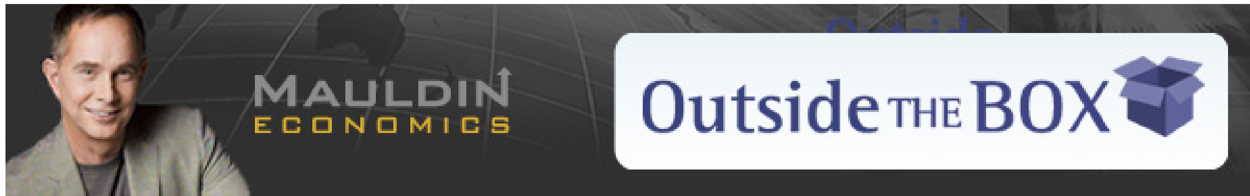

Large Bank Risk: Liquidity Not Capital Is the Issue

JOHN MAULDIN | June 8, 2016

Today's *Outside the Box* is a little bit different – which, considering that most *Outside the Box* pieces can be classified as a little bit different, is not that unusual; but this one needs to come with a warning label that you may find it a tad wonkish. It's from my friend Chris Whalen of the Kroll Bond Rating Agency. When I want to understand something about banks, Chris is one of my go-to guys.

In Chris's latest memo he talks about the push to increase the capital levels of the eight largest US banks. He is critical of that effort in that it doesn't address the real issues. He highlights the fact that even if we do increase the capital requirements of the largest banks, that doesn't mean we won't have problems with them in the next crisis.

It wasn't insufficient capital that got the banks into trouble the last time around. If we don't sufficiently address the issues that hurt the banks and the economy then, there can be no assurance that there won't be problems of a similar nature next time, even with increased capital. This is worth thinking about as you ponder the risks to your portfolio that will come with the next downturn. You can't assume there will not be problems with US banks. Maybe there won't be, but I wouldn't ignore the risk. Good management is more important than capital.

I write this introduction from 32,000 feet, flying back to Dallas. I had several great meetings while in New York; but the highlight was dinner last night with Art Cashin; Jack Rivkin, a longtime PaineWebber partner and now the brains at Altegris; Peter Boockvar of the Lindsey Group; Rich Yamarone, chief economist at Bloomberg; Lakshman Achuthan, the guiding light at ECRI; and Vikram Mansharamani, a Yale professor and author of *Boombustology*. These are the proverbial smartest guys in the room, and I posed a series of questions to them about the timing of the next recession, their thoughts on the upcoming election, and the economy in general.

I'll take up their range of predictions and consensus regarding the recession call in this weekend's letter, and go into some of the risks these gentlemen see, as well as dive into more of my notes from the conference.

My decision to not go to a game three or four of the NBA finals and hope for a game six –knowing that it could be a possible closer and hoping that it would be a win for the Cavaliers while I was down front in a box seat – now looks to be a bit suspect. I may not be making that trip unless Lebron and the Cavs get their act together and sweep the Warriors at home. After those first two games, I think I'll hold off booking the tickets.

You have a great week. I think I'll call a few more friends and get some additional takes on a recession. Just for giggles and grins.

Your thinking about portfolio risk analyst,

John Mauldin, Editor
Outside the Box

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> "Credit means that a certain confidence is given, and a certain trust reposed. Is that trust justified? And is that confidence wise? These are the cardinal questions."
>
> – Walter Bagehot, *Lombard Street* (1873)

Summary

- Kroll Bond Rating Agency (KBRA) notes that since the 2008 financial crisis and the passage of the Dodd-Frank legislation two years later, global financial regulators have been pushing a deliberate agenda to increase the capitalization of large banks. Despite the fact that the 2008 financial crisis was not caused by a lack of capital inside major financial institutions, raising capital levels has become the primary policy response among many of the G-20 nations.

- KBRA believes that using higher capital to change bank profitability and, indirectly, corporate behavior is a rather blunt tool for the task of ensuring the stability of financial markets. Part of the problem with using capital as a broad prescription for avoiding rescues for large financial institutions, aka "too big to fail" or TBTF, is that this approach explicitly avoids addressing the actual cause of the problem, namely errors and omissions by major banks that undermined investor confidence.

- One of the key fallacies embraced by regulators and policy makers is the notion that higher capital levels will help TBTF banks avoid failure and, even in the event, the failure of a large bank will not require public support. KBRA believes that there is no evidence that higher levels of capital would have prevented the "run on liquidity" which caused a number of depositories and non-banks to fail starting in 2007.

Discussion

Since the 2008 financial crisis and the passage of the Dodd-Frank legislation two years later, global financial regulators have been pushing a deliberate agenda to increase the capitalization of large banks. The objective of this increase in capital, we are told, is to make public rescues of the largest banks less likely and to change their corporate behavior. Despite the fact that the 2008 financial crisis was not caused by a lack of capital inside major financial institutions, raising capital levels has become the primary policy response among many of the G-20 nations and the prudential regulators who oversee global banks.

Most recently, Federal Reserve Board Governor Daniel Tarullo revealed on *Bloomberg TV* (June 2, 2016) that he is "quite confident" that the eight largest U.S. banks will get hit with an additional capital surcharge that will translate into a "significant increase" in capital. However, he noted that there will be "some offsets in other parts of the stress tests so that it won't be just a straight addition of the surcharge." Tarullo opined that he doesn't think the charge will go into effect for the next round of tests, and instead there might be a "phase in."

Lawmakers and federal regulators have made a number of other changes in the regulation of US banks that impact asset allocation and risk taking, including greater emphasis on liquidity and an end to principal trading. Policy makers have explicitly ruled out direct punishment for individual or institutional instances of fraud, thus we are left with an indirect approach that punishes the creditors, shareholders and customers of the largest banks. President Obama formed a "Financial Fraud Enforcement Task Force" in November 2009 to "hold accountable those who helped bring about the last financial crisis," but the Obama administration has generally chosen to pursue institutions over individuals when it comes to fraud prosecutions. "More equity may get [bank] boards to care more," argues Dr. Anat Admati of Stanford University, but KBRA believes that using higher capital to change bank profitability and, indirectly, corporate behavior is a rather blunt tool for the task of ensuring financial stability.

Part of the problem with using capital as a broad prescription for avoiding rescues for large financial institutions, aka "too big to fail", is that this approach explicitly avoids addressing the actual cause of the problem, namely errors and omissions by the officers and directors of major banks that undermined investor confidence. A combination of poor loan underwriting, excess risk taking in the trading and investment portfolios, deliberate acts of deceit, a systemic failure to disclose the true extent of bank liabilities, and/or acts of securities fraud actually caused the failure of or need to rescue institutions such as Wachovia Bank, Washington Mutual, Lehman Brothers, Bear, Stearns & Co American International Group (NYSE:AIG) and Citigroup (NYSE:C), to name but a few. These rescues or events of default were driven by a sharp decline in liquidity available to these obligors and led to the wider financial crisis in 2008 and beyond.

Thus when regulators and policy makers sign on to the idea of higher capital levels as a solution for TBTF, are we not all effectively burying our collective heads in the sand? In mid-2008, when Wachovia was receiving inquiries from bond investors about early redemption of long-term debt, the bank's stated level of balance sheet capital was not at issue. Instead, investors, counterparties, and corporate/institutional depositors were concerned that they no longer understood or trusted the bank's asset quality and financial statements, and therefore backed away from any risk exposures with the bank. This is also why the Federal Reserve Board and Treasury chose to conceal the true condition of Wachovia from the FDIC, as former FDIC Chairman Sheila Bair documents in her 2013 book.

> Fed Chairman Ben Bernanke noted in [the dark days of 2008]:
>
> Meeting creditors' demands for payment requires holding liquidity--cash, essentially, or close equivalents. But neither individual institutions, nor the private sector as a whole, can maintain enough cash on hand to meet a demand for liquidation of all, or even a substantial fraction of, short-term liabilities... [H]olding liquid assets that are only a fraction of short-term liabilities presents an obvious risk. If most or all creditors, for lack of confidence or some other reason, demand cash at the same time, a borrower that finances longer-term assets with liquid liabilities will not be able to meet the demand.

There are two basic reasons why the current fixation with higher capital levels should be a cause for concern among policy makers. First, there is no evidence that higher levels of capital would have prevented the "run on liquidity" which caused a number of large depositories and non-banks to fail starting in 2007. Reckless and questionable financial decisions characterized, for example, by a failure to properly evaluate the creditworthiness of borrowers were the proximate causes of an erosion in investor confidence which ultimately caused these firms to collapse. (See Whalen, Richard Christopher, The Subprime Crisis: Cause, Effect and Consequences (2008). Networks Financial Institute Policy Brief No. 2008-PB-04. http://ssrn.com/abstract=1113888)

Careful observers of the banking scene in the 2000s noted that names such as Washington Mutual and Countrywide Financial were starting to contract in terms of sales volumes and access to liquidity as early as 2005. The originate-to-sell mortgage production models used by these and other banks depended crucially on access to stable market funding and a steady supply of new paper. In mid-2007 when Bank of America (NYSE:BAC) announced a partial rescue for its largest warehouse customer, Countrywide, the mortgage bank led by Angelo Mozilo was already doomed because of ebbing loan volumes and liquidity. More non-bank than commercial bank, half of Countrywide's balance sheet was funded by non-deposit, market sources.

Second, significantly higher capital levels and other regulatory constraints reduce the profitability of banks and limit credit expansion. The fact that the U.S. banking industry was able to fund the post-crisis cleanup internally by diverting income is a remarkable achievement, yet the response from policy makers has been to take deliberate action that make banks less profitable and less able to fund future losses.

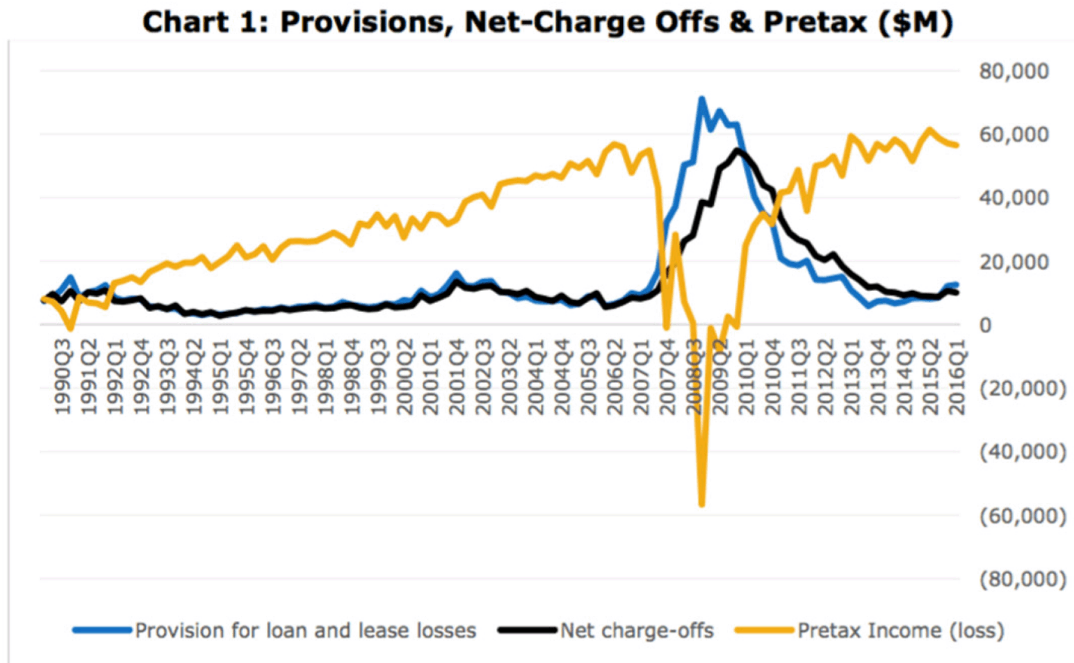
More, higher capital levels have negative effects on capital formation and credit creation that may work against the broader goals of financial stability and economic growth. Witness the declining bank lending volumes in the US residential mortgage market. Banks which cannot achieve sufficient equity returns to retain investors will, over time, either shrink or discontinue businesses altogether to survive. Under the current regulatory regime, banks in the G-20 nations are effectively being turned into utilities which take little or no credit risk and thus do not support economic activity.

Not only do higher capital levels and other forms of punitive regulation reduce the availability of credit from depositories, but these strictures will tend to force consumers and businesses to seek out credit from unconventional sources that may actually increase systemic risk to the financial system. The proliferation of various types of non-bank lenders purporting to offer "new" business models are a familiar response to increased regulation and tougher prudential standards. Many of these models have originate-to-sell business models similar to that used in originating subprime mortgages in the 2000s. For example, JPMorgan Chase & Co. Chief Executive Officer Jamie Dimon, says marketplace lenders might find that sources of funding evaporate during a downturn. (Hugh Son et al, "Dimon Says Online Lenders' Funding Not Secure in Tough Times," *Bloomberg News*, May 11, 2016.)

Capital vs. Confidence

One of the key fallacies embraced by bank regulators is the notion that higher capital levels will help TBTF banks avoid failure and, even in the event, the failure of a large bank will not require public support. First and foremost, banks fail not because they run out of capital, but because a lack of confidence results in a diminution of liquidity available to the enterprise.

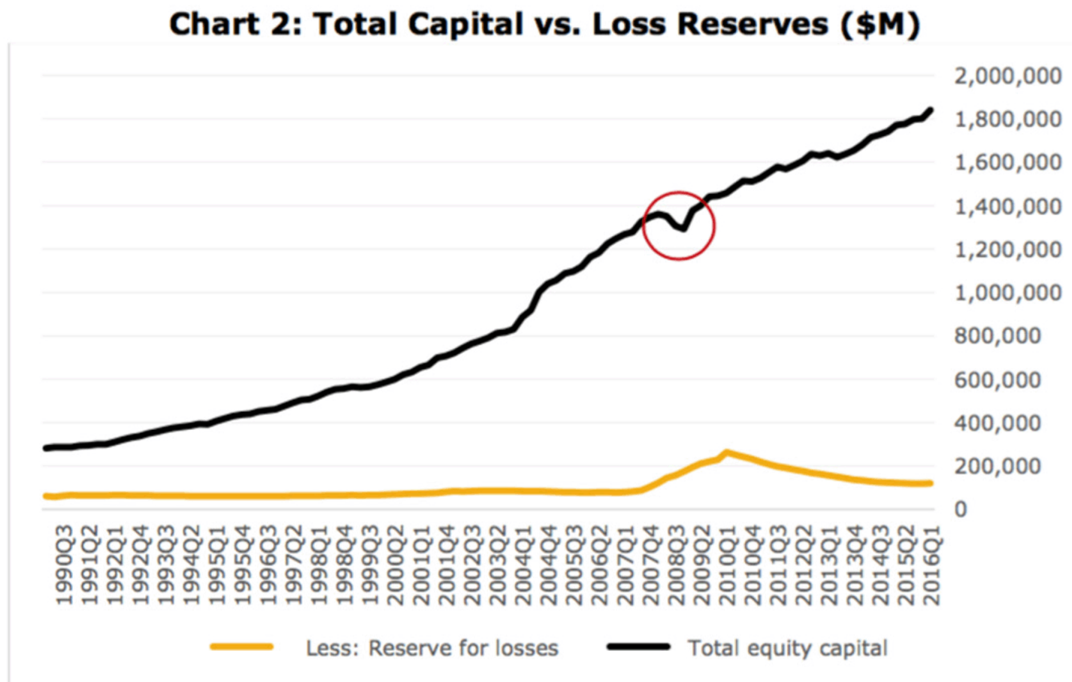
Indeed, during and after the 2008 financial crisis, with the notable exception of Citigroup and AIG, U.S. banks as a group did not require government support and consumed little capital in resolving failed institutions. Instead, banks diverted current income to fund loan loss provisions and FDIC insurance premiums. Using data from the FDIC, Chart 1 shows provisions, net charge-offs, and pretax income for all U.S. banks since 1990.



Note that the sharp drop in industry operating income in 2008-2009 included the cost of pre-paying several years of FDIC insurance premiums. Not only did the U.S. banking industry fund the clean-up of most failed banks privately and without taxpayer support, but the financial crisis turned out to be an issue of reduced income rather than capital impairment. Though hundreds of banks did fail because of loan losses, the balance sheets of these institutions were marked to market and absorbed by the surviving banks, which largely used income rather than capital to manage the resolution process. Indeed, at no point did any major bank "run out of capital" because the institutions which did fail stumbled long before due to a lack of cash liquidity and were sold by the FDIC.

Ultimately, market liquidity is a function of investor confidence, and not capital. Cash flowed into the largest banks in the weeks after the failure of Lehman Brothers because the banks were big and investors believed these banks would receive government support. Liquidity is the key determinant of whether a bank or nonbank fails. Indeed, for most credit professionals surveyed by KBRA, credit spreads and ratings, and other dynamic market indicators, are far more important measures of particular counterparty risk than static, backward-looking measures of balance sheet capital.

In Chart 2, we show total capital vs. loss reserves since 1990. Again, aside from accounting adjustments and some large bank resolutions in the 2008-2009 period (see circle in Chart 2), the U.S. banking industry has continued to build capital steadily. When Wachovia Corp was acquired by Wells Fargo at the end of 2008, the target charged off its entire loss reserve and equity capital in Q3 2008, resulting in a substantial write-down of doubtful assets and the creation of a loss reserve for the acquirer. As the FDIC noted at the time, this transaction involving the fourth largest U.S. bank holding company skewed the aggregate industry data during that reporting period.



Conclusion

In his famous exchange with attorney Samuel Untermyer over a century ago, John Pierpont ("JP") Morgan stated the problem of bank solvency correctly and for all time. In those days, bear in mind, the Fed did not exist and JPMorgan & Co was the *de facto* central bank. Because Morgan was not a member of the New York Clearinghouse, other banks had to stand in line inside the bank's lobby to transact business:

> Untermyer "Is not commercial credit based primarily upon money or property?"
>
> Morgan: "No sir. The first thing is character."
>
> Untermyer: "Before money or property?"
>
> Morgan: "Before money or property or anything else. Money cannot buy it ... because a man I do not trust could not get money from me on all the bonds in Christendom."

The chief flaw with the current regulatory focus on capital, KBRA believes, is that it ignores important qualitative factors involved with the ownership and management of banks that ultimately determine corporate behavior. When banks and non-banks decided to underwrite and sell bonds based upon subprime mortgages in the 2000s, the level of balance sheet capital was not at issue. Merely raising the level of capital required for banks may provide the illusion of progress in the minds of many policy makers, but for investors the most basic issue involved in any counterparty risk assessment comes down to trust.

Managing the liquidity of a bank or non-bank involves not just cash and collateral, but also reputation and transparency. Measuring the static level of capital on a bank's balance sheet may provide some comfort as to enhanced financial stability. Managing liquidity, however, is a dynamic task that defies easy quantification but is, at day's end, crucial to maintaining financial and economic strength. By focusing much of the attention of regulators and policy makers on the static issue of capital, KBRA believes, we are not addressing the true qualitative, behavioral issues that undermined investor confidence in all types of financial institutions and led to the 2008 financial crisis.

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