NASHVILLE NOTES

Selling The Silver

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By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

The saw that the market will tend to go in the direction that will cause the most pain for the most investors is playing out this year. The bond market has deviated from the beginning of the year's consensus expectation of six Fed policy rate cuts to suggest that the answer may be none. Markets make opinions, as another saying goes, so sentiment and market expectations can change again.

Midway through the first-quarter earnings season, it is clear that most of the net interest margin (NIM) compression story is in the rearview mirror for the banking industry. However, the rate environment remains a grind for most banks.

Truist Financial Corp. noted during its first-quarter earnings call that it expects net interest income to bottom out in the second quarter, though if there are fewer than three rate cuts there would be more downward pressure. Presumably, no cuts would push the trough further into the future, and/or impact the modest improvement expected for the second half of the year. At the beginning of the year the company assumed five rate cuts.

The NIM issue for most banks has not elevated to "pain," in part because NIMs expanded during 2022 as the Fed began to raise rates aggressively, while most banks were able to lag deposit rate increases until Silicon Valley Bank failed.

> ***The pain for much of the banking industry is the burden of low-coupon assets that cannot be sold without incurring a sizable loss until the bond market rallies.***

The pain issue I see comes from bond portfolios and residential mortgage portfolios with yields well below incremental funding costs that are above 5% today. Truist, as an example, had a tax-equivalent yield of 2.46% on its securities portfolio in the first quarter, and the portfolio was roughly 25% of assets based upon average balances. The residential mortgage book yielded 3.84% and represented about 10% of average assets.

The bulk of the securities portfolio consists of residential mortgages, so the issue, like so many banks face, is low yields on which durations have extended as prepayment rates plummeted. Some banks face a worse issue, in that the portfolios include sizable amounts of municipal bonds on which there is no regular principal amortization. Many of these long-duration bonds will mature when new executives — or owners — are in place.

For Truist, the offset — aside from floating-rate loans — is a great deposit franchise. Average non-interest-bearing deposits funded roughly 21% of average assets in the first quarter, down slightly from 23% in the year-ago quarter. There is no mark-to-market of core deposits, though the difference between the net spread and NIM is a good proxy in my view. The gap for Truist was 89 basis points in the first quarter: 2.89% NIM versus 2.00% net spread. The math for most commercial banks with good deposit franchises is similar.

The pain for Truist, and much of the industry, is the burden of low-coupon assets that cannot be sold without incurring a sizable loss until the bond market rallies with or without Fed rate cuts — if ever. Unfortunately, bad investment decisions made during 2020 and 2021, when deposits flooded into the banking system, are not (like the Fed's prior description of inflation) transitory. There is no way around losses recognized either through selling or through holding the bonds to maturity.

> ***Kudos to Truist management for getting a great price on the sale of the company's insurance unit.***

Some banks, like Truist, have insurance operations to sell. Others have Visa Inc. class B stock that has not yet been sold, on which sizable unrealized gains may exist. Most, however, do not.

Truist will generate about $10 billion of after-tax cash and boost its common equity Tier 1 capital ratio by over 200 bps from the sale of Truist Insurance Holdings LLC, which should close this quarter. Much of the unit was assembled via acquisitions that predecessor BB&T Corp. made over several decades. Kudos to Truist management. They got a great price for the unit at 18x EBITDA multiple, based upon my work with insurance acquirers.

Some amount of the stupendous gain may be used to reposition the balance sheet. Over a decade ago, BB&T's 2019 merger partner SunTrust Banks Inc. sold its 60 million share interest in Coca-Cola Inc., which dated to 1919, to generate capital to deal with the fallout of Global Financial Crisis-related losses.

Cadence Bank, Eastern Bankshares Inc., Trustmark Corp. and Evans Bancorp Inc., among others, have also sold their insurance operations in deals in which pricing also appears to be great. Eastern used the gain to facilitate a merger with Cambridge Bancorp. Cadence used a portion of its gain to realize bond losses.

Better to have assets with sizable unrealized gains that can be harvested, though these transactions feel a bit like selling the family silver to pay the bills.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.