

## Bank Capital and Liquidity: COVID-19 Questions You May Be Considering

March 20, 2020

The U.S. federal banking agencies have encouraged banking organizations to use their capital and liquidity buffers to support customers in the face of the economic effects of COVID-19 mitigation. Yet, the extent and stringency of the capital and liquidity requirements developed and implemented since the 2008 financial crisis raise a number of questions for banking organizations. Below, we set out several of the more urgent questions and some related insights.

### ***Do we have to submit our capital plan on April 5? Will the Federal Reserve be conducting the 2020 Comprehensive Capital Analysis and Review (CCAR)?***

As of today, the Federal Reserve has not provided any indication of a delay or postponement of the due date (April 5) for submission of capital plans or company-run stress tests, nor has the Federal Reserve indicated any delay or postponement of the 2020 CCAR exercise.

The European Banking Authority indicated on March 12 that the EU bank stress test will be postponed. The Bank of England also cancelled 2020 bank stress tests on March 20.

We believe it unlikely that the Federal Reserve will postpone or significantly delay CCAR. The supervisory stress tests were introduced in the midst of the 2008 financial crisis to reassure the market and depositors about the soundness of the largest U.S. banking organizations, and CCAR provides an opportunity to provide similar reassurances in the current crisis.

### ***Will we be getting a stress capital buffer number in June, or will the Federal Reserve delay implementation of that new rule?***

As of today, the Federal Reserve has not provided any indication of a delay or postponement in implementation of the stress capital buffer rule. The Federal Register version of the rule was released on March 18, with an effective date of May 18, 2020. The release of CCAR results on or around June 30 is expected to include each CCAR firm's stress capital buffer. Unless postponed, a firm's first stress capital buffer will be effective from October 1, 2020.

The Federal Reserve projects that the stress capital buffer rule will reduce effective risk-based capital requirements for CCAR firms (other than the 8 U.S. global systemically important banks (GSIBs)). Because the stress capital buffer could generally provide some capital relief to most CCAR firms, we would not expect its implementation to be delayed given current circumstances.

Modifications to the stress capital buffer rule such as eliminating the dividend prefunding requirement or allowing the dividend pre-funding to be drawn down in times of stress are changes that could be accomplished swiftly through an interim final rule before the stress capital buffer takes effect. Banking

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organizations could benefit from renewed advocacy for these changes in advance of the stress capital buffer's effective date of October 1, 2020.

***What if our capital ratios fall below our GSIB surcharge or our capital conservation buffer?***

Notwithstanding the agencies' encouragement to use both "management" buffers ("extra" capital above regulatory minimum and buffer requirements) and the regulatory buffers, firms still must heed the restrictions triggered when dipping into regulatory buffers. Based on an FAQ issued by the agencies on March 19, a firm with capital ratios dipping into its GSIB surcharge or capital conservation buffer would still need to apply increasing restrictions on capital distributions and discretionary bonus payments to C-suite executives.

An interim final rule released by the Federal Reserve on March 18 offers modest relief to all banking organizations subject to regulatory buffer requirements by making more flexible the definition of "eligible net income". In case a firm may have depleted its net income (from which distributions are taken) over the previous four quarters through dividends or share repurchases, the interim final rule allows all banking organizations to calculate any restrictions based on a new definition of "eligible retained income"—the greater of (i) net income for the four calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects; and (ii) the average net income for the four calendar quarters preceding the current calendar quarter, without distributions excluded.

Banking organizations may want to advocate for relief from the distribution and bonus restrictions. On one hand, the agencies have already indicated this week that they view the buffers as capital that should be used to assist customers, and therefore restrictions that cause bank reluctance to use the buffers would appear counter to this policy goal. On the other hand, it is possible that relief may not be politically palatable to the agencies, given that the restrictions on capital distributions and share buybacks caused by dipping into the buffers may be consistent with Congressional policy views during this crisis.

***What if we dip into our reserved high quality liquid assets (HQLA), and fall below 100% of our liquidity coverage ratio (LCR)?***

Notwithstanding the agencies' encouragement to use both "management" buffers ("extra" above the minimum 100% LCR) as well as the LCR, a March 19 FAQ issued by the agencies indicates that dipping below a 100% LCR still requires a remediation plan "promptly". Furthermore, the LCR regulation indicates that a banking organization must notify its regulator on any day in which it has fallen below the 100% minimum. While a plan is required, the agencies reiterated that there "is no requirement to rebuild HQLA within a specific time period."

This notification to the Federal Reserve that a banking organization is using its LCR buffer capacity would not be publicly disclosed. However, banking organizations subject to the LCR must publicly disclose on a quarterly basis quantitative information about their LCR calculation.

Prompt notice to an institution's primary regulator, followed by appropriate oversight, in lieu of a remediation plan, could have been better encouragement to banks. The possibility of a remediation plan will effectively act as a deterrent to using more of a firm's high quality liquid asset store. Banks may want to advocate for more leniency in relation to this requirement.

### ***How might participation in some of the recently announced funding and liquidity facilities affect my capital and liquidity compliance?***

Generally, the facilities are designed to add cash liquidity to, and to replace other assets on, a firm's balance sheet. Effects may be different for each banking organization depending upon how the liquidity is deployed. Generally, the agencies have indicated where they have thought there might be a capital or liquidity consideration:

- *Money Market Mutual Fund Liquidity Facility (MMLF)*. In connection with the MMLF announced on March 18, the agencies issued an interim final rule on March 19 "to exclude the effects of purchasing assets through the MMLF from a banking organization's regulatory capital." In effect, the agencies have fully exempted from risk-based capital and leverage requirements (i) any asset pledged to the MMLF and (ii) any asset purchased from a qualifying fund on or after March 18, 2020 that the firm intends to pledge to the MMLF upon opening of the MMLF.
- *Primary Dealer Credit Facility (PDCF)*. The Federal Reserve Bank of New York released FAQs on March 19 stating: "[the LCR rule] does not require a firm to recognize an outflow for a secured funding transaction that matures more than 30 calendar days from the calculation date. As such, primary dealers that are affiliates of entities subject to the LCR rule would not recognize an outflow for so long as the maturity of the loan is not within 30 calendar days of a firm's calculation date. As the remaining maturity of the loan declines, the primary dealer may choose to pre-pay the loan and request a new loan up to 90 days."
- *Discount Window*. In FAQs issued on March 19, the agencies indicated that banking organizations may assume the original (up to 90 day) maturity date when factoring into their LCR.

### ***Could there be other capital or liquidity relief coming?***

Other areas in which the Federal Reserve and the other agencies could provide swift and targeted capital relief could include:

- *CECL*. Delaying requirements to incorporate the impact of the Financial Accounting Standard Board's (FASB's) new "current expected credit loss" (CECL) accounting standard into a banking organization's capital ratios. In a related move, FDIC Chair McWilliams sent a letter to FASB on March 19 urging postponement of implementation of CECL, which is intended to be this quarter for SEC-registered issuers.
- *eSLR*. Immediate adoption of changes proposed in April 2018 to revise the enhanced supplementary leverage ratio (eSLR) buffer from the current 2% buffer requirement for U.S. GSIB bank holding companies (and a parallel requirement for their subsidiary banks to maintain an SLR of at least 6% in order to be considered "well capitalized") to a variable buffer based on 50% of the GSIB's applicable GSIB surcharge. Relief on Tier 1 and supplementary leverage ratios may be particularly important in light of the increased balance sheet usage that may occur during this crisis.
- *Government Guarantees and Loan Forbearance Programs*. Should the U.S. government guarantee loans or other obligations of certain industrial or commercial sectors, such as the small business interruption loans proposed by the Treasury, the guarantee should reduce total risk-weighted assets

because of the 0% risk weight benefiting exposures that are unconditionally guaranteed by the U.S. federal government. In addition, we would expect any future programs that permit or require banks to provide forbearance to obligors on mortgage loans, student loans or other similar assets could be accompanied by capital relief to lower the 150% risk weight that generally applies to exposures once they are 90 days past due or on nonaccrual.

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Cleary Gottlieb has established a [COVID-19 Resource Center](#), providing information and thought leadership on developing events. In addition, we have a [COVID-19 Task Force](#) that is acting as a repository for practical solutions, best practice and issue-spotting to help our clients by sharing market experience, insight and advice from across our global presence.

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