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Loan yields continue to grind lower

By Jeff K. Davis

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Early reporters JPMorgan Chase & Co. and Wells Fargo & Co. did not provide the Street with any real surprises on Friday when third-quarter earnings were released; neither did the conference calls. That results were supported by a nominal $75 million loan loss provision at Wells Fargo and a negative loan loss provision of $543 million at JPMorgan was not a surprise either, though JPMorgan's $9.2 billion provision to build the legal reserve (to $23 billion) is another form of a credit cost today, even though the size of the charge makes it extraordinary and presumably nonrecurring.

As much as the Street may want to push results ex-mortgage banking as improving, I see sideways operating results for banks that have been in place for a while. The credit recovery has run its course; loan demand beyond corporate refinancing is tepid. Maybe credit costs are to the point where losses are below through-the-cycle expectations? JPMorgan's auto losses for example were 0.28% on an annualized basis year-to-date. The one standout exception is underwriting and advisory that constitutes investment banking revenues at JPMorgan, which on a year-to-date basis rose 15%. These activities are closely linked to traditional large corporate financing and imply more activity than flattish commercial loans since year-end at both JPMorgan and Wells Fargo imply.

While perhaps stabilization is near for larger banks, I continue to think the one area investors should pay close attention to when thinking about earning power of a given bank is loan yields, which remain under pressure due to competition and excess liquidity in the banking sector. Unfortunately, investors cannot directly see the result of weakening underwriting standards that may accompany price competition until it is too late. Loan yields can move in a given quarter for any number of reasons, ranging from a significant move in nonaccruals to changes in underlying benchmarks like 30-day LIBOR. The CRE yield at Wells Fargo increased 20bps from the second quarter to 4.12%. But the yield on the $188 billion C&I portfolio continues to grind lower, declining 11 bps from the prior quarter and 26bps from the year ago quarter to 3.58%. The yield on JPMorgan's $723 billion loan portfolio fell 5bps and 41bps to 4.57%.

There is no shoe waiting to drop from sustained pressure on yields. Only unexpectedly large and sustained credit losses pose disaster to investors given leverage inherent in bank balance sheets. And the corporate bond market for now continues to signal serenity as measured by credit spreads; however, declining loan yields when deposit rates cannot re-price lower point to underlying pressure on core profitability of the banking model. Wall Street seems as though it wants to look past this, especially when measuring performance on 90-day cycles and asserting earning power based upon higher short rates. The reality is that loan yields are easing and the earnings outlook for most banks is flat at a time when credit costs are very low.

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