Bauerle's Bank Notes

Inside the Ring Fence

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Comptroller of the Currency Thomas Curry used the occasion of Fed Chair Janet Yellen's Federal Funds rate increase last week to fire a shot across the bow of the nation's banks. According to the OCC's Semiannual Risk Perspective for Fall 2015, published Dec. 16,

> Banks and thrifts are easing credit underwriting standards and practices, including structure, terms, pricing, collateral, guarantors, and loan controls in response to competitive pressures and growth objectives. This easing is particularly evident in high-growth loan segments, such as indirect auto, commercial and industrial, and multifamily.[i]

Curry and his colleagues are determined not to be caught off guard when the next financial crisis breaks. In April 2008, Fed Chair Bernanke opined that markets would self-correct for any excesses, words he had to eat within a matter of weeks.

The trouble with Curry's pronouncement is the brush with which he paints is as broad as a barn door. The Philadelphia Federal Reserve Bank last week reported that manufacturing activity in the Third District weakened for the third month out of the last four. In the Midwest and the Gulf States, primary metals, oil and gas, mining and minerals are all in a China-induced slump. As noted in this column last week, the Wall Street Journal's research shows small and medium size businesses do not qualify for bank loans, so they resort to higher-cost funding provided by non-regulated lenders.

Curry's perspective also fails to account for differences that exist among the nation's banks. What is true of Wells Fargo is not necessarily true for First National Community Bank of Muskogee. Too much undifferentiated competition is part of the problem. More insidious is the predation that is occurring as the nation's "too big to fail" institutions cannibalize the business of their smaller peers. A useful example crossed our desk last week.

National Bank A received a request from Customer B asking permission to have Customer B's accounts receivable due from Fortune 500 Company C factored by one of the

nation's four largest banks, which we will call Big Bank D. Now factoring is a type of financing not normally associated with Big Bank D-sized banks. Instead of lending money to a business, a factor buys accounts receivable from the business at a discount and then collects the accounts directly from companies that owe the money to the business. It is a type of financing typically used by businesses that are not creditworthy in the eyes of banks. In today's market, factors charge rates from 9-15% per annum. Their business has grown significantly as reported in the Journal article.

In the Big Bank D variant of this structure, Big Bank D purchases the account of Fortune 500 Company C, which always pays its account on the 89th day after it receives the corresponding invoice. Under Big Bank D's program, the bank pays Customer B for the account on day 1 and finances 88 days' activity on the account. Big Bank D prices the credit risk based on the credit quality of Fortune 500 Company C plus a spread to Big Bank D. Even with a generous spread, the cost of credit to Customer B is less than what National Bank A would charge under its existing working capital loan agreement with Customer B. So Customer B is happy. Fortune 500 Company C is indifferent, since it pays the account on day 89 as it always did. Big Bank D is very happy because it is making a spread over what it would otherwise earn on Fortune 500 Company C credit risk. What's not to like?

The loser is National Bank A. Gone is the interest income it would earn for Customer B's 89 day borrowing against the account due from Fortune 500 Company C. Too, the overall credit quality of Customer B's pool of accounts receivable is reduced, since Big Bank D has skimmed the most credit worthy accounts for its factoring program. Consequently, National Bank A holds a marginally more risky loan to Customer B without getting paid for the incremental credit risk.

In one respect, the scheme draws on major banks' experience creating the sub-prime lending phenomenon. Customers are risk rated and loan pricing is correlated to specific account risk profile. What is different from the sub-prime precedent is who wins and who loses. Instead of charging a yield premium for funding weaker borrowers, Big Bank D collects a premium for taking credit risk of the best commercial credits. Conceptually, National Bank A should charge Customer B a higher interest rate for the reduced quality of its remaining pool of accounts receivable. However, in the banking environment Curry describes, if National Bank A does that, it risks losing Customer B's business to a competitor.

If you are Big Bank D's primary bank regulator, you applaud the ingenuity of its factoring program for accounts payable by Fortune 500 companies. If you are National Bank A's primary bank regulator, you grimace at the hit to earnings and credit quality the program inflicts on National Bank A and its peers. In the actual example presented to me, Curry and the OCC are both banks' primary regulator.

"Ring fence" was a phrase that became a cliché during the crisis of 2008. Regulators were out to ring fence every risk they could. They adopted new capital rules. They banned proprietary trading. Congress created the Consumer Financial Protection Bureau. Residential mortgage regulations grew to epic size and complexity. From the

vantage point of seven years' hindsight, the ring fence looks rickety.

Curry's dilemma is that it is politically difficult to do what he should do: block Big Bank D, and other institutions of like size and capability, from denuding the credit portfolios of smaller national banks. "Too big to fail" should not be a license to beggar thy neighbor. As part of their commitment to ring fence systemic risk, the regulatory community should reconsider who they are protecting, from what and why.

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[i] http://www.occ.treas.gov/news-issuances/news-releases/2015/nr-occ-2015-161.html

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