B | S Perspectives

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Quarterly Earnings Review | 2019 | Q2

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REGIME CHANGE

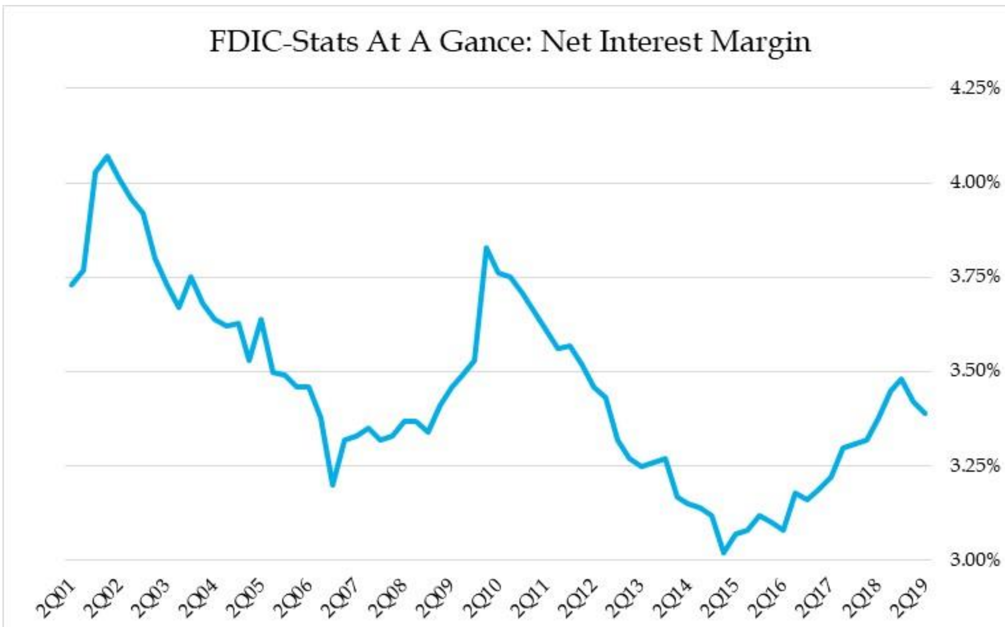
We have seldom (never?) sat down in front of our computer to write a Perspectives piece to find that words have failed us. After all, readers know that we almost always have a strong point of view—pro or con, yes or no, good value versus value trap—and that we are seldom caught out without a determined opinion about where the banking industry is headed. But we must admit that at this point we are forced to deal with a number of competing scenarios that would send the prospects for bank profitability in very different directions, and that reality requires more than the usual amount of mental gymnastics and careful wordsmanship.

How a few words can change things—especially when those words are "mid-cycle adjustment," a seemingly innocuous phrase uttered by the Chairman of the Federal Reserve on July 31. That was Jay Powell's explanation for the Fed's 25 basis-point cut to the Fed funds rate, which was the first cut since the Financial Crisis. The cut was widely anticipated and should have come as no surprise to the markets, but it did, indeed, resulting in market volatility that prevailed through the normally moribund month of August. It seems that—for the moment, anyway—the path that the Fed had laid out months ago toward normalizing rates and encouraging a steeper yield curve (and eventually easing out of its role as the enabler of global equity markets) has been abandoned in favor of "data dependence" and the fighting of "global headwinds."

One financial pundit characterized Chairman Powell's new dovish stance as a moment of "regime change," and we would agree. The problem is this—what is the new regime, exactly? If the old one was a return to a state of interest rate normalcy in response to strong economic growth, then is the new one a period of interest rate "abnormalcy"? Is this period of fighting global growth headwinds indefinite, or does it have both a time limit and a limit on how much the Fed can do to stave off a recession after one of the longest expansions on record? Will the Fed flirt with the idea of negative rates yet once again, in spite of the demonstrated damage that such a rate regime has done to the European banks?

In fact, that is one of our primary concerns—that the Fed is throwing the American banking industry under the bus in its quest to keep the capital markets elevated. We fear that Powell and his colleagues are taking the present robust state of the American banking industry for granted, forgetting the years of shareholder pain that came in the wake of the Financial Crisis as the industry reduced dividends, built ample capital cushions, and generally turned itself into the world's premier banking industry. Indeed, the *Wall Street Journal* recently highlighted the global dominance of American banks in a September 4 article titled "How American Banks Took Over the World," and while this piece detailed the successes of the nation's largest banks, a similar declaration of success could be made for the nation's growth community banks as well.

Perhaps the Fed is making a calculated bet that the American banks—large and small—are strong enough and profitable enough at this juncture to allow it to make the interest rate cuts that will inevitably present challenges for bank profitability even as they prolong growth. Indeed, the impact of falling rates and the aberrational yield curve on net interest margins was widely evident in second quarter results as the Fed's December increase in rates (a fond memory at this point) played out and the banks were caught in an interim period of higher deposit costs and falling asset yields. The NIM at the Southeast's largest banks took a tumble in the second quarter—from 3.20% in 1Q19 to 3.11% in the second—and **Bank of America Corp. (BAC)** CEO Brian Moynihan forecast a $175 million negative impact on net interest revenues (in the banking book) going forward as a result of the shape of the curve. This is hardly a devastating hit coming on a base of $12 billion in quarterly net interest income, but it is indicative of the direction and magnitude of margin erosion that will be experienced among the larger banks.



Source: FDIC

Net interest margin trends are always trickier in the community banking segment due to the variation in funding sources and the different business strategies of these companies, but CEO Robert Hill of **South State Corp. (SSB)** seemed to sum it up in his guidance that, while SSB's trends ultimately depended upon the continuation of strong non-interest-bearing deposit growth, it was wise to assume "modest compression" in the NIM going forward. Terry Turner of **Pinnacle Financial Partners (PNFP)**—a bank concentrated in commercial lending and more reliant on negotiated funds—has directed PNFP's relationship managers to begin rate renegotiations with their clients to reflect the new interest rate reality. (We'll be interested to see how these talks have turned out.) But overall, the consensus in the banking industry is that the costs of deposits will begin to come down after peaking in 3Q19.

During the recent years of low rates, the banking industry has consistently responded to net interest revenue challenges by cutting overhead, and those trends continue to be reflected in quarterly earnings trends. There have been ongoing expense cutting programs among the major banks—within Bank of America and **Wells Fargo & Co. (WFC)**, most notably—and the success of these efforts continued to drive down the overhead ratios in this segment, from 59.2% in 1Q19 to 57.7% in 2Q19. (We would note, however, that Wells Fargo has recently indicated worse revenue trends than anticipated and likely slower progress toward its goal of a 60%-or-better overhead ratio, versus 63.7% in 2Q19.)

Overhead ratios have historically not received the same level of attention in the community banking segment—these banks tend to operate with less of a regulatory and compliance infrastructure than the majors and tend to have a more easily understandable correlation between revenues and what it takes to generate them—but we wonder if even the growth community banks will not have to take (yet another) scalpel to expenses if the current rate environment prevails.

Many of these companies have been active acquirers over the past few years and most have at this point achieved the first "tranche" of expense saves from their acquisition programs. But even very efficient community banks like Pinnacle Financial (48.4% Overhead Ratio in 2Q19) continue to consolidate branches acquired in the **BNC Bancorp** deal, while "transforming" banks like **Atlantic Capital Bancshares (ACBI)** (59.5% Overhead Ratio) are cutting expenses the old-fashioned way (by reducing salaries and benefits.) Our gut feel is that there is still ample room for most of these banks to achieve operational efficiencies in the face of revenue challenges—and to upgrade and modernize product offerings and product delivery in the process—and we expect that we will hear more about the subject of expenses in 2H19 than we have heard in some time.

Where the Fed taketh away, the Fed also giveth, and the ongoing astonishingly positive credit quality environment may be the most positive result of the Fed's newly dovish stance. We saw a few blips in 2Q19 credit trends, but increases tended to have no origin in any one lending segment or industry and instead tended to be a natural consequence of an extended credit cycle.

But we must also note that the issue of CECL is ongoing, in spite of regulatory blowback, and the banking industry will begin to comment on this coming event more extensively in the upcoming quarter. Our view is simple—with the possibility of recession rising and with bank stocks underperforming, this could not be happening at a worse time. And with levels of criticized assets at historic lows for most banks, is it an efficient use of capital to be raising the level of the loan loss reserves throughout the banking industry dramatically? We take Bank of America's 1Q19 admonition that they might have to raise reserves by as much as 20% in response to CECL as a serious possibility, and wonder whether creating a capital hole in advance of a possible economic downturn is wise policy for any regulatory entity involved.

So margins are compressing, expenses will need extra attention, fee income will likely get a short-lived bounce from increased mortgage activity, the credit cycle will remain beneficent, and banking life goes on. In the last few days, the overall environment has brightened somewhat as long rates have mysteriously risen in the face of a likely Fed rate cut today, and there has been just the glimmer of a market rotation from "growth" stocks into "value" shares. Bank stocks have been major beneficiaries of this new favorable sentiment. So we have to ask—WHERE are the DEALS?

We cannot imagine a time when it would be more advantageous for community banks to be thinking about (and then doing) beneficial mergers. While core deposit funding may not be as dear in a period of falling rates as it was even a few months ago, the fact remains that the acquisition of non-interest-bearing core deposits helps squeeze the last few drops out of whatever yield may be out there, and with deposits come customers who may want broader relationships with a larger bank. The expense case should be self-evident—while the bulk of saves generally come from the acquired bank, we have never seen a bank merger that did not present an opportunity for the acquirer to take yet another look at its own cost base and to eliminate services (and personnel) that might not be up to snuff.

The fact that low rates will extend the cycle of strong credit quality is yet another plus for merger transactions, as due diligence will not be taking place in an environment when a change in the credit environment is imminent, and the work-out of possibly troubled assets can proceed at a more reasoned and profitable pace. And finally—FINALLY—it is very possible that the whole regulatory attitude toward bank deals—of any size—may do a 180-degree turn should a Democrat win the presidency in 2020 and banks once again come to be seen as the enemies of income equality. While we understand and respect the words of **ServisFirst Bancshares (SFBS)** CEO Tom Broughton in his bank's 2Q19 call that "we will use excess capital at an appropriate time", it's hard to see any time in the near future that may be more appropriate than now.

But in the absence of deals, there are other tacks that may be taken by banks, and these are worth considering in an atmosphere when the whole purpose of American companies is getting a rethink. Jamie Dimon, the acknowledged "thought leader" of American banking, said earlier this year that **JPMorgan Chase & Co. (JPM)** would discontinue giving quarterly guidance in the hope that investors would begin to focus more on the company's long-term goals and potential than on the day-to-day path of earnings minutiae. (This was a view that has been long promoted by Warren Buffett and his peers.) This change has been followed by Mr. Dimon's (and the Business Roundtable's) recent advocacy of the "stakeholder" concept of corporate management, where employees, customers, and "societal good" are given equal consideration with the rights of shareholders in the setting of corporate goals.

We have written in other venues that Mr. Dimon's views are very likely informed by his experience as a banker who has long functioned within the structure of a regulated oligopoly, one where his bank's fate is not always entirely within his hands. (One need only remember how TARP funds were "distributed" to appreciate the degree to which banks must sometimes subjugate corporate independence to regulatory fiat.) And while he has received a fair amount of pushback on his advocacy for stakeholders, we think that his view on eschewing quarterly earnings guidance to the emphasis of longer term goals will begin to gather more adherents.

We have been speaking recently with managements of the growth community banks, and the observations of one young CFO of a fast-growing bank especially gave us some food for thought. When asked what his "top of mind" issues were these days, he named one esoteric topic—the transition from LIBOR to the "Secured Overnight Financing Rate" (SOFR)—and how banks may be unprepared for that transition. But he also mentioned an issue with which most bankers can identify: how much capital is appropriate for this stage of the economic cycle, particularly given pressure from investors to return capital and to lower tangible capital levels.

His third issue had immediate resonance with us—whether his company should give up present profitability to the cause of funding future growth, especially with the earnings challenges that are inherent in an environment of slowing growth. (Jamie Dimon would be proud, we're sure.) Can you imagine—bankers everywhere beginning to worry more about the future and less about Wall Street and its need for the quarterly attainment of to-the-penny earnings estimates?

Bank stocks as safe, long-term investments—now that is what we call regime change.

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