AMERICA'S BIGGEST BANKS ARE BIGGER THAN EVER. ARE THEY SAFER?

SIZING UP BANKS

In July, small business and middle market lender CIT Group joined an elite club. In acquiring California's OneWest Bank, the phoenix that arose from the ashes of mortgage lender IndyMac, it voluntarily crossed the threshold to being a "systemically important" financial institution. With $67 billion in assets, the combined bank will be subject to regulatory requirements stricter than those imposed on the average U.S. bank.

The deal is key for CIT because it will cut its cost of funds by bringing under its umbrella a huge deposit base ($28 billion), and because it will reduce its reliance on debt to fund lending. During CIT's second-quarter earnings call in July, CEO John Thain said the bank is positioned to satisfy all the infrastructure and controls requirements of being categorized systemically important.

CIT, having itself experienced a crisis as an independent lender that had to declare bankruptcy in 2009, obviously believes it's now in a better position to withstand financial market

BY VINCENT RYAN

Following CIT Group's acquisition of OneWest Bank in July, CEO John Thain said CIT was ready to meet the requirements of a systemically important financial institution.

instability. And why not believe it? Despite the efforts of U.S. banking regulators to prevent having to bail out another large financial institution, they have not made "big" or "big and complex" a disadvantage. Indeed, although the window into the quality of their loan books and trading operations is still foggier than investors and regulators would like, most big banks are healthier overall, with larger government-mandated capital buffers.

Just how healthy will be tested in the months ahead. With the Federal Reserve continuing to taper its monthly bond buying, interest rates won't stay at rock-bottom levels; on average, Fed officials predict a benchmark federal funds rate of 2.5% by 2015. Meanwhile, the commercial loan portfolios of systemically important banks are growing substantially. What will be the effects of these and other developments—a possible recession, say—on the business and balance sheets of the banks deemed too big to fail?

PASSING GRADES

All but one of the nation's 30 largest banks met the 5% minimum capital requirement in the Federal Reserve's 2014 stress test.*

Bank	Tier 1 common ratio	Bank	Tier 1 common ratio*
State Street	13.3%	Wells Fargo	8.2
Discover	13.2	UnionBanCal	8.1
BNY Mellon	13.1	Capital One	7.8
American Express	12.1	BMO	7.6
Northern Trust	11.7	Huntington	7.4
RBS	10.7	Santander	7.3
KeyCorp	9.2	Citigroup	7.2
PNC	9.0	Goldman Sachs	6.9
Regions	8.9	HSBC	6.6
SunTrust	8.8	Ally Financial	6.3
Comerica	8.6	JPMorgan Chase	6.3
BBVA Compass	8.5	M&T	6.2
BB&T	8.4	Morgan Stanley	6.1
Fifth Third	8.4	Bank of America	5.9
U.S. Bancorp	8.2	Zions	3.6%

*Severely adverse scenario, Q4 2013 to Q4 2015
Source: Federal Reserve Board

WHEN QE WINDS DOWN

With assets of $2.5 trillion, JP Morgan Chase's balance sheet is gigantic, and CEO Jamie Dimon acknowledged as such on the bank's second-quarter earnings call. "We have $350 billion or almost $400 billion at central banks around the world," he said. "We have an investment portfolio of $350 billion. We have a loan portfolio of $700 billion." Some of JP Morgan's seemingly boundless liquidity, though, is grossly inflated by the Fed's quantitative easing program, according to CFO Marianne Lake.

When the Fed reverses QE as early as the summer of 2015, JP Morgan forecasts $100 billion in deposit outflows, with up to $1 trillion for the entire U.S. banking system. Neither JPMorgan nor peers Bank of America and Citigroup seem concerned, believing they have plenty of liquidity and stickier deposits than the other guy. They expect neither the end of QE nor higher interest rates will drastically change their liabilities.

In an advisory letter to commercial banks in spring 2014, however, the Office of the Comptroller of the Currency issued a warning: "Segments of a bank's core depositors may react differently in an increasing interest-rate environment than they have in a low-rate environment. ... Many banks are using deposit assumptions that are not well supported or are overly reliant on either customer behavior before the crisis or behavior since the surge in volume since the crisis."

For small banks that get a large amount of deposit funding from brokers, the problem could be acute. The rise in interest-rate risk is "more dramatic" at small banks and more likely to affect their assets, which can cut into net worth and capital levels, according to a Federal Reserve Bank of Cleveland report released in June. For example, higher interest rates mean current loans a bank wishes to sell in the open market will decline in value.

On the loan side, higher interest rates will be a major positive for the big banks, says Paul Schaus, president and CEO of consulting firm CCG Catalyst and a former bank CFO. Few follow the traditional model of lending long and borrowing short nowadays.

"Most banks' portfolios are short term; they are tied to the prime rate or LIBOR, so when there is a shift, you are not going to see a big impact," Schaus says. "Even in com-

Opening spread, Andy Sacks/Getty Images. This page, Bloomberg via Getty Images

JPMorgan Chase CEO Jamie Dimon

mercial real estate, while the loans may not reprice with prime, they reprice at the one-year or three-year mark."

The only danger, he says, is if higher interest rates hinder the borrower's ability to pay.

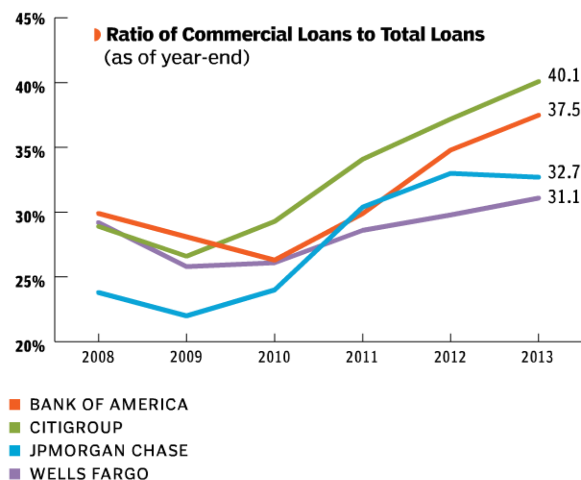
RISING LOAN VOLUMES

With banks moving whole-hog into originating business credits, especially as mortgage lending lags, the big question is if the asset side of their balance sheets will get out of whack again.

Commercial and industrial loans at U.S. banks grew by $400 billion, or 34%, during the four years ended September 30, 2013. In a year to July 2014, outstanding C&I loans rose 11%. Commercial loans represent 37.5% of the loan book at Bank of America, as of the end of 2013, and 33% of the portfolio at JPMorgan. They are 40% of the book at Citigroup.

BUSINESS EXPANSION

The loan portfolios of the top four U.S. banks are increasingly concentrated in commercial credits.



Source: S&P Capital IQ

Schaus says the growth is healthy. "We're getting more toward normal," he says. "We got down to pitiful loan-to-deposit ratios, and banks were screaming for loans. Commercial lender had LDRs of 50% or less, when historically LDRs were 80% or more. There's still a lot more room for lending."

But there are two caveats. One is the nature and quality of commercial underwriting. To stay competitive, large banks have built fewer protections into highly leveraged loans in the current cycle. Maintenance covenants have almost disappeared: in a report published in July, Standard & Poor's said that "covenant-lite" loans accounted for 66% of leveraged loans originated in 2014 so far, compared with 25% of issuance at the peak of the last credit cycle, in 2007. The average total-debt-to-EBITDA multiple for leveraged loans is above 4.5 and rising.

If the U.S. economy sours suddenly, and the bond markets stop gobbling up junk-grade issues, large banks could certainly experience significant defaults. But the greater danger may be what happens before a rise in defaults, when the volume of business loans bumps up against its natural limits. When it's harder to find borrowers, banks may lend to less creditworthy businesses.

Says Richard Reynolds, national banking and capital markets internal audit leader at PricewaterhouseCoopers: "Auditors need to be aware when a loan growth begins to slow, since this can often be followed by a slippage in bank underwriting standards."

The second danger is concentrations—inordinate amounts of business lending to one industry or subsector. "Where regulators get concerned is concentrations; commercial is not a concentration," says Schaus. The concern would be if a bank were doing "a lot of X type of C&I loans to X type of borrower," he says—for instance, originating large amounts of floor-plan loans to car dealerships, loans that would go south if the market for new cars suddenly dried up.

Regulators, of course, are closely watching banks so these concentrations don't happen, pushing them to get more sophisticated at analyzing loan-level data as well as larger issues like liquidity. "The root issue is just not having the data at a granular enough level, so we are seeing a ton of activity on data mining and analytics, as well as a focus on data quality," says Gary Fink, a managing director in the financial services practice at Accenture.

STRESS MANAGEMENT

What would happen to the biggest banks if the economy once again plunged into a deep recession? Earlier this year, the Federal Reserve revealed its latest annual stress test of bank holding companies with assets greater than $50 billion. Under the Fed's "severely adverse scenario," 5 of 30 banks failed the test. But only Zions Bancorp failed to meet the Fed's required minimum of a 5% Tier 1 common capital ratio; the other 4 banks failed because of "qualitative deficiencies." For all 30 banks, the aggregate

Wikipedia

Tier 1 ratio fell to a projected minimum of 7.6%, compared with an actual level of 5.5% at the beginning of 2009.

But the Fed's scenarios may not be all that useful, for banks or their counterparties. Although its stress tests incorporate certain assumptions about the economy—featuring high unemployment and sharp declines in the equity and housing markets—the Fed may need a more explicit narrative about an economic meltdown, Mark Zandi, chief economist at Moody's Analytics, told *CFO* in 2012. "[Are the numbers] due to a housing crash, skyrocketing interest rates, or an unraveling of the euro zone? For banks this has a big impact on what is affected and by how much," he said.

The banks' living wills "provide no credible or clear path through bankruptcy that doesn't require unrealistic assumptions and direct or indirect public support," stated Hoenig.

FDIC Vice Chairman Thomas M. Hoenig

YouTube

By trying to develop "living wills" for systemically important banks—blueprints for how to unwind a distressed financial institution—U.S. regulators are attempting to unearth all of the complexity in the banking system and eliminate future government bailouts. Only tiny portions of these living wills, which run to thousands of pages, have been disclosed to the public, so they are certainly not adding to the transparency of large financial institutions.

Regulators are also highly unsatisfied with the living wills submitted by the largest banks. Commenting on them in August, Federal Deposit Insurance Corp. vice chairman Thomas M. Hoenig stated: "In my view each plan being discussed is deficient ... Despite the thousands of pages of material these firms submitted, the plans provide no credible or clear path through bankruptcy that doesn't require unrealistic assumptions and direct or indirect public support."

TRANSPARENCY ISSUES

Boiled down, the concerns over the largest financial institutions are ones of transparency. JP Morgan, for example, has quadruple the assets Lehman Brothers had in 2008, and 3,391 subsidiaries. Neither the living will nor the stress tests are much help to the bank's counterparties, at least as of yet.

A new report from the investment professional group CFA Institute, "Financial Crisis Insights on Bank Performance Reporting," brings up an issue just as relevant to counterparties as to investors: "the inherent complexity of bank business models, as well as [the] challenges associated with the opacity of these institutions." The report declares that "better reporting of risk, timely loan write-downs on balance sheets, and investor access to comparable reporting of information across jurisdictions, will improve transparency and reduce investor risk aversion towards the banking sector."

The particular problem CFA Institute researchers found with banks was that "it was hard to obtain any measure reported in the financial statements that fully captures the aggregate entity-specific risk." Given the business that banks are in, that information would seem to be essential.

But U.S. regulators have fallen behind their international counterparts in calling for incremental changes to bank accounting. The International Accounting Standards Board, for instance, has issued a rule requiring banks to recognize expected as well as incurred credit losses. The Financial Accounting Standards Board is still working on its proposed changes to loan-loss models, and they could be watered down by the time they are finalized.

Luckily for big banks, more transparency for investors is not at this point a necessity for surviving a financial crisis. "Despite its no-bailout pledge, Dodd-Frank leaves open many avenues for future TBTF rescues," testified Deniz Anginer, a professor of finance at Virginia Tech, before the Senate banking committee in late July. "For instance, the Federal Reserve can offer a broad-based lending facility to a group of financial institutions in order to provide a disguised bailout ... In addition, Congress can sidestep Dodd-Frank by amending or repealing it."

Removing the government safety net would force management of the biggest banks to suffer the financial consequences of risky, outsized gambles. Also, it would end some of the motivation for industry consolidation. As banking institutions increase in size and become more complex, they are more difficult to manage from a risk standpoint, and potentially more dangerous to financial stability.

But for now, the biggest banks continue to retain an advantage denied to their smaller brethren. "Almost every participant in the financial marketplace continues to believe that a small number of banks remain too big to fail and will, most definitely, be bailed out in a time of stress," says Cornelius K. Hurley, a professor at Boston University. "This is the essence of what it means to be a systemically important financial institution." CFO

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