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INSIGHT

VIEWPOINT

"It's an Eminence Front?"

The C&I Loan Puzzle

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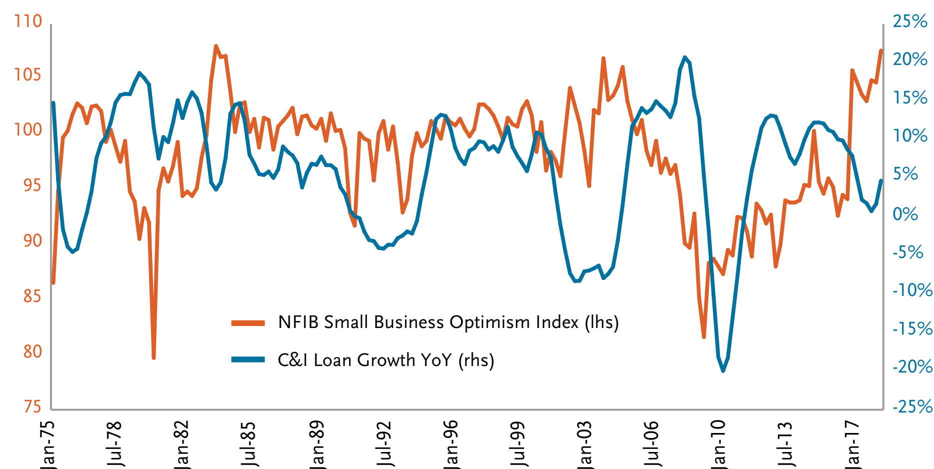
Mr. Malhotra joined the TCW in 2016 as a Credit Analyst with the Fixed Income group responsible for credit research in the financial sector. Mr. Malhotra has over 20 years of investment experience that he brings to the firm, having previously served in various leadership roles; most recently, Mr. Malhotra was with a credit hedge fund, DA Capital, LLC as a Managing Director and Senior Credit Analyst where developed various strategies within high yield debt, leveraged loan, and public equity sectors. Prior to joining DA Capital in 2005, he was a Director and Senior Credit Analyst at Crédit Agricole focused on the automotive, industrial, homebuilding, aerospace, and equipment rental sectors. Earlier in his career at ORIX USA Corporation, Mr. Malhotra was Vice President in the Corporate Finance Group with sector coverage across telecommunications, consumer products, high-yield structured products, cable, homebuilding, gaming, and paper. Additionally, in this capacity, he was responsible for the structuring, as well as the day-to-day management of a $547 million fund, Astron CBO Ltd. Mr. Malhotra received a BA in Economics from The American University in Washington, DC.

Eminence Front is an epic song written by Pete Townsend of The Who that describes the illusion of a false sense of prosperity. This dynamic is also exemplified by the current dichotomy between business executive overconfidence and tepid lending activity – especially in the midst of aggressive Fed rate hikes late in the credit cycle. (See Exhibit 1).

Exhibit 1: NFIB Small Businss Optimism Index vs. C&I Loan Growth YoY



Source: FRED, Bloomberg

To parse this question it is useful to emphasize not what business executives say but instead what they do. Through this lens it is quite clear that Commercial and Industrial (C&I) loan growth is anemic. The relevant question is why?

C&I loan growth has slowed dramatically due to factors that include rising interest rates and peak financial leverage impeding demand for credit. Furthermore, the unwinding of the Fed's balance sheet, or Quantitative Tightening (QT), continues to drain excess bank reserve liquidity and deposits amid the regulatory policies of the still-stringent Basel III Liquidity Coverage Ratio (LCR) and the Dodd Frank Living Will liquidity frameworks, thus incrementally constricting the supply of credit.

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Weak Demand for Credit

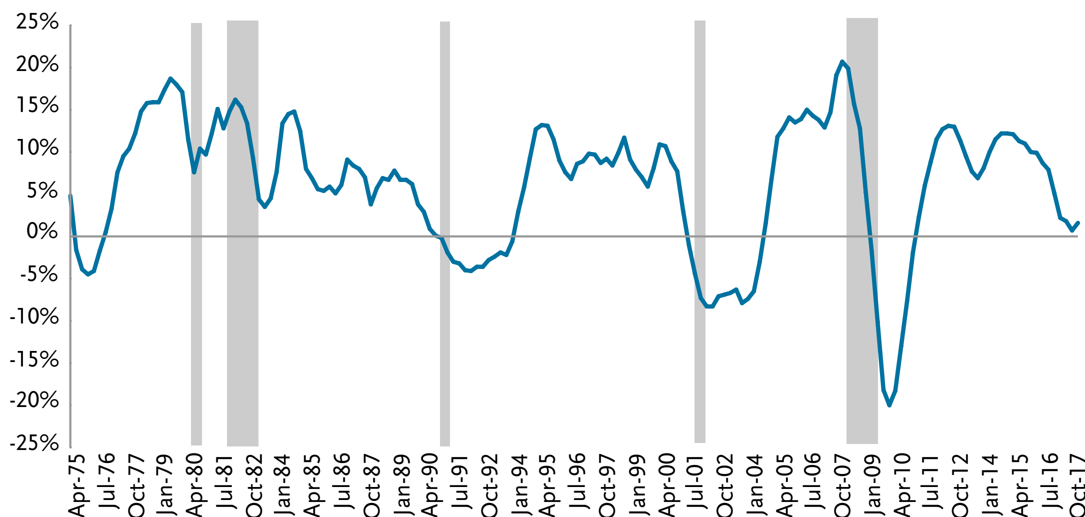
Demand for credit has been affected in numerous ways as outlined below.

C&I Loan Growth: Stalled Out

C&I loan growth has decelerated sharply over the last six quarters, from a +9.1% annual growth rate in 2016 to only a +2.4% rate in 2017. At the end of 1Q18 C&I loan growth was running at a meager +1.7% YoY. Loan growth was up +4.7% YoY in April and recent economic signs point to further improvement in 2Q18. However, the bounce may be temporary given a sustained deceleration in deposit growth, as we look past 2018. Recall that post-2016 elections, C&I lending growth unexpectedly slowed despite exuberance around new fiscal stimulus and deregulation. While 2017 real annual GDP growth did accelerate, it coincided with C&I loan growth deceleration.

C&I loan growth has been consistently undershooting nominal GDP growth since late 2016, while late cycle instances historically lead to significant reductions in lending activity and/or economic recessions. (See Exhibit 2). *Is this time different?* We are skeptical, given a relentless flattening of the yield curve, but acknowledge a wide range of possible future outcomes.

Exhibit 2: Quarterly Commercial & Industrial Loan Growth YoY



Source: FRED
Recessions are shaded in grey.

Aggressive Rate Hikes Commence in 2015:

The Federal Reserve has commenced a series of rate hikes in 2015, lifting the Effective Fed Funds rate off its Zero Interest Rate Policy (ZIRP) to ≈2.0% currently. The rate of change in the Effective Fed Funds rate has impacted loan growth and is potentially even more impactful than the nominal number suggests, given that the Fed continues on its path of rate hikes.

The rate of change in the Effective Fed Funds rate has a strong 47% correlation with C&I loan growth deceleration with a two-quarter lag dating back to 1955. The current rate of change of recent Fed rate hikes has been the most aggressive since 1959. The quarterly rate of change in the Effective Fed Funds rate increased from +60% in late 2015 to +227% in early 2016; which cast the die for substantially decelerating loan growth in our view. (See Exhibit 3).

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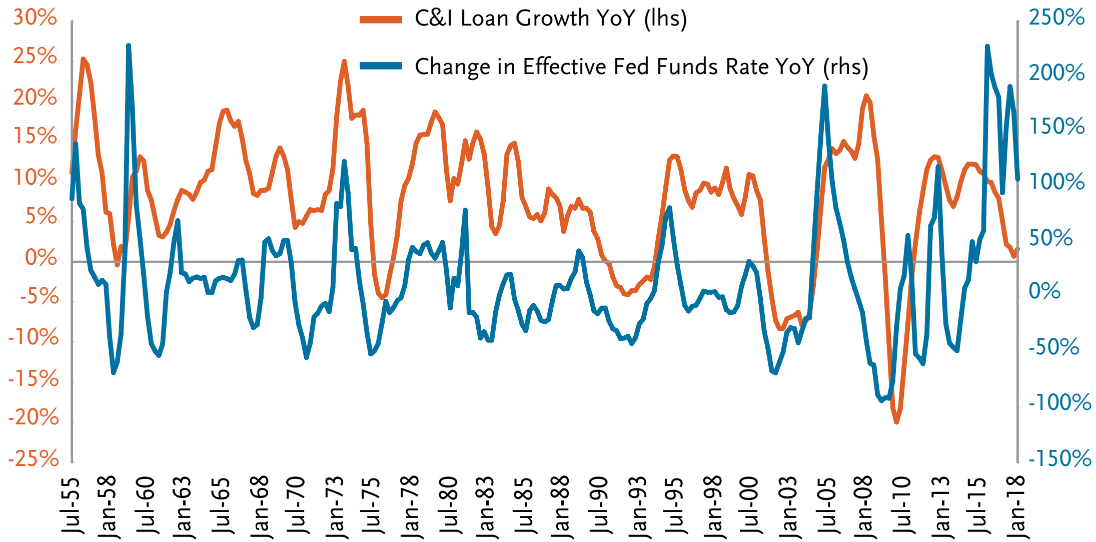
Exhibit 3: Commercial & Industrial Loan Growth YoY vs. Change in Effective Fed Funds Rate YoY



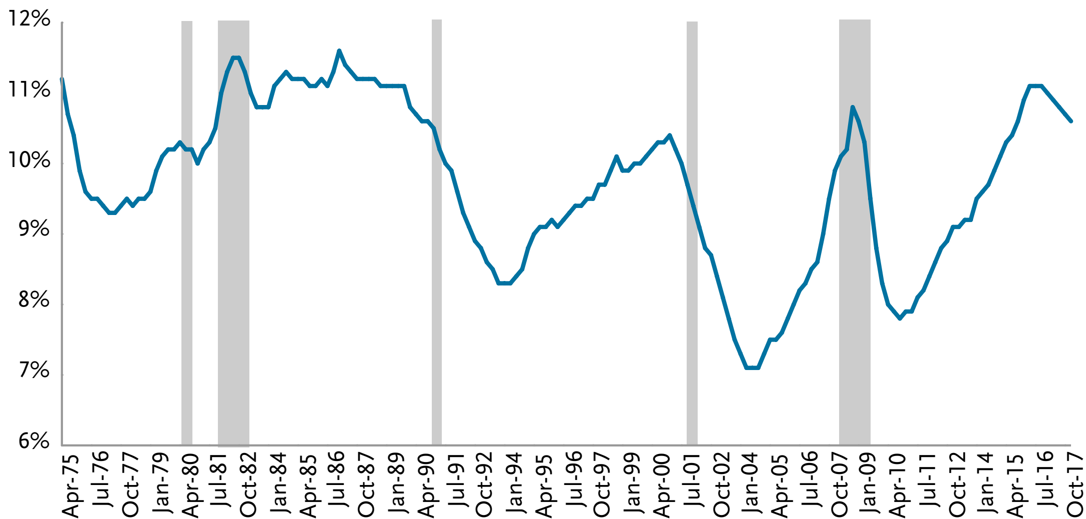
Source: FRED

Peak Cycle Leverage:

The U.S. banking universe has oversupplied the economy with C&I credit, recently at 11% of GDP, a level typically associated with previous peaks in economic expansions. In addition, other peak indicators include profit margins/GDP of 9%, net worth to disposable personal income of 682%, and bank credit/GDP of 63%. In fact, the Boston Fed recently suggested that Global Systemically Important Banks (GSIBs) should increase their counter cyclical capital buffer, which is another late cycle indicator.

At these cyclical peak levels incremental demand for business credit can decelerate dramatically in conjunction with excessive monetary tightening. (See Exhibit 4).

Exhibit 4: Commercial & Industrial Loans/Nominal GDP



Source: FRED

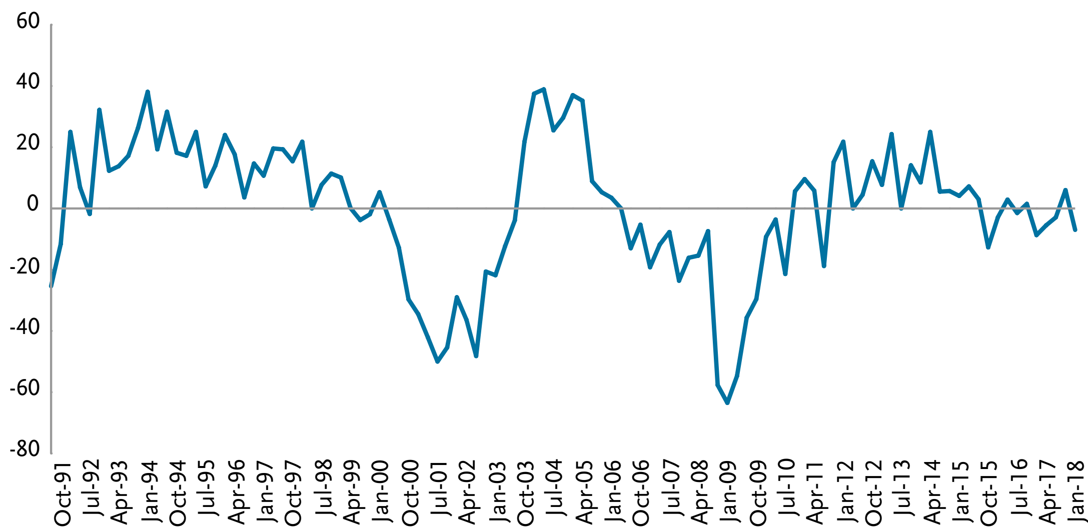
Fed's SLOO Survey: Weak Demand

The Fed's Senior Loan Officer Opinion (SLOO) survey corroborates relatively weak demand for C&I loans in nine of the last ten quarters. Any temporary and minor improvement in demand in recent years turned out to be short lived. (See Exhibit 5). As the cost of credit rises from Fed rate hikes and tightening money supply, it isn't surprising that demand for credit continues to be weak given that corporate balance sheets are already at peak leverage.

TCJA & Dollar Repatriation:

Pursuant to the Tax Cuts and Jobs Act's (TCJA) Deemed Repatriation Tax has also enabled U.S. corporates to repatriate dollar cash balances, at the margin, from overseas to pay down debt and use for general corporate purposes including voracious capital returns to shareholders. This dynamic may have also curbed C&I loan growth, as cash balances are now more tax efficient and usable than in the past.

Exhibit 5: Net % of Banks Reporting Stronger Demand for C&I Loans



Source: FRED

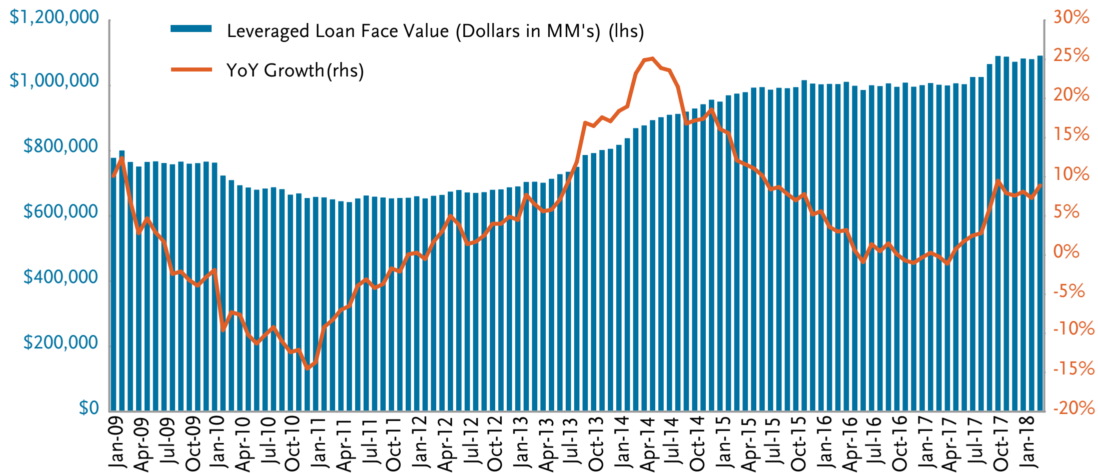
Supply of Credit Pressures

Credit supply has also been impacted by various factors referenced below.

C&I Disintermediation:

Per Credit Suisse the total leveraged loan market totals \$1.1 trillion. However, a much smaller portion is owned by commercial banks and included in the C&I loan category. TCW estimates that 15% or ≈\$300 billion of leveraged loans are represented in the \$2.2 trillion commercial bank C&I loan category. This would suggest that 1Q18 C&I loan growth (ex-leveraged loans) may have been flat and/or potentially contracted if one were to strip out leveraged loans currently growing at a robust +9% YoY. (See Exhibit 6).

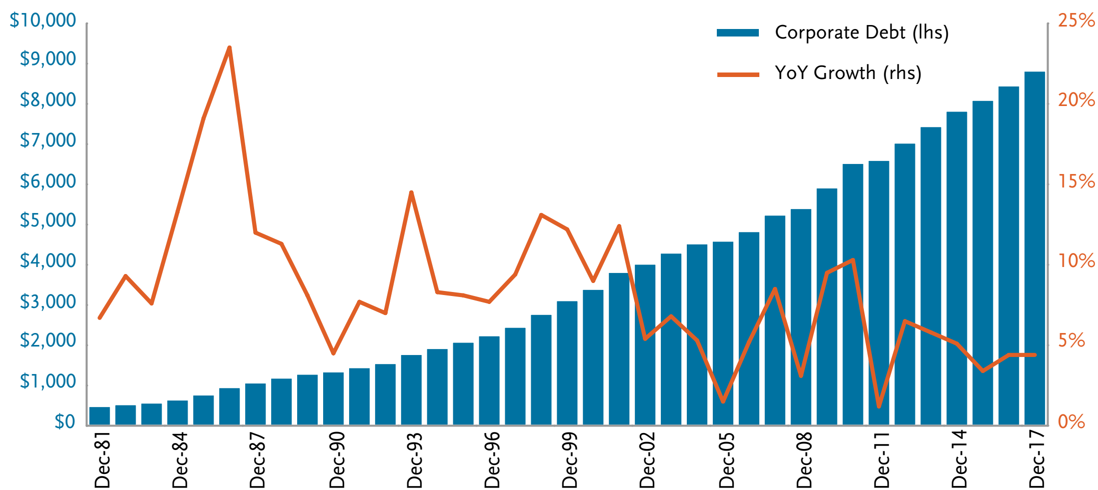
Exhibit 6: Leveraged Loan Market ($ in MM’s), YoY Growth



Source: Credit Suisse

C&I loan growth likely is getting partially disintermediated. The leveraged loan market has been a conduit for LBO financings, dividend recapitalizations, refinancing and other financial engineering. However, general C&I loans are historically correlated to working capital, capex, and more GDP sensitive levers. On the margin, a higher proportion of leveraged loans within the C&I universe may suggest a maturing business cycle. In addition robust investment grade issuance likely has offset some C&I lending activity. (See Exhibit 7).

Exhibit 7: U.S. Corporate Bond Market ($’s in billions), YoY Growth



Source: SIFMA

The driving force behind leveraged loan disintermediation of C&I loans has been collateralized loan obligations (CLO) creation. CLOs purchase over 60% of these loans, and are not subject to the same Basel III and Dodd Frank regulatory constraints that are applicable to C&I loans on bank balance sheets.

CLO demand is dependent upon the resilience of CLO equity arbitrage, the difference between loan collateral spreads and liability costs. If CLO arbitrage were to be adversely impacted by a market dislocation, the negative feed-back loop to CLO issuance, and in turn leveraged loan growth, could be sizeable. This does not appear to be a significant concern in current market sentiment.

Bank Capital Charges: Disincentivizing C&I Loans at the Margin

Post the global financial crisis, Advanced Approach[1] GSIB bank capital charges and risk weights have meaningfully increased in concert with the Dodd Frank Act Stress Test. (DFAST).

A recent study conducted by the Brookings Institution in its "Strengthening and Streamlining Bank Capital Regulation" paper, whose authors include ex-Fed Governor Jeremy Stein, suggests that C&I capital charges are more stringent than other loan categories, using disclosures from the largest GSIB's most binding Fed stress test constraints in 2017. (See Exhibit 8). This would likely reduce the incentive of banks to supply C&I loans at the margin, providing alternative lenders a gap filled by Business Development Corporations (BDCs), CLOs, and the private shadow loan universe. As a result, larger GSIBs have tended to emphasize higher quality C&I loans. The Office of the Comptroller of the Currency (OCC) has also imposed leveraged lending guidelines that discourage the retention and syndication of loans with total leverage greater than 6.0x debt/EBITDA. (*Although the OCC has recently conveyed mixed messages about the continued need for these guidelines.)*

Exhibit 8: Estimated Capital Charges

		Capital Charges Based Only on Tightest Constraint					
	Tightest Constraint	Commercial and Industrial Loans	Residential Mortgages	Other Mortgages	Credit Cards	Other Consumer Loans	Treasuries
G-SIBs							
JP Morgan Chase	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
Bank of America	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
Citigroup	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
Morgan Stanley	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
Goldman Sachs	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
Wells Fargo	Tier 1	10.5	5.3	10.5	10.5	10.5	0.0
BNY Mellon	SLR	5.0	5.0	5.0	5.0	5.0	5.0
State Street	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
Other large bank holding companies							
U.S. Bancorp	CCAR Tier 1	8.7	1.1	8.7	5.8	5.4	-1.7
PNC Financial	CCAR Tier 1	8.7	1.1	8.7	5.8	5.4	-1.7
Capital One	CCAR Tier 1	8.7	1.1	8.7	5.8	5.4	-1.7
HSBC	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3
TD Bank	CCAR SLR	5.7	1.1	5.7	2.8	2.4	1.3

Source: Author's Calculations
Source: "Strengthening and Streamlining Bank Capital Regulation" Brookings Papers on Economic Activity, Fall 2017

GSIBs face tighter Method 2 GSIB scores that feed into their minimum GSIB Capital Surcharge[2] requirements. (See the green bars that show limited room to the next higher GSIB bucket especially for JPM, C, & BAC in Exhibit 9[3]) By extension these constraints could be putting pressure on GSIBs' incremental ability to lend. JPM recently stated in its 2018 Investor Day presentation that the *"current calibration of GSIB coefficients could become a barrier to further economic growth."*

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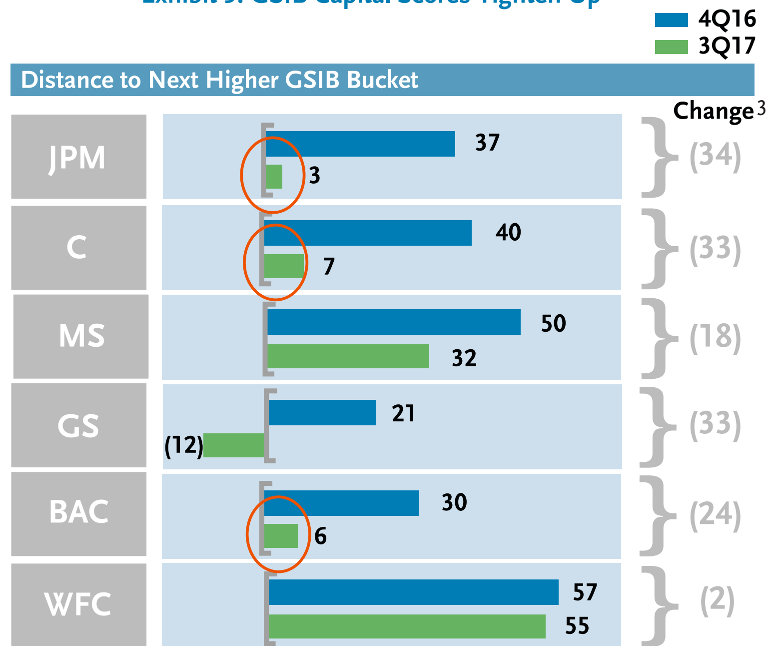
Exhibit 9: GSIB Capital Scores Tighten Up

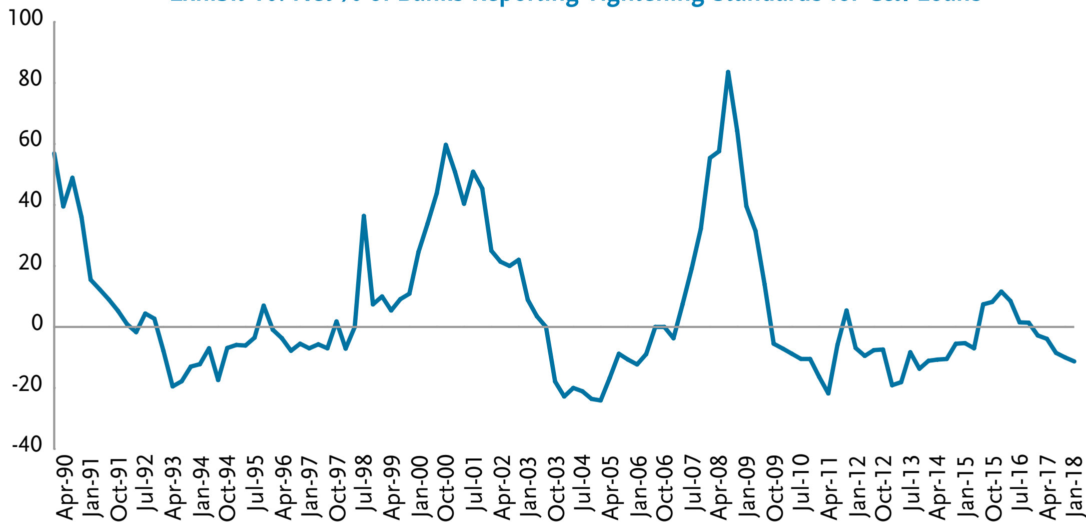


Source: JP Morgan 2018 Investor Day presentation.

At the very least tight GSIB scores may be raising the risk-adjusted return hurdles on loan investments, given this higher regulatory tax on bank capital. To the extent banks get relief on Method 2 GSIB scores, C&I loan capacity and growth could improve, but this may be partially offset by a new dynamically calibrated Stressed Capital Buffer (SCB). Moreover, the 2018 Fed DFAST stress tests have proven to be more restrictive on GSIBs than initially expected, especially as it relates to Supplementary Leverage Ratios (SLRs[4]) under duress.

Notwithstanding the above, substantial capital charges on C&I loans is somewhat at odds with the 1Q18 Fed Senior Loan Officer Opinion (SLOO) Survey that illustrates a loosening of standards for C&I loans. (See Exhibit 10). One might surmise that although the GSIBs' willingness to lend seems highly constructive, their incremental ability to lend may be somewhat limited by tighter and dynamically imputed capital constraints.

Exhibit 10: Net % of Banks Reporting Tightening Standards for C&I Loans

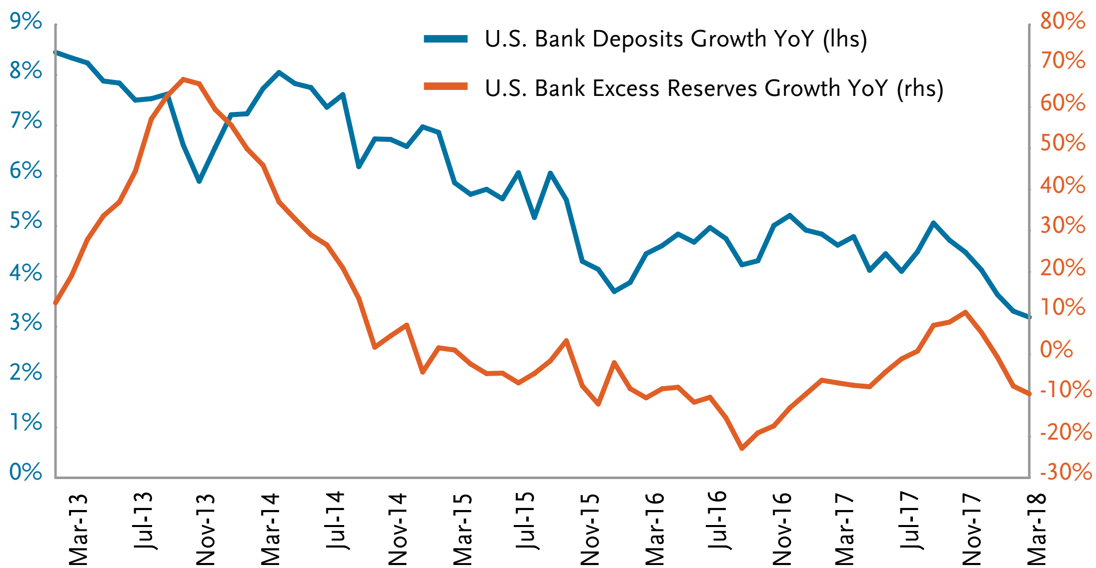


Source: FRED

Fed Balance Sheet Unwind: Reserve & Deposit Shrinkage

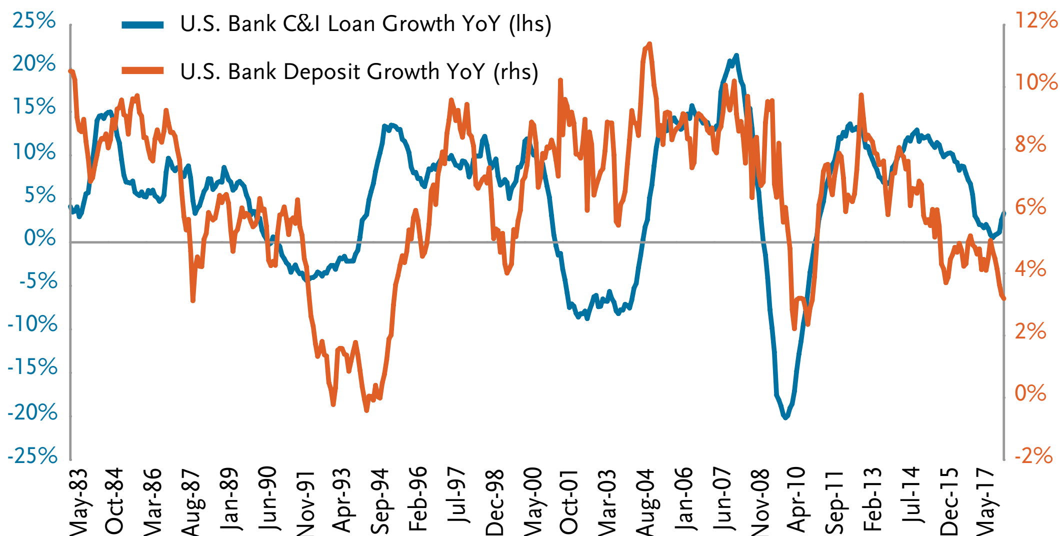
Further to the Fed's current Balance Sheet Unwind (aka QT); excess reserves in the banking system are being drained in part by heavy T-Bills issuance that is being purchased in large part by investors such as government money funds, thus reducing their deposits at GSIB clearing banks. Banks are simultaneously drawing down their excess cash reserves at the Fed. In the Quantitative Easing (QE) unwind process the banking system in aggregate is shrinking its balance sheet substantially in tandem with the Fed's balance sheet. Exhibit 11 illustrates a strong correlation between excess reserve drain and deposits. Importantly, deposit growth is the requisite oxygen that powers loan growth. (See Exhibit 12). The Fed has an aggressive plan to reduce its balance sheet and extinguish $1.5 trillion of excess reserves over the next four years. (See Exhibit 13). According to some estimates this could shrink deposits by at least $1 trillion over the same period, which may further de-lever C&I loans, and other risk assets while pressuring U.S. dollar liquidity.

Exhibit 11: U.S. Bank Deposits: Growth YoY vs. U.S. Bank Excess Reserves: Growth YoY



Source: FRED

Exhibit 12: U.S. Bank C&I Loan Growth YoY vs. U.S. Bank Deposit Growth YoY



Source: FRED

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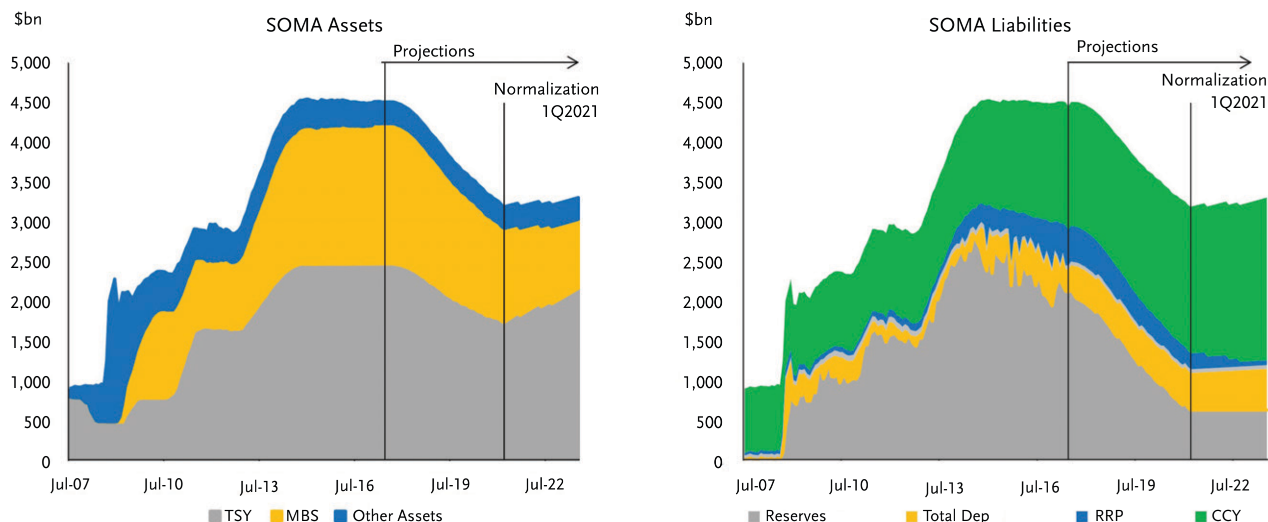
Exhibit 13: Fed Balance Sheet Projections (System Open Market Account)



Source: Treasury Presentation to TBAC FY 2017 Q3 Report

Regulatory Pro Cyclicality: Negative Amplification

Under the current QT plan, deposit and excess reserve reduction may impair dollar liquidity in the U.S. and global banking system. This liquidity is subject to stringent minimum LCRs of 100%, as well as Resolution Liquidity Adequacy and Positioning (RLAP) minimums also known as "living will" liquidity. There are also Net Stable Funding Ratio (NSFR) liquidity requirements that banks are also finalizing ahead of implementation. While the banking system is currently flush with High Quality Liquid Assets (HQLA); the pool of "***usable liquidity***" is actually constrained by LCRs and RLAP minimums, especially as the Fed follows through with its balance sheet reduction plans.

Currently there is a total of $2.2 trillion of cash in the banking system and total excess reserves of $1.9 trillion parked at the Fed. Net of QE, cash liquidity in the banking system is less than 2% of total assets vs. close to 10% back in the mid-1980s. In other words the banking system's liquidity has never been more beholden to the Fed's devices. (See Exhibit 14 and 15). What could go wrong? Possibly more than most think.

Under an acceleration of QT, liquidity ratios would be expected to fall. In this potentially stressful scenario, banks will probably want to defend their liquidity and keep solid LCR, RLAP, and NSFR ratios and prefer to ration their balance sheet deployment. Ambitious capital payout ratios in excess of 100% may need to be ratcheted back providing a negative signaling effect. In aggregate, this may exacerbate C&I loan deceleration, flattening yield curves, further catalyzing negative pro cyclicality, while amplifying downside global stress and collateral damage. There have been similar episodes of reserve drainage via the Fed's Temporary Open Market Operations (TOMO) from 2014 to 2016, which increased financial stress via higher risk premiums and presented downside risks to C&I lending activity. (See Exhibit 16 and 17).

In a downside case the Fed/regulators might be able to arrest this dynamic if they capitulate and reverse course on QT, and/or relax liquidity requirements. However, relaxing liquidity requirements is at odds with the post crisis Basel III/Dodd Frank framework that investors draw a great deal of comfort from. The Fed's $4.3 trillion balance sheet is unprecedented and unwinding it is a completely untested endeavor which presents unknown challenges.

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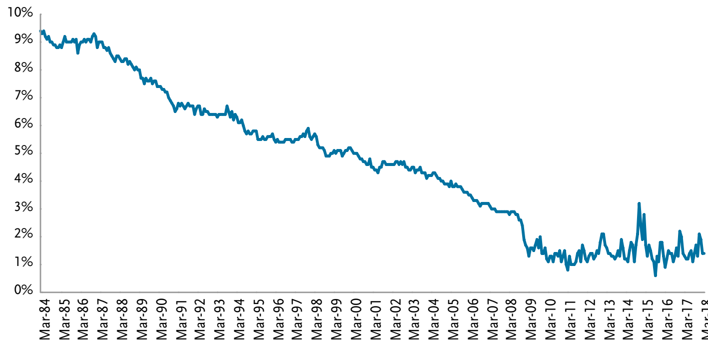
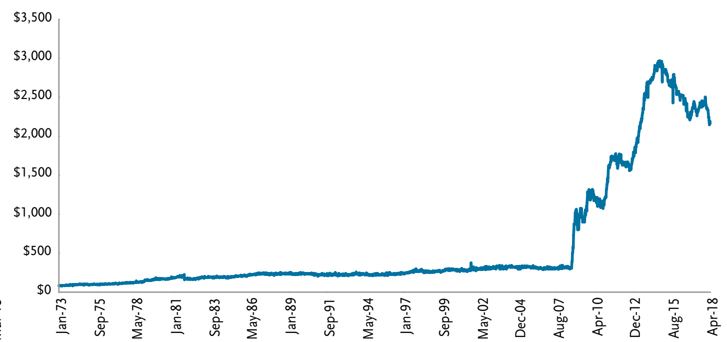
Exhibit 14: (Commercial Bank Cash – Excess Bank Reserves)/Total Assets



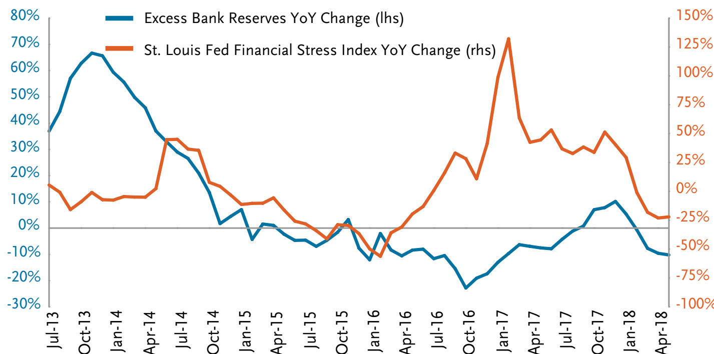
Source: FRED

Exhibit 15: Commercial Bank Cash Assets ($ in Billions)



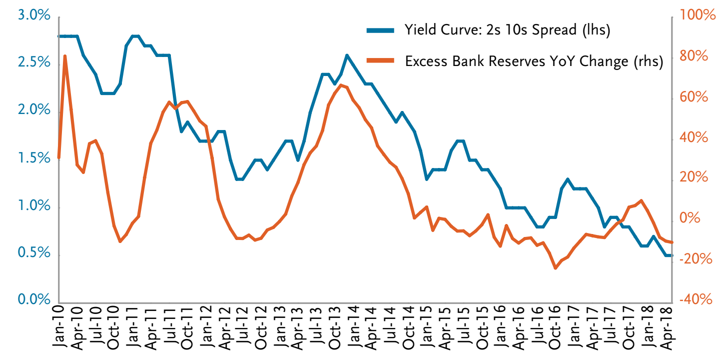
Source: FRED

Exhibit 16: Excess Bank Reserves YoY Change vs. St. Louis Financial Stress Index YoY Change
(Decelerating YoY Change in Stress Index = Higher Stress)



Source: FRED

Exhibit 17: Excess Bank Reserves YoY Change vs. Yield Curve: 2s 10s Spread



Source: FRED

Conclusion

The cumulative and lagged impact of an aggressive Fed rate hiking cycle in conjunction with peak leverage has considerably weakened the demand for C&I loan growth. Combining this with incrementally more dynamic and stringent imputed C&I capital charges along with tighter GSIB scores, collectively has accelerated late cycle C&I lending disintermediation at the margin. Finally, the gravitational pull of declining excess reserves and deposits pursuant to the Fed’s balance sheet unwind, coupled with stringent regulatory liquidity constraints, has the potential to amplify further deleveraging of risk assets and is a headwind to C&I loan growth - *albeit not necessarily in a straight line.*

As a result, TCW believes that the current corporate exuberance is susceptible to a significant retrenchment, given a lack of a solid underpinning fundamentals, and might best be described as just an “Eminence Front.” ■

1 Banks with greater than $250 billion in assets and have greater than $10 billion in foreign exposure.
2 GSIB Surcharges are established using Method 2 GSIB scores which quantify a bank’s size, interconnectedness, cross jurisdictional activity, short term wholesale funding and complexity.
3 The green bars represent the distance to the next higher GSIB bucket which is currently limited.
4 SLR Ratio = Tier 1 Capital/(On Balance Sheet Assets + Off Balance Sheet Exposures)

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