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Fiscal Cliff Could Kill Bank Profitability, Curb Lending

By Victoria Finkle

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WASHINGTON — As the country peers over the edge of the impending fiscal cliff, the banking industry may be haunted by the words of Butch Cassidy: "The fall will probably kill you."

Should lawmakers fail to make a deal postponing the steep budget cuts and tax hikes that are slated to go into effect in early 2013, analysts said it could significantly reduce lending demand, savage bank profits and cripple merger and acquisition activity.

While formal discussions of the issue are expected to resume after the November elections, bankers are becoming increasingly nervous about the potential impact if a deal isn't reached. There are already signs the sheer uncertainty around the issue may be hitting institutions, industry representatives said.

"There's definitely concern on the part of the financial sector over the need to tackle this," said Robert Nichols, president and chief executive of the Financial Services Forum, pointing to both the immediate fiscal cliff and the longer-term national debt situation.

"You're introducing tremendous market uncertainty at a time when we already have economic fragility."

As the end of the year approaches, industry focus on the issue is mounting.

Fund managers at Bank of America's (BAC) Merrill Lynch reported in a survey earlier this month that the fiscal cliff is now the top investor concern, beating out the European debt crisis, which has topped the list since the spring of 2011.

"I think investors and everyone in the space are looking around and saying, 'What now? What's next?'" says Isaac Boltansky, a vice president and policy analyst at Compass Point.

The country is expected to hit the fiscal cliff at the beginning of 2013. That's when a number of Bush-era tax cuts, the payroll tax cut and other provisions expire and when sweeping budget reductions are mandated to take place under a 2011 law. The measures could reduce the federal deficit by more than $500 billion next year alone — but at a steep cost.

The Congressional Budget Office has predicted that should lawmakers fail to reach a deal to avoid the tax increases and budget cuts, the economy would likely fall into recession, shrinking 2.9% in the first half of 2013, and 0.5% the year. Unemployment would also rise back to 9.1%, according to the CBO.

If those predictions are correct, bankers could face sharply reduced demand for loans and higher credit costs for banks, among other issues.

"That gearing down of activity would absolutely have an impact on bank activity," says Jason Ware, an analyst with Salt Lake City-based Albion Financial Group, who adds that banks are a "beacon" of the health of the larger economy.

Jaret Seiberg, a managing director and senior policy analysts at Guggenheim Securities, predicted that "home purchases will grind to a halt."

"We will also see defaults spike as borrowers lose jobs and give up on their homes. Losses could be even higher than expected as many of these borrowers just barely kept their homes through the last crisis," Seiberg wrote in a note to clients.

While consumer credit held up remarkably well during the last crisis, it's unclear how long that trend would continue in the face of another recession.

"We question if consumers will prioritize consumer debt as much this time. That means higher losses are likely on consumer credit cards and auto loans," Seiberg said.

A shrinking economy would also likely stem merger and acquisition activity, analysts predict.

"If we roll over the fiscal cliff and the stock market declines and corporations are more in limbo, there's the possibility of less bond issuance and less equity activity — even less than we're seeing now," says Ware. "IPOs and M&A seize up, and those are all absolutely things banks are going to have to contend with."

One relatively bright spot for the industry is the strength of bank balance sheets, at least compared with four years ago.

"It wouldn't be a balance sheet recession — it would be an earnings recession for the industry," says Frederick Cannon, director of research at Keefe, Bruyette & Woods.

Patrick Parkinson, a managing director at Promontory Financial Group, adds that stress tests performed earlier this year underscore that point.

"The magnitude of economic shocks considered in stress tests from early this year was quite severe, and the results were encouraging in that they showed the vast majority of banks could weather those shocks and still remain adequately capitalized," he said, while noting that the tests focused on just 19 large firms.

"Large banks generally are in much better shape than they were a few years ago to weather an economic storm, whether it is caused by a lack of political will to put our fiscal house in order or other factors.