US banks

Banks are benefiting less than expected from higher rates

US institutions hurt by stubbornly low bond yields and hints of rising competition

2 HOURS AGO by: Alistair Gray in New York

Along with lower taxes and financial deregulation, higher interest rates were supposed to give a big boost to US banks after Donald Trump's election.

Executives have been telling investors they will be able to push up charges for borrowers, pay a pittance to savers, and pocket the difference.

The Federal Reserve has obliged by increasing base rates three times since December.

However, a mixed batch of financial results in recent days shows that a recovery for banks from years of depressed returns is not as straightforward as some investors believed.

"Interest rates are going up, and we're starting to see some benefits, but in some cases it's not quite turning out to be the case," said Chris Wheeler, US bank analyst at Atlantic Equities. "We're still trying to understand what the full impact is."

The dynamics in the US hold lessons for executives in banks based in Europe and elsewhere, who are similarly hoping tighter monetary policy could give succour to their institutions.

Bank of America, Citigroup and JPMorgan Chase all posted lower net interest margins — the spread between what banks pay for their funds and what they earn from lending and other activities — in the second quarter compared with the first.

Among the big four US retail banks, only Wells Fargo managed to eke out an increase in the closely watched metric.

Sadly for bank investors, the interest rate set by the Fed is far from being the one that determines bank profitability. Yields on bonds, which are set not in Washington but in the capital markets, are just as influential. These have tumbled since March as investors have taken a dimmer view about the prospects for the US economy and inflation.

Charles Peabody, analyst at Compass Point, said some investors had "underestimated" the profit-sapping impact of what is known in the jargon as a flattening yield curve.

"Forward guidance isn't being met," he said. "It's telling me we're at an inflection point. We're at an end of the cycle."

To be sure, some of the boost to bank bottom lines from rising rates has indeed come to pass. Plenty of bank loans are short-term; interest charges on them easily reprice upwards. In some cases they automatically do so soon after the Fed raises rates, under the terms of the loan.

The US "prime rate" — used to determine interest charges on several types of assets such as credit cards and some corporate loans — has risen from 3.5 per cent a year ago to 4.25 per cent.

Other loans, however, are longer term. Terms on mortgages, for instance, stretch out for decades.

"We had a significant improvement in net interest income from the short end — but the long end also did significantly impact us relative to what we were expecting," said Paul Donofrio, BofA's chief financial officer, citing the group's securities portfolio.

JPMorgan, meanwhile, cautioned that its net interest income this year would be $500m less than it had previously guided, in part because of downward pressure from lower long-term interest rates.

The theory that higher interest rates allow banks to automatically boost returns on short-term loans is also being tested.

For instance, the return that BofA made on its $89.5bn credit card loan book was unchanged at 9.55 per cent. That may mean that more customers are paying off their cards on time, and so are avoiding interest charges completely. It could also reflect intense competition in the credit card industry.

So far, banks have been able to limit the amount they pay out to savers. The average rate on savings accounts has remained unchanged — at 0.08 per cent — from a year ago.

However, executives acknowledged they were starting to feel the need to offer better deals to more corporate and institutional depositors, which are less likely to put up with measly returns.

“In the wholesale space, we’re seeing it,” said Marianne Lake, JPMorgan’s chief financial officer. “In the retail space, we haven’t seen that yet.” She described the phenomenon as a “tale of two cities”.

Forward guidance isn’t being met. It’s telling me we’re at an inflection point.

CHARLES PEABODY, COMPASS POINT

Moreover, deposits are not the only source of funds. Banks also rely on wholesale funds from institutional investors.

Bank of America’s payments to depositors of $346m accounted for little more than 10 per cent of its total interest expenses in the second quarter. Holders of the bank’s long-term debt received almost five times more, at $1.59bn.

Mr Wheeler, of Atlantic Equities, said this was a reflection in part of post-crisis regulation, which had changed the structure of bank balance sheets.

“There’s been a lot of changes since the financial crisis and it’s difficult for us to understand quite what the unintended consequences are,” he said.

Executives also pointed to rather more prosaic factors constraining interest margins. Citigroup, for instance, noted that its cash balances had risen about $36bn from a year ago. The bank sought to build liquidity to comply with regulators’ “living will” regime.

“We had some transient kind of things this quarter — there are a lot of variables that go into this,” said BofA’s Mr Donofrio, referring to the bank’s net interest income. “One of the biggest ones, by the way, is predicting people's behaviours, predicting customers. But look, we feel good about where we are."