Banking Sector Analysis

Commercial Banking after the Crisis: Steady as She Goes at the Expense of Some Profitability

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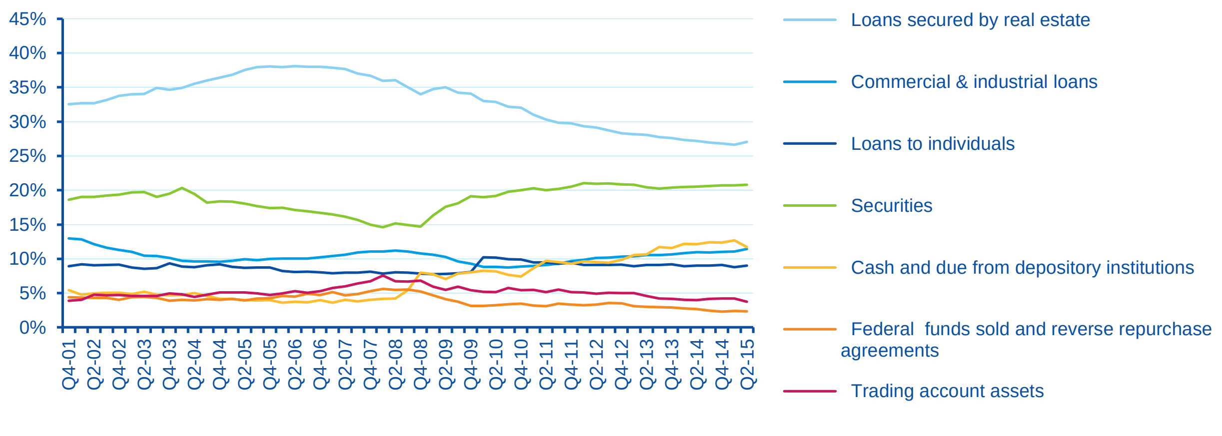
- **The banking industry's balance sheet is significantly transformed as a result of the crisis**
- **Returns on assets and equity have stabilized at lower levels than before the crisis**
- **We expect steady growth in deposits and loans over the next four years**
- **While the industry's financial performance could improve, it will not be dramatic**

Commercial banking in the U.S. has undergone significant changes since the global financial crisis as a result of regulatory changes and increased risk awareness. The industry has adapted to the new reality, but at the expense of some profitability. This brief primarily analyzes FDIC data from the end of 2001 to mid-2015 to identify how the industry's post-recession balance sheet and performance compares to the period before the crisis. It also presents an outlook for the next four years.

Balance Sheet Changes, Pre vs Post Crisis

Assets of commercial banks and savings institutions[1] look different today than before the crisis, as seen in Chart 1. The biggest shift has been the movement away from real estate. Loans secured by real estate have declined from a high of 38% of assets in Q2 2007 to 27% in Q2 2015. This ratio increased slightly from 26.7% in Q1 2015, which was the lowest level since the FDIC started publishing its Quarterly Banking Profile in 1984. Loans secured by real estate, together with mortgage backed securities, accounted for only 38.4% of assets in Q2 2015 (up slightly from 37.9% in Q1 2015), whereas they made up close to 48.6% of the industry's balance sheet in Q2 2006.

Chart 1
Types of Assets as Share of Total Assets, Percent (All FDIC-insured Institutions)

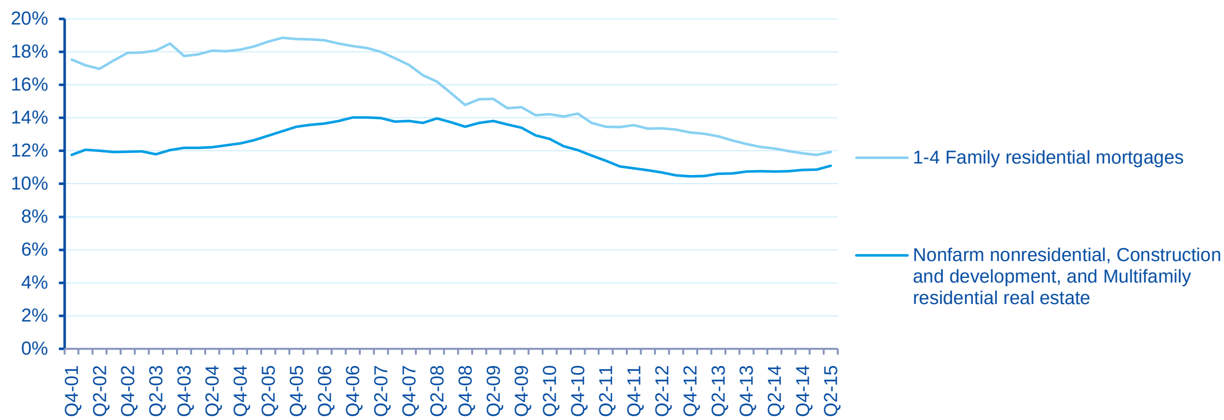


Source: FDIC and BBVA Research

[1] Commercial banks account for the vast majority in the data and determine the main trends

This relative reduction is a result of the decrease in home prices (S&P/Case-Schiller Home Price Index in May 2015 was 172, compared to a high of 185 in June 2006) and home sales volumes (existing home sales in July 2015 stood at 552,000, compared to a high of 699,000 in September 2005[2]), a 60% drop in construction and development loans, and a 28% drop in the volume of home equity lines of credit. The increase in originations of mortgages by non-bank lenders has also likely contributed to the trend. According to a March 2015 report, in just three years, large non-banks' share of mortgage originations doubled to 42%, and non-banks' share in mortgage servicing more than tripled to 27%.[3] Comparing different types of loans secured by real estate (Chart 2), it can be seen that the share of 1-4 family residential mortgages has decreased more than the share of other non-farm real estate lending.

Chart 2
Share of Different Types of Loans Secured by Real Estate in Total Assets, Percent (All FDIC-insured Institutions)



Source: FDIC and BBVA Research

While real estate related lending has gone down, investments in securities have increased to close to 21% of assets, after a dip in the period around 2008 when they dropped to below 15% of assets. This brings the share of securities in total assets slightly above where it stood prior to 2004. Investments in securities are used to manage cash, risks, and liquidity, and are tied to regulatory requirements and the level of non-interest bearing deposits collected. Cash and due from depository institutions has increased from an average of around 5% of assets before the crisis to around 12% in Q2 2015, to a large extent due to regulatory changes. The higher cash holdings have contributed to the stability of the banking industry's balance sheet, but also lowered its profitability. As banks have also been dealing with compressed interest margins in the post-crisis low interest rate environment, some have started to search for other high risk-return sources of revenue.

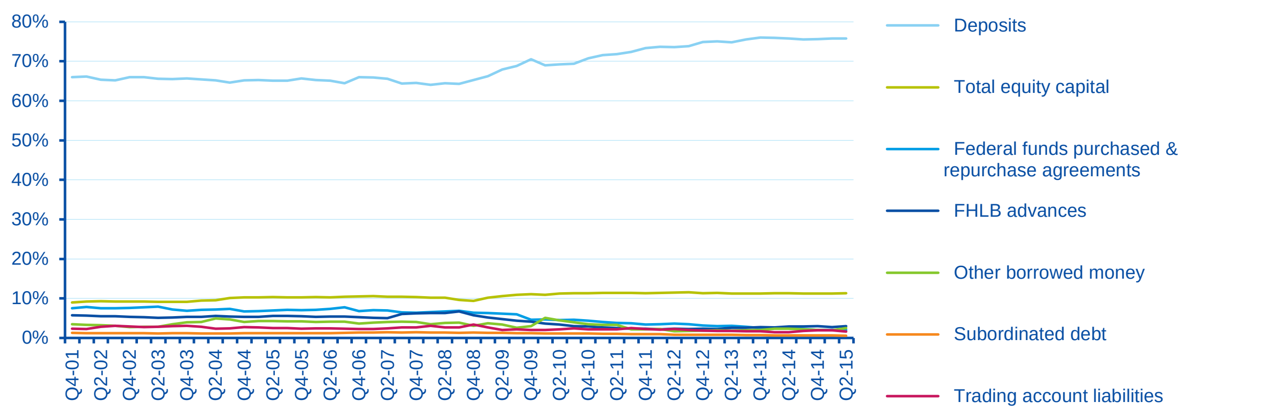
The increase in commercial and industrial (C&I) loans has offset to some extent the decrease in real estate lending. C&I loans currently account for over 11% of assets, compared to a low of 8.7% in Q3 2010. In nominal terms, C&I loans went from $1.17 trillion in Q3 2010 to $1.80 trillion in Q2 2015, which represents 9.6% compound annual growth rate (CAGR), reflecting the improving economic environment over this period.

On the liabilities side, as shown in Chart 3, there has been an increase in the shares of deposits and equity capital in total liabilities and capital, at the expense of all other sources of funding. Deposits have increased from

[2] National Association of Realtors. Economics and Research Division. "Home Sales."
[3] Goldman Sachs Equity Research. The Future of Finance. The rise of the new Shadow Bank. March 3, 2015

around 65% before the crisis to around 75% after. This was driven to a large extent by increases in non-interest bearing domestic deposits, which have increased from around 11% to around 18% of total liabilities and equity capital. Non-interest bearing deposits have tended to increase when there has been a high preference for liquidity due to uncertainty and volatility, so, quite expectedly, they have increased rapidly in the 2008-2011 period. The trend continues to date but at a slower pace, and might also be a result of banks seeking cheap funding. While the increase in non-interest deposits might have contributed somewhat to the profitability of the sector, it has limited the space for stronger loan growth, thus indirectly hurting the profitability of the sector at the same time. The large increase in non-interest bearing deposits also explains to a certain degree the increase in investment in securities.

Chart 3
Types of Funding as Share of Total Liabilities and Equity Capital, Percent (All FDIC-insured Institutions)



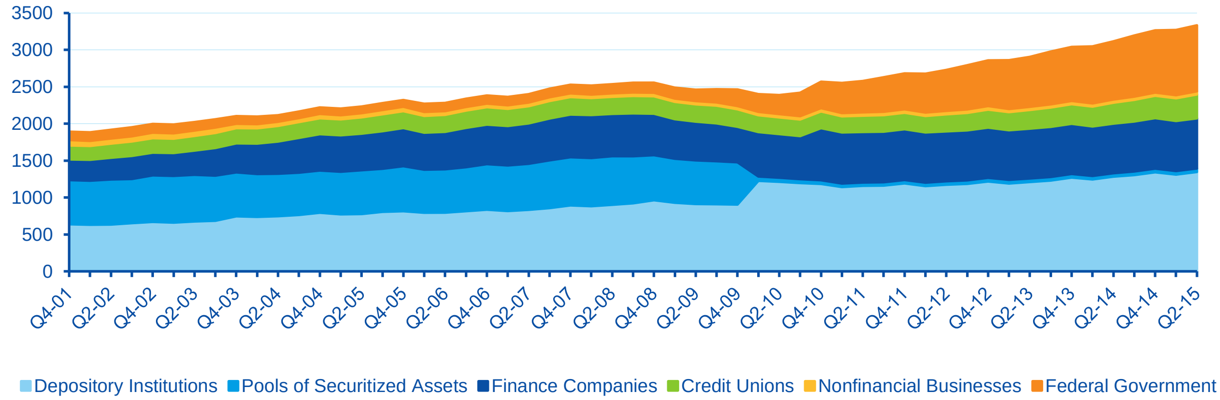
Source: FDIC and BBVA Research

What is Going on with Consumer Credit?

Non-real estate related loans made by commercial banks and savings institutions to individuals have accounted for less than 10% of total assets after the crisis, as shown in Chart 1. In nominal terms, these loans have been roughly flat for quite some time (Chart 4) after taking into consideration that part of the credit reported as "held in pools of securitized assets" prior to 2010 is now reported as credit "held by depository institutions[4]." All of this has happened while consumer credit overall (including lenders other than depository institutions) has increased by 4.25% CAGR over the last 10 years, but with almost all of the growth coming from non-revolving credit expansion - more specifically, federal government student loans. Loans by commercial banks to individuals are roughly the same today as at the beginning of 2010, likely reflecting decreased propensity to borrow, lower consumer confidence compared to the period before the crisis, and household deleveraging. That said, there has been one exception – auto loans have increased at 8% CAGR since 2011, a result of the increased pace of replacement of older vehicles after the crisis, necessary to keep up the functionality of the U.S. vehicle fleet.

[4] The change is based on the reporting requirements issued in Financial Accounting Standards Board's Financial Accounting Statements 166 and 167.

Chart 4
Major Holders of Consumer Credit, Billion $

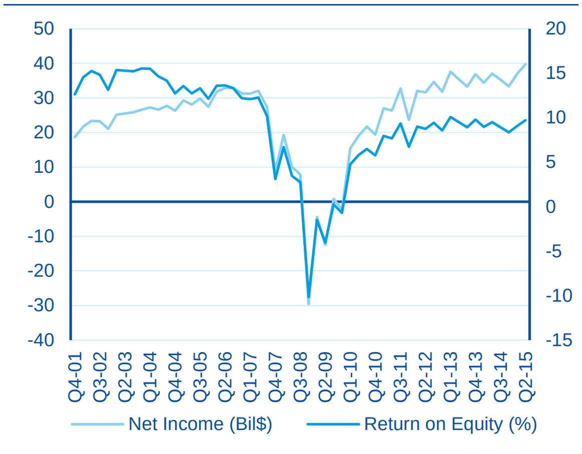


Source: Federal Reserve Board and BBVA Research

Overall Financial Performance

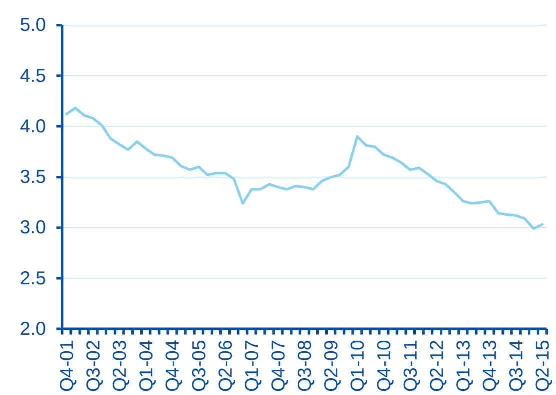
While the total net income of commercial banks has recovered to pre-crisis levels, the return on equity (RoE) was about 7.6% over the last six years, compared to 13.6% in the six years prior to the crisis, as shown in Chart 5. Return on assets (RoA) also decreased, averaging 0.85% over the last six years, compared to close to 1.31% in the six years prior to the crisis.

Chart 5
Net Income and Return on Equity, FDIC Insured Commercial Banks



Source: Haver, FDIC and BBVA Research

Chart 6
Net Interest Margin, FDIC Insured Commercial Banks, Annual, Percent

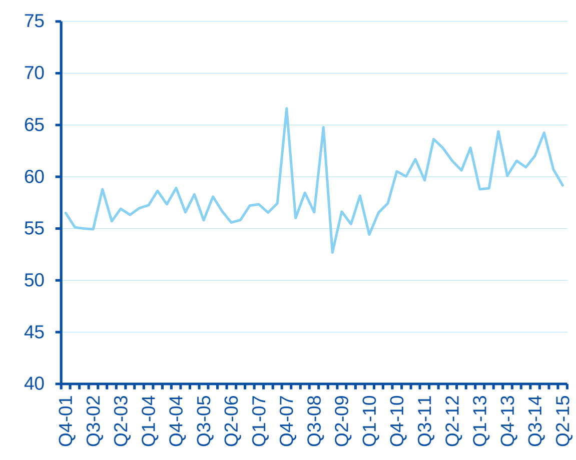


Source: Haver, FDIC and BBVA Research

Net interest margin (NIM) was down to a decade low of 3% in Q1 2015, but increased slightly in Q2 2015 to 3.1% (Chart 6). NIM has been decreasing because of the prolonged low interest rate environment, which compressed the interest rate spread between loans and deposits. The efficiency ratio[5] after the crisis is higher (Chart 7) averaging 60.2% over the last six years, compared to 56.8% in the six-year period before the crisis, indicating that more operating revenues are being absorbed by overhead expenses. The increase is a result of the faster growth of non-interest expenses than operating revenues. Close to 90% of non-interest expenses consists of salaries and benefits, and "expenses other than salaries and benefits and property and equipment"[6]. That said, the ratio has been improving this year, but it is too early to conclude that it is a trend. Going forward, the industry could increase the efficiency ratio by increasing operating revenues as the economy grows, while containing the growth of non-interest expenses. Noninterest income has not been growing as fast as before the crisis.

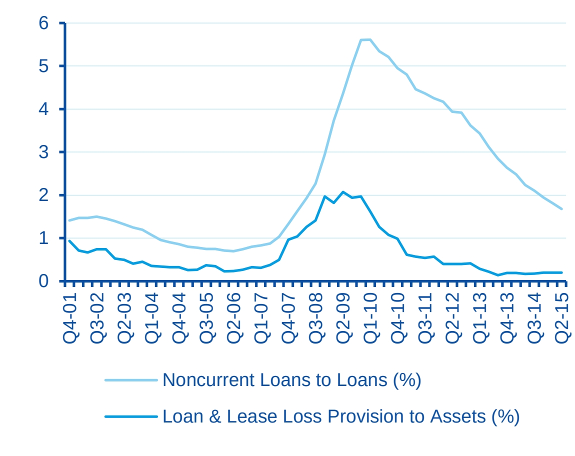
The industry today seems stable with loan and lease loss provisions at 0.2% of assets for the industry, less than in any quarter from 2002 to 2008, but slightly higher than the 0.14% minimum in Q3 of 2013 (Chart 8). Non-current loans to total loans have also been consistently decreasing since the 2009 peak, a signal of better economic conditions.

Chart 7
Efficiency Ratio, FDIC Insured Commercial Banks, Percent



Source: Haver and BBVA Research

Chart 8
Noncurrent Loans and Loss Provisions, FDIC Insured Commercial Banks, Percent



Source: Haver and BBVA Research

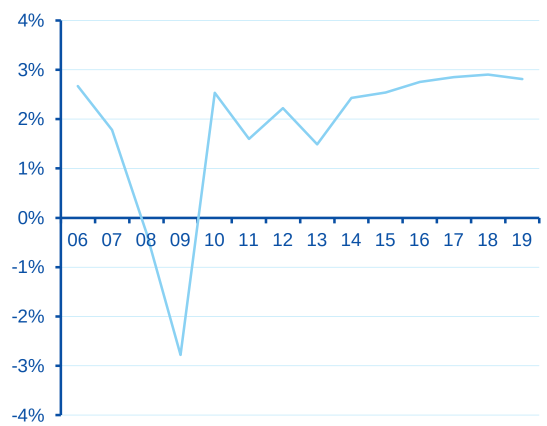
What to Expect Going Forward?

In light of our forecast of a moderate increase in GDP (Chart 9), we expect deposits to grow around 6% per year until 2019, and loans by 6.5% (Chart 10). The loan to deposit ratio will not change much from its current level, and will stay significantly below what it was prior to the financial crisis, to a large extent due to regulatory requirements. Our models suggest that the demand for loans should not be significantly impacted by the anticipated gradual increases in the federal funds rate, as the level of economic activity and the resulting expectations play a much larger role in determining the demand for credit. In the next four years, the industry will face difficulty in significantly increasing its profitability from the current level, as the capital and reserve requirements are likely going to stay stringent and banks will remain precluded from engaging in high-risk

[5] Noninterest expense less amortization of intangible assets as a percent of net interest income plus noninterest income. Measures the proportion of net operating revenues that are absorbed by overhead expenses. Lower value indicates greater efficiency
[6] Expenses other than salaries and benefits and property and equipment mostly consist of: data processing expenses, advertising and marketing expenses, directors' fees, printing, stationery, and supplies, postage, legal fees and expenses, FDIC deposit insurance assessments, accounting and auditing expenses, consulting and advisory expenses, automated teller machine and interchange expenses, and telecommunications expenses.

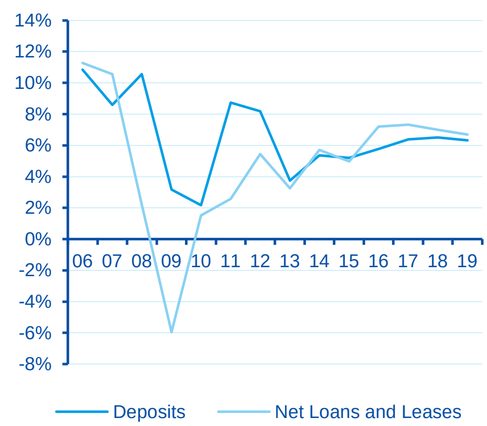
activities. However, the anticipated higher interest rate environment is likely to benefit the industry, as the pressure on the interest rate spread between deposits and loans will decrease, as long as the demand for loans stays as predicted. We do not expect the industry to face existential threats to its business model during the next four years, but challenges in the mid- to long-run are possible, coming from disruptors that deploy technology to capture parts of the commercial banks' value chain – primarily on the lending side. Deposit-taking is likely going to stay the domain of banks for the foreseeable future.

Chart 9
Real GDP, Annual Growth, Percent



Source: Haver and BBVA Research

Chart 10
Deposits and Net Loans and Leases, Annual Growth, Percent



Source: Haver and BBVA Research

In sum, the U.S. commercial banking industry has adapted to the new reality after the financial crisis, but at the expense of some profitability. The industry seems positioned to benefit from the economic developments we expect in the coming period, primarily continuously expanding GDP; however, it will not be able to return to the levels of profitability reached before the crisis.