Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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It Takes an Optimist*

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March, 2016

It takes an optimist to observe recent news and economic events and not be concerned in the context of bank regulation.

Current Economic Environment

We are pressed to find anything worthy of enthusiasm in the current economic environment. We've seen downward pressure on commodity prices, especially in the energy sector, for months. Despite low prices for crude, oil continues to be extracted. Oil is now stored offshore in tankers, or in rail cars, notwithstanding widely recognized environmental risks. Bottled water now is more expensive than oil. In part, it has been reported that the slowdown in the Chinese economy is responsible in large part for the fall in prices. Emerging markets also are slowing. Central banks around the world are responding to this environment by consciously devaluing currency through interest rate policy or by promising further accommodation. These tools ultimately become ineffective when implemented by multiple countries. We've seen this before.

One of the prices we pay for living in a global economy is that it is more difficult for the U.S. to resist downward economic drafts that originate abroad as a result of the actions of investors and foreign central banks. The dollar has risen in value as a result of these decisions, making exports more expensive, imports more affordable, and further weighing on the ability of domestic businesses to raise prices, contrary to the wishes of the Federal Reserve. The markets, despite earlier expectations of further rate increases by the Federal Reserve, are coming to anticipate no such action in the near term. Persistently low interest rates around the world (negative in some cases) and resistance to efforts to raise rates imply weakness in economic outputs, and little demand for credit. After a while, those effects can begin to be felt in the U.S. as well. In this respect, manufacturing in the U.S. has been shrinking, some speculate because of reduced exports resulting from a stronger dollar.

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While there has been some good news on the domestic employment front, particularly the decreasing reported rate of unemployment, enthusiasm for that development should be tempered by the low participation rate of employment of the working age population, as discouraged workers no longer seek employment. Also, living standards seem no better than before the onset of the Great Recession. This implies that those who lost jobs and found new work do so at a reduced or stagnant wage. There are scattered reports of a strengthening labor market, but it also was reported that participation in the food stamp program remains at near record levels, with no signs of abatement. Notwithstanding the Federal Reserve's efforts to maintain the level of equity markets through quantitative easing, equity indices can't seem to significantly meet or exceed pre-recession levels. Several observers warn of a market top in equities, especially as gains are concentrated in a few winners (e.g., the so-called FANG stocks). What's more, there are signs of an over-heating real estate market, given high levels of "flipping," i.e., speculation, reported in certain markets.

Regulatory Environment

U.S. bank regulators are slowly but surely grinding ahead in adopting regulations to implement Dodd-Frank mandates. Regulators continue to raise the pressure on banks through adoption of tougher regulatory requirements than Dodd-Frank itself required. Regulators have doubled capital requirements and on top of that are proposing surcharges on the largest banks. Since the crisis, regulators encouraged banks to issue bail-in debt, debt that behaves like equity in times of losses and turmoil. Regulators also want bankers to hold longer dated liabilities to match more effectively the assets on the balance sheet. This latest push discounts the settled premise that banks exist to profitably transform short term liabilities into longer dated assets.

On the asset side, as part of their ongoing shared national credit reviews, regulators are persistently criticizing banks for simply originating, let alone holding, leveraged loans. Increasing the pressure, bankers now must hold more liquid and safer (and therefore lower yielding) assets than before in response to the requirements of the liquidity coverage ratio.

Dodd-Frank requires banks to give up activities that regulators previously had encouraged banks to engage in as a means of diversifying earnings. For example, the Volcker Rule has prompted banks to cease certain trading and market-making activities, and those prohibitions have had an international impact. Market participants have noticed the resulting impact on liquidity. Markets are more volatile when they are less liquid. The prohibition on investments in covered funds has made it more difficult for organizers of funds to go to market to sell interests, even in purely off-shore transactions, making capital allocation less efficient.

The largest banks face the most direct heat. The living will process continues and banks face the consequence of still higher capital requirements if their wills are not "credible." Banks must develop these documents with little advance guidance from regulators as to what a credible document looks like. With a theory based on shaky premises, it is unclear whether two or three large institutions could sell themselves or large parts of their business at the same time under adverse economic conditions, i.e., in a fire sale, at a time of general crisis. There is continuing pressure to break up large banks, without a basis for judging whether a large bank broken into ten pieces can offer the public the same scale and scope of services that the original bank currently can deliver (let alone as efficiently).

It is understandable why regulators are acting in this way. They do not want a recurrence of the last crisis and they face pressure from Congressional oversight committees to act aggressively to prevent such a recurrence. Observers of the current Presidential election process will search in vain for a candidate who vows, if elected, to undertake a critical re-examination of the Dodd-Frank Act mandates to determine whether some relaxation is needed. Some eight years after the crisis there remains much suspicion of banks. But the actions of regulators and politicians may have unintended side effects on the banks and ultimately on their customers.

Banks — in a Bind

The current environment and regulatory developments result in the application of pressure on all quadrants of the bank balance sheet, flowing directly to the income statement. As a result, bank share prices remain under pressure. It is difficult for banks to grow and without such growth it is difficult for the larger economy to grow.

Pressure on commodity prices suppresses earnings at large commodity firms and their suppliers, prompting increasing numbers of bankruptcy filings. Lower prices also have suppressed earnings at those firms' creditors, including banks. Buried in last autumn's interagency report on shared national credits was a warning that credit quality in the lending cycle had peaked and was due to fall. Little wonder. With depressed commodity prices (70% in some cases involving energy in little more than a year), reserves are losing value and, by extension, collateral backing bank loans also is proportionately decreasing in value. Separately, there are reports that some consumer loans are subject to stress, particularly in the case of nonbank lenders. While car sales are rising, so are loans to less creditworthy borrowers, setting the stage for a new round of loan losses.

More than doubling capital levels may make policymakers and regulators sleep more soundly, but it can worry bankers. Effectively, any loan that a banker now may make to you, dear reader, becomes twice as expensive as before, dollar for dollar. Thus, banks now have to run twice as fast as before just to maintain their earnings. That can induce bankers to take increased risk in order to achieve enhanced return, ironically so since increased capital is premised on a desire to enable banks to absorb existing risk levels more comfortably. That dovetails nicely with regulators pressuring banks to hold back on leveraged lending. That unfulfilled demand, however, will be satisfied by other nonbank lenders. What we do not know is whether those lenders have systems sufficient to deal with the losses that such lending will present in a downturn, and as a result, what second order effect, if any, may be felt by less leveraged bank borrowers and their bank lenders.

Banks are increasing their loan loss reserves to address weaknesses in the energy sector, and banks report they are less exposed to that sector than in the case of prior downturns. That is salutary, but what we forget is that correlations have a way of verging to one (as opposed to zero) in times of crisis, and it is unclear what types of spillover effects banks may encounter in other economic sectors in the event that the reduced price levels in energy remain depressed over a lengthy time horizon.

High regulatory costs continue to plague banks, both in terms of implementing systems to respond to Dodd-Frank requirements, and the drag on earnings that higher capital levels entail. Institutions that bought bail-in-able debt have recently discovered that in return for what earlier appeared to be high returns, the market now has discounted that advantage, and holders face unrealized losses on their investments. In future, banks may face a more difficult time selling these instruments. Increased liquidity also carries a high price tag, so that banks will be less competitive than their nonbank counterparts that fund themselves without such constraints. Regulators may feel well rested enough to deal with fortress-like banks in the current environment, but they seem less than prepared to deal with the business that banks have shed to attain their current "strength" — business that has migrated to the shadows — out of sight for the moment.

Given the general suspicion with which Congress and regulators have come to view large banks, it should not come as a shock that the largest banks are not growing. If anything, they are beginning to shrink. That means one must look downstream for any merger activity in the banking sector. Owners of small banks complain that they cannot sell themselves into the market. There can be any of a number of reasons for this phenomenon — smaller banks often can be found in areas lacking robust economic growth (in essence, they were and continue to be passed over as buyers search for value) but also there is a smaller number of purchasers to absorb these institutions, resulting in lower prices, simply as the result of the supply and demand function. Interestingly, there are few applications for new charters since the crisis. Apparently there is an oversupply of market participants and an absence of economic inducement sufficient to attract new competitors to the scene.

Extrapolation — What to look for

Against this background, one can make a few observations as to prospects in this sector. Given the fact that 2016 is an election year, one will look in vain for any governmental effort to reduce regulatory requirements on banks, large or small. There may be some greater sympathy for smaller banks, but prospects to increase the thresholds for application of Dodd-Frank requirements to reach only the largest institutions are at best ambitious.

There has been no concerted effort by regulators to study, let alone understand, the cumulative effects of Dodd-Frank and its implementing regulations on banking and the economy. We see dark clouds and we hope that the mechanisms adopted by regulators to deal with recoveries and resolutions will be less disruptive and more effective than the remedies that regulators have applied before. There is a leap of faith required to believe that creditors will be discerning in considering the prospects of separate holding components and accept the assumptions of the single point of entry theory, rather than simply abandon any entity with a name that merely resembles that of the parent holding company.

It would be helpful for regulators to stand back and consider whether some relaxation of eight years of restrictive approaches is appropriate before the storm.

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