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Rodgin Cohen discusses risks to the banking system, suggests regulatory changes

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By Nathan Stovall

Sullivan & Cromwell LLP partner and Chairman H. Rodgin Cohen on Sept. 9 discussed the immediate and longer-term risks facing banks, while also highlighting recent positive indicators and the potential for industry consolidation.

The veteran attorney spoke to a crowded room of investors at a Rodman & Renshaw LLC investor conference in New York. He covered a wide range of topics, including the FDIC's approach to resolving failed banks, the new rules regarding private investments in failed banks, the U.S. Treasury Department's proposal for new capital requirements, the impact of the stress tests and possible changes to the regulatory structure that could positively impact the banking system.

Cohen said the principal, immediate threat to the banking system is the likelihood of a sharply elevated failure rate among smaller banks, equating to several hundred bank failures occurring in a relatively short period of time. Since the beginning of 2008, 114 banks have failed, and most observers expect more failures to occur.

Indeed, Cohen said the results of the stress tests, subsequent capital raises and various government programs have helped restore confidence in the nation's largest banks, but he noted that many small banks do not have implicit government support or access to the capital markets. He said a high failure rate among those smaller institutions could pose systemic risk and possibly reignite a downward spiral as contagion spreads and actual runs on banks occur.

Even if an elevated failure rate does not cause bank runs, continued bank failures will weigh on the FDIC's already famished deposit insurance fund. Until quite recently, Cohen said the average loss to the FDIC's deposit insurance fund averaged about 15% of the failed institution's assets, but that loss rate has risen to roughly 30%.

Assuming that loss rate continues, Cohen noted that if 250 banks with average assets of $500 million failed and the loss to the FDIC averaged 30% of the failed institution's assets, the ultimate loss to the deposit insurance fund would be about $40 billion. Such a burden would fall on banks that remain open, and Cohen said that would result in a substantial hit to earnings of even the healthiest banks.

"Few doubt that a just a year ago we were on the verge on a collapse of our financial system. We can scarcely afford to assume that we are out of danger," Cohen said.

Cohen suggested using a multifaceted program to counter the risk of widespread bank failures. He proposed an "enhanced and more enlightened" approach to using TARP for smaller banks. Small banks are eligible for TARP funds based on their current condition. Cohen suggested changing the process so the eligibility to access TARP funds is based on a bank's condition after it receives the government's money, which he said would significantly expand the number of institutions that could access the program.

He further encouraged what he called a "necessary liberalization" toward private equity investments in banks. The FDIC recently moved forward with even more stringent qualifications for private investments in failed institutions that Cohen agreed could have broader implications for all private equity transactions in the banking industry. He said the FDIC has strongly encouraged noncontrolling investments in banks, like Warburg Pincus LLC's recent transaction with Webster Financial Corp., and has all but turned its nose up at club deals or silo structures that would allow private equity firms to invest in banks without being subject to control rules under the Bank Holding Company Act.

The government evidenced some willingness to loosen the control rules roughly a year ago, increasing the ownership limit that private equity firms can hold in banks without being subject to bank holding company rules. However, he said the government has since backed away from that stance completely. Cohen said that shift is clearly a "policy decision because both [the FDIC and Federal Reserve] have substantial legal latitude."

As the government places barriers on private equity investments, Cohen said the removal of certain accounting and tax barriers to strategic acquirers looking to buy troubled banks is important. Current accounting rules require that a buyer mark a seller's portfolio to market at closing, but Cohen noted that very few acquirers can actually withstand such a capital hit.

"The idea that loans are worth less at a healthier institution, I don't understand," Cohen said.

He also encouraged legislation that would expand acquirers' ability to carry back losses of a target to five years from two years. Although the proposal was eventually overturned, the IRS released a similar guidance in 2008 that was effectively responsible for Wells Fargo & Co. closing its acquisition of Wachovia Corp. and PNC Financial Services Group Inc. completing its purchase of National City Corp., he said.

The attorney said legislation that would allow banks to carry back losses further has been introduced and has actually received bipartisan support. He said that legislation would result in minimal revenue lost to the government, but it could keep many banks from failing, thereby reducing the eventual losses to the government.

Cohen said making changes to the system is imperative because during the next downturn, the industry may not be as fortunate as it was this time in having a decisive government.

"We shouldn't wait until congressional committees identify the problems and move quickly with legislation," Cohen said.

To correct and prevent the mistakes of the past, legislators will need to fully understand how they happened. Cohen boiled the problems down to three issues: A number of institutions were unregulated, such as mortgage brokers; few recognized the risks of certain products, such as credit default swaps; and too many financial institutions operated with an unacceptable level of risk.

The Treasury has proposed higher capital requirements for all banks, but rather than targeting capital, Cohen suggested implementing capital requirements at the regulatory level. That would allow regulators to determine appropriate capital levels for banks on a case-by-case basis in connection with their business activities.

Those suggestions and others aside, Cohen does see some positive signs on the horizon. He noted that the stress tests have proved to be quite stringent despite initial concerns by many observers. He also said the stress tests assumed higher losses than the banking industry has ever experienced during a two-year period, even during the Great Depression. He further said the stress tests did not account for banks' ability to raise capital and assumed static balance sheets.

Banks will also benefit from less competition in the lending markets, he said, as many lenders outside of the banking system no longer can access funding. That will lead to more rational loan pricing. Meanwhile, banks have improved their own underwriting standards and built their capital levels, Cohen noted.

Cohen does not expect those positive indicators to lead to acquisition activity, though, at least in the near term, simply because there are many barriers to M&A in the current environment. For instance, he noted that the Federal Reserve is discouraging banks with a CAMEL rating of 3 from making acquisitions, and that includes a sizable portion of the industry. He also noted that the capital hits associated with acquisitions will likely keep deal activity at bay.

However, once the dust settles, Cohen does expect an era of abundant consolidation. He said the U.S. is overbanked and has suffered from ruinous competition where weaker players engaged in irrational pricing simply to stay in business. He further noted that many institutions will face revenue headwinds and cost saves that come with deals can help alleviate that pressure. *i*

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