

## SNL Blogs



Tuesday, July 29, 2014 6:53 AM CT

## Making it up with volume

By Jeff K. Davis

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The second-quarter earnings season for U.S. banks is nearly over. There were few consequential earnings surprises other than [Goldman Sachs Group Inc.](#) on the upside and a smattering of downside surprises such as [BB&T Corp.](#) Qualitatively, loan growth appears to have been modestly better than the Street expected. [Comerica Inc.](#) management upped its [projected growth](#) in average loans for 2014 to a range of 4% to 6%, from 3%. SNL's Nathan Stovall in a July post examined whether [loan growth](#) was at an inflection point. The conclusion, for now, is that loan demand is better, but it is not necessarily transitioning to a broad-based increase in demand. A small minority of banks such as New York City-based [Signature Bank](#) and Dallas-based [Texas Capital Bancshares Inc.](#) continue to post robust loan growth most quarters.

But it is a weird operating environment. It is the opposite of the 1980s when idle cash had a punitive cost. Banks, processing companies, insurance companies and even nonfinancial companies spent a lot of effort trying to reduce float to create more investable assets. Not doing so represented a huge opportunity cost when short-term rates were above 10%. In the aftermath of the financial crisis, cash was king. The cost of not investing it did not seem to be so bad. The psyche around cash for banks and maybe their customers has changed. Cash is a riskless asset, but it is also a return-free asset in the zero interest rate order that the Federal Reserve has established. The cost of holding cash since the immediacy of the financial crisis passed in mid-2009 accumulates with time.

So a second question might be: How much loan growth reflects the lowering of prices and the loosening of loan standards by bankers in order to convert cash into an earning asset? I do not know, but perhaps some of it. Lower the price (and terms) and demand should increase.

The story-within-the-story aspect of second-quarter earnings is the ongoing grinding lower of portfolio loan yields as a result of a hyper competitive environment in which there is limited fear of credit risk and an intense focus on maintaining revenues. I have not done a word search of SNL's conference call transcripts, but (lower) loan yields was a common theme discussed by managements. Comerica noted that a further decline in the portfolio yield is expected due to stiff competition. And Comerica does not have a high yielding portfolio at 3.31%. I suspect this will also be a common theme for BDCs once their earnings season occurs.

The Street, so far, has not focused too much on the yield issue. I think this is the case because the relative increase in loans as a percentage of earning assets has cushioned the impact on net interest income. The Street also expects the Fed to begin to raise rates in the next year or so.

Kansas City, Mo.-based [Commerce Bancshares Inc.](#) is an example. Average loans increased by \$1.1 billion in the [second quarter](#) compared to the year-ago quarter, while average earning assets rose \$795 million as reductions in bonds and short-term securities partially offset loan growth. Tax-equivalent net interest income was virtually unchanged at \$168 million, however, because the net interest margin declined 8 basis points to 3.13%. The yield on the loan portfolio declined 29 basis points, paced by a 28 basis point reduction in "real estate — business" to 3.86%, and a 22 basis point reduction in "business" loans to 2.85%.

[U.S. Bancorp](#) reported a 16 basis point reduction in its NIM to 3.27%, primarily due to a 29 basis point reduction in the noncovered loan portfolio yield to 4.19%.

The story is pretty much the same across the industry, though it is worse for the smaller banks where yields are usually higher. At some point portfolios will reprice such that the yields will approximate the yield on new production, assuming no (or little) change in interest rates or the level of price competition. That point has not yet arrived, however.

[BankUnited Inc.](#) CEO John Kanas said "loan pricing is getting to be ridiculous" during his [review](#) of second-quarter results. Kanas has a great sense of timing. He and his board agreed to sell North Fork Bancorp to Capital One Financial Corp. during March 2006, about a year before the financial crisis emerged. During the second quarter BankUnited sold \$303 million of indirect auto loans and [exited](#) the business, which is beset with ferocious competition and miniscule yields for prime loans and high yields for subprime borrowers whose debt service capacity is questionable. Kanas noted during the call that the indirect portfolio's yield was close to the securities portfolio yield — hence the reason it was sold. He also noted that BankUnited lost a large multi-family loan in New York to another bank that was willing to make a 10-year, interest-only loan.

Among smaller banks, I had a CEO of a bank located in the Deep South tell me he lost two \$15 million loans during June where the lenders (one was a mortgage REIT) made very long-term loans, with no recourse, and allowed the borrowers to take a significant amount of equity out of their businesses.

Wall Street is cheering loan growth, as it should in the early and mid-years of an economic expansion; however, investors should be clear-headed about the trade-off that may be occurring. Growth for growth's sake usually comes back to haunt banks. I do not think that is the case yet, other than perhaps in subprime auto and some parts of the leveraged loan market. If the Fed were to aggressively raise rates — they will not, if at all, in my opinion — then the date when the next credit cycle begins would move forward. Investors should pause though. Loan growth also eats capital, the equivalent of evaluating a business based upon EBITDA without considering capital expenditures.

I remember BB&T CEO Kelly King remarking during a 2008 earnings conference call that for the first time since he was a young lender, BB&T and other banks were finally going to be paid for lending. That was probably very true during 2008, 2009, 2010, and perhaps 2011. Since then, that looks to be an increasingly distant proposition for banks — and their investors.

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