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Chutzpah as duck food

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The press is full of stories about regulators running amok with mandates to get tough on the banks; however, not every bank is being cowed by regulators. Some have exhibited chutzpah vis-à-vis their regulators.

Santander Holdings USA Inc., the majority parent (60.5%) of subprime auto lender Santander Consumer USA Holdings Inc., recently entered into a written agreement with the Federal Reserve. Written agreements are not something any bank or bank holding company wants, but they do occur — usually when credit and capital are an issue, and increasingly when compliance poses a problem. But Santander Holdings' issue is surprising. Santander Consumer declared a $52 million dividend in May after the Fed rejected Santander Holdings capital plan as part of the Comprehensive Capital Analysis and Review (CCAR) earlier this year. CCAR is a very public and maybe politicized regulatory test for some banks (e.g., Citigroup Inc.). I guess communications broke down — or never occurred — between the subsidiary, the parent and the regulators relating to permissible dividend payments. Nevertheless, the gaffe involving a company that went public early this year is mindboggling. At least the public shareholders got to keep their initial dividend, though the company does not expect the Fed will allow it to pay dividends during the remainder of 2014.

And Credit Suisse Group AG may be heading for a written agreement. According to press reports, it has earned the ire of the Federal Reserve for apparently not heeding regulatory guidance regarding leverage lending. Last year banking regulators updated their 2001 leverage lending guidance. For anyone involved in banks or credit, you should read it because leverage lending has expanded significantly in recent years. Leverage lending totaled $1.1 trillion in 2013, according to Thomson Reuters, though new money lending accounted for only one-third of the volume. Year-to-date through August, leveraged loans totaled $668 billion, compared to $797 billion last year.

My read of the guidance is that it entails wiggle room for banks, but there are some bright lines. A loan to a borrower whose total debt exceeds 4x EBITDA is considered to be a leveraged loan, as are loans for purposes of dividend recaps and LBOs. Management information systems are supposed to capture this so that the risk monitoring process ensures the bank's exposure stays within its policy guidelines. The bigger issue is when the borrower's total debt exceeds 6x EBITDA. Even though industry conventions may entail higher than 6x, such loans "raise concerns for most industries." I assume this is especially the case if the loan includes payment-in-kind (PIK) options and/or has questionable capacity to amortize under less favorable cash flow projections than the base case.

The guidance is tough today because leverage ratios have been ratcheting higher, yet how does a bank like Credit Suisse walk away from a gravy train when the bar to participate has increased? According to Thomson Reuters, the average leverage multiple for broadly syndicated leverage loans were 6.4x during the first half of 2014, while the multiple for middle market leverage credits was 5.3x (the respective pre-crisis peaks were 7.0x and 5.5x in 2007).

If Credit Suisse were a bit player in the leverage loan (and high yield bond) market, then executive management could tell the group originating such loans to move elsewhere; however, Credit Suisse is the #1 book-runner of U.S. marketed LBO loans and #5 for all leveraged loans, according to a September 19 report by Leveraged Finance News. Maybe management's implicit plan was to push the Fed to see how many such loans could be originated before they were told to stop. That may not seem likely for an international bank, but never underestimate decision making when huge dollars are at stake. According to a report by KBW, leverage lending fees were $14 billion in 2013, or 1.3% of originations, Bloomberg reported.

And maybe Credit Suisse's inaction — if true — can be explained by a Wall Street axiom. It states that when the ducks are quacking, feed them; meaning when clients want something, give it to them. I believe the Fed's zero rate interest policy (ZIRP) is causing investors and lenders to take much more risk than they would in a normal rate environment. That said, maybe 6x is the new 4x when interest rates are at zero and the Fed has supplied Wall Street with easy liquidity for years? If rates stay at or very near zero for years, who is to say that it does not make sense for corporations to replace equity with cheap debt.

The Fed and other regulators are apparently going to deal with perceived excesses in the leverage lending market through enhanced regulatory scrutiny. Fed Chair Yellen has said as much this summer when she expressed a preference for oversight rather than rate hikes to rein in risk taking. Maybe I am being cynical, but that seems like regulatory chutzpah because the Fed's economic forecasting has not been very good and its regulatory oversight in the years leading up to the crisis was lacking.

There is nothing like unexpected Fed rate hikes to wring excesses from the system. Since the financial crisis occurred, I have wondered if the abuses that occurred in the mortgage market could have been largely avoided and thereby pre-empted the 2008 crisis had the Fed been more aggressive during 2004 through 2006 when the Fed Funds target was raised in 25 basis-point increments to 5.25% from 1.00%. The yield on the 10-year did not move that much as the Treasury curve flattened. During 1994 through mid-1995, then-Chairman Greenspan waylaid the bond market by raising the target to 6.0% from 3.0% in increments that included 25 basis points, 50 basis points and even a 75 basis-point hike. The yield on the 10-year went from about 6.0% to 8.0% by mid-1994 and helped snuff out excessive risk taking that seemed to be on the rise. Orange County, California was one casualty; it was forced to seek bankruptcy protection.

It seems very unlikely to me that the Fed will end ZIRP with aggressive rate hikes — or if it even ends ZIRP; rather, we will see if Credit Suisse drops in the leverage lending rankings and is replaced by the likes of Jefferies Group LLC or if the Fed can cause leverage lending multiples to stabilize around 6x by limiting the supply.

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