STREET TALK

Excess liquidity, low rates leave banks between a rock and M&A

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Market Intelligence

Pressures on revenue from excess liquidity and low interest rates could force many banks to consider right-sizing their cost structures through M&A.

While many banks hoped that loan demand would return with an improved economic outlook and the surge in deposits over the last year would wane, that has not come to pass. Jeff Davis, managing director at Mercer Capital, said in the latest Street Talk podcast that the real risk facing the banking sector is that interest rates do not increase materially from current levels and that excess liquidity remains on balance sheets longer than many expect.

"If we stay in this extremely low-rate environment, this question of how do you generate yield is going to be a huge, not just cyclical issue for a management team, but it really becomes almost a structural or secular issue to deal with," Davis said in the episode.

Deposits ballooned across the banking sector in 2020 due to government stimulus, funds from the Paycheck Protection Program and actions by the Federal Reserve to flood the markets with liquidity.

The explosive growth has shown no signs of slowing in 2021 either, while interest rates remain historically low. Banks have kept much of their powder dry, parking large amounts of funds at the Fed where they earn just 10 basis points, with the hope that loan demand would return in force. That has not come to pass yet, and bank managers do not have many attractive yield opportunities to deploy funds in the bond market either, where Davis noted they are likely to earn 150 basis points in new purchases.

Davis said banks' traditional revenue streams have also come under pressure at a time when digital adoption has accelerated considerably due to the pandemic. Against that backdrop and a low-rate environment where deposits are worth less, Davis noted that many banks are operating with elevated cost structure associated with their branch networks.

"How do you deal with overhead, with the outlook for declining revenues that maybe are not fully appreciated by The Street? You have to combine," Davis said.

Some bankers might have recognized this and pushed social issues associated with the makeup of the pro forma's company board, management team and even brand aside when coming to the deal negotiating table.

"I think the maneuvering room is maybe less than appreciated," Davis said. "These handful of issues are huge, and they've got to be dealt head on, and I would argue they need to be dealt with now."

Davis noted that a few unique franchises were already positioned for the change. He pointed to Axos Financial Inc., which has very few branches, and the unique business model at Live Oak Bancshares Inc., which operates a nationwide small business model without branches, as examples.

He said the majority of the banking industry, however, has substantial costs associated with branches. Davis said mergers can provide institutions the cover to deal with painful issues tied to that higher-cost distribution system that has declined in value as customers increase their reliance on digital channels.

"I think we'll see a lot more of the MOES, or quasi-MOEs. I think they make sense. Sometimes the market reacts well to them. Sometimes the market does not. But the management teams and the board strategically at every institution is facing these same issues and it requires action," Davis said.

He further noted that a handful of banks announced transactions before the pandemic that gave them a running start in the new paradigm. For instance, he noted that the combination of BB&T/SunTrust — which formed Truist Financial Corp. — as well as the combination of First Horizon Corp. /IberiaBank, gave those combined institutions a head start on moving their cost structure down before the onset of the pandemic.

"We're going to see this across the industry, and it's for investors. It's not really about stroking a big gain on these transactions. It's about really about taking the cost out to protect the earnings stream as the revenue equation is going to be under pressure unless this rate regime really changes," Davis said.

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