NASHVILLE NOTES

Credit Contraction Virtually Guaranteed

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By Jeff K. Davis

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I was in New Orleans in mid-2002 for one of my periodic visits to banks in the region, including Whitney National Bank, which today is part of Hancock Whitney Corp. At the time lending was sluggish, especially for commercial-focused lenders such as Whitney. Interest rates were low, and Whitney had a lot of non-interest-bearing deposits that would drive margin expansion once the Federal Reserve began raising rates a couple of years later.

I asked the then-Whitney president, King Milling, about the balance sheet. He shrugged and said that when the bank's clients start to invest the balance sheet leverage (to loans) will increase.

The yield curve was then steep as the Fed was in the process of cutting its policy rates toward 1%. Many banks would take advantage of the steep yield curve by adding construction- and mortgage-related assets as the real estate frenzy gained steam until rapid credit expansion turned to credit contraction in 2007.

Steep yield curves are a magnet for leveraging capital, especially with assets that are funded with cheap wholesale funding. Additional net interest income pads earnings and drives ROEs higher.

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Inverted yield curves are the opposite. Banks and other lenders are incentivized to shrink assets given the high cost to carry assets when measured by marginal funding costs. Now that the yield curve is deeply inverted today like the early 1980s, the question is which assets, and how fast does shrinkage occur.

The deeply inverted yield curve today invokes the saw, "markets tend to follow the path that will cause the most pain for the most investors." Beginning in 2007, the most pain was meted to those who leveraged capital to pile into subprime mortgages, construction lending and other derivations of the housing bubble.

This time it's asset duration. Unrealized losses on bond and fixed-rate mortgage portfolios are massive in proportion to the capital at many banks. Worse, most of these assets now or will entail a negative carry as deposit rates climb, and/or wholesale funding must be utilized to fund deposit outflows. If the market saw holds true, then it also means a Fed pivot to lower rates is not going to occur anytime soon because lower rates would solve the negative carry issue.

In an ideal world, banks would take losses on bond portfolios to reinvest some of the proceeds at higher yields, while using the balance to retire wholesale funding and build liquidity to fund loan demand and deposit outflows. However, unrealized losses that are realized reduce regulatory capital, which I think is a tough proposition for many banks with the credit cycle poised to turn down. Plus, many managements rightly or wrongly are inclined to wait for the bonds to mature at par.

A recent article in the *New York Times* unintentionally nails the de-leveraging conundrum banks face, as it relates to mortgage-based securities and residential mortgages by describing a low-rate loan originated two years ago as the "hottest thing in real estate today." There is little refinance activity, and most borrowers have no incentive to retire debt early, other than for the presumed virtue of less leverage is better.

> ***The net result is that, I think, a serious credit crunch is going to be tough to avoid. Liquidity must be rationed.***

The immediate solution for most has to (or will) be to restrict loan originations to only the best customers, which almost always are borrowers who have a meaningful deposit relationship. If so, commercial real estate has another financing obstacle because most do not generate many deposits, though banks will be forced to modify and roll over existing CRE loans because widespread foreclosure activity is unappealing.

Pacific Investment Management Co. LLC CEO Manny Roman told Bloomberg that banks are going to be capital-constrained and will have to sell assets, which PIMCO will look to buy. I think Roman meant they'll be tight on liquidity today, though they may be tight on capital in 2024 or 2025.

The net result is that, I think, a serious credit crunch is going to be tough to avoid. Liquidity must be rationed. Cash flows from maturing bonds and loans at many institutions will be directed to pay down wholesale borrowings or fund deposit outflows for now.

Ironically, a credit crunch will become a fait accompli if regulators push through a 20% boost in capital requirements based upon press reports. While such a rule might hit nontraditional "banks" like Charles Schwab Corp. and Morgan Stanley the hardest, in time the tougher capital regulations probably would extend to a wider swath of banks. The easiest way to boost capital ratios is to curtail lending to shrink the balance sheet.

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