NASHVILLE NOTES

Certainty for banks will intensify the need to merge

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My ego is more modest than imagining I could order companies out of China. My aspirational dictate relates to vocabulary: if I could ban one word it would be "uncertainty." Maybe it is just me but it seems like the word has been imprinted on the frontal lobe of investors, management, Fed officials and other talking heads that offer commentary to the financial media. It is silly; tomorrow always is uncertain.

So, uncertainty is at the center of debate about the meaning of collapsing U.S. Treasury bond yields. Is it fundamental because the market sees an economic slowdown coming or maybe risk related to a financial shock? Or, is it technical related to money flows into U.S. securities because yields in the rest of the developed world are even lower? Maybe it is both or something else?

With humility I offer four certitudes from the collapse in yields — provided no reversal will be forthcoming soon.

One certitude is that no matter how many public policy types wring their hands about the absurdity of zero and negative interest rate policies (i.e. ZIRP and NIRP) pursued by central banks, governments and the entrenched political class are a huge beneficiary. As long as governments can auction debt to raise funds to sustain deficit spending the status quo will remain in place. It is counterintuitive. The rate charged to borrowers should rise as risk increases, but in our highly indebted world the rule has been reversed. Punitive is an adjective that used to describe a penalty rate assigned to a risky borrower; now punitive is the rate the creditor receives (or pays in Europe).

The only negative I can think of from a politician’s point of view is that public pension funds will go deeper in the hole as prospective returns on investments sink and the present value of future liabilities climbs. Judging by what is unfolding in Puerto Rico, that will be a problem for bondholders more so than the pensioners.

The second certitude I see from what appears to be a return to ZIRP is a large bank issue that probably is not top of mind for most investors. The fixed income business generally has been mediocre since the financial crisis passed except for a few quarters when volatility spiked for one reason or another. How much interest can there be in the bond business (or derivations of it) that entails trading bonds with essentially no coupons? Presumably, very little. Lots of price risk paired with negligible coupons for customers does not seem like a product that should have a lot of demand beyond regulatory requirements.

The third is that net interest margins will head lower, as will bank profitability absent an offset. NIMs are under pressure today due to the flat-to-inverted yield curve and a highly competitive market for deposits. Even if the Fed cuts short-term rates more than the FOMC apparently wants to do, NIM relief may not be forthcoming or may be less than expected for two reasons. Bank balance sheets are relatively illiquid today with high loan-to-deposit rates. A decade or so ago banks were able to slash deposit rates because deposits were flowing into banks as loan demand from creditworthy borrowers evaporated. Also, the more the Fed cuts, the more noninterest bearing deposits are devalued; there is no rate to cut.

I realize NIM pressure is no great revelation; bank stocks have underperformed the broader markets for a reason over the past year. Nonetheless, I think it is worth noting that the NIM damage will be focused on core deposits, especially noninterest deposits that are golden when rates are high and less so when they are not. Comerica Inc., as an example, posted a 3.73% NIM during the first half of 2019 compared to 2.60% at the end of 2015, the last year in which short-term rates were close to zero.

I have seen a number of sell-side analyst notes the past few weeks that make good points about particular banks that have leverage to lower rates (New York Community Bancorp Inc. seems to be on everyone's list); however, I think most of these benefits will be a Pyrrhic victory tied to incremental funding. Credit funds, business development companies and other lenders that rely upon gobs of short-term wholesale funding will benefit, I suppose, but even for these entities refinancing in time will weigh on asset yields. The charts of mortgage REITs Annaly Capital Management Inc. and AGNC Investment Corp., both of which cut dividends in 2019, do not appear to reflect investor optimism that margins are on the cusp of expanding dramatically.

The last certitude of plunging rates is that pressure on banks to merge will intensify. That also is no great revelation on my part. The industry has been undergoing consolidation for over 30 years since a landmark ruling by the Supreme Court in 1985 upheld regional reciprocal banking arrangements. When the ruling was issued there were approximately 18,000 FDIC-backed banks and thrifts. By the end of 2019 the number should be close to 5,000.

Ed Herlihy and Brandon Price of Wachtell Lipton's financial institutions group published a thoughtful piece last week that addressed the opportunity for "strategic business combinations" in a difficult operating environment. Among the points made was that challenging times can be an opportunity for similar banks to merge with the admonishment that there can be too much attention paid to acquisition premiums. I would add "price" to the extent that a merger involves a share exchange among nonpublic companies.

Maybe board members should not overly focus on acquisition premiums, but bank investors will. A review of M&A activity since year-end 2013 as compiled by S&P Global Market Intelligence indicates the median five-day acquisition premiums for OTC-, NASDAQ-, and NYSE-listed banks that agreed to be acquired are 41%, 18% and 14%. Acquisition premiums can be icing on a cake as far as investing returns go, but they can prove to be fleeting if investors have reason to question the combined banks' earning power.

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