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Trump's Tariffs Threaten Banks' Credit Portfolios

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> *Banks' senior executives and risk management must create a framework to analyze how tariffs and reduced foreign investment in the US might affect their banks' existing and future borrowers' ability to repay existing credit lines. Here's what they need to look out for.*

In the past two weeks, global US-headquartered companies Fiat Chrysler, Ford, General Electric, General Motors, and Whirlpool have announced lower earnings than in the same quarter in 2017 or have reduced their earnings expectations for the remainder of the year; in some cases they did both. All these companies rely heavily on importing goods from abroad that are subject to President Trump's tariffs, such as steel and aluminum, or in exporting their goods to countries that have retaliated with tariffs.

If these diversified, internationally active companies are having difficulties in this new environment, smaller, more domestically active US companies are likely to feel the effect even more. For example, after the Trump administration imposed a 25% tariff on imported steel, nail orders at the Mid-Continent Nail plant in Poplar Bluff, Missouri, plunged 50% once the company raised its prices to cope with higher steel costs. The company just laid off 12% of its work force and stated that it might have to relocate to Mexico, which would mean more workers will be laid off.

At a recent G-20 meeting in Buenos Aires, Argentina, even US Treasury Secretary Steven Mnuchin admitted that Kentucky bourbon, Maine lobsters and the soybean sector have been adversely affected by the tariffs.

It is not only tariffs that are causing a problem. The Trump administration's attitude toward global alliances and treaties is affecting foreign direct investment in the United States. As economist Adam Posen explains in Foreign Affairs:

"U.S. President Donald Trump's hostility to globalization is ruining the United States' attractiveness as a place to do business. … This year, net inward investment into the United States by multinational corporations—both foreign and American—has fallen almost to zero, an early indicator of the damage being done by the Trump administration's trade conflicts and its arbitrary bullying of companies and governments."

In the short term, trade tariffs will disrupt the supply chain of numerous companies; in the long term, an intensifying trade war and reduced foreign direct investment will reduce US GDP. Moody's and the U.S. Chamber of Commerce have estimated that millions of Americans could lose their jobs due to the Trump administration's tariffs on a wide range of products coming in from Canada, China, Europe and Mexico. Last week, significant auto trade groups and car companies warned that hundreds of thousands of jobs in the US may be lost if Trump imposes tariffs on imported vehicles; the tariffs also threaten industry spending on self-driving cars.

Banks of every size should not wait for the long run to figure out how tariffs and reduced foreign direct investment may affect their credit portfolios. While it is impossible to predict with any certainty the number of jobs at risk given the unpredictability of how different politicians in all the countries involved might react, this should not stop banks' senior executives and risk management from creating a framework to analyze how tariffs and reduced foreign investment might affect their banks' existing and future borrowers' ability to repay existing credit lines.

Especially, community and regional banks in states with a significant number of jobs supported by exports, or especially those whose customers are importers of steel and aluminum, should evaluate the likelihood of job losses and subsequent loan delinquencies. This is a very good time to evaluate loan covenants and quality and price of collateral posted for the loans. States where export supported jobs represent a bigger percent of their GDP, such as Louisiana, Alaska, South Carolina, and Alabama are at even higher risk from the adverse effects of the tariffs.

Not only are agriculture lending banks and community banks sensitive to the uncertainty caused by tariffs but so are regional banks such as BBVA Compass, Capital One, and Fifth Third which have significant borrowers in states with industries targeted by the tariffs. Because of the mission of these banks, they do not have the ability to diversify their risks in the way that internationally active banks do.

Even states that have less exposure to export supported jobs are not immune. As any company lays off even a few workers here and there, how long will it be before laid off workers stop paying their credit cards, auto loans and mortgages?

Unfortunately, the tariffs might also lessen loan availability and make those approved loans more expensive to borrowers. Standard and Poor's recently pointed out that, "While not directly impacted by President Trump's tariffs, diversified banks and investment banking and brokerage companies are reexamining their business investment and lending decisions due to the levies' potential negative repercussions on economic growth." So those companies dependent on imports that have tariffs levied on them will likely find it harder and more expensive to take out loans precisely when they need them.

Any type of bank exposed to the sectors most sensitive to the tariffs, such as agriculture, steel, aluminum, and the automobile industry, should immediately review the quality of the loans to borrowers in those sectors.

Risk managers should make sure that their policies and procedures address risks posed by individual loans as well as the aggregate portfolio. As the Office of the Comptroller of Currency states in its Comptroller's Handbook on Agriculture Lending, "Even when individual loans are prudently underwritten, groups of loans that are similarly affected by internal and external market factors may expose the bank to a heightened level of risk and warrant increased board and management attention."

At the very least, bank risk managers and portfolio managers should identify the sectors where they have high concentrations of borrowers and conduct loan sampling. They should pick loans that are of average or low credit quality and review:

- financial documentation and repayment capacity analysis, including updates on outside debt,
- budget or cash flow projection analysis,
- liquidity monitoring,
- stress testing,
- guarantor analysis, when applicable,
- crop and livestock inspection requirements, including appropriate frequency and timing of inspections and valuations,
- equipment inspections and valuation expectations,
- expectations for the content and frequency of real estate evaluations and appraisals,
- title and lien verification,
- insurance policy requirements, and
- frequency of credit checks.

Banks with significant credit risk concentrations, especially to borrowers in the agriculture, steel, aluminum, and automobile supply chain related sectors, should maintain appropriate capital levels to mitigate concentration risk. While capital is not free, banks with heavy exposures to borrowers in the sectors most affected by the tariffs, should start raising their capital levels so that they can sustain unexpected losses. Any bank wanting to put off intensifying their analysis of their current credit portfolio, risks being unprepared when the tariff's effect is felt even more acutely in the coming twelve months.

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