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Monday, July 06, 2015 2:22 PM ET

Jimmy Lee, leverage and liquidity

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JPMorgan Chase & Co. Vice Chairman Jimmy Lee's life ended unexpectedly on June 17. I never met him, but by all accounts, his life covered a lot of ground and was at the intersection of several powerful forces that he helped shape and which continue to shape Wall Street today. Lee caught my attention nearly 20 years ago when he appeared on the cover of *Institutional Investor* under the tagline "Gotta Have Leverage" that maybe should have had a subtitle, "and liquidity."

Lee went on to have a great career as a go-to deal-maker at JPMorgan; however, it was his role in developing the leveraged loan market three decades earlier that probably is the most impactful. I see a couple of themes that he influenced or was around and that are still impactful today.

One is the intersection of commercial and investment banking. When he appeared on the cover of *II* he was then the global investment banking chief of Chemical Bank of New York. The article was published shortly following the merger of Lee's Chemical Bank with Chase Manhattan Corp. in 1996. At the time, New York's money center banks were in the middle of an M&A wave that saw Chemical Banking Corp. acquire Manufacturers Hanover Corp. in 1991, Chase and then J.P. Morgan & Co. in 2000 to form JPMorgan Chase & Co. It was not until Jamie Dimon joined in 2004 via the acquisition of Bank One Corp. that the process seemed complete. (Sidebar: Legendary value investor Michael Price was instrumental in helping sway Chase Management to merge with Chemical when he turned up with a 6% position in the bank.)

Each bank brought a particular strength to the table. Lee's Chemical Bank evolved into a power in leveraged finance — first in loans and then later in high-yield bonds; Chase Manhattan Bank was internationally focused with thousands of correspondent bank relationships around the world thanks to patriarch David Rockefeller's global reach; and J.P. Morgan brought a focus on investment-grade debt, equity and asset management.

Lee and others helped drive the return to a universal bank model that became a fait accompli not when the Glass-Steagall Act was repealed in 1999; rather when Section 20 affiliates of J.P. Morgan, Citicorp and Bankers Trust Corp. were granted debt underwriting authority by the Fed in the late 1980s. Lee's Chemical did not get authority until 1993. J.P. Morgan was the first to get equity underwriting approval in 1990.

The Section 20 approval for a separately capitalized subsidiary of a bank holding company occurred during a period when the line between commercial and investment banking was becoming really blurred. Among the fault lines were the introduction of the cash management account (CMA) by Merrill Lynch in the 1970s and the increasing reliance by investment-grade companies on the commercial paper and corporate bond markets for financing that otherwise would be met by commercial banks. There was no restriction on an investment bank making a loan, but a deposit-taking commercial bank could not deal in "ineligible" securities. Enter Chemical Bank, Lee and his efforts to create a new asset class during the 1980s: leveraged loans.

Loans are not securities in a legal sense, but the market looks a lot like securities in terms of underwriting, distribution and secondary market trading. Lee's innovation straddled the commercial banking and investment banking models as the legal separation between the two frayed. By all accounts, I have seen Lee was the eternal optimist, but I doubt he envisioned when he started leveraged lending at Chemical that issuances would rise to $1 trillion annually 30 years later with institutional investors absorbing about half of the issues. In effect, the market has offered its bloodless verdict of the initiative.

Another contribution of Lee's efforts is price discovery. The beauty of the capital markets is that they are highly efficient at pricing and distributing risk. While price signals can and do become skewed by the ebb and flow of liquidity, markets provide real-time feedback on asset prices, including credit. The traditional commercial bank model of "originate and hold" at par unless something bad happens does not do this. That said, commercial bank portfolios are not intended to be a pool of tradeable assets; they are to be held until the loans mature or refinanced. And the steady and usually sizable pretax, pre-credit operating income stream allows banks to build sizable capital buffers when needed if afforded enough time.

The rise of the leveraged loan market occurred because it was a more efficient model and because levered loans evolved into a stand-alone asset class for investors. Levered loans are senior in the capital structure to high-yield bonds, and therefore, have a higher recovery rate in the event of default. Plus, fixed-income investors can manage duration more easily with a combination of levered loans whose base rate usually floats with LIBOR and high-yield bonds that are typically issued with fixed rates and maturities of five to 10 years. Time will tell, but levered loans may be poised to outperform high-yield bonds over the next several years if the Fed really does raise short rates because the interest rate paid to investors will rise and should credit become a bigger concern the senior position will matter.

Another takeaway about Lee is to be flexible and optimistic. He evolved with the markets and Chemical Bank over the decades. JPMorgan CEO Jamie Dimon probably will acknowledge his contributions to investors when the bank releases results July 14. Dimon also may express concern about the lack of liquidity in fixed-income markets that the Volcker rule has wrought and I would argue central banks' zero and negative interest rate policies have exacerbated. Why bother when the coupon is in the low-single digits? I do not know how Lee felt about the issue, but I bet he would have (or did) jumped on his colleagues to get in front of Bank of America Corp. when the bank recently began to offer (for a price) to more quickly trade corporate loans that can take well over a week to settle. Liquidity has a price as Lee proved decades ago. As it relates to the Volcker rule restricting market-making and inventory levels, loans are not securities — I think.

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