



Are Big Banks Ready for an Emerging-Market Storm?

By Matt Egan

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If the turbulence in emerging markets morphs into a full-blown crisis, it would serve as an early test of the new regulatory regime put into place to prevent a repeat of the 2008 financial meltdown.

It's clear major U.S. banks have bolstered their balance sheets by raising excess capital while simultaneously dialing back the leverage that got them into trouble last time.

But observers are mixed about whether or not big banks and regulators are truly prepared to weather another calamitous storm.

"The emerging market crisis has all of the characteristics of a 2008 like shock, if not worse. All that has to happen is one major link in the chain goes down, like Lehman Brothers," said Michael Greenberger, a professor at the University of Maryland and former official at the Commodity Futures Trading Commission.

It's too early to say whether or not the turbulence in emerging markets like Argentina, Turkey and the Ukraine will reach crisis level on a global scale. At this point, the turmoil hasn't even merited mention from the Federal Reserve, whose policy committee this week declined to shift strategy or even acknowledge the market volatility.

But the fear is that the trouble in specific emerging markets will spread to others countries, cause liquidity problems for local banks and eventually infect the highly-interconnected global banking system.

Banks Are Better Fortified

Some analysts believe the regulation-inspired changes to bank risk management practices have lowered the risk of serious problems this time around.

"The state of the United States' banking system is more solid today than it has been in decades," Dick Bove, vice president of equity research at Rafferty Capital Markets, wrote in a note to clients this week.

Bove cited a number of promising metrics on the U.S. financial sector, including 77-year highs for common equity-to-asset ratios, 40-year highs for liquidity ratios, 40-year lows for loan-to-deposit levels and historically average levels of troubled loans. The analyst also said the off-balance sheet problems of six years ago are "virtually gone."

"Our banks are far more well-capitalized and one assumes they've learned their lessons from the past in terms of risk management and exposure per country," said Ernie Patrikis, former general counsel of the New York Federal Reserve and now a banking partner at White & Case. "The risk management techniques have been improved by a huge amount over the last number of years."

SNL Financial analyst Marshall Schraibman said banks have strengthened their capital adequacy metrics, which measure the amount of money lenders have available to absorb losses in the event of large writedowns. "No one really debates that," he said.

According to SNL Financial, the median supplementary leverage ratio of globally systemically important U.S. banks under Basel III has climbed to 4.9%. That means this ratio of capital to assets is on track to meeting the 5% threshold required by January 2018.

As of the third quarter of 2013, several of these huge banks had leverage ratios that exceeded 5%, including Bank of America (BAC) and State Street (STT). Others, like Bank of New York Mellon (BK) and Morgan Stanley (MS) were closer to the 4% level, according to SNL.

'Wake-Up Call'

Still, Patrikis said if he were at the Fed, he would instruct bank examiners to calculate each bank's exposure to emerging markets and what they are doing to manage that risk.

"If anyone isn't awake, this should be a wake-up call. But I assume people are awake," said Patrikis.

Other observers are less optimistic about the ability of big U.S. banks to weather a serious emerging-market storm.

"I think they've increased capital requirements to withstand the mild shock but not the kind of shock we had in 2008," said Greenberger. "If there's the kind of systemic break there was in 2008, it's going to be a calamity."

He pointed to successful efforts by big banks to delay or dilute bank regulation.

For example, central bankers recently approved an international standard for leverage ratios that offered some concessions to banks and led critics to say they've been watered down. The new Basel III rule changes, announced January 12, sent shares of big European banks like Deutsche Bank (DB) and Barclays (BCS) sharply higher the next day.

Big banks have also managed to slow and fight the implementation of the Dodd-Frank financial reform law.

"It's political contributions overwhelming logic. They have the members of Congress so dazzled by political contributions that they look for excuses to accept JPMorgan's (JPM) argument even though they are jeopardizing taxpayer money and the world economy," said Greenberger.

Contagion Risk

Cam Harvey, a finance professor at Duke University, shares concerns over the readiness of large global banks.

"The banking system, particularly in Europe, is still undercapitalized, making many banks vulnerable to emerging market defaults," Harvey said in an e-mail.

Greenberger said he's found that "banks have a uniformly optimistic take on the world. Part of that is either expressly or implicitly an assumption that they can't do anything wrong because if all goes south, they'll be rescued!"

Yet it seems likely the political appetite for fresh bailouts of big banks is even less than it was during the deeply unpopular 2008 TARP rescue.

Among U.S. banks, Citigroup (C) appears to have greatest direct exposure to Argentina, which has been one of the most troubled emerging markets this year amid surging inflation and dwindling cash reserves.

According to Keefe, Bruyette & Woods, Citi has \$4.2 billion in assets and \$749 million in equity in its Argentine subsidiary.

"In isolation, losses in Argentina may be manageable but contagion could present a real risk to Citi," KBW analyst Frederick Cannon wrote in a note to clients late last week.

On the upside, some U.S. banks could actually benefit from increased emerging market turmoil.

Bove said deposits would likely "surge" into custodial banks like BNY Mellon, State Street and Northern Trust (NTRS). He also said domestic regional banks that see their stock prices tumble due to contagion fears "should be bought aggressively" since they aren't involved.

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