

Fed Deems Banks Have Enough Capital Following COVID-19 Stress Test

By Steven Kelly

Original post [here](#).

On December 18, the Federal Reserve [announced](#) the [results](#) of its first-ever mid-cycle stress test. The test showed the 33 largest banks in the U.S. remain well-capitalized against pandemic-induced stress scenarios designed to be more adverse than those designed pre-COVID.

With the release of these results, the Fed loosened payout restrictions it put in place in June. It will allow these banks to make total shareholder dividends and repurchases in the first quarter of 2021 up to the quarterly average of their 2020 net incomes. Previously, it had capped dividends at the levels banks paid in the second quarter of 2020; allowed dividends up to the four-quarter running average of net income; and temporarily banned repurchases.

When the Fed [released](#) its regularly scheduled stress test [results](#) in June, large banks likewise all passed. However, the scenarios in those tests did not reflect the financial stresses of COVID-19. As a precaution due to the ongoing pandemic, the Fed announced blanket payout limits. It also said it would run a second, mid-cycle [stress test](#) to better reflect the plausible downside economic scenarios of the COVID-19 pandemic as its effects continued. For a discussion of the new stress test's [design](#), see [this YPFS post](#).

Despite the more severe scenarios, all 33 banks – whose average common equity tier 1 (CET1) capital ratio was 12.2% as of the stress-test start date – remained above the minimum 4.5%, with the average, post-stress CET1 ratio bottoming out at 9.6% over the course of the nine-quarter severely adverse scenario, starting from June 30. This is only slightly lower than the 9.9% post-stress average found in June, for which banks started with a 12.0% CET1 ratio.

As noted, banks have been subject to capital-distribution restrictions in the second half of 2020, while the largest banks [voluntarily suspended](#) share repurchases as early as March. The Fed noted that this capital conservation and banks' [material buildup of loss reserves](#) in the first half of 2020 bolstered their updated post-stress results.

In the severely adverse stress scenario, several banks fell below their minimum supplementary leverage ratio (SLR), which eschews risk-weighting and is intended to [backstop](#) risk-based capital measures for the largest banks. HSBC fell below its minimum of 3%, while four of the eight U.S. global systemically important banks (GSIBs) – Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley – fell below their 5% enhanced SLR minimums. Under the Fed's new stress-test [framework](#), finalized in March, large banks no longer face restrictions if the stress test shows them falling below their leverage ratio minimums.

The Fed [temporarily loosened](#) the SLR on April 1 to ease the ability of large banks to support the Treasury market and their customers during the early days of the pandemic. The Fed allowed large banks' holding companies to exclude Treasuries and reserves deposited with the Fed from

their SLR calculations through March 31, 2021. On May 15, the federal banking regulators [expanded](#) this exemption to these companies' depository subsidiaries.

Distributions Allowed to Pick Up with Rise in Earnings

With the release of the stress test results, the Fed also loosened its restrictions on large banks' payouts that it put in place in June. Governor Lael Brainard again cast the [lone dissenting vote](#). She [said](#) that the payout limit modification “nearly doubles the amount of capital permitted to be paid out relative to last quarter” and argued for stricter restrictions limiting banks to “more modest payouts to preserve lending to households and borrowers during an exceptionally challenging winter.”

In June, the Fed barred large banks from share repurchases in the third quarter and said banks could not increase the size of their dividends over the amount paid in the second quarter. The Fed also limited total quarterly dividend payouts to banks' average net income over the preceding four quarters. In September, the Fed [extended](#) this restriction through the fourth quarter as a precaution, as it deemed banks to be “[well capitalized](#).”

Following the release of the December results, the Fed stated it was “extending the current restrictions on distributions, with modifications.” The share repurchase restriction will be dropped in the first quarter of 2021, while the requirement that dividends remain at or below their second quarter level and total payouts not exceed the recent income formula will remain.

Given that dividends typically account for about [30% of large U.S. banks' shareholder payouts](#) in the U.S. (with the balance being accounted for [by repurchases](#)), removing the share repurchase ban could allow for a significant boost in capital distributions. As long as dividends do not increase, a firm may pay out in the first quarter of 2021 as much 100% of its average quarterly income over the previous four quarters in dividends and repurchases combined.

Several large banks [announced plans](#) to resume share buybacks in 2021 following the release of the test results. The Fed offered no guidance on its capital distribution policies beyond the first quarter.

Capital Requirements Will Not Be Adjusted

Breaking with annual stress test practice, the Fed did not update firms' capital requirements based on this mid-cycle stress test. The [capital requirements determined by the annual stress test](#) released in June will remain in place, as of the fourth quarter of 2020. The Fed [assessed that](#) “with the current capital requirements and distribution restrictions in place, banks have built capital over the past year” and that the ongoing income-based limitations would serve to keep them well-capitalized going forward.

However, the Fed also extended the period during which it can inform firms of a new capital requirement. While it is normally to provide notice within 75 days, the Fed is “extending the time period to notify firms whether their stress capital buffer requirements will be recalculated until March 31, 2021” due to the ongoing uncertainty of the pandemic.