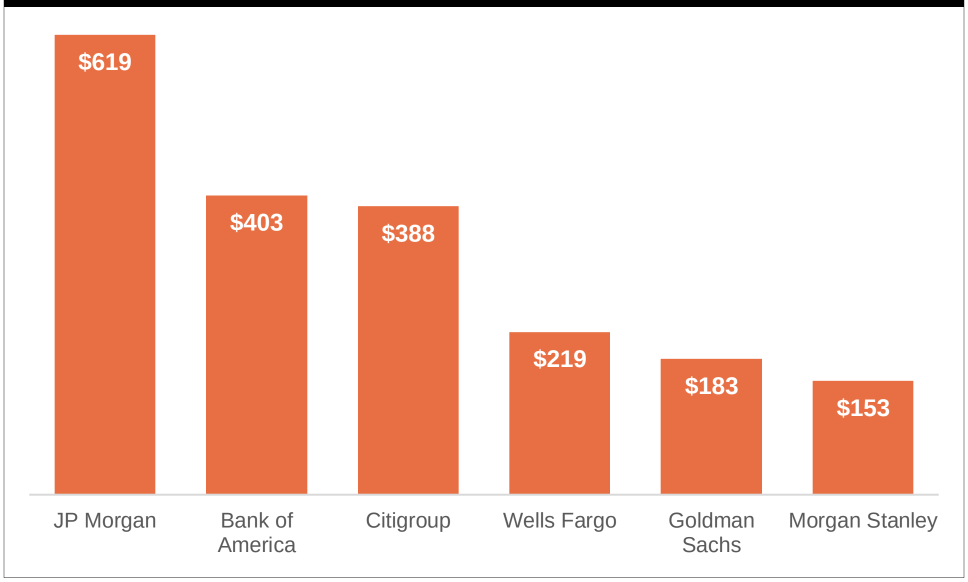
(financial exposure).[1] This exemption impacts calculation of the bank's supplementary leverage ratio (SLR). The SLR measures the amount of the bank's own equity relative to the total amount of assets it owns, to determine whether it can absorb any losses that might occur without a public bailout. The nation's largest banks are required to maintain a minimum of a 5 percent SLR, meaning that they must hold an amount of their own equity capital equal to at least 5% of the total financial exposure they have in the markets.

Exempting holdings of Treasuries and positions with central banks from the total financial exposure metric used in the SLR means that the banks measured exposure was much lower for purposes of determining how much capital they had to hold to satisfy the 5% SLR requirement. Specifically, in the second quarter of 2020 this rule permitted the nation's six largest banks to remove $1.96 trillion in exposures from their assets, meaning that they did not have to hold equity capital against these positions. (Figure 1 shows the exposures removed for each bank). At a 5% SLR ratio, this meant the banks had to hold almost $100 billion less in their own capital.

Regulatory Forbearance — Loan Loss Reserves

At the end of March regulators issued a rule that delayed by two years the requirement for banks to count certain types of loan loss reserves against their earnings.[2] By artificially increasing measured earnings, this gave the banks additional funds they could use to satisfy their equity investment requirements. The rule specifically exempts increases in loan loss reserves put in place to address the failures of loan loss reserving observed during the financial crisis (the so-called "current expected credit loss" or CECL approach). However, for our purposes the key issue is that it permits banks to effectively "double count" their loan loss reserves as both current earnings and reserves against losses, thus permitting an artificial enhancement in their apparent solvency.

Fig. 1: Nearly $2 Trillion in Big 6 Bank Assets Exempted Under SLR Rule
(in billions, Q2 2020)



In Q2 2020 this exemption allowed the six largest banks to add an additional $19 billion to their reported bottom line and therefore to their estimated capital reserves. This is a meaningful amount, but more important than its immediate impact in the second quarter is the long-term effect of this regulatory forbearance over the course of the recession. As the Covid-19 economic impact continues, more and more loans may need to be written down and loan loss reserves will increase. This regulatory exemption will mean that bank capital and earnings may be deceptively inflated even as loan performance declines.

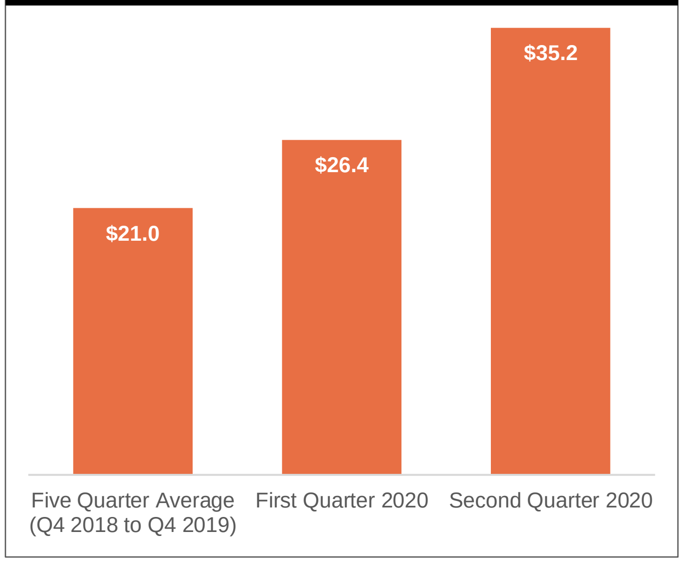
Increased Earnings due to Federal Reserve Support for Financial Markets

The Federal Reserve balance sheet – a measure of their support for financial markets -- has increased by $3.5 trillion over the last year due to massive asset purchases. That's well over twice the $1.3 trillion the Fed flooded the markets with during the 2008 financial crisis. Combined with the promise of a direct Federal Reserve backstop for credit markets that was made by the CARES Act, this is an unprecedented level of direct support for financial markets.

Unlike in the 2008 crisis, the largest banks are not nominally the core recipients of much of this intervention, which is directed at securities trading markets more generally. However, the major banks are the most important dealers in these trading markets, which have boomed since the peak of Federal Reserve intervention in March and April. Federal Reserve programs such as the Primary Dealer Credit Facility (PDCF) also advanced cheap credit to primary dealers, which include the major banks, in order to support trading operations.[3]

The result is that the major banks are indirectly supported by Federal Reserve financial market support. This can be clearly seen in the level of trading and investment banking revenues received in the first half of 2020, since market interventions began in March. Q2 2020 trading and investment banking revenues were 67% higher than their pre-pandemic average for five quarters from Q4 2018 through Q4 2019 (see Figure 2).

Fig. 2: Big 6 Banks' Trading and Investment Revenues 2020 and Pre-Pandemic Average
(in billions)

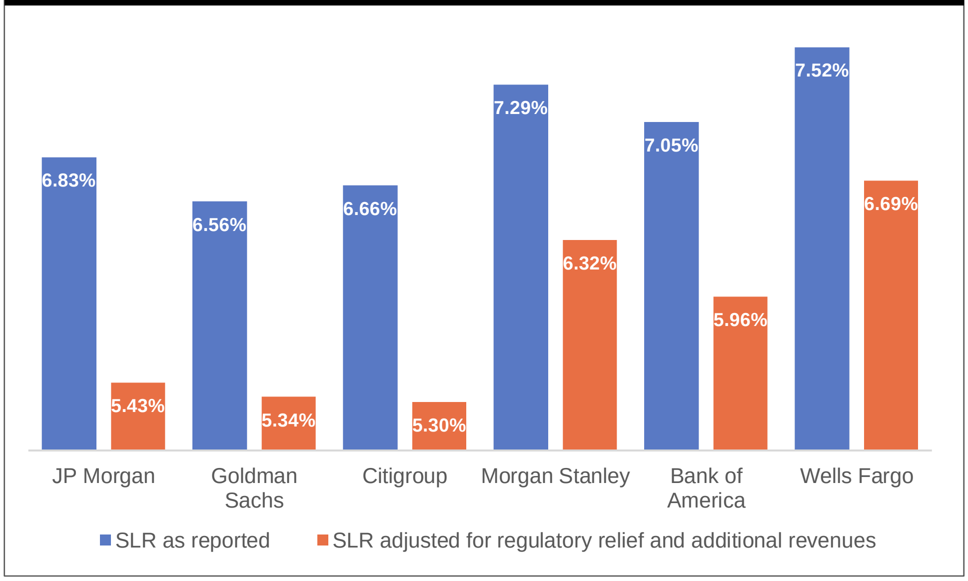


On the assumption that in the absence of Federal Reserve intervention, trading and investment banking revenues would have been at or below their Q4 2018-Q4 2019 average, this implies that at least $19.6 billion in additional revenues during the first half of 2020 were available to the six largest banks. Gains were especially large for the major trading banks, JP Morgan, Goldman Sachs, and Citigroup.

Impact of Forbearance and Interventions on Bank Leverage Ratios

In combination, the above forms of regulatory forbearance and capital market interventions significantly assisted the ability of the major banks to portray themselves as comfortably solvent even in the face of the Covid-19 crisis. The broadest measure of bank solvency is the Supplementary Leverage Ratio (SLR), which

Fig. 3: Reported vs. Adjusted Supplementary Leverage Ratios
(Q2 2020)



as described above measures the bank's own equity held against losses as a fraction of its total financial exposures. The SLR provides a summary metric of losses the bank can take before becoming insolvent.

Figure 3 below shows the SLR for each of the six major banks before and after adjustment for the three factors above. The unadjusted SLR is simply the SLR as reported by the bank in Q2 2020. The adjusted SLR shows what would happen if each bank was required to capitalize its U.S. Treasury holdings, was required to count all loan loss reserves against earnings, and had its trading and investment banking revenue revert to the mean for the five quarters of Q4 2018 through Q4 2019 (so additional revenue was not available to bolster its capital position).

The adjustments have a major effect and bring three of the banks very close to the 5% regulatory leverage minimum. With the adjustments Goldman Sachs, JP Morgan, and Citigroup have supplementary leverage ratios just 30 to 40 basis points (less than half a percentage point) above the 5% regulatory minimum. Overall, the six largest banks move from 1.99% (199 basis points) above the regulatory minimum leverage threshold to just 0.84% (84 basis points) above the threshold.

Conclusion

Regulatory reporting shaped by permissive deregulation and massive Federal Reserve intervention in the markets makes the major banks look comfortably solvent in the face of the Covid-19 crisis. But a closer look at the situation shows banks in a significantly shakier position than currently acknowledged.

Furthermore, in an extended recession banks will come under even more capital pressure. This is apparent in the Federal Reserve coronavirus stress tests, which show banks nearing regulatory minimums for risk-adjusted capital within a year.[4] The impact of a recession will be even greater as benefits to borrowers under Federal programs such as the Paycheck Protection Program slow or stop.

These findings underline the urgency of immediately halting the payment of bank dividends. Especially given the Federal support for banks, these are essentially transfers from taxpayers, who are less protected against the possibility of another bank bailout, to bank insiders and shareholders. Federal regulators are permitting banks to pay out dividends of up to $50 billion for 2020.[5] These dividend payments represent a direct transfer from bank capital resources designed to protect the public against financial disruption, to bank executives and shareholders.

The findings also show the importance of reconsidering the bank capital framework in general. Even without accounting for the forbearance discussed in this document, overall capital levels for the largest banks have been steadily declining over the course of the Trump Administration. As Figure 4 shows, large bank leverage capital ratios are now at their lowest level since 2011.[6] Much of the progress made since the financial crisis in safeguarding against future bank failures has been lost, and this is before the impact of a possibly extended recession has been experienced. Navigating a recession with undercapitalized banks risks financial disruption, and will harm economic recovery by restricting lending and financial intermediation.

Fig. 4: Leverage Capital Ratios at Large Banks 2009-2020
(Tier 1 leverage ratio for banks >$750B in assets, Federal Reserve Y9C))

Endnotes

[1] Federal Reserve System, "Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio". Docket No. R-1707; RIN 7100-AF81, April 14. 2020, available at https://beta.regulations.gov/document/FRS-2020-0121-0001

[2] "Regulatory Capital Rule: Revised Transition of the Current Expected Credit Losses Methodology for Allowances", Federal Register, Vol. 85, No.62, March 31, 2020. Available at https://www.govinfo.gov/content/pkg/FR-2020-03-31/pdf/2020-06770.pdf

[3] Federal Reserve, Primary Dealer Credit Facility, information available at https://www.federalreserve.gov/monetarypolicy/pdcf.htm

[4] Federal Reserve, "Assessment of Bank Capital During the Recent Coronavirus Event", June, 2020, available at https://www.federalreserve.gov/publications/files/2020-sensitivity-analysis-20200625.pdf; See also Federal Reserve Bank of Minneapolis, "Covid-19 Stress Test Tool", available at https://www.minneapolisfed.org/banking/financial-studies-and-community-banking/run-your-own-stress-test-on-large-banks

[5] Americans for Financial Reform Education Fund, "Big Bank Dividends During the Coronavirus Crisis", April, 2020. Available at https://ourfinancialsecurity.org/wp-content/uploads/2020/04/AFREF-Big-Bank-Dividends-During-Coronavirus-Crisis-4-2020-1.pdf

[6] This chart shows Tier 1 leverage ratios, not the Supplementary Leverage Ratio shown elsewhere in the document, since SLR data is not available before 2016. The two are similar except that the denominator of the Tier 1 leverage ratio does not include certain off-balance sheet exposures included in the SLR.