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Lessons learned from last crisis can be applied today

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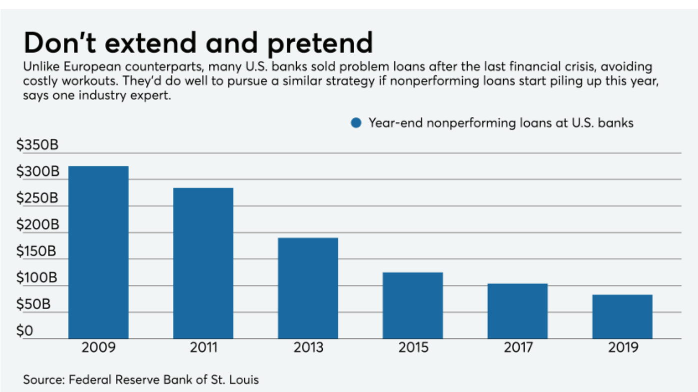
A tidal wave of nonperforming loans is expected to land on banks' balance sheets in the second half of the year largely as a result of the coronavirus pandemic.

But how management teams will respond to that onflow is a critical question bankers must ask themselves now. Will they follow the strategy that worked in the Great Recession to restart growth? Or, will they get mired in a long war with their balance sheets?



History shows the fastest way to return to health is to engage in active portfolio management and sell problem loans once the market resets asset prices.

Case in point: the dramatically different outcome for U.S. banks compared with European banks in the aftermath of the financial crisis.

Many U.S. banks, prodded by regulators, quickly disposed billions of dollars of distressed loans in the secondary market. They avoided long workouts that sucked up management time and capital.

By moving decisively, banks were able to put problems behind them and refocus on new loan originations in a relatively short period of time.

What followed was a decade of phenomenal growth and stock price appreciation for U.S. banks before the pandemic.

By contrast, European banks adopted an "extend and pretend" strategy, hoping to resolve the problem credits through workout. Europe's largest banks are still sitting on $500 billion in nonperforming loans, despite progress in the past four years due primarily to the sale of bad loans. Whereas U.S. banks had $83 billion in nonperforming loans in the fourth quarter, according to the St. Louis Fed.

Other factors played a supporting role in the lopsided performance of U.S. banks. But the experience of the previous crisis shows clearly that banks with a large amount of nonperforming loans can't grow organically or by acquisition. Their share prices suffer greatly.

Another key takeaway from the Great Recession is that a strong balance sheet is a big advantage in M&A.

Banks that shed distressed assets and rebuilt their balance sheets were well positioned to grow through M&A. The same scenario is likely to play out again in the U.S. because regulators and shareholders will want it to happen.

Regulators will be looking for healthy banks to absorb weaker ones and strengthen the financial system. Shareholders will view the pandemic as an opportunity to gain market share, particularly midtier and community banks seeking to expand their existing footprint or into contiguous areas.

Also, the repricing of asset values underway is most evident in commercial real estate, the asset type that caused havoc for banks in the last cycle. CRE is experiencing a once-in-a-generation shift in business and consumer behavior that will likely play out over the next few years.

For example, vacancy rates are likely to climb back to levels reached during the Great Recession. The CBRE predicts vacancy rates will rise over the next two years and peak at 15% for office and 12% for retail.

The demand for commercial space is also weak. Jones Lang LaSalle said during its first-quarter conference call that office leasing activity fell "dramatically," by 20.8% in the U.S. and 28% globally, compared with a year earlier. And investors remain pessimistic about the outlook for office, retail, and hospitality industries.

All of this means bankers need to decide soon whether they will adopt an active portfolio management strategy to address the expected rise in delinquencies.

If management teams embrace this strategy, they should start by placing pre-COVID problem loans in their own category.

Most likely, these credits are not coming back and should be sold first. The far bigger category will be the distressed loans that show up once the full force of the pandemic hits.

Another proactive step is to stress test portfolios now to see around the curve.

Many banks lack forward-looking visibility about their loans because they don't frequently update key data such as loan-to-value and debt-to-income ratios after loan origination.

As a result, loans may show debt service that doesn't exist. This is a systemic problem across the industry. Stress tests can analyze loan performance and the impact of the leverage. The analysis will help determine which loans should be held or sold.

Once problem loans have been identified, the question is how they should be sold.

The secondary market for whole loans remains highly liquid and is viable option to maximize recoveries on distressed loans.

Sellers should find plenty of buyers. Distressed debt funds are adding more to the significant dry powder that's already been accumulated. Hedge funds and opportunity funds will emerge, along with banks and other financial institutions that will selectively purchase assets that fit their business strategy.

Investors hoping for fire-sale prices will likely be disappointed. Judging from the experience from a decade ago, demand for distressed loans will far outweigh the supply.

Prices will adjust based on the status of the seller and collateral, but will not require an additional discount to find clearing prices. Sellers will have the upper hand.

If the last financial crisis reaffirmed anything, it's that active portfolio management works.

Let markets reprice assets so buyers and sellers can determine the best course of action. For banks, that best course of action is usually disposing of loans quickly to restart growth.