HOW SHOULD U.S. BANK REGULATORS RESPOND TO THE COVID-19 CRISIS?

Michael Blank, Sam Hanson, Jeremy Stein, and Adi Sunderam
Harvard University and Harvard Business School
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OVERVIEW

- Lessons from the Global Financial Crisis of 2008-09
- Market-based signals this time around
- A table-top COVID stress test
- Promoting dynamic resilience in times of stress
- Some specific policy recommendations
LESSONS FROM THE GFC

- In hindsight, was a major policy failure not to stop payouts and push for equity raises sooner.
- Not appealing for banks to issue equity at 40% decline from peak. But by waiting, had to do it after a 70% decline, with support from government and specter of nationalization.
- Bank stock prices as useful early warning signal.
- In cross-section, pre-Lehman stock price decline is highly informative about subsequent loan losses.
- Much better than accounting-based metrics.
Bank stocks down by about 40%: much more than overall market, or even value stocks.

In cross-section, bigger price declines for banks with more loans/assets, especially C&I loans and consumer loans.
- As in GFC, seems to be real fundamental information in bank stock prices.

C&I leveraged loan prices down by 10% (even with Fed support of credit markets).

Weighted CMBS prices down by 9%.
**A TABLE-TOP COVID STRESS TEST**

- We use slightly modified version of Fed’s CLASS model: maps macro assumptions into evolution of category-level loan losses and bank-level capital ratios based on historical time-series relationships.
  - Unemployment rate as primary macro driver; also residential and commercial real estate indices.
  - Study 21 BHCs included in 2020 CCAR.

- Obvious caveats about extrapolating past history to the present case: dynamics of unemployment path are very different.

- Think of as a crude attempt to get a handle on magnitude of what could happen if things continue to go south.

- In our most optimistic case, with unemployment peaking at 17.8%, CET1 drops by $389B and CET1 ratio falls from 11.5% to 7.3%. In most pessimistic case, with unemployment peaking at 28.7%, CET1 ratio falls to 5.5%.
A TABLE-TOP COVID STRESS TEST

Effect of different unemployment rate scenarios on loss projections

Effect of scenario severity on CET1 ratio

Effect of scenario severity on net charge-offs
Cumulative projected NCOs as percentage of 2019Q4 loan balance

Residential real estate

Commercial real estate

C&I

Consumer

- All less adverse
- All more adverse
- More adverse UR
- Less adverse UR
- GFC (2007Q3 - 2010Q3)
Cross-validation: banks with bigger stock-price declines show bigger hits to CET1 ratios in our stress tests.

These tend to be consumer-focused banks.
In a simple model, Greenwood et al (2017) show that optimal response to a major shock to bank capital consists of two elements:

- A loosening of marginal capital-ratio requirements on new loans and other desired activities.
  - As would happen e.g. with relaxation of a counter-cyclical capital buffer.
  - Or with exclusion of Treasuries and reserves from denominator of SLR.

- An increase in dollars of equity in the banking system.
  - Dividend stoppages and equity raises.
  - Was a fundamental insight of 2009 SCAP: focus on dollars raised, not just capital ratios.

Analogy to taxation: want to simultaneously broaden the base to maintain revenues, while cutting marginal tax rates to encourage desirable activities.

US policy thus far has been almost entirely focused on loosening capital-ratio requirements.
  - Unlike many other countries which have imposed dividend stoppages on banks.
**Policy Recommendations**

**Short run**
- Immediate halt to all bank dividends and share repurchases.
- Encourage substantial new common equity raises.

**Longer-term**
- Consider ways to more explicitly incorporate market-price information into stress-testing process. Not mechanically, but as a way of imposing some discipline on forward-looking assumptions during times of rapid change.
- Make it a default setting that counter-cyclical capital buffer is turned on in good times. Gives more scope to relax in a crisis.
- Exclusion of reserves from denominator of SLR is likely to be (and should be) semi-permanent. Not at all clear that Treasuries should be excluded on ongoing basis.