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Repeating Crisis Mistakes

Taking the policy rate to zero, propagating CECL, and opening the discount window are all 2008-2009 redux when credit collapsed. (CECL is just a worst-case stress test made worse.) Moreover, we have no signs of credit starvation. Rather the reverse - declining demand for over a year. Total loan growth at large banks is now down to 3.8%, year-over-year, while community and regional banks are holding up their end at 6.2%. The latter provides a disproportionate level of credit to small businesses and has grown loans faster than the largest since 2014.

If the objective is to satisfy credit needs, particularly for small businesses, regulatory actions taken to enhance credit availability are having the opposite effect. Business loans have now decelerated to only 1.1%, the result of six straight quarters of business investment deceleration, as confidence steadily eroded even before the virus and oil shocks. Emergency rate cuts only amplify fear and decrease confidence. Most business managers understand the limits to monetary policy and have only lost more conviction to spend and borrow.

Dangerous to say it, but pushing rates lower is a direct and effective way to kill the incentive to lend. Liquidity is another matter, which can be supplied as needed. ZIRP not only reduces lending incentive, it cuts into deposit inflow, which is the primary bank fuel after capital.

1) **Pause CECL:** Sadly, most regulatory and monetary moves to date have an unavoidable political context. A CECL pause should be the least offensive to political interests. CECL did not contemplate a virtually coincident pandemic at implementation. A one-year pause seems highly logical and important. Without impugning CECL in any way, this is clearly not the time to attempt detailed, forward-looking loss modeling on something unprecedented in our history. CECL is clearly pro-cyclical. FASB is not the answer. Only a higher power, the U.S. Treasury, is in a position to consider an order for pause.

2) **Rate Cuts:** Regarding the latest policy rate cuts, which stand in stark contrast to the Lagarde ECB's move, have two implications. The first is the cosmetic damage of firing two emergency rounds back-to-back that will have little benefit considering an abnormally low rate environment to begin with. All it does is elevate fear itself, rather than subordinating fear. Historic market volatility has been the result.

   Second, it is a huge suppressant to bank lending, crushing margins further. Only selective, spread-manageable lending can be an offset. The ECB avoided another policy rate cut but did expand its TLTRO (Targeted Longer-Term Refinancing Operations), although those rates have been driven further into negative territory. Lending rates should go up, not down.

3) **Discouraging buybacks:** We just highlighted the reasons FOR buybacks, especially in a dead zone of credit demand. But if the politics can't be resisted then short-selling should be banned in parallel. This should be obvious. Moreover, this is not 2008-2009 with exceedingly weak bank capital and extreme mortgage promotion. At under 4% loan growth, banks are generating serious capital. It may be politically correct to halt buybacks but unnecessary and incorrect strategy. It is replicating the last crisis mindset. When demand is there, banks have excess capital above the need for likely growth and business borrowers are not driven by rates alone.

4) **Tempting negative rates:** With both ZIRP and QE4 underway, the search for lower means negative rates may eventually evolve. While the Fed can presumably stop that from influencing Fed Funds, it cannot control the long end of the market unless it sells, rather than buys Treasuries and MBS.

So far we have taken the wrong fork in the road.

Additionally we recommend considering Kevin Warsh's editorial published in the Wall Street Journal.

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