NASHVILLE NOTES

Not an accounting entry

Thursday, June 30, 2022 7:57 AM CT

By Jeff K. Davis

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

I think it was Jamie Dimon, CEO of JPMorgan Chase & Co., who five or six years ago said something to the effect that "it is just an accounting entry" in response to a question about how the company's loan loss reserve might change. He is right, of course.

Debit loan loss provision expense and credit loan loss reserve to reduce equity and increase reserves. If the entries are reversed, reserves are released and equity increases. In doing so capital toggles between the highly leverageable Tier 1 and less so Tier 2 regulatory capital categories.

The vagaries of the current expected credit loss accounting method require management to make many assumptions about factors that will impact losses over the life of a loan, including macro factors. Given the deterioration in economic indicators this quarter, I would not be surprised if more than a few banks miss estimates because the CECL methodology requires more reserves.

Absent a really substantial increase, I do not think investors will care. Bank stocks have fallen during the second quarter as investor concerns about the not so virtuous late cycle credit dynamics have overtaken the virtuous early rate hike cycle dynamics that usually support bank stocks. Stated differently, the economic cycle appears to have compressed this spring.

Still, any increase in reserves for macro reasons incorporated into CECL methodology will reflect an accounting entry for the assumptions made; net charge-offs are an economic loss that reduce capital and therefore really matter. So are losses realized on the sale of presumably "good" loans.

Bloomberg News reported recently that Bank of America Corp., Credit Suisse Group AG and The Goldman Sachs Group Inc. could face about $1 billion of losses on leverage loans originated to finance the $16.5 billion take private acquisition of Citrix Systems Inc. The deal was announced Jan. 31 and is expected to close within the next couple of months.

Timing matters. Financing was committed when the deal was announced. Since then, base lending rates such as the London interbank offered rate and secured overnight financing rate have risen, and credit spreads have widened in the bond market sell-off. The market clearing price for the loans is lower today.

Citrix is a single data point showing that capital markets absent support from the Federal Reserve are less friendly to lenders and investors. Had the deal been struck in June, presumably the transaction price would have been lower given the reduction in stock prices and higher borrowing costs.

Citrix also has a subplot that speaks to the intersection of the capital markets and lending. Loans are not securities and therefore there are no requirements to comply with securities laws per se; however, the leverage loan market functions like the corporate bond market in which loans are underwritten, distributed via a syndicate to other banks and institutional investors, and then traded in a secondary market.

The leverage loan market has been around since the 1980s when James Lee, the deceased vice chairman of JPMorgan, pioneered the market while he was then at Chemical Bank. It has grown enormously in the years since the financial crisis.

So too has the high yield bond market that emerged from obscurity in the 1980s when Michael Milken was then at Drexel Burnham & Lambert. Milken pioneered the "highly confident letter" that financing could be obtained for a leverage transaction before it was actually secured. I am sure Drexel suffered an occasional underwriting loss like the Citrix lenders have when market conditions turned violently as occurred this spring.

The beauty of the capital markets is that they are highly efficient at pricing and distributing risk. While price signals can 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.

Nonetheless, Citrix and maybe earning misses attributable to CECL reserve builds point to credit surprises that may skew negative in the coming quarters.

This S&P Global Market Intelligence news article may contain information about credit ratings issued by S&P Global Ratings. Descriptions in this news article were not prepared by S&P Global Ratings.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Published with permission. Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.