

NASHVILLE NOTES

A slow-moving crisis unfolded 40 years ago

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By Jeff K. Davis

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I think it was Oaktree Capital Management LP Co-Chairman Howard Marks who said, "we won't know until the future arrives." The same applies to the fallout for U.S. banks as it relates to the government's response to COVID-19. It may be several years before we fully know the economic impact, but we should have a better sense by the fourth quarter, assuming the lockdown ends in May.

An obvious starting point to contemplate the impact on the banking system is the first Great Financial Crisis (GFC1) — this being the second Great Financial Crisis (GFC2). A less obvious comparison unfolded 40 years ago.

Before capital markets were as robust with deep liquidity (usually) as has been the case for several decades, banks played a much larger role in the allocation of capital. Around 50 years or so ago banks in the U.S. and U.K. were awash in deposits from oil-producing countries that then constituted the nouveau riche of the era. Saudi Arabia, Kuwait, the United Arab Emirates and others were flush with cash as oil prices rose, especially following the 1973 Arab embargo in reaction to the 1973 Israeli-Arab war.

The predecessors to today's globally systemic important banks (G-SIBs) — such as Citigroup Inc., Bank of America Corp. and JPMorgan Chase & Co. — were the recipients of these deposits. Rather than earn a modest spread from investing the deposits in bonds, they were loaned to developing countries that needed capital to pursue developments. South American countries were especially large borrowers, but petrodollar deposits were lent around the globe.

Sometime during this era Walter Wriston, Chairman and CEO of Citicorp from 1967 to 1984, argued that countries do not go bust. Wall Street's quip reply was: but the banks that lend to them can.

The crisis arrived in August 1982 when Mexico announced it could not service its debt, in part due to very high rates in the U.S. (much of the debt was dollar denominated) and a deep recession in the U.S. and elsewhere. The issue for the lenders was not confined to Mexico and spawned the term Lesser Developed Country (LDC) debt crisis that was centered in Latin America.

Wriston was wrong, and Wall Street was right. Countries have gone broke since the dawn of time, and so too have their lenders. According to the Federal Reserve, the nine largest money center banks (i.e., some of today's G-SIBs) held Latin American debt equal to 176% of capital and total LDC debt of 290% of capital. The banks were broke.

I raise this episode because the banks could not mark-to-market the LDC loans through a sudden reserve build because they did not have the capital. Had they done so they would have tested another maxim that I believe is attributed to Wriston that banks do not need capital so much as liquidity. My guess is that had the banks taken massive write-downs, large depositors would have tested his liquidity maxim, too.

Regulators were pragmatic because they had to be. Regulatory forbearance was granted while negotiations over restructuring the debt continued for several years. In 1987, John Reed, who replaced Wriston as the CEO of Citicorp, surprised the market when the bank made a \$3.3 billion provision to the reserve for losses that were eventually recognized. Other banks followed suit with \$61 billion of loans forgiven from 1989 to 1994, which perhaps not coincidentally represented about one-third of the debt.

U.S. banks do not face the same issue today that the old money center banks faced in 1982 because of the COVID-19 economic shutdown. But in a sense, it is similar.

Consumer and commercial borrowers across the U.S. have raised or soon will raise their hands and say that like Mexico, they cannot pay. No one knows how bad the losses will be, but they are not going to be trivial.

While there will not be a five-year period of dallying as it relates to reserve building, it may be drawn out over several years if losses are sufficiently high because existing capital and reserves are likely not sufficient to absorb such a shock.

As of year-end 2019 the leverage ratio for banks with \$10 billion to \$250 billion of assets was 10.12% and it was 8.87% for banks with more than \$250 billion of assets, compared to 9.09% and 6.41%, respectively, at year-end 2006 before GFC1 got underway. Additional buffers include existing loan loss reserves and 2020 earnings that can be directed to the reserve rather than the bottom line. The cushion for what is now GFC2 is larger than it was for GFC1, but the last crisis required significant injections of capital for the industry — or at least Citigroup, Goldman Sachs Group Inc. and Morgan Stanley — to survive.

Regulators are going to have to look the other way for a while as occurred in the early and mid-1980s. Likewise, banks are in the process of extending forbearance to borrowers, many of which ultimately may fail. Regulatory forbearance is starting to unfold as seen in the move to exclude cash and U.S. Treasuries from the supplementary leverage capital ratio. Also, COVID-19 related loan restructurings will not be labeled troubled debt restructurings.

What will the regulators ask in return? I would not be surprised if they push for suspension of common and perhaps preferred dividends later this year if the morass is deep enough.

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