GE Capital succumbs to changing regulatory climate

By Tom Braithwaite, Barney Jopson, and Gina Chon

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The dismembering of GE Capital, the sprawling financial arm of General Electric, marks the next stage in a great reordering of US finance, heavily influenced by the US government.

At first blush, it seems like strong deal markets drove Friday's dramatic announcement that GE — America's best-known conglomerate — would sell down GE Capital's assets from $363bn to about $90bn, and return to its industrial roots.

Executives were keen to emphasise that they had been confronted with increasing evidence that GE Capital was worth more detached from its parent.

First, the spin-off of Synchrony Financial, a private-label credit card business and consumer finance company. GE floated it last year at more than $19bn and it is now trading with a market value of $25bn.

Second, GE managed to sell an Australian consumer finance business to a KKR-led consortium for A$8.2bn last year, about twice book value.

Third, GE received a flurry of confidential enquiries, mainly from private equity groups, about its remaining businesses, which include a middle-market lending platform. "People came and offered valuations that we thought, 'That's different'," said one person familiar with the situation.

But the regulatory climate was always a factor. GE Capital has been earmarked for special supervision ever since it was bailed out during the financial crisis with $130bn of government loan guarantees.

To reduce the risk of future bailouts, Congress in 2010 gave regulators responsibility for selecting non-bank financial groups — "systemically important financial institutions (SIFIs)" — for tougher supervision.

There had been debate over whether designation would be a "badge of honour" or a "scarlet letter" but the latter camp seems to have been correct. MetLife, the largest US insurer, is

suing the government to try to escape its designation. Now GE Capital is planning to apply next year for "de-designation" after accomplishing more of the planned disposals.

Even if all goes to plan, GE Capital will have to endure a brief period of strict oversight and the company has embarked on a massive recruitment drive to hire risk managers and financial modelling experts to help it prepare for annual stress tests by the Federal Reserve.

People close to the matter said GE Capital had the most contentious relationship with regulators out of the four non-banks designated as SIFIs.

In February, about the same time that he began drawing up a plan to dispose of most of his division, Keith Sherin, chief executive of GE Capital, wrote to the Fed to complain about the proposed oversight.

In a 57-page letter, he said that "critical aspects" of the Fed's plan "fail to satisfy . . . basic tests" to tailor supervision differently to that of banks. He argued the Fed was considering imposing capital requirements that were so stringent that they were "out of proportion" and would place GE Capital at "an unjustified competitive disadvantage".

The truth is that GE Capital was already at a competitive disadvantage, squeezed between banks which can borrow much more cheaply by paying depositors almost nothing for their funds, and more agile non-banks which have no limits on their leverage.

Its performance has suffered. In 2008, looking — somewhat prematurely — to its post-crisis future, GE realised the world had changed but underestimated the magnitude. It estimated returns on equity would be down from 20 per cent to 15 to 20 per cent.

In fact, the returns have been much worse. In 2014, return on equity was 8.6 per cent and would have been significantly worse without Synchrony. That is below GE's cost of capital and a brake on the better performance of the industrial side of the company.

Those returns are already hampered by regulatory capital requirements, which restrict the amount of debt the company uses, and could be worsened further if the Fed applies an even tougher regime that Mr Sherin railed against in his letter.

Banks that buy some of GE Capital's assets would also face the same problem of making good returns, although some might have the scale to do so.

But buyers are expected to come predominantly from a pool of private equity groups that have invested heavily in growing their credit arms in recent years. Apollo, Ares, Fortress, Blackstone, GSO are already in the minds — some have already been on the phones — of GE and its advisers at Centerview and JPMorgan.

The rise of those firms poses more questions about whether the focus of regulators on banks and a tiny handful of large non-banks, such as GE Capital, is distorting competition and whether it is making the overall system any safer.

“The process was supposed to reduce risk in the system. This has to be the biggest question: are we reducing risk in the system or are we simply reducing risk in individual institutions?” says Mark Calabria, a former Senate banking committee aide now at the Cato Institute.

Aaron Klein, a former Treasury official who is now a director at the Bipartisan Policy Center, asks: “Is financial risk like the law of thermodynamics? It can never be destroyed, it just moves around.”

Additional reporting by James Fontanella in New York

GE retreats from UK financial market

General Electric is pulling out of the UK financial market, where it operates under the GE Money brand, in a move that will put billions of pounds of mortgage assets up for sale, *writes Emma Dunkley*.

The US group revealed plans on Friday to shrink its global finance arm in order to return to its manufacturing roots. That move includes the retreat from the UK market and could lead to the sale of about £10bn of British mortgage assets.

A number of specialist lenders and “challenger” banks in the UK are in talks with GE about potentially acquiring some of the assets, said people familiar with the situation.

The group recently sold £250m of second mortgages to a specialist lender, but still has £10bn of primary mortgages on its balance sheet, the people said.

“GE would’ve loved to have sold the UK mortgage business some time earlier, but there was no one around to buy, or the prices were unacceptable. But now, the price of the assets has gone up,” according to one source.

Ray Boulger, of broker John Charcol, said: “Private equity firms have an interest in getting into higher margin parts of the mortgage business.”

He said that GE Money was known for subprime lending before the financial crisis. The lender subsequently offered mortgages to customers that “represent good credit risk but do not have a perfect credit score”.

“GE Money falls into this capital category, so it’s likely private equity funds will look at buying the existing mortgage book and using it as a launch pad to get into the UK market,” he added.