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NASHVILLE NOTES

Banks may spend corporate tax windfall on deposit repricing

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One of my tennis partners, who is a banker, implicitly summed up the state of the business when I asked him how the quarter finished. He responded it was fine but noted there were some large loan payoffs at quarter-end. He then added that loan growth is not what he is worried about. I didn't ask, but I assume he meant sourcing low-cost (i.e., cheap) core deposits.

Good luck with that.

Banking has been a cyclical industry forever, which includes both the availability of credit and its alter ego bank liquidity. A decade ago banks — solvent ones — were in the process of rapidly transitioning from "tight" balance sheets marked by high loan-to-deposit ratios to very liquid balance sheets as funds sought the safety of the explicit Federal Deposit Insurance Corp. guarantee for small balances and an implicit guarantee for large balances deposited with the too-big-to-fail banks. The next several years brought weak loan demand, leaving most banks flush with deposits well in excess of loans. As a result, many banks retired wholesale borrowings and then invested the balance in very low-yielding bonds that offered plenty of risk and little return.

Today loans are abundant, liquidity is tight and growth in low-cost core deposits is tough to produce. However, high-cost, noncore deposits are almost always available at some price. Today the price is much higher than a couple of years ago when wholesale funding was dirt cheap.

F. Scott Dueser, CEO of First Financial Bankshares Inc., commented during a presentation I attended in May that an out-of-state bank advertised in the local paper (Abilene, Texas I presume) for a 2.4% CD. He also noted that he never had seen a bank that advertised a deposit special nationally that was not in trouble.

I do not know which institution he was referring to, but if it is the banking subsidiary of the likes of Ally Financial Inc., Goldman Sachs Group Inc., or Synchrony Financial, I am not so sure that is the same as National City, Wachovia or Washington Mutual scrambling for deposits in 2008. These companies' funding models are different from that of a traditional commercial bank. Nonetheless, the point is well taken. The wind has shifted.

The issue of how much did a particular bank have to pay to attract incremental deposits is teed up for analysts as the focal point for second-quarter conference calls. In Dueser's example the "out-of-state" bank offered 2.4% for a CD, a rate that is just below the current yield on a two-year U.S. government bond. That is expensive money for a banking system that had gotten used to virtually rate-free deposits.

But I posit a question that implies things could be worse: What if this rate and liquidity cycle transition from the cost of obtaining the marginal deposit to the cost of retaining core deposits?

A perusal of rates posted on various banks' landing pages as cataloged by S&P Global Market Intelligence indicates that most have not raised core deposits much even though Federal Reserve rate hikes have pushed short rates toward 2%; hence, the low deposit betas that are regularly cited by bank management. As an example, the national average rate for a $5,000 interest checking account is 0.11%, while a $10,000 money market is 0.24%; both amount to nothing.

Yes, more affluent consumers and corporate treasurers are demanding and obtaining higher rates, or they are moving large balances to obtain more competitive rates. But a tipping point may be at hand for a broader swath of deposits.

Both of my daughters who are in their early 20s recently asked me to help them find better rates than their bank offers without any prodding from me. They found the interest received to be insulting. Some of the funds now reside at Charles Schwab Corp.

If the entire deposit spectrum has to be meaningfully repriced higher, that could pose a risk to bank results next year. The trigger for such an event, I think, will be an economy that continues growing to an extent that forces Bank of America Corp., JPMorgan Chase & Co. and Wells Fargo & Co. to meaningfully reprice all interest-bearing deposits.

If that happens, all banks would be forced to follow suit, and it would represent a ceding of some of the corporate tax windfall to protect core deposit franchises. Of course, the big three and the super-regional banks are rational competitors. They will have to be pushed into a corner to make such an impactful decision.

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