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SNL NASHVILLE NOTES

Wednesday, June 21, 2017 8:40 AM CT

Penland, CCAR and the vantage of hindsight

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I recently had a reason to review the slide deck Fifth Third Bancorp prepared for its $1.1 billion acquisition of Charlotte-based First Charter Corp. that was announced on August 5, 2007. It is by no means in the league of Ben Bernanke's testimony to Congress in March 2007 that "problems" in the subprime market seemed likely to be "contained", but I was struck by Fifth Third's characterization of First Charter's exposure to Penland as "an isolated situation" with "adequate" reserves.

The "Penland situation" was a reference to a real estate development in Spruce Pine, North Carolina, known as the Village of Penland, that cost First Charter, United Community Banks Inc. and a number of other area banks tens of millions of dollars. While Penland entailed fraud perpetrated by the developer (and borrower greed in some instances), Penland was not a one-off in the broader scheme of the coming CRE lending debacle. It was part of a mosaic of too much capital that was perhaps encouraged by rates that were too low in the early years of the decade flowing into an asset class (i.e., real estate) that pushed prices higher, only to fall hard once the credit spigot was shut-off.

Along the similar vein of falling asset prices that are financed with debt, CapitalSource Inc. CEO John Delaney once remarked to me in the years after the Great Recession that he thought some of the company's (problematic) real estate projects had 25% to 30% equity when the loans were made; however, once the market cratered, CapitalSource as the lender had 25-30% losses because whatever equity existed was vaporized.

Executives at Fifth Third, CapitalSource and across the U.S. did not know. One only knows for sure when looking back. The media and broad swaths of Wall Street likely will trumpet regulators' and banks' annual attempt to look forward as a stamp of approval when the industry releases results of the Dodd-Frank Act Stress Test (DFAST) on June 22 and the Comprehensive Capital Analysis and Review (CCAR) on June 28. Aside from perhaps one or two companies being deemed not quite up to snuff (Santander Consumer USA Holdings Inc.?), the consensus view appears to be that banks subject to CCAR will be able to return a higher percentage of earnings to shareholders over the coming year in the form of dividends and buybacks. They should; substantial capital has been built in the years since the financial crisis, and "meh" loan growth implies that organic growth will not absorb much internally generated capital.

But let's not equate "no objection" by the Fed to proposed distributions as providing much insight into likely losses under the prescribed downturn scenarios beyond some superficial understanding of what could occur. History tells us this. The Fed was no better than most of the Street in predicting the 2007 to 2009 disaster even though it should have had the best view of credit risk after management.

A rhetorical question: had DFAST/CCAR existed pre-crisis would the Fed have objected to National City Corp.'s capital distribution in 2007 when the company announced a tender offer for up to 75 million common shares for a price not greater than $38.75 per share (about $2.9 billion)? My assumption is no, but perhaps I am wrong.

In the January 2007 release that announced the buyback, CEO David Daberko was quoted as saying, "given our substantial excess capital position, the tender offer allows the Company to deliver value to stockholders who elect to tender their shares, while at the same time increasing the proportional ownership of non-tendering stockholders." About 18 months after the tender offer was announced for which Lehman Brothers Inc. served as the financial advisor, National City agreed to be acquired by PNC Financial Services Group for $2.23 per share. Somewhat perplexing to me given the controversy that surrounded National City's mortgage exposure at the time was that only about 40 million shares were tendered by early March, although the company also had authorization to purchase about 44 million shares through the open market.

This summer marks the ten-year anniversary of the beginning of the financial crisis if it is dated to the failure of two Bear Stearns-affiliated hedge funds that invested in subprime mortgages. Southeastern bank investors might date it to the Penland disclosure. Others may date it to early 2007 to coincide with the failure of New Century Financial Corp. and other subprime-focused mortgage companies. Maybe it should be dated to National City's ill-fated tender offer that was announced on Jan. 25, 2007?

The Dodd-Frank Act was one outcome of the calamity. A worthy goal of strengthening the financial system seemingly has been lost, I think, in its bureaucratized blizzard of rule and directives that from a safety and soundness standpoint could have been met with a requirement for more common equity capital and better liquidity management. The Fed, which saw little if any of it coming, has been given greater powers to regulate bank holding companies in the aftermath, including administering DFAST and CCAR.

My reference to Bernanke's infamous subprime comment is a bit unfair. Be it the Fed, CEOs, institutional shareholders or an SNL contributor, one can never really know for sure until the vantage is hindsight. One can have a well-grounded view on the direction of things, but the magnitude and when are especially unknowable. The press and perhaps many on Wall Street will take the results as a stamp of approval that all is okay; however, one day that will not be the case because lending always has been and always will be a highly cyclical business.

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