GRANT'S
INTEREST RATE OBSERVER®
Vol. 38, No. 16e 233 Broadway, New York, New York 10279 • www.grantspub.com AUGUST 7, 2020

Hoping for the best

"Right now, if you look at the underlying data on consumer delinquencies, you don't see a recession at all," a knowledgeable friend tells *Grant's*. "In fact, in some cases, they are better than before. Home prices haven't gone down. Consumers are paying their credit-card bills. Auto prices are going up. Home prices are going up. Consumer savings are going up. Consumer incomes are higher, not lower. You see nothing that looks like a recession, but it is coming."

If the recession is invisible, the government is omnipresent. Whether it shall remain so is the question of the hour. Supplemental unemployment benefits, a key component of the federal response, have lapsed and may or may not be renewed at $600 a week. As we go to press, Democrats and Republicans remain in cordial and collegial discussion about what's in the best, nonpartisan interest of the country.

In the phantom recession, banks are confronted with the difficult question of how to reserve for loan losses when unemployment is high but realized losses are low. Soaring levels of loan deferrals further complicate matters. The Coronavirus Aid, Relief, and Economic Security (Cares) Act, which authorized that big bump in jobless benefits, also allowed banks to suspend standard GAAP treatment of loans whose status may be compromised by the consequences of the pandemic (a sprawling category, to be sure). For the relevant passage in the law, just thumb your way to Section 4013.

Thus empowered, banks are granting debt-service deferrals. And they can keep granting deferrals until the sooner of Dec. 31, 2020 or 60 days after President Trump has declared an end to the Covid-19 national emergency. The law directs that, come the close of the grace period, such loans be treated as performing. They won't be counted as delinquent unless and until they fall into arrears once the post-emergency clock starts ticking.

The prior issue of *Grant's* laid out the bear case for Signature Bank (SBNY on the Nasdaq), which showed 21% of its loan book in deferral at the end of the second quarter. "This high level of borrower relief also makes it impossible to gauge the health of Signature's loan book," we said.

What we failed to appreciate, though, is that Signature is accruing interest income on those deferrals. It's booking debt-service income but receiving no cash. Reduce interest income from loans and leases by 21%, and the June quarter's earnings per share would drop to 97 cents from the reported $2.22. The decline in income would lift Signature's dividend payout ratio to 57% from 25%, a problem if borrowers continue to struggle after the payment moratoria end.

Of course, Signature is hardly alone. Keefe Bruyette & Woods, Inc. analyst Thomas McJoynt-Griffith recently sifted the numbers on 131 banks that reported second-quarter earnings and June 30 deferral figures. On average, 16% of such loan books were in deferral, up from 13% on March 30. Commercial real estate (20% of loans in deferral at the end of the second quarter) and commercial and industrial loans (14%) were the biggest problem areas. Consumer loans (6%) and residential mortgages (10%) showed better.

"Banks have some discretion, obviously, in the assumptions there," says Brian Foran, a partner at Autonomous Research who covers universal and regional banks. "We don't get a ton of disclosure. So, knowing which banks are more and less aggressive on that accounting is tough."

"Loan losses have stayed low so far because the boost to total consumer income from Cares Act-related income support has overwhelmed the drop in employment income," Lakshman Achuthan, co-founder of the Economic Cycle Research Institute, advises us by email. "But the jobless rate is not only above all post-World War II recession highs, but also will remain elevated for years to come, long after the burst of fiscal support ends this year. Seen in that light, it's actually optimistic of the banks to put much of their loan books merely in deferral, instead of writing them off."

Inspiration for the Cares Act deferrals didn't come from nowhere. The Emergency Economic Stabilization Act of 2008, which created the $700 billion Troubled Asset Relief Program, nudged the Securities and Exchange Commission to allow the suspension of mark-to-market rules pertaining to certain illiquid bank assets. The commission dutifully followed Congress's lead, and a little bull market in illiquid bank assets got under way.

"However," as colleague Evan Lorenz observes, "pretending that asset prices are higher does not make them higher. In 2008, beleaguered banks raised $475.1 billion in new capital. In

2009, they went back into the market to raise $267.9 billion more. (While Bloomberg's data on capital-raising during the Great Financial Crisis lump North and South American figures together, the vast majority of activity was within the 50 states.)

"In other words, losses will be determined by the depths of this peculiar recession and by the pace of the subsequent recovery. Fiddling with accounting only changes the timing of when banks recognize those losses, not the ultimate economic cost."

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