NASHVILLE NOTES

Things Change

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By Jeff K. Davis

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I generally have not worked from home that much because my office is nearby, I like being with others, and my wife is on the phone constantly because she is a realtor.

Recently, I had enough of a cold to keep me away for a week lest I give it to others. About midweek, my wife complained that I was on the phone constantly and I was too loud. It struck me that she was not on the phone much because rising rates have iced the housing market.

Things change.

Historically, the two executives in the C-suite on the hot seat have been (and may yet be) the chief credit officer and the head of commercial real estate lending. At the onset of the "Great Recession" 15 years ago, I suspect the tone in monthly board meetings with the two executives trended from mild concern in early 2007 to panic by late 2007.

Now, the treasurers and the CFOs at many banks are on the hot seat — fixed income salespeople, too.

Rising interest rates have clobbered fixed-rate assets that are marked-to-market, which primarily are securities classified as available for sale at most commercial banks. Fixed-rate loans have been clobbered, too, but these assets are easier to ignore because accountants do not mandate mark-to-market. Of course, core deposits that are a key contributor to the current expansion in net interest margins are not marked-to-market, either.

Wall Street icon Leon Cooperman is credited with coining the phrase "certificates of confiscation" in the late 1970s to describe bonds that did not offer enough coupon to compensate investors for inflation. Bonds were depreciating assets during much of the 1970s as rates rose and prices of previously issued fixed-rate bonds fell.

The same phenomenon is playing out today as those who called bonds return-free risk propositions in the years since the Federal Reserve and other central banks adopted zero-interest-rate policies were proven correct.

Among the early reporters, Comerica Inc. is a leader in the reduction of tangible book value per share, or TBVPS, because of the reduction in the value of its securities portfolio and apparently swaps book. TBVPS fell about 25% from June 30 and 40% from Sept. 30, 2021. Fifth Third Bancorp and KeyCorp also had similar reductions in TBVPS from a year ago.

Nearly 30 years ago, the CFO of Union Planters Corporation, which was one of the regional banks that merged to form the current Regions Financial Corp., told me he thought it was a bad idea for the accounting profession to force banks to mark-to-market bond portfolios because it would distort return on equities.

If he said a rising-rate environment would crush TBVPS and tangible common equity ratios, I do not recall. Comerica, Fifth Third and KeyCorp all reported a tangible common equity ratio of less than 5% as of Sept. 30.

Yet, here we are. In an unusual way the big mark to Comerica's equity via "accumulated other comprehensive income" contributed to a near doubling of return on average capital employed to 23.3% in the third quarter from 13.5% a year ago. However, Comerica also reported record quarterly earnings of $2.60 per share, compared to $1.90 per share in the same quarter last year, on record revenues largely because its net interest margin expanded 127 basis points from the year-ago quarter.

So, what are we to make of the situation in which a company reports record earnings via margin expansion rather than gimmicks, but the shares fall 9% on the day of the earnings release? I am told one trading desk described Comerica as a "battleground" stock, where investors focused on earnings and (partially) marked balance sheets square off.

One take relates to optics. Comerica reported too big of a headline shock in which tangible common equity declined to less than 5% of tangible assets and tangible TBVPS fell by 25% from June 30 in spite of record earnings. But, would it have mattered to investors had Comerica classified most of its bonds as "held-to-maturity" that are not marked-to-market unless there is an impairment?

Market value information for bonds has always been disclosed in Securities and Exchange Commission filings and Call Reports for as long as I can remember.

Marking balance sheets for unmarked bonds, and where possible, loans, is the first adjustment analysts are supposed to make to reported values. Are they doing that now?

As for capital, the impact of unrealized losses on equity does not matter to regulators (or is not supposed to, but maybe it kind of does) because there is no tangible common equity ratio mandate. All regulatory ratios exclude unrealized losses and gains from capital.

I suppose credit was not top of mind for Comerica investors, but it should be for bank investors. When JPMorgan Chase & Co. CEO Jamie Dimon was asked if the leverage loan market has cleared yet, he said it had not. How much will rate hikes matter to credit quality after two years of insane monetary policies? We do not know, other than it is unlikely to be little longer than the Fed persists in pushing rates higher.

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