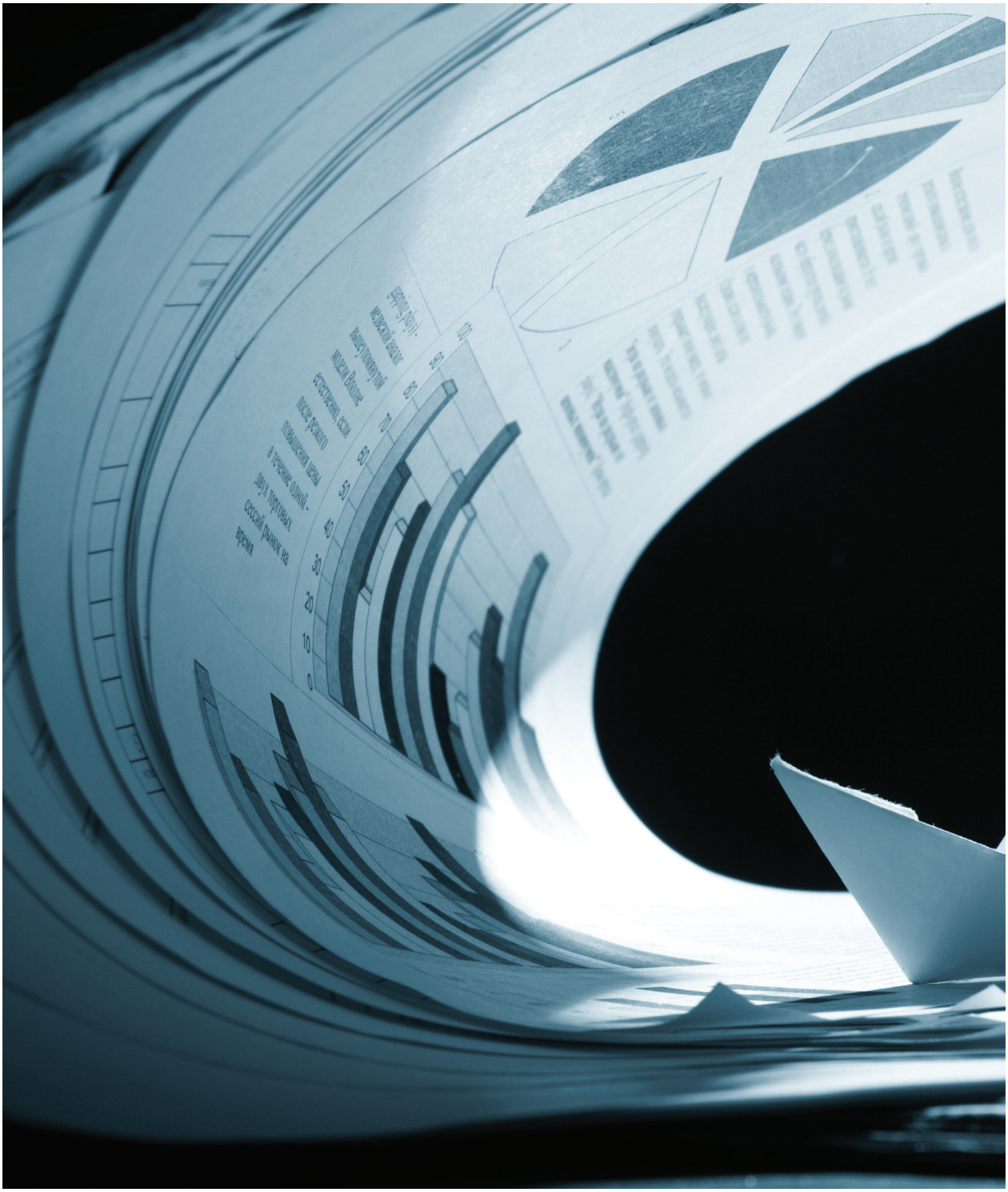
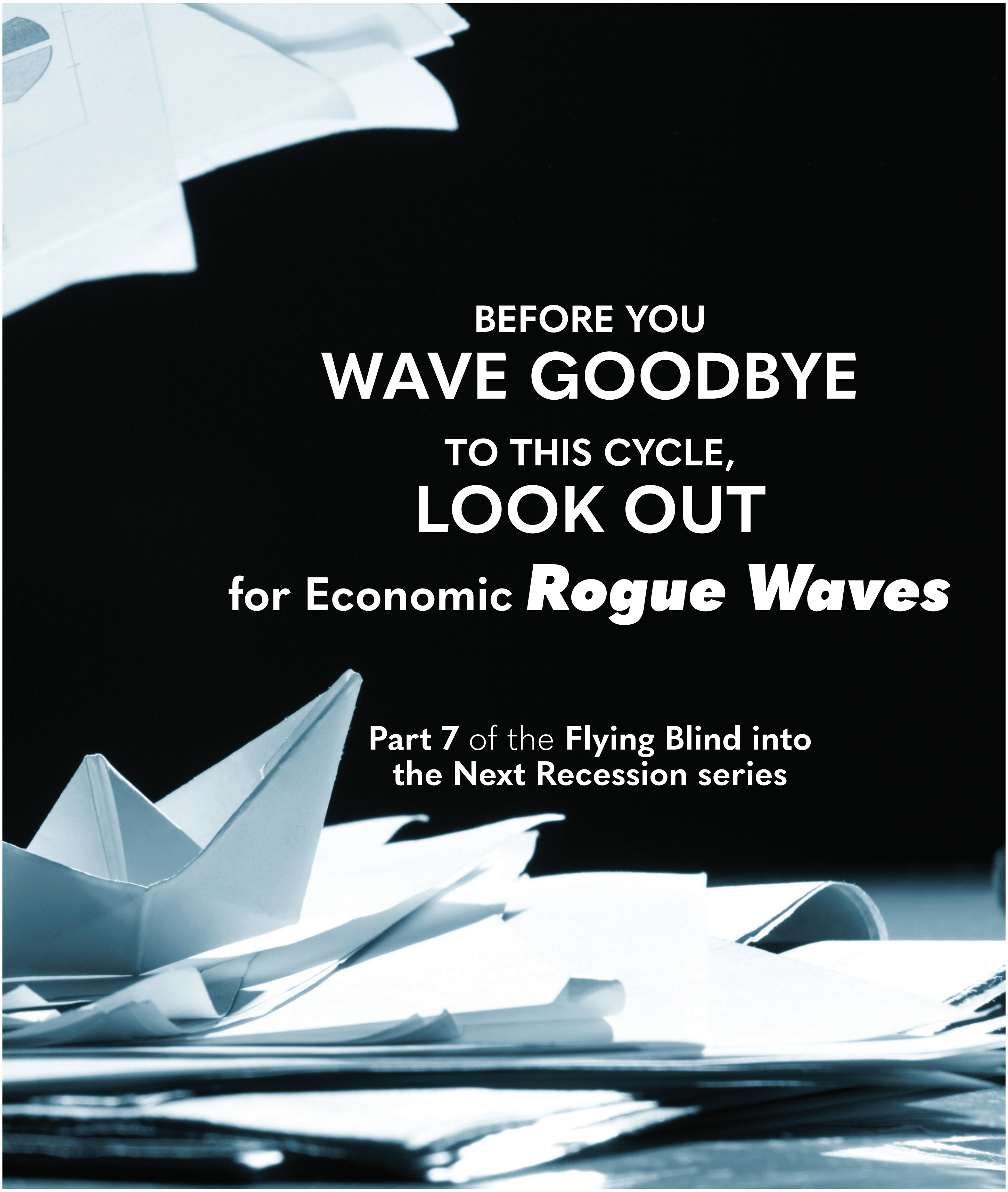




BEFORE YOU WAVE GOODBYE TO THIS CYCLE, LOOK OUT for Economic *Rogue Waves*

Part 7 of the **Flying Blind into the Next Recession series**

ROGUE WAVES ARE UNEXPECTED phenomena in which winds, currents, and other circumstances cause a wave to briefly form that is usually twice the height of an average wave. We finish out this series on how to prepare for changes in the business cycle with an evaluation of economic phenomena that might create a larger trough in a recession. Parts 1-3 of this series, published in *The RMA Journal* in early 2018, investigated key factors often ignored or undervalued by commercial banks—fundamentals that matter regardless of where we sit in the credit/economic cycle. Parts 4 and 5, released in the June and July/August 2019 *RMA Journal,* built on this effort, contrasting the economic, financial, and political environment prior to the Great Recession with where we stand now. In Part 6 we examined the lending ramifications of the rise of M&A activity in key sectors. In this final installment of the series we will provide a recap of previous work and consider some esoteric issues that are likely to drive bank performance. The authors presented some of the key elements of this paper at RMA's Annual Risk Management Conference in New Orleans in October 2019.

"The art of war teaches us to rely not on the likelihood of the enemy's not coming, but on our own readiness to receive him. Not on the chance of not attacking, but rather on the fact that we have made our position unassailable."

– Sun Tzu, Chinese Military Strategist

BY RICK BUCZYNSKI, KENT KIRBY, AND DEV STRISCHEK

THE MOTIVATION BEHIND this series was to provide guidance on preparing for the inevitable economic downturn. Although we are not possessed by any Nostradamus-like foresight or cursed by Cassandran prophecies of doom, we do subscribe to the consensus that we are entering, or are already enveloped in, the end of the current credit cycle. So, the time for preparation is now, if not yesterday.

Our plan has been to isolate two categories of factors to help prepare for economic stress. *The first are factors that always matter regardless of where we sit during a credit cycle.* These time-tested attributes take on even greater weight during recessions.

The second set of factors are those unique to the current cycle—where history, models, and institutional knowledge provide little solace. Given these forces, determining what is actionable for both risk mitigation and identifying prudent lending opportunities require intuition, common sense, and dialogue. Neil Berdiev's article in the November 2019 *RMA Journal* on effective communication offers a concise reminder of the importance of dialogue in credit risk management.

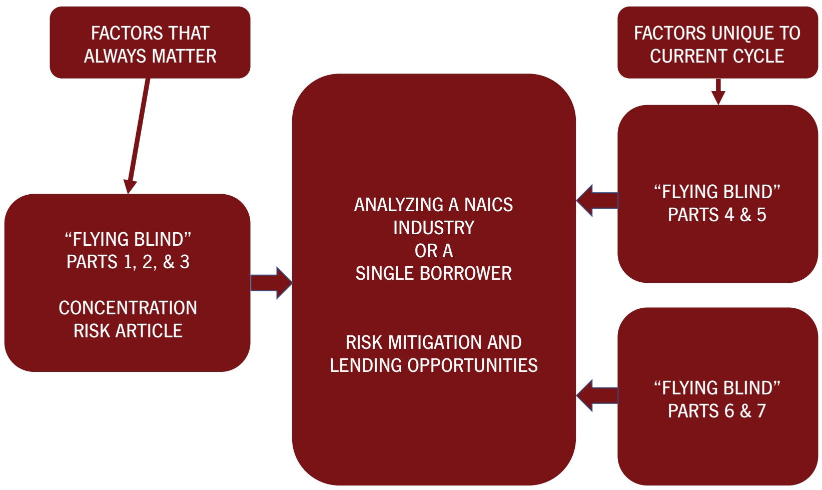
This series provides a checklist of factors for identifying safe and sound lending opportunities, either by industry segment, line of business, or specific borrower.

Lending Factors That Always Matter

Parts 1-3 of this series[1] describe fundamentals that matter *regardless* of where we sit in the credit/economic cycle: the "Eight Deadly Sins" of lending. In summary:

- *Ignoring the attributes of discretionary versus non-discretionary spending.* Industries dependent on discretionary spending (luxury goods) are more vulnerable to downturns than those dependent on non-discretionary spending (necessities). In healthcare, consider hospitals vs. sports medicine. Understand the differences between non-durable/durable goods. Think toothpaste vs. flat screen TVs, and highly discretionary travel/tourism spending that is typically boom/bust.
- *Forgetting the perils of small retail business exposures.* Be cautious of obligors that operate in a highly competitive environment, are not "price makers," have low barriers to entry, are living on thin margins, and are located next to a suffering "anchor" retailer.
- *Being seduced away from doing your homework when it comes to the introduction of new technologies.*

GAME PLAN OF THE FLYING BLIND SERIES, A SAFE AND SOUND LENDING CHECKLIST



Don't follow bandwagons into areas where you don't have institutional knowledge, and where there are many more losers than winners. Does the dot-com boom/bust foment any thoughts?

- *Forgetting the obvious dangers and opportunities in an industry's life cycle.* Target firms in the growth phase of their industry cycle and aim for mature industry cash cows. Beware of emerging industries—technological change can be hard to analyze—and be cautious regarding late-cycle industries such as department stores, newspapers, and broadcast media.
- *Failing to recognize the threat of substitute products or services.* Watch for these red flags: a consumer's switching costs are low, a substitute product/service is highly price competitive, and the substitute product/service is of equal or superior quality.
- *Overlooking one of a banker's greatest fears: volatility.* For example, commodity-based industries and those dependent on energy/mineral-based suppliers require higher risk premiums to compensate for the volatility in their market prices. Another example is the ongoing healthcare policy debate that injects considerable uncertainty into a sector that has been historically stable. The healthcare industry's pricing structure has been built on a foundation of predictable cost-plus pricing. Can this foundation survive political shockwaves?
- *Underestimating the significance of capital spending cycles.* CAPEX (private non-residential fixed investment) is historically hypersensitive to both upturns and downturns in economic cycles, making it another boom/bust segment. In the second half of 2019, CAPEX began to decline in inflation-adjusted terms because of concerns about trade wars and the waning health of the global economy. Be vigilant for signs of stress in industry segments that are correlated to CAPEX, e.g., industries tied to machinery and equipment, commercial construction (especially industrial infrastructure), software/systems, and training.
- *Disregarding the domino effects of hidden concentration risks.* (See Buczynski and Kirby, May 2019 *RMA Journal*.[2]) Recall the recent housing crisis, whose contagion infected construction contractors and correlated industries, including furniture, carpeting, appliances, forest products, and building materials.

Key Takeaway # 1

Be aware of the fundamentals of risk mitigation and prudent lending that always matter regardless of where we sit in the credit cycle. Emphasis should be placed on the difference between discretionary vs. non-discretionary spending, industry volatility, and latent concentration risks.

Factors Unique to the Current Cycle: Review and Updates

Parts 4 and 5 of the series[3] built on earlier installments, contrasting the economic, financial, and political environment prior to the Great Recession with where we stand now. They focused on relative comfort zones, given tensions in international trade, and examined the impact of rising government, corporate, and household debt.

Several areas described in Parts 4 and 5 beg for further analysis and a quick update.

The *"retail apocalypse"* and *"Amazon effect"* march on. Once the jewel of retail, Sears announced that by February 2020 it will have only a combined 182 American retail stores, down from 425 a year earlier and almost 2,000 five years ago. This latest reduction occurred after filing a Chapter 11 restructuring plan intended to salvage the company. One clear casualty of the retail retrogression is America's shopping malls.

Considering the CRE risks, reconfiguring existing shopping malls isn't easy. Many are being demolished; others are being reconfigured into medical clinics, video gaming hubs, megachurches, fitness centers, and even homeless shelters. Bankers must evaluate the attributes of a property's ownership and how vulnerable banks are to the potential erosion in their borrowers' collateral capacity, capital, business conditions, and character that determine the borrower's ability and willingness to repay. Sound like the Five C's of Credit? Also consider the collateral damage associated with proximity. Deteriorating malls becoming blighted can have a knock-on effect on the valuations of nearby properties, regardless of use.

While major, nationally based department stores have been under fire since well before the advent of online retail, others are flourishing despite the Amazon effect. The likes of Walmart and Target are winning the market-share game at the expense of once venerable nationwide retail chains. They have reached Andrew Grove's "strategic inflection point"[4] and are, for now, riding the wave of their adaptation. Here's what Grove had to say:

…A strategic inflection point is a time in the life of business when its fundamentals are about to change. That change can mean an opportunity to rise to new heights. But it may just as likely signal the beginning of the end.

Also, consider the obliteration of "mom and pop" shops, given the demise of anchor stores and newly established, highly competitive market invaders. Example? ZIPS Dry Cleaners nuking small, independent dry-cleaner establishments.

In your footprint, do you have exposure to car and personal loans, mortgages, or education debt where obligors rely on income from retail-related industries? In a CNN report last fall, economist Mark Zandi of Moody's Analytics calculated that some 200,000 retail employees have lost their jobs since the beginning of 2017. Can you stress test these attributes? Talk about latent concentration risk.

Key Takeaway # 2

The structural demise of traditional retail is accelerating. It's not just the big-name retailers, it's debtors with exposures to CRE-related projects, and smaller businesses whose success is graced or damned by traffic drawn by anchor stores. Watch for correlated concentration risk here; retail-related workers also have accounts at your bank.

Trade relations are likely to remain fluid. It's not just about U.S./China relations. Remember that relations with Europe are complex and increasingly combative, with Brexit-related issues further fueling tumult across the continent. In mid-October, the World Trade Organization granted the U.S. permission to levy tariffs on more than $7.5 billion of European exports annually in retaliation for rule-breaking European government subsidies provided to Airbus. Another example? The United States has threatened to assess tariffs against a variety of French products in retaliation for France approving a digital services tax (3% of revenues) targeting large U.S. tech firms such as Facebook, Amazon, Apple, Netflix, and Google.

Perhaps the most important trade issue is the fate of the NAFTA replacement, the United States-Mexico-Canada Agreement (USMCA). On December 10, the Trump administration and House Democrats reached a deal on the USMCA, opening the door for likely ratification in 2020. The agreement would assuage concerns over supply chain disruptions while benefiting American steel exports and aluminum product producers—given the lifting of the 10% U.S. tariff on Canadian aluminum. The pact should also aid America's struggling auto industry by lifting local content provisions on cars and trucks manufactured in North America, and requiring 40% of production to occur where average wages exceed $16 per hour. Meanwhile, U.S. agricultural exports stand to increase, as Canada and Mexico are the leading buyers of U.S. farm products. Nonetheless, given the inevitable political jockeying prior to the 2020 elections, the outcome is far from guaranteed. America's largest trading partners share its northern and southern borders, and the U.S. should not take Canadian and Mexican patience for granted.

Finally, tensions with China entail much more than the well-publicized trade war. Along with the trade practices the U.S. has deemed unfair, including China's subsidizing its export industries and alleged currency manipulation, there are long-held concerns over the theft of intellectual property, and the forced transfer of American technology to China for firms operating there.

Key Takeaway # 3

If your borrowers are exposed to overseas business, look beyond the rhetoric of trade with China. America has many trading partners, including our neighbors north and south as well as the European Union and Brexit Britain. Many banks have latent exposures to American-based clients that are linked not just by trade but are also vulnerable to technology/patent drain. Can you identify these warning signs in your portfolio?

Debt, Interest Rates, Creditworthiness, and the Pursuit of Yields. The issue of growing debt by households, the U.S. government, and corporations together with extreme financial risk-taking was analyzed in Part 5 of this series. We are increasingly troubled that this might be the funeral pyre that ignites the next recession and turns assets into ashes.

Extremely low interest rates for nearly two decades have expanded the risk appetite of the entire American economy, not just the banking sector's, and have spawned a collective insatiable hunger for more cheap debt. Consequently, Japanese and European central banks have undertaken unprecedented negative interest rate policies on excess bank reserves, effectively mandating a storage charge for cash. Consider the likely turmoil a negative interest rate policy would provoke in the U.S. It could usher in a perverse incentive for banks to aggressively approve loans during a period in which they would favor more prudent lending. Don't forget: we are closing in on the end of the current credit cycle. A related operational risk is whether bank accounting systems can even accommodate negative interest rates. And consider how such a policy stance would affect a bank's net interest margins that have been under stress for more than a decade. This is a seriously worrisome prospect.

Regarding debt, we remain wary of the federal government's lackadaisical resolve to manage the growth of fiscal deficits and the national debt, which, if you agree with economics textbooks, crowd out private investment and limit funds needed to upgrade America's infrastructure. The composition of household borrowing, examined in Part 5 of this series, is a more serious factor than its numbers would suggest because a growing share of personal loans is to subprime and near-subprime borrowers.

Perhaps our gravest worry is the stunning surge of corporate debt—not the enormity of the increase, but how the funds are being employed and the quality of the debt. Corporate debt is approaching $10 trillion—or almost half of America's GDP.

COMPANIES ISSUE RECORD AMOUNTS OF DEBT, USE THE DEBT TO REPURCHASE RECORD AMOUNTS OF STOCK, THEN, IN TURN, INSIDERS SELL HUGE AMOUNTS OF STOCK TO THEIR OWN COMPANY.

An October 2019 International Monetary Fund (IMF) report noted:[5]

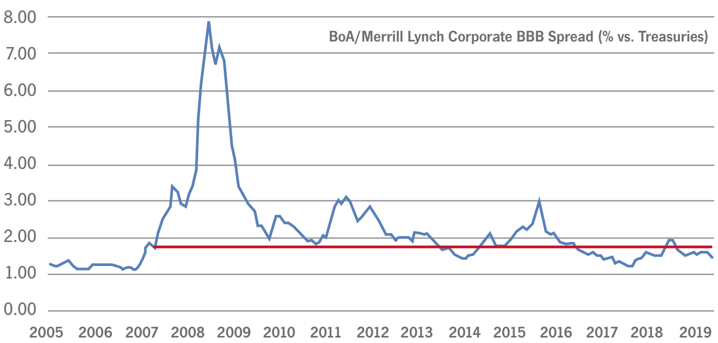
The search for yield in a prolonged low interest rate environment has led to stretched valuations in risky asset markets around the globe, raising the possibility of sharp, sudden adjustments in financial conditions.

The IMF also reported that a global downturn half as severe as the one driven by the previous financial crisis would result in $19 trillion of global corporate debt being considered at risk. The IMF defines "at risk" debt as from firms whose earnings would not cover the cost of their interest expenses.

Leveraged lending has been on regulators' radar screens for several years.[6] Recently, it has been increasingly used to finance mergers and acquisitions (see Part 6 of this series[7]) and equity buyouts in which companies repurchase shares, benefitting insiders that sell off their holdings. In short, companies issue record amounts of debt, use the debt to repurchase record amounts of stock, then, in turn, insiders sell huge amounts of stock to their own company. This has come at the unfortunate expense of CAPEX, as noted above. It is not a welcome state for longer-term economic growth prospects or a recovery from the next recession. Our corporate physical infrastructure's maintenance and improvement is being neglected in favor of paying dividends and buying treasury stock.

According to a MarketWatch report,[8] the number of U.S. companies whose bonds have a BBB credit rating is rising, and the probability of them being downgraded to "junk" is mounting. Moody's and Standard & Poor's explain that a B-rated company can repay debt in favorable economic periods. But what about in not-so-favorable economic times? Such companies typically have high debt-to-asset ratios and are prone to shortages of cash. Therefore, they have difficulties meeting debt obligations. Banks, especially the mega-lenders, are primary contributors to the growth of BBB bonds. The issuers are concentrated as well, with AT&T, General Motors,

FIGURE 1: REACHING FOR RETURNS EVAPORATES YIELDS: WELCOME BACK PRE-CRISIS SPREADS



Source: Bank of America/Merrill Lynch via https://fred.stlouisfed.org/series/BAMLC0A4CBBB

Ford, and Verizon leading the pack. In addition, CVS, Marriott, Hyundai, and Nordstrom are heavily leveraged while hovering around BBB ratings. Ford bonds were chopped to junk status during 2019.

Figure 1 illustrates how BBB corporate bond spreads have narrowed against U.S. treasuries to pre-financial crisis levels. Are we continuing to seek short-term returns, thus driving the yields we are seeking lower?

There's more to this story. An October 2, 2019, a Bloomberg report noted:

Collateralized loan obligations—typically chock-full of broadly-syndicated debt—are increasingly being stuffed with private loans made to highly leveraged medium-sized companies with limited access to bank financing. Known as middle-market CLOs, the asset class has ballooned to $57 billion, from just $20 billion six years ago.

The problem with the popularity of these CLOs is that they may be a harbinger of losses in high-yield markets, where many banks are now invested. Large syndicate leaders are well-established and have the resources and capital to withstand a non-crisis blip. But smaller banks, particularly those that are lean in due diligence—and only passively engaged in "dialing for dollars" to build outstandings through their participation in syndications of this genre—are cause for concern. Has your organization looked at its participation portfolio process to evaluate its credit quality management?

The façade of the marketization/securitization of risky debt hasn't morphed much in the past decade. Banks and others are chasing returns in a near-zero interest rate world. Sacrificing credit quality seems to once again be an end-of-cycle attribute. Even traditionally conservative pension funds are hunting for returns, as the *Wall Street Journal* noted in a November article ("Pensions Embrace Riskier Investments in Hunt for Returns").

BUSINESS CONFIDENCE IS CLEARLY WANING, INDICATED BY DECLINES IN REAL PRIVATE INVESTMENT AND SLUGGISH ORDERS.

Key Takeaway # 4
Be wary of exposures to BBB bonds, especially in CLO syndications where many over-leveraged, mid-sized companies' debts are housed. You might also have direct commercial loan exposures to these very same firms.

Several other market factors have emerged since the publication of Parts 4 and 5 of this series. Some of these present perplexing conflicts.

- While the stock market continued its record-setting ascent in mid-2019, the bond market experienced several inversions as short-term interest rates became higher than long-term rates. Inverted yield curves are often considered forerunners of recessions. These are often mixed signals, but inverted yield curves can suggest a flight to quality as some investors gobble up safe long-term government bonds. This is inconsistent with narrowing spreads depicted in Figure 1.
- While buyouts by corporations hit record highs in 2019, buyout activity by private equity firms declined by about 25%. With inflated stock prices, many private equity firms view potential deals as overvalued and have decided to sit on their massive cash holdings. Is this another schizophrenic distortion of market perception?
- Repurchase (repo) rate swings have threatened liquidity in bond markets. In mid-September, the rates in the repo agreement market, where banks and money market mutual funds lend very short-term cash, surged above 10%. Declining bank reserves, looming corporate tax payments, and a government bond auction were thought to be the culprits, but many banks decided to hold cash rather than lend overnight. In addition, hedge funds are active in the repo market, both as a source of funding and arbitrage opportunities. The Fed intervened in a manner unseen since the financial crisis, pumping in more than $100 billion on September 25 alone. This incident introduced a factor that has been widely neglected: the U.S. Treasury Department and Fed are quietly shoring up an inherently volatile repo market. Is it any wonder liquidity risk management has become of paramount importance?

What can we make of this?

First, there appear to be some divergent sentiments among households, businesses, and investors. This is always a red flag. To wit: the University of Michigan's mid-December Consumer Sentiment Index was up from the beginning of the year, retail sales in late-2019 looked reasonably robust, and consumer borrowing remained strong—particularly for auto and education loans. But curiously, a significant portion of new personal loans are "near-prime," i.e., to borrowers with credit ratings from 600 to 699. These debtors can easily manage month-to-month payments, but may succumb to the stress of economic slowdowns or recessions. More on this later.

Meanwhile, business confidence is clearly waning, indicated by declines in real private investment and sluggish orders. In November, the Institute for Supply Management's manufacturing index dipped to its fourth consecutive sub-50 reading. Readings below 50 indicate that business conditions are deteriorating. The ISM's service industry index is receding as well.

Key Takeaway # 5

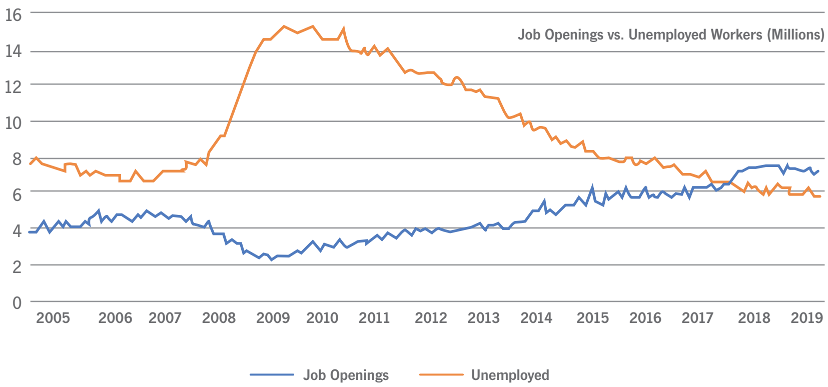
While your consumer book might look safe now, businesses are becoming extremely cautious, and layoffs can occur quickly, despite record low national rates of unemployment and tight labor markets in many segments. Don't get caught flying blind. Many of your consumer clients might be as vulnerable as their employers. Re-check the credit scores of your consumer and small business books. In other words, stress test!

Second, recent out-of-the-blue liquidity concerns, as technically perplexing as they might be, have considerable implications for all banks. Will the Fed resort to quasi-quantitative easing moves, building up asset balances again and perhaps limiting its ability to exercise preemptive counter-recessionary moves? This is difficult to answer while liquidity anxieties persist, but the Fed still has the girth to increase its balance sheet.

Key Takeaway # 6

Be observant of the much-talked about but mostly neglected issue of liquidity risk. Markets freeze when even Type 1 and Type 2 capital can't quickly find a home. Determine which of your clients are dependent on very short-term credit and assess the remaining availability in their credit lines, not just balances outstanding.

FIGURE 2: AMERICA HAS AN EMPLOYMENT GAP IN TRADE WORKERS



Source: Bureau of Labor Statistics

In Part 6 of this series, on M&A activity, we speculated that "retirement communities will continue to grow rapidly and experience a high incidence of merger activity." A November *Wall Street Journal* piece put a damper on this notion, claiming that aging baby boomers—some 72 million born between 1946 and 1964—are reluctant to leave home when compared with predecessors from the Great Depression/World War II era.

Some of this reticence can be attributed to technological innovations, including the development of remote health monitoring devices and facial recognition to identify extended care visitors. Houses with malleable designs—and even convenient transportation services such as Uber—are additional factors that could keep seniors in their homes. If your organization is attracted to retirement community lending, pay attention to projections of seniors choosing to move to retirement communities. What appears to be hot now may plateau sooner than expected. Consider the duration of your commitments and exit strategies.

Some Esoteric Factors Unique to the Current Cycle

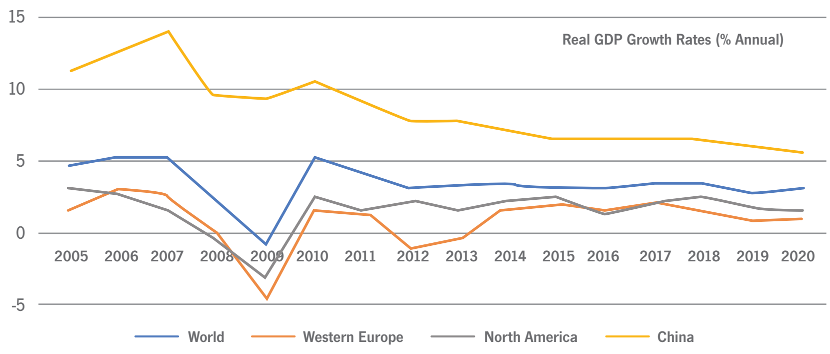
The Labor Market Ain't What it Used to Be: Labor Shortages and Supply Chain Disruptions

While the unemployment rate and absolute number of unemployed nonfarm workers gradually declined since the start of the Great Recession, the number of unfilled jobs crept along, finally reaching an unusual and startling inflection point in March 2018. There were more employers looking for workers than the number of available unemployed!

The gap—almost 1.35 million workers—is more structural than cyclical, and is related to a dearth of skilled trade workers. The average age of an American welder is 67. Skilled labor shortages are curbing a revival in furniture manufacturing. There is a scarcity of short- and long-haul drivers. Consider supply-chain disruption risk if you have borrowers dependent upon intermodal transportation and just-in-time inventory strategies.

According to an IBISWorld report,[9] the construction sector's tightening labor market is creating difficulties among small- and medium-sized building firms as jobs go unfilled, making delivering projects on time more difficult. Shortages are also prevalent in very high-skilled areas, such as the STEM (science, technology, engineering, and mathematics) industries we analyzed in Part 4, and in health care.

FIGURE 3: GLOBAL ECONOMY SOFTER NOW THAN PRIOR TO THE GREAT RECESSION



Source: International Monetary Fund

Key Takeaway # 7

The lack of skilled workers in blue-collar areas and high-skill fields is more of an issue when the economic/credit cycle turns positive than when we sink into recession. Be prepared for higher wage costs for your borrowers that employ this type of worker, and don't forget about the supply-chain risks your clients are vulnerable to.

Global Economy Less Robust This Time Around

Compared with the end of the last credit cycle, the global economy is on considerably weaker ground. According to the IMF's October 2019 World Economic Outlook, the prognosis "remains precarious" owing to a downturn in global manufacturing and rising trade barriers. The across-the-board surge in government, corporate, and consumer debt potentially limits countercyclical fiscal policies.

Other recent data suggests America's service exports may be faltering. The balance on service trade has been a strength of the U.S. economy, but was down 10% in September 2019 from a year earlier, suggesting that anemic economic conditions overseas have taken a toll. Segments like the broad "travel services" that include lodging, food, and tuition spent by foreigners weakened, while transportation of cargo and intellectual property sales faded.

Key Takeaway # 8

A weak global economy appears to have threatened trade in services, historically a strength of U.S. businesses. So keep a careful eye on your exposures to commercial obligors dependent on service trade, particularly related to travel and tourism, as this area is showing early signs of vulnerability. Be equally attentive to the risks associated with consumer loans where earners are concentrated in these sectors.

A New Paradigm for American Energy: Risks Thrashing Opportunities?

At first glance, Figure 4 looks amazing. And why not when compared to the oil shock era of the 1970s?

In less than 15 years America's petroleum production—including natural gas and oil-shale—has more than doubled, while net petroleum imports have collapsed.

This has conjured the idea that America can partially supplant Saudi Arabia as a "swing producer," potentially minimizing volatility in global oil markets. While some indicators seem to suggest declining volatility in oil prices, oil price volatility is inherently bound to the low responsiveness (inelasticity) of both supply and demand to short-run price fluctuations. Worse, global political factors continue to destabilize energy without warning.

Before you check out Figure 5, a trivia question: Name the top five oil-producing nations in the world.

The swift growth in U.S. oil production has added to an existing glut, holding down prices and benefitting energy-intense manufacturers and motorists. This hasn't made life easier for oil-producing companies, which have seen stock prices fall. Profitability has been an issue. Many private equity firms are struggling to earn a return on investments. Dozens of fracking oil-and-gas producers went bankrupt in 2019, and many more are heavily in debt and have issued junk-rated bonds. Private producers and small publicly held firms have been particularly hard hit, many finding it difficult to service obligations when oil prices dip below $60 a barrel. Consequently, by late 2019, many frackers were cutting back on pumping oil to stabilize prices as investors put more pressure on profits than production. OPEC reinforced this move in December by agreeing to cut extraction by 40% in 2020. But OPEC "agreements" often don't go the distance.

Another problem to consider: As the boom fades, manufacturers supplying drillers with cranes, engines, and pipes are in jeopardy. For some banks in the oil patch, this industry co-variance aggravates concentration risk. Desperate for cash, many shale firms are floating asset-backed securities promising future output of existing fields. Predicting future production is an inexact science and risky business, indeed.

And, if that is not enough, there is a nascent movement in the U.S. that is steadily picking up steam—clean energy. While not a major producer, New York has already banned fracking, and there is a push to expand that to other states. Activists have slowed the construction of new pipelines, resulting in movement of hydrocarbons by rail and periodic supply disruptions as existing pipelines are taken down for maintenance. Many states require utilities to purchase a certain percentage of energy from clean sources, resulting in a decline in the need for natural gas. This list goes on.

Although energy is the largest and one of the oldest industries in the world, its rapid growth and struggle to operate profitably seems to resemble the characteristics of an emerging industry rather than a mature one. Consider the dot-com boom/bust of two decades ago. As such, we expect many more bankruptcies and a high degree of consolidation. Increasing financial exposures in this area are not for the faint of heart, or novice.

Key Takeaway # 9

Taking on clients in shale firms is risky business, requiring strong in-house expertise to make prudent, highly selective decisions.

Emerging Competitive Threats to Banking: It's Not Just Nonbanks or Fintechs, It's Big Techs

Much has been written about the competitive landscape in banking since the financial crisis. A recent report by the FDIC[10] on the growth of nonbank lending is a must-read for specifics on leveraged lending and farm credit. It indicated that the share of bank vs. nonbank origination of home mortgages was trimmed from banks' 78% share in 2007 to a 50-50 split by 2017. In early December, the Financial Stability Oversight Council singled out competitive, fast-growing mortgage companies—which aren't as closely regulated as banks—as an increasing source of systemic risk.

Not so coincidentally, the report noted that banks' collective loan exposure to nonbank financial institutions rose dramatically, from about $50 billion in 2010 to nearly $450 billion by 2019. If you can't lick them, loan to them? According to the report:

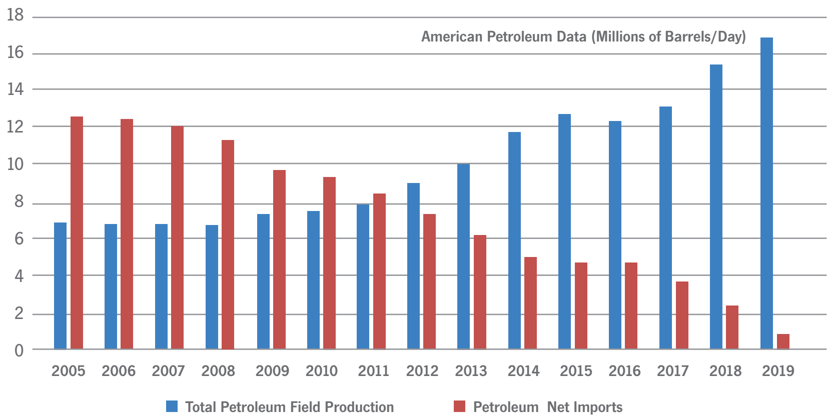
Banks may also hold securities that expose them to risks from nonbanks. For example, banks may hold collateralized loan obligations that include leveraged loans. Because call reports do not require detail about these asset classes, understanding the underlying credit risk of a bank's portfolios of securities and loans to nonbank financial institutions is difficult.

Key Takeaway # 10

Be alert to the hazards of nonbank financial institutions in your portfolio. They will likely become increasingly risky if the economy slows, and this type of exposure may be difficult to track.

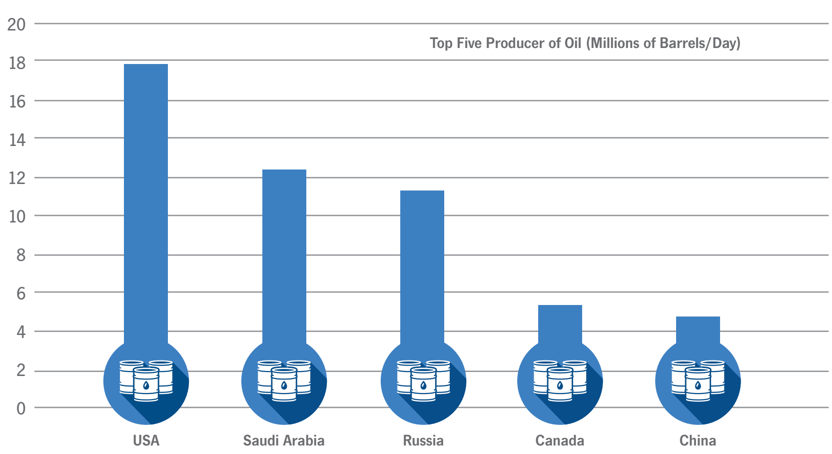
Much analysis has honed in on the fintech craze: smartphones, online payment apps, chatbots, artificial intelligence for fraud detection,

FIGURE 4: WATCH AMERICA'S ENERGY PROFILE DEFINE A NEW PARADIGM



Source: U.S. Energy Information Administration

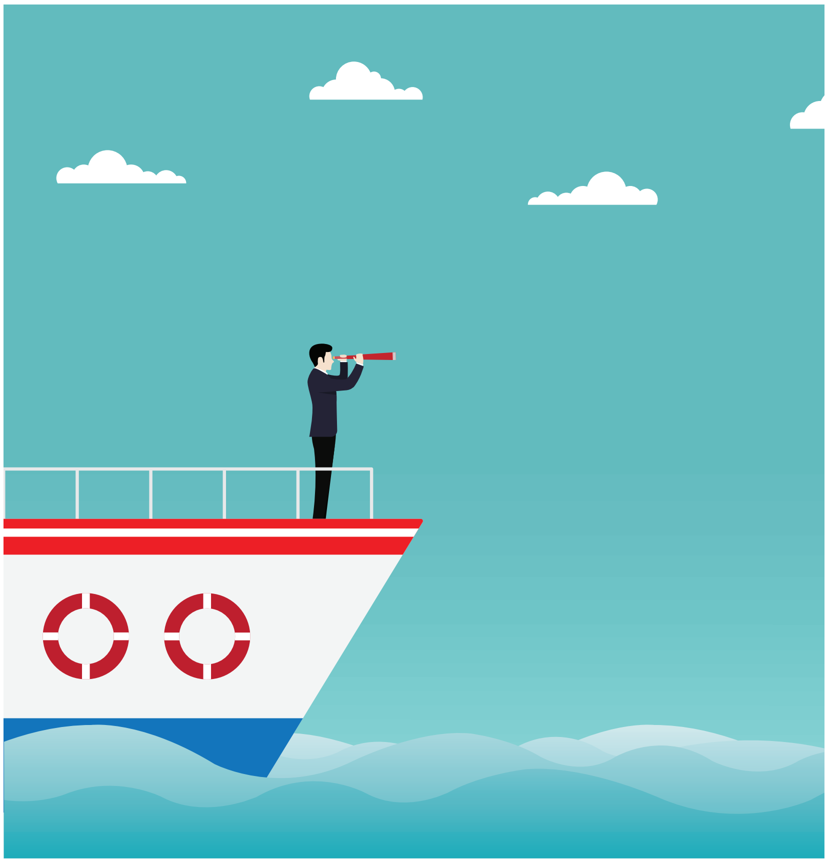
FIGURE 5: AMERICA IS NUMBER ONE IN OIL PRODUCTION



blockchain for transaction security, etc. Many banks are embracing these unstoppable technological advances, notably larger banks that possess the resources for the necessary technical staff and investments.

Many fintechs are becoming serious competitors in credit and other banking services, including payment platforms. A few leading examples in the U.S. include.

- LendingClub: Personal and small business loans.
- LendingTree: Personal loans, credit cards, and insurance.
- Avant: Major online personal lending platform.
- SoFi: Student loan refinancing, mortgage loans, personal loans, wealth management, and life insurance.
- Robinhood: Online brokerage.
- Stripe: Payment platform leader.
- Coinbase: Offers cryptocurrency custody and professional and institutional trading platforms.



Nonetheless, we have deeper concerns, as echoed recently by Dan Murphy[11] of the Milken Institute Review. His argument is that the invasion of banking by what he calls "big tech" is considerably more worrisome than fintech:

The real threat, the bankers are coming to recognize, is big tech, not fintech. Unlike fintech startups, firms such as Amazon, Google, Alibaba, and Tencent have deeper pockets and better access to data than any bank. Most important, big tech firms have uniquely intimate relationships with their customers. These factors turn big tech's lack of regulatory oversight into a competitive advantage, allowing them to operate on the margins of financial regulation at a much larger scale than a fintech startup.

Rather than brashly setting out to replace banks altogether, big tech's strategy is to quietly seize the customer relationship one product at a time by offering a seamless digital financial services experience tied to their core platforms. This presents bankers with a dilemma: Should they try to beat back the invaders or join forces to gain access to their customers?

Consider Google's recent push into banking by offering checking accounts through Citigroup. The risk here seems to be aimed at smaller banks that may find it challenging to play ball with these mammoth corporations.

Additional concerns over nonbank financing include a growing number of subprime auto loans to many individuals carrying negative equity when trading in their "underwater" vehicles for new models, i.e., loan balances exceed a vehicle's value. Further, America's middle class seems addicted to online credit[12] called the online installment loan, a form of debt with much longer maturities than payday loans but often charging the same sort of debilitating, triple-digit interest rates.

Mind the GAAP: The Impact of CECL and Lease Capitalization on Lending Risks

Before we wrap up this series, a quick note on the potential interplay of CECL and the credit cycle. The Financial Accounting Standards Board's (FASB) new accounting principle, current expected credit losses (CECL), has been a controversial change in how firms deal with future credit losses. The first point bankers must remember is that it applies to all entities, not just banks. The second point is that its implementation has turned out to be more complex than FASB envisioned. FASB has deferred its implementation for smaller entities, and—depending on the effort expended by larger, publicly traded companies—FASB may consider deferring it a little longer.

Without delving too much into the details, banks must estimate the credit loss inherent in a loan—over its lifetime—at a loan's inception. All things being equal, longer-term loans will have more credit loss than shorter-term loans. Therefore, banks extending mortgages, car loans, and other multi-year obligations will have to put more into their loan loss reserves than banks with short-term credit products, such as business lines of credit or short-term business loans. Could the outcome be a collective diminution in the availability of long-term credit? What about non-bank manufacturers that sell their output via long-term arrangements—agricultural implement and construction equipment manufacturers such as John Deere, Case, and Caterpillar—to buyers in extremely sensitive and vulnerable industries, e.g., agriculture and construction?

Lease capitalization warrants a brief warning, too. All leases longer than 12 months, regardless of size, are to be capitalized, finally plugging the off-balance-sheet loophole leasing has provided since 1973's FAS 13. Lease cap will put both a liability and a right-of-use (ROU) asset on balance sheets. The most expeditious way of reducing the size of the liability is to shorten or pay off the lease. Commercial real estate lenders expect that income-producing properties have lease tenants with terms equal to or greater than their commercial real estate mortgages. How will banks cope with borrowers whose tenants are negotiating for shorter lease terms, e.g., two- or three-year leases while the property's mortgage term is 15 years? The ROU asset carries some risk for banks that happen to lease considerable amounts of property and equipment, such as branches and computer equipment. All things being equal, a bank's return on assets (ROA) is likely to drop a few basis points. ROA has been a closely watched indicator of bank performance over the years.

Warning: Rogue Waves Ahead?

Harry Truman once explained, "It's a recession when your neighbor loses his job; it's a depression when you lose yours." We began this final installment of our series with a warning about rogue waves. Sailors fear them not only because they are dangerously large but also because they are unexpected. Some unanticipated combination of winds, currents, and other circumstances cause these brief but giant waves to form quickly. Here, we have reviewed a number of items that, by themselves, might not be problematic. But when combined, they could cause an economic wave that some borrowers and industries might not survive. A successful Walt Disney boasted, "I've heard there's going to be a recession. I've decided not to participate." Unfortunately, the next recession is unlikely to be a ride on a boat through Disney's Small World or Pirates of the Caribbean. And even if it seems that way at first, watch out for those rogue waves.

Our epilogue? The "Flying Blind" series is a project that began in August 2016 with the unwavering support from RMA and the *RMA Journal* staff. The first crude draft was submitted by Rick Buczynski to Richard Parsons, a member of the editorial board of the *RMA Journal,* in February 2017. Without Parsons's guidance, and co-authors Ken Brown, Kent Kirby, and Dev Strischek, this three-plus year voyage wouldn't be possible. The contents were vetted on dozens of occasions at private seminars by IBISWorld commercial banking clients, and at public forums, including the past three RMA Annual Risk Management Conferences and some RMA chapter meetings.

To quote Albert Einstein: "Once you stop learning, you start dying." All of us involved in this project have learned. We hope that you have as well. ®

Notes

1. See https://www.rmahq.org/flying-blind-i1. See https://www.rmahq.org/flying-blind-into-the-next-recession-part-1/, https://www.rmahq.org/flying-blind-into-the-next-recession-part-2/ and https://www.rmahq.org/flying-blind-into-the-next-recession-part-3/
2. Rick Buczynski and Kent Kirby, "Worried About the End of the Credit Cycle? Concentration Risk Revisited," *The RMA Journal,* May 2019.
3. See https://www.rmahq.org/flying-blind-into-the-next-recession-part-4/ and https://www.rmahq.org/flying-blind-into-the-next-recession-part-5-be-alert-as-the-credit-cycle-grows-old/
4. https://www.goodreads.com/quotes/519007-a-strategic-inflection-point-is-a-time-in-the-life
5. https://www.reuters.com/article/us-imf-worldbank-gfsr/imf-heightens-warnings-on-corporate-debt-following-central-bank-cuts-idUSKBN1WV1N5
6. See Office of the Comptroller of the Currency, "Leveraged Lending," Comptroller's Handbook series, February 2008
7. https://rmajournal.org/rmajournal/november_2019/MobilePagedArticle.action?articleId=1533946#articleId1533946
8. https://www.marketwatch.com/story/plenty-to-fret-about-in-growing-pile-of-bbb-rated-us-corporate-debt-2019-09-28
9. https://www.ibisworld.com/industry-insider/analyst-insights/top-five-sectors-exposed-to-labor-shortages-in-2018
10. https://www.fdic.gov/bank/analytical/quarterly/2019-vol13-4/fdic-v13n4-3q2019-article1.pdf
11. https://www.milkenreview.org/articles/big-techs-invasion-of-banking
12. https://www.bloomberg.com/news/articles/2019-10-29/america-s-middle-class-is-getting-hooked-on-debt-with-100-rates

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