The Daily Dish

Banks and the Evolution of the Crisis

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Eakinomics: Banks and the Evolution of the Crisis

There is a reflex among policymakers to treat the current pandemic recession as a repeat of the 2007-08 downturn, including referring to the current woes as a financial crisis. But, in fact, the two events have little in common. The 2007-08 downturn originated in poor products, practices, and management in the financial services sector, and spread to the Main Street economy. The current pandemic downturn began with a sharp pullback in spending by high-income households seeking to avoid infection and transmission of the virus. The ongoing concern, however, is that the woes in the business – especially small business – sector will manifest itself as failure to be able to repay debts, leading to weakness in the financial sector.

The 2007–08 financial crisis featured the failure and bailout of numerous large financial services firms, especially large banks. As detailed in the latest from Thomas Wade the Comprehensive Capital Analysis and Review (CCAR) was instituted to check whether large banks with over $50 billion in assets hold sufficient capital. These "stress tests" have two phases. Per Wade: "The first phase, considered a lower hurdle, measures whether banks are holding sufficient capital in the event of hypothetical catastrophic losses. The second phase is considered more stringent and focuses on a bank's capital plan, including cash the bank intends to return to shareholders."

The 2020 CCAR process risked irrelevance because the scenarios used by the Federal Reserve (Fed) in the stress tests were published in February, before the onset of the recession. As a result, the stress test had a lot less stress than conditions right now. As a result, the Fed added a "sensitivity" analysis that included three scenarios: V-shaped (a sharp decline and a sharp recovery); U-shaped (a sharp decline and a gradual recovery); and W-shaped (a double recession).

The good news is that the banks would continue to meet the minimum capital requirements even in the worst of circumstances. Again, as Wade reports: “Bank capital would, however, decline from the 12 percent of Q4 2019 to between 9.5 and 7.7 percent in the most adverse scenarios.”

The bad news for the banks is that the Fed also announced a prohibition on share buybacks, a limitation on dividends in the third quarter, and a request for banks to refile their capital plans. In short, the banks are seemingly doing fine but that doesn’t stop the Fed from micromanaging their financial plans.