SNL Blogs

NASHVILLE NOTES

Wednesday, January 20, 2016 7:05 AM ET

Dimon was spot on last week

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

I have no more insight into the future than the next person. I have views on where things are headed shaped by trend observations, intrinsic analyses and biases. It did not take a rocket scientist to predict that the fourth quarter would be the start of an uptrend in energy-related credit losses following a slow start once the downtrend became pronounced a year ago; however, Street reaction, blogs and some media outlets offered views that ranged from surprise to around-the-corner contagion as a result of the pending bankruptcy of a lot of energy lenders. Why the surprise?

Like the lenders that financed the breakneck expansion of the U.S. railroad industry in the 19th century, losses are now going to be incurred. A lot of debt will be haircut and then converted to equity. The stronger companies will absorb the assets of the failed ones. So what? And there is another upside I see. American engineering and financiers made possible the shale revolution that turned the tables on Russia, OPEC and other unsavory oil producers. The U.S. is stronger for that. The hundred million plus of consumers who will pay about $30 to fill an 18-gallon tank will be better off than they were in mid-2008 when they paid about $70.

I could be wrong that the losses to be recognized during 2016 and 2017 will be painful but manageable for most lenders. If today's tight and illiquid leveraged -loan and high-yield markets freeze, maybe credit contagion will infect the broader lending markets. Credit, rather than the level of the S&P 500, is the lifeblood of economies. If so, surely the Fed will tap JPMorgan Chase & Co., Goldman Sachs Group Inc. and other banks on the shoulder and say "loosen up your market making and lending — we promise no lawsuits." Some have speculated there already has been regulatory forbearance in terms of delaying loss recognition — presumably by the OCC (rather than the Fed) that regulates the banking units of larger bank holding companies. That may have occurred in some form, but it is critical that losses ultimately be realized to clear the system.

On the other hand, I may be right that the loss cycle will be manageable, absent a deep recession. Wells Fargo & Co. is a case in point. It has been flogged the past few days following management's disclosure that the company's energy exposure consisted of $17.5 billion of loans and $2 billion of securities. Management described "most of it" as non-investment grade. Junk does not mean deadbeat; it means levered.

The key questions for each credit and the portfolio are: (a) what is the probability of default; and (b) what is the loss in the event of default. If a disaster is looming for about $20 billion of levered energy credit exposure, it should not be a disaster for a diversified Wells Fargo. Loans held-for-investment totaled $917 billion at year-end 2015, and the company's pretax, pre-provision income in 2015 was $36.3 billion. Exposure seems manageable. Presumably any second derivative issues like residential mortgage and CRE lending in Texas, Oklahoma and North Dakota will be manageable too. Smaller institutions such as BOK Financial Corp. may have a larger relative problem. Still, it seems unlikely that lightening would strike twice in which historically well-managed BOK constitutes a 1982 replay of Penn Square Bank.

Yes it is going to be ugly, but the financial world should not end solely because ultra-low rates engineered by the Fed led to a speculative lending boom in the energy sector that few noticed (especially me) until it was too late. The real issue I see is whether falling oil prices and widening credit spreads are an indication that the global economy is stumbling badly. If so, banks will have trouble. Nevertheless, I think JPMorgan CEO Jamie Dimon got to the root of banking during the earnings call last week when he said a bank is supposed to be there for clients in good times and bad times. Banks should be consistent lenders (and market makers) through a cycle. And the better clients should absorb the assets of the weaker ones.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.