

## NASHVILLE NOTES

# Liquidity — same story, different rate cycle

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I recently had lunch with the CEO of a Tennessee-based bank. He mused about the same concept he had brought up six months earlier with me: liquidity. He reflected that vast new cities (i.e., lots of vertical construction) had been created in the years since the financial crisis with funding that cost virtually nothing. Now liquidity is tight and funding costs have risen sharply. His question: what next?

In the case of the CEO, his management team decided last September to halt loan growth to allow lower yielding assets originated a few years ago to roll-off or reprice rather than aggressively bid for deposits or tap wholesale funding in order to maintain loan growth. The same trend more or less has played out in the banking industry in which loan growth at best has been sluggish the past six months.

Deposit growth is tough to generate today without paying a "high" rate for incremental funds that are close to what the capital markets will charge to borrow. Worse from a bank's perspective, a negative mix shift is underway. Rates have risen sufficiently that depositors are moving existing funds from accounts that pay little to accounts that pay a competitive rate, which today is north of 2%.

There is nothing new in the phenomenon other than it is playing out at very low rates of interest. Banking has always been cyclical and always will be, unless central banks completely destroy markets.

Liquidity in the banking system more or less runs countercyclical to the availability and pricing of credit. Once an economic expansion runs for a while, loan growth tends to outpace deposit growth (or at least low-cost deposit growth) which in turn results in a draw-down of excess liquidity that was built in the last recession. Bank balance sheets went coast-to-coast from tight with high loan-to-deposit ratios at the end of 2006 to liquid by year-end 2009.

Overlay a Federal Reserve rate hiking cycle and net interest margins eventually will come under pressure, too, as incremental funding costs overwhelm an increase in asset yields. There are always exceptions, including lenders that limit the loan-to-deposit ratio to a level that is comfortably below 100% and banks such as Comerica Inc. and Zions Bancorp NA that have an enormous amount of noninterest-bearing deposit funding.

So, what about the cities constructed with oceans of money that cost nothing until a couple of years ago? They are not going to fall from the sky, but for lenders, profitability has peaked as NIMs compress somewhat and asset growth slows or maybe even stalls for a while. The big earnings delta for banks, however, will be the path of credit costs rather than the degree of incremental pressure on NIMs. Credit costs will eventually rise sufficiently to meaningfully dent profitability, but that will not happen as long as the economy remains reasonably strong.

That said, there are two risks to note aside from whatever blow-up outside the U.S. could occur and infect our markets: one is old and hard to see and one is new and very visible.

The machinations within the shadow banking system are hard to see. The shadow banking system covers a large assortment of lenders than runs the gamut from private credit funds and BDCs to securitization vehicles. Assets financed range from generic to speculative, while leverage employed to finance the assets varies by entity.

A rising rate cycle is usually followed by a down credit cycle. Shadow lenders that rely on short-term financing will be the first to face liquidity issues if their creditors begin to raise questions about credit quality and decline to roll over funding.

Twelve years ago a tsunami started to build in the shadow banking system when subprime lenders and levered funds that invested in similar assets could not roll over financing. That tsunami eventually rolled through the entire banking sector. That seems unlikely to occur anytime soon because it was equivalent to a 100-year flood, but there can be modest replays.

The other risk that is very visible but is new and hard to quantify is the impact of digitization. Money is more fungible than ever. Incumbents are ramping up digital offerings to counter disruptors.

Liquidity will ebb and flow in the banking system, but the digitization of money and the ease at which it can be moved may mean banks will have to pay depositors a rate closer to what the capital markets would charge all of the time, rather than just late in an economic cycle when banks pay up for incremental funding.

Stated differently, funding costs may continue to grind higher for structural reasons as depositors find it increasingly easy to move money in the digital age to institutions that pay a competitive rate. The offset will be much greater reductions in branch networks than have occurred to date and more M&A to extract cost savings.

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