JULY 29, 2020

Warren and Schatz Again Raise Concerns About the Stability of the Financial System During the COVID-19-Induced Recession, Citing Recent Bank Sensitivity Analyses

Senators urge the Federal Reserve to fix its' "grave error" by preventing banks to from paying dividends and to immediately provide more information banks' risks to policymakers and the public. Despite COVID's risks to the economy, reports suggest the Fed is urging Congress to give regulators the authority to roll back critical capital requirements put in place to keep financial system stable after the last financial crisis.

Washington, DC - United States Senator Elizabeth Warren (D-Mass.), and Senator Brian Schatz (D-Hawaii), both members of the Senate Banking, Housing, and Urban Affairs Committee sent a letter to the Federal Reserve Chair Powell and Vice Chair for Supervision Quarles raising concerns about the Fed's lack of transparency and inaction to improve stability in the banking system following recent sensitivity analyses that showed banks may be vulnerable to losses during the COVID-19-driven recession.

"We have serious concerns about the Fed's opaque decision making and its failure to take the necessary steps to keep our banking system stable in light of the coronavirus disease 2019 (COVID-19) pandemic," the Senators wrote. "These concerns are especially disturbing in the context of recent reports that the Fed is urging Congress to give regulators the authority to roll back critical capital requirements that were put in place to keep our financial system stable after the last financial crisis."

When the financial system crashed in 2008, regulators did not have a solid understanding of the extent to which banks were exposed to different types of risks. After the 2008 crisis, regulators developed stress tests to gather key information on the health of the banking sector to ensure the sector's resilience to shocks and monitor how banks perform under various adverse economic scenarios. The scenarios for this year's tests were announced this February, before the extent of the economic damage associated with COVID-19 became clear. (The scenario that was designed to model "severely adverse" economic conditions, for example, included the unemployment rate peaking at ten percent and quarterly Gross Domestic Product (GDP) declining by a maximum of 9.9 percent. By comparison, the April 2020 unemployment rate was 14.7 percent and certain estimates show second quarter GDP declining by 35 percent.) As a result, it became clear in March that the stress tests would be unable to accurately measure the impact on the banking system of a severely adverse COVID-19 related economic scenario.

Aiming to capture possible effects of COVID-19 on the banking system, the Fed conducted additional "sensitivity analyses" to examine how banks could fare in three hypothetical economic scenarios stemming from the pandemic-driven downturn in order to help inform decisions on the banks' capital

distributions. The results of the Fed's "W-shaped" recovery scenario, the most severe of the three, painted a deeply concerning picture of the banking system's present ability to absorb potential losses. However, unlike with the normal stress tests, the Fed did not release the results of this scenario for individual banks and failed to include the effects of the different scenarios on a number of important metrics. As a result, the Fed is depriving policymakers and the public of crucial information about the health of the banking sector.

"Despite these troubling results," the senators wrote, "the Fed inexplicably announced that it would not suspend dividend payments. Instead, banks are allowed to continue paying their dividends, albeit at a capped amount calculated by looking backward to banks' previous net income-contradicting the forward-looking purpose of a normal stress test. The failure to take this action is a grave error that could have serious consequences for financial stability amidst a severe recession. Banks should be conserving capital to bolster their ability to withstand future losses and to support lending to businesses and households."

The Senators urged the Fed to reverse the decision to allow banks to continue to pay their dividends and immediately provide more information to the public about the current risks to the banking sector, including additional findings from the sensitivity analyses the Fed has failed to release. They requested a response no later than August 11, 2020.

###