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Why Banks Won't Lend

Credit is scarce and the outlook is gloomy, so what can be accomplished in this economic environment?

by Michael T. Newsome

Bank credit remains the essential lubricant of a free-market economy. Without it, many firms are in for a protracted bout of "liquidity gridlock," making it difficult and, in some sectors, impossible to fund operations. It is no secret that the financial services industry and the broader economy hit a sharp inflection point in October, in what can best be described as a "deflationary debt bust." In response, the U.S. Treasury and the Federal Reserve have intervened in credit markets in manners never before seen, applying virtually every tool at their disposal. Perhaps, this has slowed the pace of de-leveraging in the financial markets, but it has not improved the availability of credit.

CAPITAL IS KING

While banks have experienced relentless pressure to rein in leverage, either by shedding assets or accumulating capital, collective leverage has actually increased slightly among the regional northwest ("NW") banks[1] and significantly for the major NW banks[2], as illustrated in the chart on the following page. Several factors have been at play here. Aggregate assets have expanded, as customers have drawn down outstanding commitments and securitized loans and mortgages have been moved on to bank balance sheets. At the same time, as non-performing assets mount, loan-loss reserves have ramped up. Collectively, over the past five quarters, the regional banks reserved nearly $400 million, while the major banks pumped up loss provisions by ten times that amount. Bankers acknowledge that further credit deterioration will trigger significant additional loan-loss provisions in the coming quarters. That expectation, coupled with the pressure to de-lever, has made bank capital very dear.

The major banks offset the losses realized to date with $59 billion of capital injections from Treasury's TARP program and raised another $26 billion (mostly BofA) from private sources. The regional banks, except Frontier, also have been replenished with TARP infusions totaling $718 million. No one has a clear understanding as to the amount of additional losses that reside on the loan books of NW banks. Given the severity of the recession and the yet to be fully unveiled spike in troubled assets, it is not unreasonable to believe that before this downturn has run its course, the losses may more than double, thereby bringing leverage ratios right back to where they started. Reflecting these concerns, institutions have stepped up efforts to trim commitment levels and conserve capital.

TIGHT MONEY

Credit is scarce, but it begs the question, what can be accomplished in today's environment and over the next year? We set out to nail that down in a series of discussions with senior NW bankers to define the art of the possible. The answers were not reassuring; but, some common themes emerged.

Fear factor. There is palpable anxiety among bankers that their institutions, and therefore their jobs, may be in jeopardy. Nothing inhibits risk taking more effectively than uncertainty and fear for survival.

Suddenly, relationships matter. Bankers are reticent to admit that they're "out of the market." For good reason, it sends a message that rarely resonates well with performing customers and major depositors. The line seems to be, "We are open to new opportunities." In reality, the credit screen is set on "extra fine." The prime consideration tends to be whether the prospective borrower is a customer or, at the very least, a well-known prospect. In other words, has the credit favorably crossed the desk of the bank's credit decision-maker in the recent past?

Every banker queried declared that they are focused on taking care of existing clients. However, the strength of that support varies widely, depending on the bank's situation and the specifics of the customer. Resilient, well-performing companies may have access to additional debt, particularly if the purpose is a value-enhancing opportunity (e.g., a conservatively priced acquisition).

Flight to quality. Bankers have become extraordinarily finicky. Assuming the relationship test is met, the terms under which new credit may be available are a major departure from what borrowers were accustomed to in the recent past. What little lending appetite there is will be focused on situations that meet the following criteria:

- Well-supported (low advance rates) with collateral valuations reflecting the weak market for most categories of real and personal property.
- Very modest financial leverage—1 to 2 times EBITDA. Bankers related stories of passing on one-times cash flow financing opportunities for performing businesses.
- Shorter maturities. Revolving credit line expirations are being limited to 364 days, in order to minimize regulatory capital requirements. Maturities on term credit are being held to three years or less.
- A well-articulated business strategy, along with a demonstrated ability to plan and budget, and evidence of highly reliable financial systems.

Struggling businesses, or those in industries

(continued p.2)

PLAN FOR THE WORST, EXPECT THE BEST

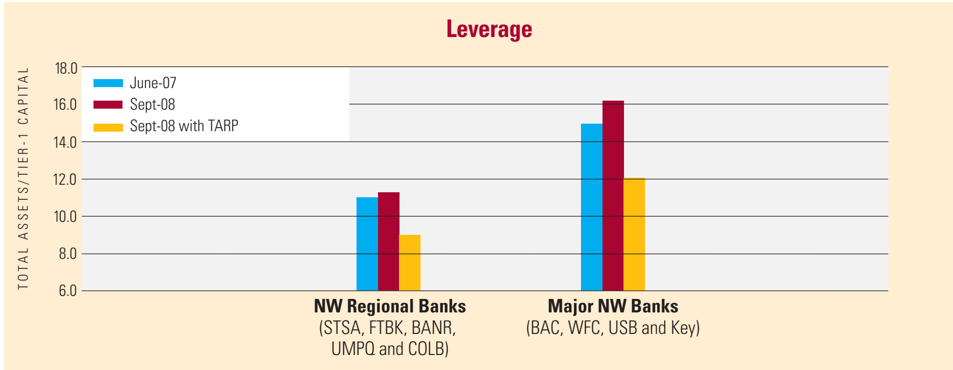
The prospect of a prolonged downturn should cause managers to take an introspective look at their businesses to consider contingency plans for reducing costs, for selling excess assets to free up cash, and for reassessing the rate and direction of growth.

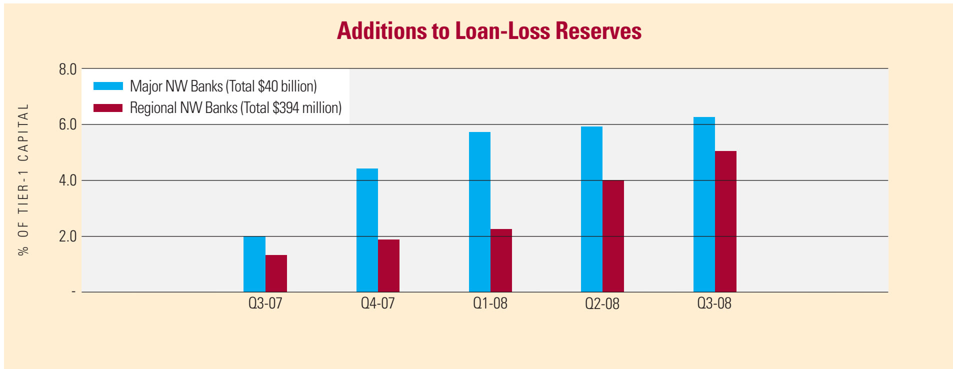
At the same time, managers should think through the opportunities provided by a downturn. Astute investments made during a downturn can position a company to strengthen its competitive advantages so as to realize benefits when times improve. A downturn can be a great opportunity to hire talent, to continue spending on strategic initiatives, and to target accretive acquisitions.

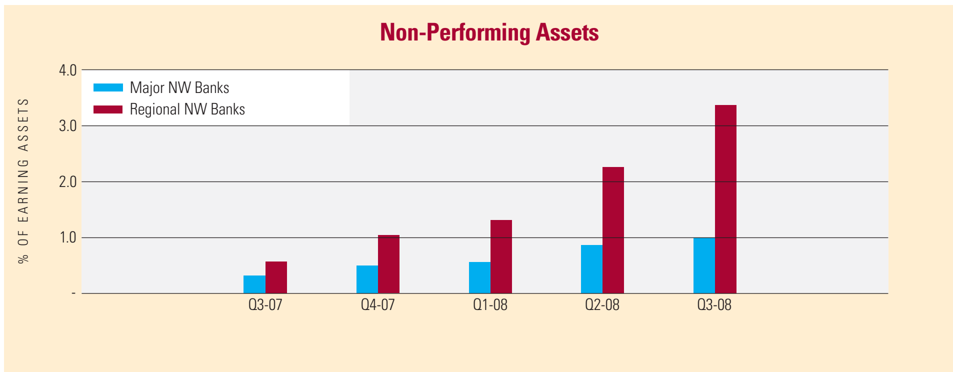
Getting to the other side will require, at minimum, continued access to external capital. Articles in this issue are intended to assist management in those endeavors, so that the business can be positioned to create the maximum amount of shareholder value when economic conditions invariably rebound. ❖

[1] *Regional NW banks include: Sterling Savings, Umpqua, Frontier, Banner and Columbia*

[2] *Major NW banks include: Bank of America, Wells Fargo, U.S. Bank and KeyBank*







deemed vulnerable or over-capitalized, are unlikely to find their bankers accommodating. The list is too long to enumerate, but credit is particularly scarce for vehicle and equipment dealers, building products manufacturers and distributors, travel and leisure operators, retailers, and, surprisingly, all aspects of health care. Several bankers confessed that no one is penalized for saying "no" in this environment, even to a compelling prospect. New business is met with a jaundiced eye; it is no time to be cold-calling bankers.

Given the capital constraints and a dearth of acceptable lending opportunities, banks have little prospect of lending their way out of this hole. Nevertheless, they are energetically attacking their earnings problem by extracting fees and ratcheting-up credit spreads, wherever possible. Risk is being repriced across the entire financial spectrum. Even "Cadillac-quality" borrowers should anticipate paying more for credit—a 100 to 150 basis point bump for strong, modestly leveraged borrowers and a tripling, or more, of credit spreads for leveraged firms. Minor covenant modifications or violations are likely to garner hefty fees and, in many cases, unravel an existing deal, with a complete revision of credit pricing. Multi-bank financings are particularly vulnerable to repricing, as minority lenders have considerable leverage over terms. Finally, bankers will be more insistent than ever that credit relationships be augmented with deposits and other fee-generating, non-credit services.

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In spite of the media and political chorus that government capital injections are intended to reinvigorate lending, the facts are that most banks are limited in their ability to extend new credit. With solvency still an issue, banks are conserving capital as they brace for default rates, over the next year, that may well test historical highs. Most bankers say that the opportunities they are seeing do not pass muster in this risk-averse world. The rules have fundamentally changed. Borrowers need to recognize this new reality and plan accordingly. ❖

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