HOW THE FED CAN USE ITS BANK PRUDENTIAL AUTHORITIES TO SUPPORT THE ECONOMY AND THE FLOW OF CREDIT

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U.S. banks were robustly capitalized prior to the COVID-19 pandemic and the resulting "sudden stop" in economic activity. However, the pandemic has significantly increased the probability of an adverse event in which U.S. banks face large losses in the coming quarters.

The escalating risk of large losses does not stem from the direct impact of the pandemic on bank profitability. However, this sudden halt in real activity means there may be a wave of household and corporate delinquencies as banks work with borrowers who are unable to service their debts. Merely postponing several quarters of debt payments will not itself generate large losses. Instead, the key risk is that the sudden stop in real activity triggers significant knock-on effects and unleashes powerful amplification forces, both real and financial. As a result, the economy could conceivably be in deep recessionary state—or even a depressionary state as recently suggested by Secretary Mnuchin—once the health emergency ends. Thus, delinquencies that would only be temporary in an ideal world in which the economy immediately returns to its early-2020 state may not "cure" in reality; as a result, banks may be forced to recognize large, permanent credit losses.

Policymakers must ensure that banks remain well-capitalized so that they can continue to provide credit to the economy, both during the public health emergency, and especially once the health emergency ends and it is safe to resume normal economic activities. Furthermore, due to the growth of nonbank credit in recent years, banks may be called upon to re-intermediate significant amounts of credit currently held by nonbanks due to the recent deterioration in credit markets.

Below we outline how the Federal Reserve can use its capital-planning and stress-testing authorities to promote financial stability and the flow of credit in the face of this unprecedented shock. In effect, we argue that the Federal Reserve can use its prudential regulatory authorities to buy "low-cost insurance" against adverse scenarios that have become more likely in light of the COVID-19 pandemic and the resulting economic shut down.

Concretely, we believe the Federal Reserve should undertake the following steps:

1. To conserve banks' capital buffers, policymakers should require banks to immediately suspend both dividends and repurchases to common shareholders. They should also push banks to suspend part, or all, of their bonuses to senior executives. These actions are clearly the financially prudent course of action at this time. And, they should be framed as banks and their executives doing their patriotic, "war-time" duty to keep credit flowing to the economy by retaining the necessary capital.

2. Instead of proceeding with the 2020 CCAR/DFAST bank stress test as they would in the ordinary course, large banks and Federal Reserve should instead undertake an accelerated stress-testing exercise in spirit of the 2009 SCAP. This exercise should consider an adverse scenario based on the specifics of the COVID-19 pandemic and the resulting sudden stop. Banks should be quickly asked to re-submit new capital plans that are adapted to the adverse scenario suggested by the pandemic. Federal Reserve supervisory staff who would normally be engaged in the CCAR/DFAST stress-testing exercise should work to produce an independent assessment of banks' capital needs in this adverse pandemic scenario.

3. Concurrently, the Federal Reserve should informally encourage large banks to raise new common equity via secondary offerings as soon as possible. While this may be "dilutive" to existing shareholders, it is prudent to issue equity now rather than in a few months. In effect, issuing equity now is a relatively cheap way—for both banks and for the economy as a whole—to buy insurance against adverse scenarios. Concerns about the costs of issuing equity today must be weighed against the potentially far greater costs of addressing solvency concerns in the midst of an adverse scenario several months from now. Moreover, if done now, this can be framed not as a response to imminent solvency concerns in the banking sector, which is still healthy today, but as banks doing their patriotic duty by building the extra capital needed to step in and re-intermediate other, more dysfunctional parts of the credit-supply system.

4. At the same time the Federal Reserve is pushing banks to raise *additional dollars of common equity*, the Fed should also consider *relaxing marginal capital charges* on new lending and intermediation activity. As we discuss in Greenwood et. al. (BPEA 2017), the idea is to pair a large "lump-sum tax" with a reduction in "marginal tax rates" on new activity. Following a large negative shock, this two-part policy is the best way to trade off (i) the threat to financial stability posed by the elevated risk of bank insolvencies and (ii) the desire to promote the flow of new credit to the economy.

   With this view towards encouraging new bank lending, prudent steps to reduce marginal capital charges may include:

   a. Allowing banks to draw down their capital ratio buffers;

   b. Waving the new accounting rules that require banks to immediately provision for lifetime expected losses when loans are originated (i.e., FASB's CECL standard);

   c. Making several technical changes to the Supplementary Leverage Ratio standard for the largest banks—e.g., exempting U.S. Treasuries from the denominators.

In conclusion, our overarching recommendation is that the Federal Reserve's supervisory and regulatory functions need to begin acting immediately to buy insurance against the risk of large bank losses which have been made more likely by the COVID-19 pandemic.