The Future of Corporate Finance at Commercial Banks and Why It Matters

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Remarks Prepared for the
Loan Syndications and Trading Association
19th Annual Conference
New York, New York
October 23, 2014

As we gather today, leverage-loan and junk-bond volumes have reached levels not seen since before the financial crisis wiped that smile off the market's face. Terms within many of these loans have also now matched or even exceeded pre-crisis ones from a flexibility – some might even say forbearance – perspective. The reason, as you well know, is not that the economic recovery here or around the world has been so resounding. Rather, it's that unprecedented accommodative monetary policy has stoked desperate investors to search for yields that keep their noses above zero rates of return. This all seemed to be going remarkably well until market turmoil last week threw a very large monkey wrench into an engine of financial production that – despite some regulatory warnings – effortlessly hummed along only a few days before.

This sharp reversal in market prices and liquidity reinforces worriers that have raised fundamental questions about the future of corporate finance. How well can transaction-driven corporate lending fare over the full business cycle in comparison with more traditional, relationship banking? Do current levels of corporate finance meet real economic need or simply promote LPO incentives that profit some while risking much? And, can through-the-cycle corporate-finance needs be met under normal monetary policy if traditional lenders are not able to compete and non-banks flee for greener pastures? Or, can investors replace banks as a major channel for corporate finance?

If the answer to my last question is yes, then corporate finance converts into a non-bank game. Does it matter to anyone other than banks, who ought to fend for themselves? I fear that tough bank rules are permanently redefining corporate finance in ways wholly unintended by the regulators and that, by the time the impact of these rules is known, we will experience a boom-bust cycle in business credit. If it's anything like the one already registering on some early-warning radars, it's frighteningly reminiscent of the subprime-mortgage debacle.

Perhaps I'm wrong and perhaps non-banks will prove resilient over-the-cycle lenders. But, smart money usually and very understandably flees at the first sign of trouble. In corporate finance, this would then deprive businesses of liquidity, operating credit, and new-venture funding right when it's most critical. That's what smart money does; it's just not what stable financial intermediation requires.

What Gives with Banks

Let's quickly review where banks stand in the corporate-finance landscape. Banking once used to be called commercial banking because that's what banks did – they made commercial loans to businesses. Individual customers were once an after-thought, if thought about at all. Banking of course has changed dramatically in the last few decades, but commercial lending still lies at the heart not only of the franchise value, but also of the social and macroeconomic functions for which banks are given unique benefits like FDIC insurance and FRB access.

As you've seen in slide 11 from S&P LCD Capital IQ, banks are now holding roughly ten percent of leveraged loans. Non-banks have to be sure been dominant in this high-flying sector since 2003, but take a look at another market – that for companies with annual sales between $25 million and $500 million. Banks lost a walloping eight percent of this market between 2012 and 2013, giving them a market share of only 73 percent in a sector once exclusively dominated by banks large and small[1].

Why so sharp a shift so fast? I know you all are familiar with the rules that increasingly determine the future of banking, especially that of the largest ones on which middle- and large-market corporate finance depends. Still, it's worth a quick run-down to demonstrate just how formidable are the challenges faced by these regulated institutions:

- **Leverage-Lending Guidance**: This is the most immediate challenge facing large banks in concert with the recent supervisory memoranda sanctioning some institutions for being too gung-ho on loans with too much leverage. At present, these standards have created terrific uncertainty combined with remaining pockets of bank support for the sector. However, as Chair Yellen and others increasingly fear that leveraged corporate finance poses macroprudential risk that cannot be curtailed with monetary policy, the greater grow the odds that the latest round of stress tests will prove deeply chastening for the very largest banks. Combined with enforcement actions on foreign banks, the outlook here is for

[1] American Banker, *Banks Risk Losing More Ground to Nonbank Lenders: Report*, October 8, 2014, available at http://www.americanbanker.com/issues/179_195/banks-risk-losing-more-ground-to-nonbank-lenders-report-1070426-1.html

greater pressure on big banks to do only a few high-profile deals and, then, only to do them when the fees make the risk worthwhile.

- **Capital**: The new risk-based capital rules under Basel III are most problematic for the nation's largest banks and, when combined with the enhanced supplementary leverage one and new capital surcharges for the biggest banks, they create a major risk-adjusted return on equity challenge. This is one reason to take a chance on higher-risk paper – it at least holds a prayer of return above the cost of capital. But, given the leveraged-lending guidance, these deals cannot be too many nor too risky. European banks – a major source of funding here – are also facing a grim reaper of their own stress tests, leading to sharp reductions in credit capacity.
- **Volcker**: One alternative corporate-credit route is to transmute direct loans into bonds, including junk ones. However, U.S. banks are under tough new bans on proprietary trading that complicate still-permissible market-making operations. U.K. banks also face tough new ring-fencing requirements, with the EU set also to impose something akin to these activity constraints in 2015. None of these rules bars either direct lending or bond underwriting – they just make it a darn sight harder to support deep and liquid markets once a bank has brought forth new debt issuances, reducing bank incentives to do so.
- **Liquidity**: The new liquidity coverage ratio (LCR) may soon be buttressed with a longer-term net stable funding ratio (NSFR). Together, they pose two problems for banks hoping to go big in corporate finance. First, larger banks must now hold large amounts of high-quality liquid assets to offset potential funding shortfalls under stress. The more of these they hold, the less capital capacity for anything else. One solution here is to eliminate lines of credit in favor of short-term funding products that give the bank an unconditional right to cancel. This works under the new risk-based and leverage rules from a bank's perspective – just not so much for a borrower trying to arrange stable, long-term liquidity.
- **Heightened Expectations**: The OCC has recently told large national banks that they are henceforth to govern themselves to ensure prudent operation, not necessarily also to be profitable. The FRB is also turning the screws to ensure big banks have the appropriate "risk culture." Although it might seem that profit and prudence can be made compatible, it's difficult to do so when all of the rules I've mentioned above impose pricing pressures often at odds with the economic risk. If they must choose the regulators' definition of prudence – which they now must – then many corporate loans will go unfulfilled by banks because even if the loan is safe and sound under critical regulatory scrutiny, it can't be priced competitively. Wipe away the competition, and even then the bank might not make the loan because the price it offers simply isn't rational from the borrower's ability-to-repay perspective.

The Securitization Solution?

Regulators in the U.K. and Eurozone increasingly hope that securitization will get their corporate-finance markets out of an ever deeper rut. As a result, various initiatives are under way to drop the capital requirements on ABS that meet varying definitions of high credit quality, simplicity, and transparency. The hope here is that banks will originate buckets of new loans secure in the knowledge that non-bank investors will eat them up.

Maybe, but the ability of non-bank investors to absorb large volumes of non-standard assets or that of banks to hold significant amounts of risk retention or the willingness of regulators to look the other way on operational risk in this sector is, at best, uncertain.

The U.S. will consider global securitization standards when these are finalized. However, I doubt they will make much of a dent in all the rules I've described. The U.S. has an increasingly strong preference for portfolio lending – the only problem here is that big banks can't figure out how to make money doing it.

Can Non-Banks Step In?

As I said, I doubt that secondary-market solutions for corporate finance will prove successful in the EU or U.S. Maybe over time as standardized scoring models advance, representations and warrantees are established, and – in the U.S. – issuers figure out a way through tough new SEC shelf-registration requirements. This could happen, but not soon, especially given risk-retention requirements and the capital cost these impose on banks.

Next Steps

The real challenge here is not what non-banks are doing per se or the way regulators are rewriting the rulebook since the crisis's five-alarm fire bells rang. It's whether that policy is focused almost monomaniacally on banks even as market capacity to circumvent them grows ever better.

In short, we're trying to have our proverbial cake and eat it too. That is, we want to regulate big banks into utilities that keep the financial market's lights on and at the same time ensure that even high-risk ventures get funded because that's where the jobs come from.

To make this happen all at once, regulators are not only sanguine about securitization, but also crossing their fingers and hoping that new investment vehicles for corporate finance will combine with stable non-bank funding to support growth. In the short run, non-banks may fund a lot of corporate credit because they can – at least if market volatility allows. The absence of all the rules I've described clears take-off. Safe landing? That's another question. With a $634 billion secondary market in corporate finance[2], this is no longer a market that relies on relationships. Instead, it's transaction driven in a way that generates liquidity – until it doesn't.

[2] Slide 13, data from LSTA Trade Data Study and S&P/LSTA Leverage Loan Index