SNL Blogs

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Observations from the initial Q1'15 bank earnings

By Jeff K. Davis

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If U.S. Bancorp CEO Richard Davis' comments on April 15 about the corrosive impact of low loan yields on bank profitability did not get the attention of the Street, it should have. Davis made an analogy to a fitness challenge that the zero rate world is increasingly stressful the longer it lasts. I thought Comerica Inc.'s results summed up what has been occurring the past few years. The company had $48 billion of loans based upon average balances in the first quarter, up about $3 billion from the year ago quarter, but net interest income only rose $3 million to $413 million.

Until this quarter, I thought the Street had not been paying much attention to what was happening to loan yields the past couple of years. Maybe because declining credit costs and a shift in earning assets to more loans and fewer bonds masked the implications of declining loan yields. And since the second half of 2014 the consensus coalesced around the view that the Fed would begin to raise short rates in June or September of 2015. Now Fed rate hikes, which may be a one-and-done move, look iffy for 2015.

Without assuming the Fed is going to change the math "next year," it is hard to ignore what the numbers are saying: earnings are at best are going to move sideways to slightly higher for most banks with high single-digit ROEs other than for the leanest of cost structures such as U.S. Bancorp and Birmingham, Ala.-based ServisFirst Bancshares Inc. ROEs will decline further whenever credit costs rise, though nothing in bank results to date indicate an upturn is anywhere near. Sustained loan growth at some point is going to require reserve building to resume, however.

At some point loan yields will bottom, but the bottom may be much lower than envisioned. First Horizon National Corp. CEO D. Bryan Jordan commented on April 17 that the market had seen an acceleration of weakening loan pricing and structure. Aircraft lessor FLY Leasing Ltd. (B1 Moody's; BB S&P) announced on April 20 that it had repriced its 2012 term loan for the third time since it was originated to LIBOR +2.75% with a LIBOR floor of 0.75% from LIBOR+3.50% and 1.00%. And a loan made by U.S. Bank NA to Pinnacle Bank earlier this year to partially finance an investment in Bankers Healthcare Group points to where the bottom may be for "A" credits like Pinnacle: the greater of zero or 30-day LIBOR plus 165 bps to 195 bps. At least U.S. Bank, and I assume most banks, is thinking about the potential for the Fed to target negative rates by writing loan agreements to set a 0% base rate floor.

In most mature industries, volume growth to offset margin pressure may not be ideal, but is manageable. Banks can do so too, but loan growth eats capital and implies risk adjusted returns may not be so good. Or in the vernacular of an operating company: capital expenditures have to increase to maintain EBITDA. My take on bank ROEs is that over extended periods of time ROE tends to be roughly 500 bps to 700 bps over the 10-year U.S. Treasury. It does not seem appealing for equity investors, but that implies current ROEs of 7-9% that banks such as Comerica Inc. and SunTrust Banks Inc. posted in the first quarter are about where they should be. But will they hold?

Investors will have to decide what entry price makes sense, which along with the decision of when to sell, is the only thing that an investor controls. For bankers there are only two logical conclusions: hack costs and/or merge. U.S. Bancorp's Davis, who runs one of the nation's best banks, commented that so far he had resisted special cost cutting and mass layoffs; however, I wonder how long even a high return bank like U.S. Bancorp can hold out if the Fed does not relent.

Headline amended at 9:25 a.m. ET on April 22, 2015, to correct a reference to first-quarter 2015 bank earnings.

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