Banking Watch

Banking outlook 1Q17

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Deposit and loan growth is expected to remain strong amid solid portfolio quality

Banks should benefit from some regulatory relief, even if large legislative changes take time to pass

Profitability will continue to improve and could be further boosted by lower corporate tax rates

The changes in banks' valuations in equity markets since the November 2016 elections are an indicator of the gains the industry stands to make in the current economic and political landscape. This brief outlines our expectations for the main industry trends in the 2017-2018 period, given the favorable macroeconomic conditions and higher interest rate environment. It also analyses the potential upside from changes in banking regulation and the tax code.

Deposits and loans

After slowing down in 2015 due to lower inflation and real GDP growth, deposit growth picked up during 2016, peaking in the third quarter at a YoY rate of 6.7%. In the 2017-2018 period, deposits are expected to grow at a rate of 5.5-6% per year, consistent with a baseline macroeconomic scenario that foresees inflation remaining under control at around 2% and real GDP growth in the range of 2-2.5% (Figure 1).

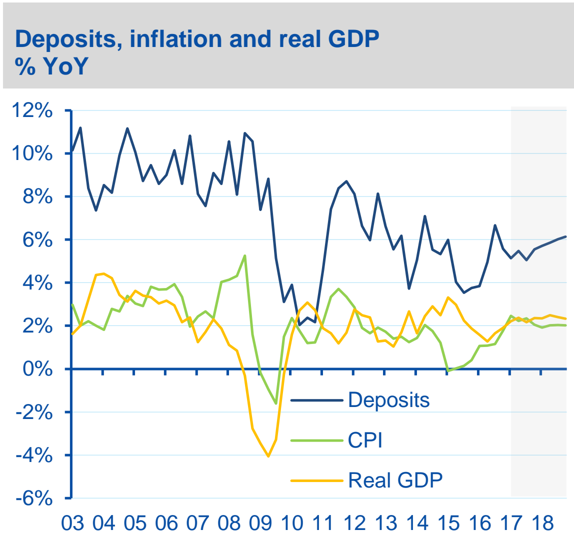
The banking sector loan portfolio grew at a rate of over 7% YoY in the first three quarters of 2016, but slowed down to 5.3% in the fourth quarter. This slowdown was primarily due to sluggish growth of banks' mortgage and commercial and industrial (C&I) loan portfolios. Mortgage growth decelerated because of a slowdown in originations for purchase, which was due to slower growth of home sales, in turn a result of tight inventories and higher home prices at the close of the year. Furthermore, refinance originations also slowed down as a result of higher interest rates after the election. The C&I loan growth deceleration was a lagged effect from the slowdown in GDP at the beginning of last year. Historically, movements in C&I loans lag nominal GDP by around three quarters. We anticipate all loan categories to continue expanding in the coming period at a solid rate (Figure 2). The industry's total loan portfolio is expected to increase at an average rate of 5.0% in 2017 and 6.0% in 2018.

In terms of retail banking, mortgage loans are expected to increase at an average rate of 2.3% in 2017, compared to 3.3% in 2016, primarily due to lower refinancing rates — a result of higher interest rates. We expect consumer loans to increase at an average rate of 5.9% in 2017, compared to 6.4% in 2016, reflecting strong job growth and higher real incomes, but also tightening of lending standards, especially for auto loans.

On the commercial side, C&I loans are expected to grow at an average rate of around 4.0% in 2017, compared to 7.4% in 2016, to some extent due to a statistical effect of a contraction in C&I loans in 4Q16 compared to the quarter before. The growth in C&I loans is expected to speed up as the year progresses due to stronger growth in the energy sector and greater risk appetite generally. For commercial real estate loans (including multifamily loans), headwinds from tighter lending standards will slow the pace of loan growth to an average rate of 7.1% — lower than in the last two years (8.1% in 2015 and 9.3% in 2016).

Figure 1

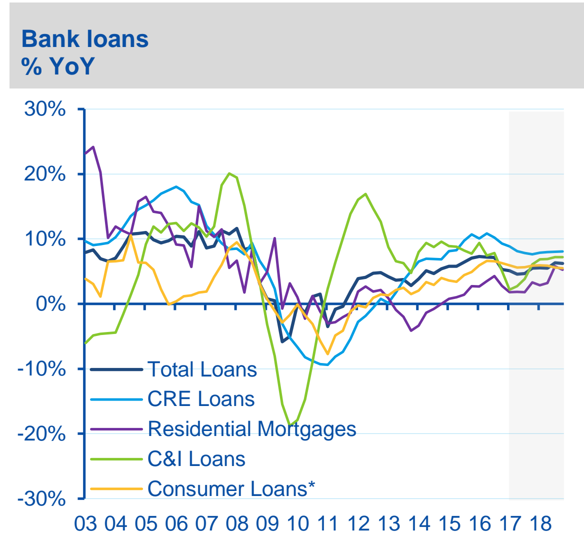
Deposits, inflation and real GDP
% YoY



Source: FDIC & BBVA Research

Figure 2

Bank loans
% YoY



Source: FDIC & BBVA Research
*Consumer loans are break adjusted for 2010 accounting change

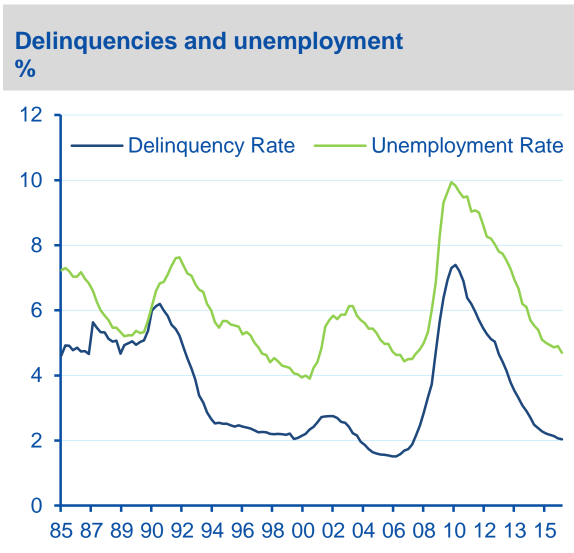
Delinquencies

The expansion of the economy over the last 7.5 years, especially the decline in unemployment, has led to strong portfolio quality for the industry overall (Figure 3). The overall delinquency rate stood at 2.0% in 4Q16, compared to a median of 2.9% since 1985. The figure is even better when taking into consideration the fact that mortgage delinquencies are still recovering from the effects of the Great Recession and are not yet back in line with their pre-crisis levels. Mortgage delinquencies are expected to continue improving, as banks' portfolios continue adding newly underwritten loans and as the share of homeowners "underwater" declines in tandem with home price appreciation. Delinquency levels for consumer loans have been increasing slowly since 2Q16, not only due to the maturing of the credit cycle, but also because of the effects from the economic downturn in some oil and gas-exposed regions.[1] The increase in consumer loan delinquencies is expected to continue, but it will be at a very slow rate, with the portfolio quality remaining solid compared to previous business cycles. C&I delinquencies have stabilized and are expected to start declining, as the shock from low oil prices abates and the oil and gas industry recovers. CRE delinquencies are expected to remain close to their current levels. All these trends will contribute to a decline in the overall delinquency levels for the industry (Figure 4). The solid loan portfolio quality should translate into low levels of loan loss provisions, which will contribute to favorable profitability of the industry going forward.

1: For more information, see brief "What's in store for consumer credit": https://goo.gl/k15jeR

Figure 3

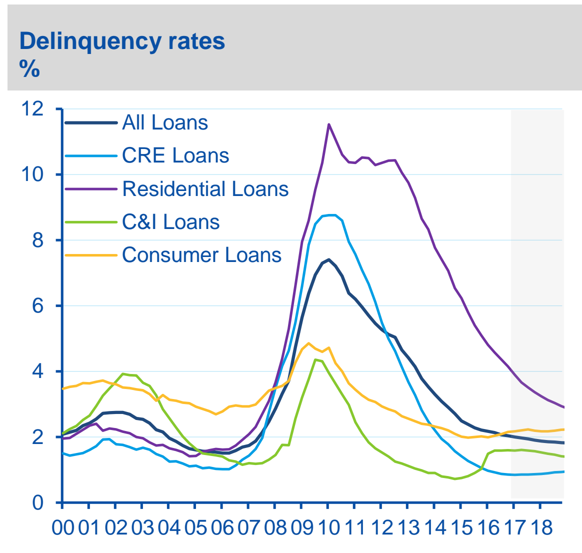
Delinquencies and unemployment
%



Source: FRB & BBVA Research

Figure 4

Delinquency rates
%



Source: FRB & BBVA Research

Costs of regulation

Since the Great Recession, the U.S. banking sector has been subject to stricter regulations (Figure 5), with the goal to increase its resiliency and curtail some of the practices that contributed to the subprime mortgage crisis and the wider financial crisis that ensued. The first wave of regulatory changes was related to mortgage lending and was followed by wider banking regulatory reform, culminating with the passage of the Dodd-Frank Act in 2010 and all the implementing regulations that followed. This new and more stringent regulation resulted in an increase in regulatory burden, as banks had to adapt to the new requirements by making changes to their processes, incurring additional operating costs.[2] Most of the operating costs incurred would show up in the banks' income statements as non-interest expenses. Additionally, with the new, more stringent regulation, banks have likely incurred some opportunity costs as well. For a bank, opportunity costs occur when regulation prevents it from engaging in profitable activities.[3] Some of these opportunity costs would be manifested in a decrease in non-interest income.

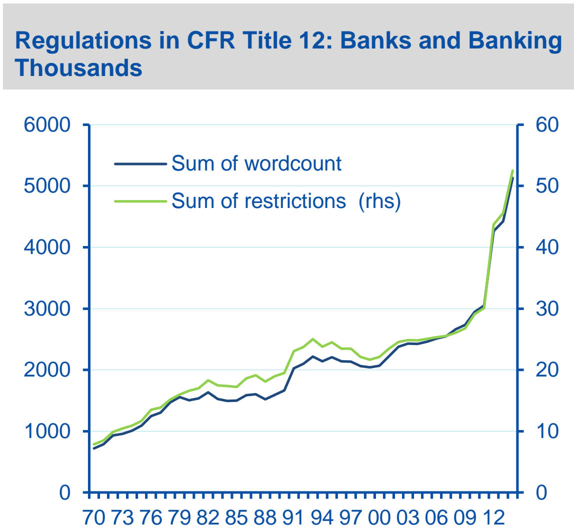
Figures 6 and 7 show the trends in actual and relative non-interest income and expense over time and the slowdown in both categories since the crisis. We developed several models to test the hypotheses that non-interest income has declined and that non-interest expense has increased since the Great Recession, while controlling for variables such as volume of loans and other earning assets, bank concentration, yield curve slope and net-interest margins. The results are mixed and do not provide clear evidence that the regulatory burden has resulted in significantly smaller non-interest income and/or significantly higher non-interest expense since the crisis, thus lowering profits for the industry overall.[4] This does not necessarily imply that the changes in

2: Elliehausen, G. (1998). The Cost of Bank Regulation: A Review of the Evidence, FRB. https://goo.gl/QWLkuT
3: Ibid.
4: While the results are mixed for the industry overall, smaller institutions could still be disproportionately negatively affected by regulatory burdens due to their inability to benefit from economies of scale based on compliance

regulation have had relatively small effects on non-interest income and expense, as the increased regulatory costs could have been offset by aggressive cost-cutting and other cost control measures, as well as bank consolidation. In addition, it is likely that the additional regulatory burden may not be teased out with the data and methods used, given the magnitude of the crisis, the slow recovery and other structural changes that impacted the economy. In any case, the increase in regulatory burden has mostly manifested itself in other ways.

Figure 5

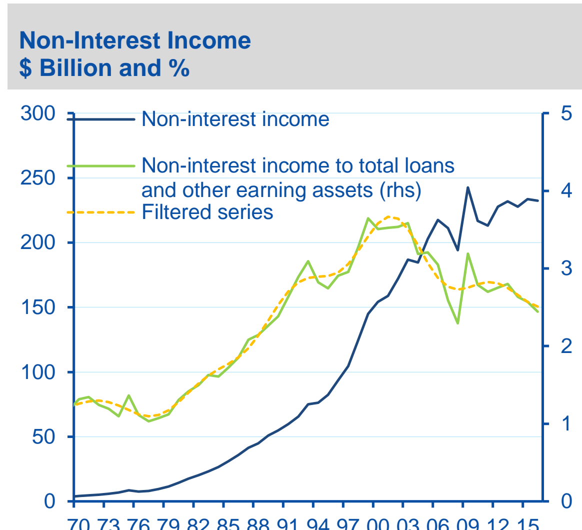
Regulations in CFR Title 12: Banks and Banking
Thousands



Source: regdata.org Al-Ubaydli, O. and McLaughlin, P.A. (2015) "RegData: A numerical database on industry-specific regulations for all United States industries and federal regulations, 1997-2012." Regulation & Governance, doi: 10.1111/rego.12107 & BBVA Research

Figure 6

Non-Interest Income
$ Billion and %



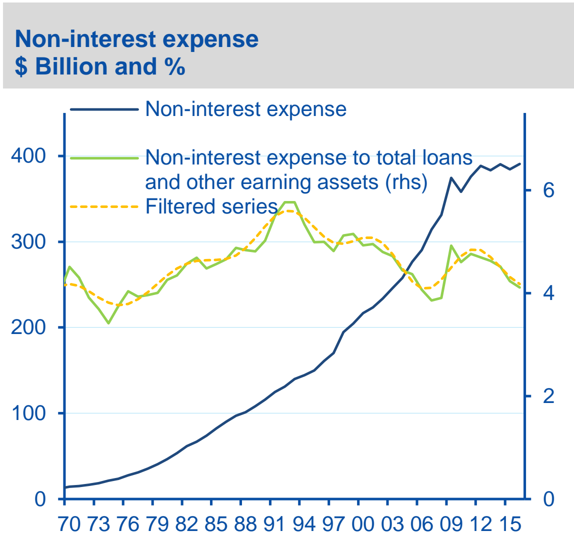
Source: FDIC & BBVA Research

Indeed, interest income has not only been lower due to lower interest rates relative to the pre-crisis period, but also due to a more conservative asset structure of the industry, to a significant degree due to stricter regulation. The ratio of net loans and leases, securities and other earning assets to total assets has declined from around 86% before the crisis to around 81% after the crisis, while the ratio of net loans and leases and other earning assets to total assets has declined from an average of around 69% to around 62% (Figure 8). Our models imply that structural factors account for around four percentage points of these differences. Not having this share of assets generating income could cost the industry up to $12.3 billion per year,[5] which is equivalent to around 3.2% of net income. Furthermore, the industry's leverage has decreased, with equity capital to assets settling at a rate that is around one percentage point higher than in the 2004-2007 period. Although this contributes positively to the stability of the banks, it also leads to lower return on equity. These findings imply a moderate upside for the industry from relaxed regulatory requirements.

5: The estimate of the upper limit is computed by multiplying four percentage points of total assets by the industry's net interest margin and reducing the potential income by the industry's effective corporate tax rate.

Figure 7

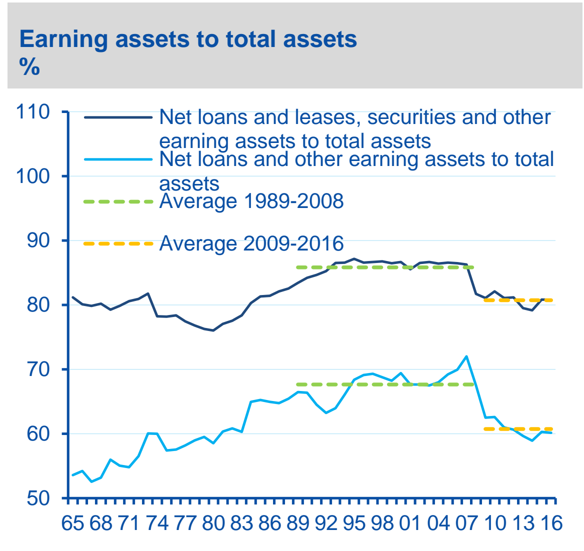
Non-interest expense
$ Billion and %



Source: FDIC & BBVA Research

Figure 8

Earning assets to total assets
%



Source: FDIC & BBVA Research

What to expect from deregulation

Administration officials have been clear that they see financial regulation as a burden and a constraint on access to credit. Because of this, on February 3, President Trump ordered a review of all financial system regulation. The Secretary of the Treasury is required to provide a report by early June that will "identify any laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other Government policies that inhibit Federal regulation of the United States financial system in a manner consistent with the Core Principles."[6] The Core Principles are: *"(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; (b) prevent taxpayer-funded bailouts; (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; (d) enable American companies to be competitive with foreign firms in domestic and foreign markets; (e) advance American interests in international financial regulatory negotiations and meetings; (f) make regulation efficient, effective, and appropriately tailored; and (g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework*."[7] It is likely that the report produced by the Secretary of the Treasury will mostly focus on principles (c), (d), (f) and (g).

The president's executive order is the first step to any Dodd-Frank reform, which even though a priority, is not the most pressing one. As stated by House Financial Services Committee Chairman Jeb Hensarling, "Clearly it comes behind Obamacare, clearly it comes behind tax reform."[8] This makes it unlikely that any significant changes to the Dodd-Frank regulations will be passed before 2018. Even then, large-scale changes will require a 60 vote majority in the Senate, which Republicans don't have, so compromise with Democrats will be

6: Presidential Executive Order on Core Principles for Regulating the United States Financial System. https://goo.gl/tlDvCG
7: Ibid.
8: Reuters. House Financial Services chairman sees Dodd-Frank reform this year. February 28, 2017. https://goo.gl/5im9sp

necessary and very difficult to achieve based on the current political sentiment in Washington. In addition to being difficult, a full repeal of the Dodd-Frank Act is also unlikely because of the administration's support for parts of it, evident from multiple public comments made by President Trump and Treasury Secretary Mnuchin.

If Republicans are able to find compromise with Senate Democrats, the alternatives for changes to Dodd-Frank range from introducing amendments to replacing parts of it with a modified version of the Financial CHOICE Act. This Act most importantly envisages the following: taking a regulatory off-ramp approach that provides relief to banks if they choose to hold higher equity capital than they are currently required to hold (many banks might find that the requirements for using the off-ramp are set very high); introducing a new chapter of the Bankruptcy code designed to accommodate the failure of large, complex financial institutions; repealing the authority of the Financial Stability Oversight Council (FSOC) to designate firms as systematically important financial institutions (SIFIs); repealing the Volcker Rule; providing regulatory relief for community financial institutions; and reforming the Consumer Finance Protection Bureau (CFPB).[9] The CFPB has so far avoided too much attention from the new administration and Congress, but its future is still unclear. Ultimately, the most likely outcome is that CFPB will be kept in place, but with somewhat curtailed authority and a lighter touch approach.

Regarding regulation and supervision by the Federal Reserve, the departures of Governor Daniel Tarullo and General Counsel Scott Alvarez create a relatively clean slate for the incoming vice-chair for supervision that President Trump could appoint, who is likely to be more bank-friendly. This represents some upside for the industry. Last, but not least, the U.S. push for higher capital requirements in the so-called Basel IV negotiations, often against the pushback from European and Japanese representatives,[10] has eased since the election. To sum up, while it is likely that the Trump administration is going to take a softer approach to banking regulation, large-scale deregulation will take some time and will be difficult to push through.

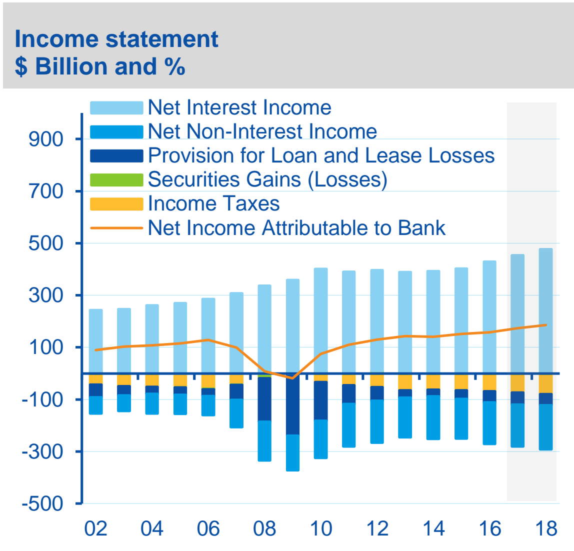
Profitability

Based on the current baseline macroeconomic scenario, loan growth and high quality loan portfolio, we anticipate a continued increase in net income for the industry going forward, even without changes in the regulatory environment (Figure 9). This will help improve the industry's return on assets and equity (Figure 10), which will nevertheless remain well below pre-crisis levels. The industry stands to benefit further from any favorable regulatory changes, but how much is difficult to quantify at this point. In regards to tax reform, if Congress lowers the corporate tax rate as proposed, the banking sector stands to benefit immediately and significantly. A move to a 20% corporate tax rate could boost banks' net income by around $26 billion in 2018, which would raise the industry's return on equity from a projected 9.5% to almost 11%.

9: House Financial Services Committee. The Financial CHOICE Act. https://goo.gl/9vFmcj
10: Bloomberg. Trump May Save Banks Billions by Disrupting Global Rules. https://goo.gl/tuPfeH

Figure 9

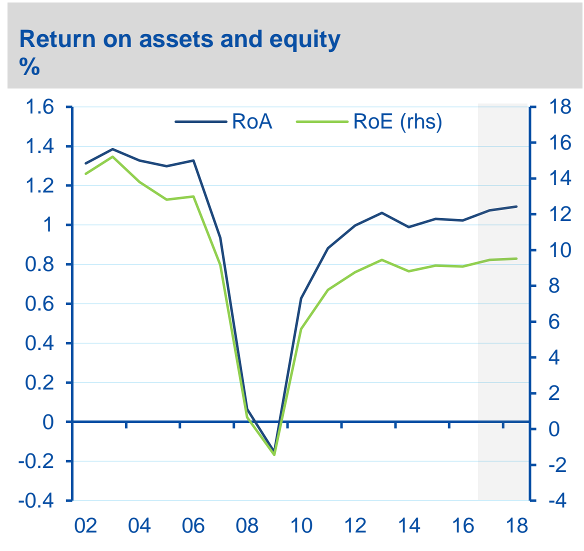
Income statement
$ Billion and %



Source: FDIC & BBVA Research

Figure 10

Return on assets and equity
%



Source: FDIC & BBVA Research

Bottom line

The outlook for the banking sector in the short- to mid-term is positive. We anticipate the solid loan growth and loan portfolio quality in a rising interest rate environment to lead to some improvements in profitability. Moreover, the industry is likely to benefit from a more favorable regulatory environment. Depending on the magnitude and timing of fiscal stimulus, tax reform, deregulation (particularly in key sectors such as energy and healthcare), infrastructure spending and foreign trade policy, the forecasts could change dramatically, resulting in even stronger performance.

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