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Removing the Overhang Plaguing Bank Equity Valuations

Posted by Edward D. Herlihy, Wachtell, Lipton, Rosen & Katz, on Tuesday March 10, 2009 at 12:48 pm

(Editor's Note: This post is based on a client memorandum by Edward D. Herlihy, Craig M. Wasserman, Lawrence S. Makow, Richard K. Kim, Jeannemarie O'Brien, Nicholas G. Demmo, and Matthew M. Guest of Wachtell, Lipton, Rosen & Katz.)

We are at a critical point in working our way through the current financial crisis. The situation initially manifested as a crisis of confidence among depositors, financial institution counterparties and market participants that led to sudden and catastrophic collapses of leading financial institutions. Now the crisis appears to have evolved beyond that stage, with declining housing prices and low consumer confidence slowing the economy and the initial panic being replaced with lingering investor uncertainty about the business model of financial institutions, the direction governmental intervention might take and the risk that the changing rules of the game – on compensation, cramdown or otherwise – will continue to whipsaw investors. Much of this crisis is fed by a 24/7 media cycle that, without actual collapses or bank runs to report, repeats speculation about financial institution balance sheet and capital (further fueling concern about the direction of government policy and actions including the spectre of actual, if not de facto, "nationalization") and inciting resentment over executive compensation, among other things.

Much of the future direction beyond this critical juncture will depend on the choices made by the new administration and in Congress. Will a clear focus be maintained on prompt, decisive steps necessary to restore confidence to the financial system, and will we let bank regulators and bank management go back to doing their jobs and join together in working our way out of the current situation? Or will the focus remain blurred by measures that (though sometimes well-intentioned) have served to discourage the capital buildup necessary to facilitate repayment of TARP funds, outright political intervention, and unwarranted punitive rhetoric that destroys the public confidence so critical to a recovery?

Getting the recovery on track is likely to involve respect for the following tenets:

• The banking system that has served our nation so well, while currently challenged, is not fundamentally broken and need not be destroyed.

• The long-term health of the economy depends on a robust, trusted banking system.

• Restoring private capital investment in financial institutions must have the highest and clearest priority, and doing so requires not only government action where necessary, but also appropriate restraint, including a renewed commitment to a stable legal framework and ceasing retroactive, game-changing interventions that cause private capital to flee.

• We already have a strong and robust system of financial regulation in place that, while it can be improved, should be allowed to function with a minimum of political interference to do the day-to-day blocking and tackling necessary to restore public confidence in the banking system. For instance, concerns regarding executive compensation could be simply and readily addressed by the existing federal regulatory framework for monitoring compensation at institutions deemed to be in troubled condition. Moreover, recognizing that all bank mergers are already subject by law to a rigorous regulatory review eliminates the need to add layers of additional rules that indiscriminately prohibit potentially useful transactions.

• Bank mergers, key employee compensation and other strategic business decisions are important tools that, when properly used, are essential for bank managers to build the strength of their institutions; these important tools should not be lightly interfered with and will continue to be used by banks, as they have been in the past, only under the watchful eyes of the banking regulators.

First: Job No. 1 is restoring private capital investment in financial institutions. Regulators already have a clear window into banking institutions and they should consider clearly communicating the financial condition of the nation's banks in advance, and in lieu, of a vaguely defined future "stress test." Relentless speculation about banks amid plunging common stock prices and indiscriminate talk that "the banking industry is effectively insolvent" has created a mistaken impression of hairtrigger fragility among the nation's banks. Regulators should play a leading role in promptly fixing this misimpression.

While there are undoubtedly institutions of varying degrees of strength, U.S. banks overall remain safe and sound, and many of them have stable sources of liquidity as well as strong capital levels that will enable them to withstand considerable additional losses. Despite the challenges, U.S. banks continue to generate strong, positive cash flows.

Regulators continue to be extremely vigilant in supervising the banks and already have access to all information necessary to form a full picture of the health of the banks. Waiting weeks to conduct a "stress test," while investors are left to fret about the outcome, will only stoke unwarranted fears about the future survival of the banks or the potential dilutive impact of additional future needed capital raises. The mere proposal of a "stress test" communicates to investors the erroneous impression that regulators currently do not adequately understand the financial conditions of banks or have preconceived, but undisclosed, notions of the direction they intend to take towards a given bank. This only further impedes banks' ability to attract significant private equity investment until the uncertainty is addressed. We cannot afford to get this wrong. Emphasis must be placed on resolving these uncertainties as soon as possible to hasten the return of private equity investment into banks.

Bank regulators already have strong, flexible tools at their disposal to work with banks on an individual basis to assess the adequacy of capital and liquidity and address shortfalls.

These tools can be deployed without – in contrast to the "stress test" – scaring away investors by giving the impression that the rules are being changed in the middle of the game or that regulators have a preconceived notion about the intended outcome. Congress may instead wish to strengthen the regulators' toolbox in more helpful ways, including broadening the power of the Federal Reserve to provide liquidity where it is needed by expanding its lending flexibility beyond discounting limited types of paper and secured lending, and reducing the significant procedural obstacles that the FDIC must surmount in order to provide open bank assistance.

Some tentative steps taken earlier may also be helpful and should be expanded, such as taking definitive steps where necessary to remove or ring-fence specific remaining problem assets that have not yet been written down, as generally contemplated by Treasury's plan, or lowering other regulatory barriers to private investment, along the lines of some helpful initial steps relating to private equity investors recently taken by the Federal Reserve, the OCC and the FDIC. These steps need to be taken in a clear way so that banks and investors know what the rules of the road are and can rely on them to be applied even-handedly.

Second, it should be recognized that talk of nationalization is unhelpful, and that in any event nationalization of the U.S. banking sector is simply not a practical alternative. Even if there was factual support for the notion that a broad government take-over of banks is likely to result in better-run banks, it is not a practical possibility in a country with as large a banking sector, and as many banks (including numerous systemically important banks), as the U.S. has. The U.S. cannot practically bring the massive balance sheet of the U.S. banking system, or even its largest banks, onto its own. The current professional managers of U.S. banks are the people that, by and large, will need to continue to manage the banks going forward. Indeed, it is important to remember that many institutions have been piloted safely through these perilous times, and credit is due to the large number of dedicated and talented bank managers who have worked tirelessly, and provided the essential leadership, to help meet the challenges of the current crisis.

For the same reason, it is counterproductive to engage in frequent public scolding of bank managers or to satisfy perceived public anger by prohibiting reasonable compensation of bank managers and of potentially significant revenue producers, especially where this leads to the perverse result of prohibiting compensation structures where pay is based on performance. Bank regulators already have strong statutory tools at their disposal to work with banks to craft compensation structures that retain the desirable features of incentive compensation while creating incentives that strongly reinforce the goals of safety and soundness and that do not encourage excessive risk-taking. The bank regulators should be allowed to do their job in a way that allows the individual tailoring necessary to encourage strong bank managements and deal appropriately with weaker ones.

Talk of nationalization, moreover, is not helpful because it indiscriminately undermines public and investor confidence and banks and their managements. Instead, the government might do better to emphasize a more balanced picture that is, in fact, much closer to the truth: so far, the response to the crisis has already been a public-private partnership, involving contributions by bank managements as well as the government.

• The government response has included targeted interventions in individual institutions; injections of capital into banks that, up until now, have remained largely successful in preventing further catastrophic meltdowns after Lehman; a multitude of facilities put into place by the Federal Reserve to inject large amounts of liquidity into important sectors of the capital markets, and aggressive steps by the FDIC that have helped revive the market for bank debt and to avoid panic by depositors.

• Banks and their managements have also taken strong and comprehensive steps. A few examples: revising underwriting standards and eliminating risky mortgage products and many types of non-relationship lending; strong banks, such as Bank of America, Wells Fargo, J.P. Morgan Chase and PNC, moving quickly and decisively to absorb weaker firms, thereby helping to avoid the systemic repercussions of these weaker firms failing; raising Tier 1 capital in the markets where the opportunities presented themselves and, where they did not, taking other aggressive steps, including cutting common stock dividends and strong cost-cutting initiatives, to best maintain capital ratios; significantly expanding balance sheet disclosure and investor communication; and undertaking outreach to depositors and borrowers and initiatives to minimize avoidable foreclosures.

Much of the damage of such speculation about nationalization is done and will take time to undo. Public and investor confidence in financial institutions and government intentions will not be restored overnight. But a consistent and sustained message of faith and reasoned optimism, and cooperation and transparency between regulators and banks, will eventually return confidence to the markets.

Third, the government should avoid unnecessarily stoking the misimpression that banks, broadly speaking, are not "using" TARP money appropriately, including by fueling the misimpression that acquisitions of other institutions somehow represent an undesirable use or misapplication of TARP capital. Mergers can have important benefits that cannot be easily duplicated by the government.

• They can result in the placement of institutions and assets in safer and more successful management hands and on enhanced capital cushions that can better absorb unexpected losses.

• To the extent that mergers absorb institutions that otherwise would have failed or become troubled, significant government and public resources are saved.

• The synergies that can be achieved in mergers preserve capital by lowering expenses.

• Many financial industry mergers are stock-for-stock exchanges and thus do not result in the depletion of capital resulting from cash payments to shareholders.

• Many assets are marked to market through the use of purchase accounting in mergers, which helps to increase balance sheet transparency.

• Mergers can also improve the strategic positioning of the combined company, and this and other benefits provide the prospect of enhanced returns that can attract additional equity capital.

• A comprehensive regulatory system is already in place to carefully review and scrutinize each and every bank merger, including safety and soundness, quality of management, capital, the effect on competition and the track record of lending to low- and middle-income communities. This provides an existing mechanism to insure that inefficient or harmful mergers are filtered out.

In short, mergers are much more likely to be an important part of the way out of the current crisis than they are to be a part of the problem. Arbitrarily discouraging mergers creates inefficient silos that may prevent excess and unnecessary capital at a strong institution from being allocated to support assets at a weaker one, thus increasing the likelihood that government support may be needed.