Creating Opportunities

Banking

U.S. banking outlook amid Covid-19

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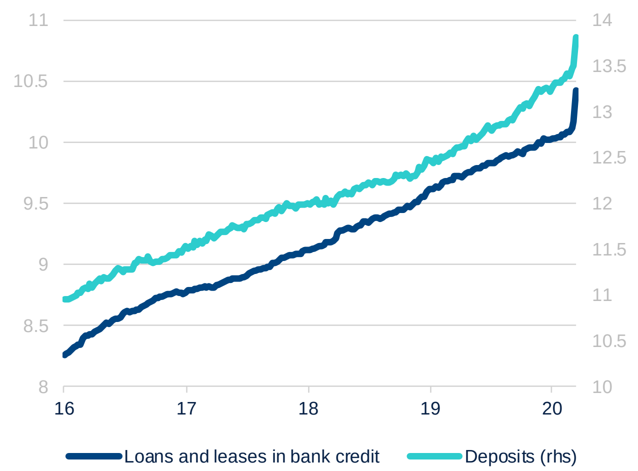
The Covid-19 pandemic that escalated in the first quarter of this year (see our recent macro brief - link) will have a dramatic impact on the U.S. banking sector. The effects will range from direct and immediate to indirect and long-term that will only emerge in the wake of the crisis. In this brief, we outline our view of the changes, challenges and opportunities that the industry will experience in the coming quarters.

Recent developments

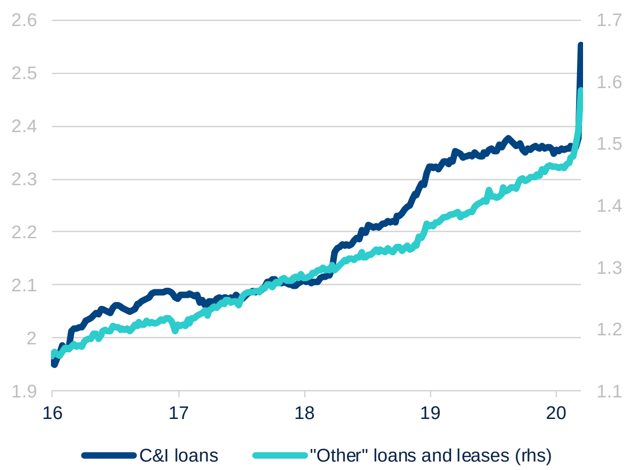
The banking sector benefited from solid economic growth in 2019. Loans and deposits increased at a solid pace and credit quality remained high. Although profitability declined slightly compared to 2018, on the back of increased provisions and lower net interest margins, it remained close to its highest level since before the Great Recession. These trends continued during the first two months of 2020 before it became obvious that the SARS-COV-2 outbreak was evolving into a deadly and socio-economically costly pandemic.

Figure 1. **Loans and deposits** ($tn)



Source: BBVA Research and FRB

Figure 2. **C&I and “other” loans** ($tn)



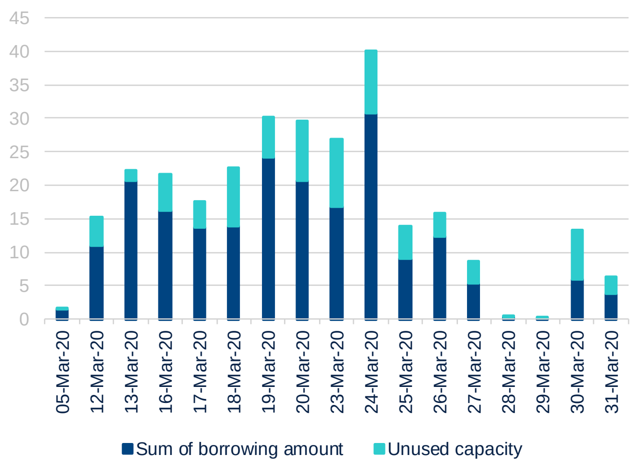
Source: BBVA Research and FRB

The immediate and direct effects of the Covid-19 crisis are reflected in the banking aggregates beginning in the second half of March. For example, YoY total loans and deposits growth increased from 4.2% and 6.8% at the end of February to 7.1% and 9.7% the week of March 16, respectively. The dramatic increase in loans occurred amid a sharp increase in risk aversion and financial market disruption and was driven by C&I and “other loans”[1] (Figure 2). The former reflects a large number of companies tapping their credit lines while the latter is due to borrowing by non-bank financial institutions and local governments. For example, publicly listed companies have drawn down about $196bn of their credit lines during March (Figure 3). As such, these companies have exhausted about 74% of

1: Other loans and leases include loans for purchasing or carrying securities, loans to foreign governments and foreign banks, obligations of states and political subdivisions, loans to nonbank depository institutions, loans to nonbank financial institutions as well as unplanned overdrafts the capacity of their revolvers. A large part of these new loans have been recycled into bank deposits and account for some of the $335bn jump between the beginning and the middle of March. The rest of the deposit inflow reflects cash buildup due to a flight to safety and the need to preserve liquidity, which has played out throughout the month.

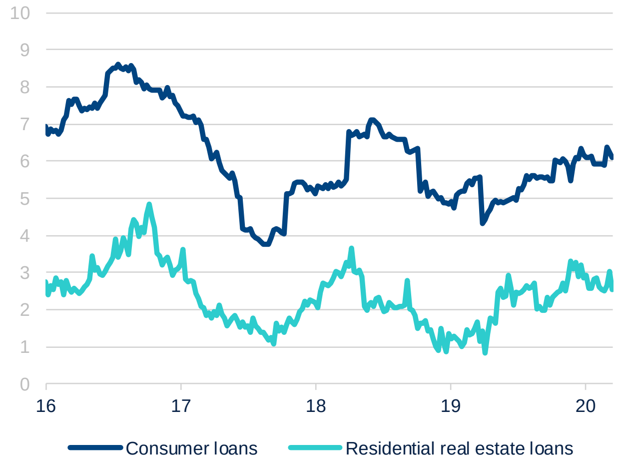
While companies increased their borrowing from commercial banks, borrowing by individuals held steady (Figure 4). Going forward, however, we expect this to change as the demand for mortgages and auto loans experiences significant decline due to the economic sudden stop resulting from the implemented restrictions to slow the spread of the virus. The expected unprecedented increase in unemployment will have a profound effect on spending decisions and cause a large increase in precautionary savings.

Figure 3. **Revolver and delayed draw term loan drawdowns, March 5-31, 2020** ($bn)



Source: BBVA Research and LCD/S&P

Figure 4. **Consumer and residential real estate loans** (%YoY)



Source: BBVA Research and Federal Reserve

What's in store for the rest of 2020?

The volatility and disruption in corporate credit markets and reduced revenue flows across small and large businesses have boosted the demand for C&I loans as firms try to maintain operations. Banks have met the initial increase in demand, and C&I lending will be further supported by fiscal stimulus measures such as the $377bn for small business loan guarantees introduced in the Coronavirus Aid, Relief, and Economic Security (CARES) Act, subject to proper due diligence and efficient implementation on the part of the government. The Federal Reserve's Main Street Business Lending Program, which is designed to assist mid-size companies not eligible for SBA assistance yet too small to access capital markets, will also support C&I lending, depending on the final formalization of that program. Assuming a large but temporary shock to private consumption and external demand, C&I loans should stabilize once firms normalize their cash positions. However, many businesses will shut down while others will delay or reduce expansion plans, particularly in sectors that have been affected the most like hotels, restaurants, airlines, and energy. The disruption to supply chains and a weak recovery in consumption spending for big-ticket items will also impact the manufacturing and industrial sectors. This could imply a slowdown in C&I activity even after aggregate demand rebounds in 3Q20.

In regards to mortgage lending, we expect a significant decline in new originations by mid-April, given the lag between the time a home purchase contract is signed and the time the mortgage is originated, This slowdown will be temporary but will depend on the progression of the pandemic. Refinance activity will accelerate somewhat over this period, as households take advantage of lower interest rates, but this will not be enough to completely offset the decline in originations of mortgages for purchase. Although we expect favorable refinance conditions, the decline in borrowing rates is not substantial relative to the levels seen over the past six months. Moreover, given the uncertainty on the magnitude and duration of the macroeconomic shock, we expect elevated spreads between mortgage rates and long-term treasury yields, reflecting a higher level of risk going into the downturn.

Consumer loans are also likely to slow down as the significant auto lending decline is only partly offset by higher credit card balances as well as personal loans. That said, assuming that the economy reverts to expansion in 3Q20, and the temporary rise in unemployment is quickly offset by re-hiring, auto lending will accelerate substantially in the second half of the year, supported by low interest rates and pent-up demand. As a result, consumer loan growth will gradually return to trend. However, if the economic damage is spread over an extended period and employment does not pick up quickly, consumer loan growth will pick up very slowly despite the end of the recession.

The immediate effects on CRE loans[2] will be similar as in the case of C&I, with an initial increase in borrowing to build up cash reserves. After the initial stages, CRE lending will be constrained due to tighter credit standards, higher vacancy rates, and lower rent growth prospects. Over the longer term, many of the trends that were evident before the crisis, such as telecommuting and e-commerce, will gain further traction and limit or reduce the demand for office and retail space. The demand from the multifamily segment will remain solid as apartments will benefit from a slower pickup in demand for single-family homes once the recovery gains traction. Moreover, during economic downturns, apartment vacancy rates tend to increase at a slower pace than other CRE segments. After the downturn, the demand for non-multifamily construction and development projects will be supported by the limited supply of new units relative to population growth over the last decade. The industrial/warehouse segment is likely to hold up well once the immediate effects from the sudden stop abate, with particular support coming from the growth in e-commerce.

Despite the volatility and uncertainty impacting bank loans, deposits are poised to grow at a strong pace. With the temporary increase in deposit growth due to the buildup of cash reserves by business entities, the flight to safety and the expansion of the monetary base due to policy responses by the Federal Reserve, YoY deposit growth will reach double digits. Due to the combination of low interest rates and risk aversion, most of the deposit growth will occur in the non-time deposits segments. Once the economy begins to recover, we expect deposits to stabilize in the latter half of the year. Deposit growth lags behind nominal GDP growth by several quarters, and this is likely to be the case this time around, too. The increase in deposits will outpace the growth in loans for a while after the immediate downturn, resulting in strong liquidity.

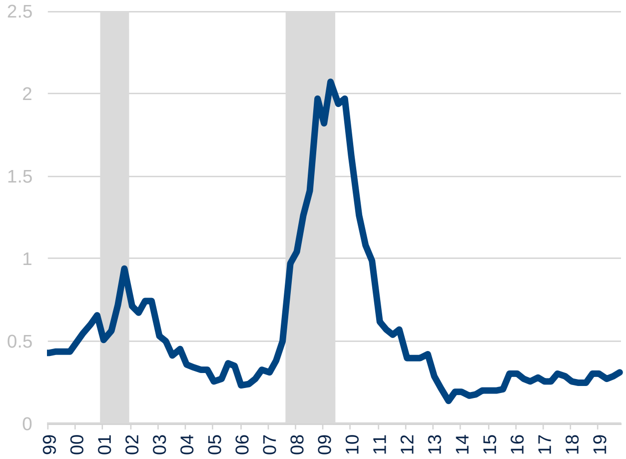
Banks' profitability is likely to remain solid in 1Q20 as credit quality deterioration has not yet occurred on a grand scale. Banks will also realize gains in their security portfolios as a result of the decline in interest rates and thus the increase in the value of their treasury and agency securities. Banks with relatively large trading operations could also benefit from the increase in market activity and volatility. Also, contrary to the previous crisis, most of the assets with a higher risk of downward repricing are held by institutions other than banks. For example, 60% of high-yield corporate bonds and leveraged loans are held by CLOs and 20% by mutual funds.

The postponement of the introduction of CECL standards, the temporary change to the supplementary leverage ratio rule, allowing early adoption of SA-CCR, increased flexibility to use capital and liquidity buffers, the reduction of the reserve requirement to 0%, and other macroprudential measures will also alleviate the immediate impact on

2: Includes construction, land development, and other land loans, and loans secured by farmland, multifamily (5 or more) residential properties, and nonfarm nonresidential properties.

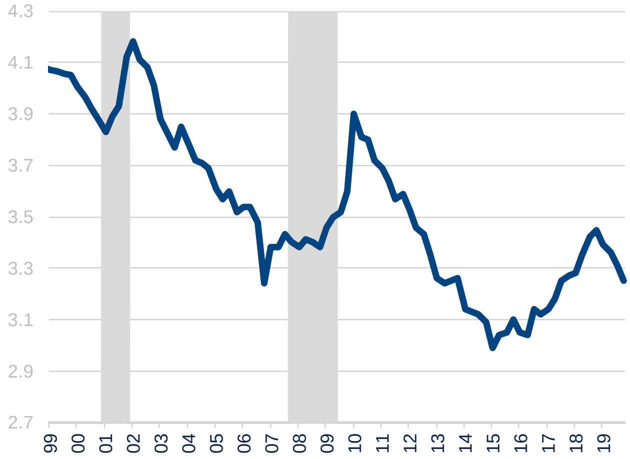
the banks' income statements and support lending activity. That said, beyond 1Q20 results, profitability could be under pressure throughout 2020 and possibly 2021. Credit quality deterioration, primarily in the C&I and consumer loan portfolios will undoubtedly lead to high loan and lease loss provisions, with a particular increase in the second and third quarters of this year. Provisions to assets tend to peak at or shortly after the end of the recession (Figure 5), which is likely to happen again this time around. On the flip side, assuming that conditions develop similarly like in the last two downturns, banks will benefit from improvement in net interest margins once the economy begins to gain traction (Figure 6).

Figure 5. **Loan and lease provisions to assets, annualized, commercial banks** (%)



Source: BBVA Research and FDIC

Figure 6. **Net interest margin, commercial banks** (%)

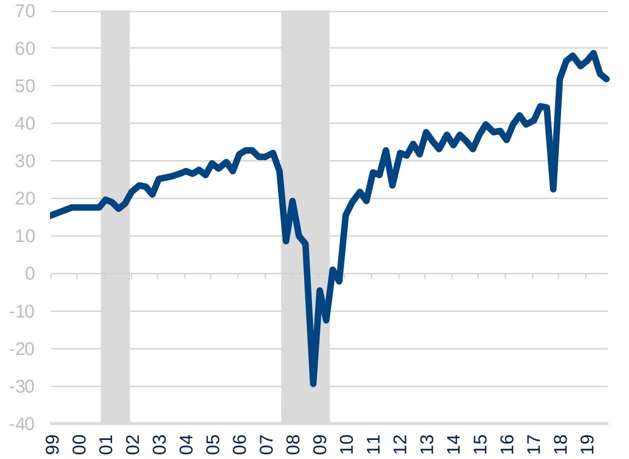


Source: BBVA Research and FDIC

The magnitude of the decline in net profits will primarily depend on the size of loss provisions. The increase in provisions in 2020 and possibly 2021 will depend not only on the magnitude and the length of the macroeconomic shock but also, and perhaps more importantly, on how effective the government implements the different stimulus measures aimed at providing relief to businesses and individuals during the peak of the crisis.

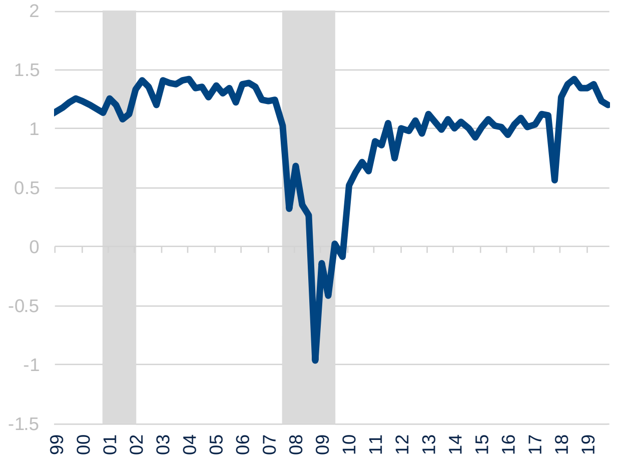
Assuming a large but temporary economic contraction and limited implementation risks on the stimulus response, the degree of impairment to banks' bottom lines will be significantly milder than in 2008-2009. Banks are well capitalized, have built up high levels of liquidity and have managed their portfolios prudently. Leverage ratios are historically low while solvency and systemic risks remain muted. In addition, there are no significant imbalances in the household sector and to some extent in the core of the business sector. In this regard, the impact could resemble the 2001 recession (Figure 9). For example, while the ratio of provisions to net interest income more than doubled from 12.5% in 4Q99 to 27% in 4Q01, it increased by more than five times from 12.9% in 2Q07 to close to 70% in 4Q08. This ratio stood at 10.6% in 4Q19. Moreover, one additional factor that aggravated the industry's net income in the Great Recession was the increase in noninterest expense as a result of increased litigation and compliance costs, which we do not expect to occur in the current downturn.

Figure 7. **Net income, quarterly, commercial banks** ($bn)



Source: BBVA Research and FDIC

Figure 8. **Return on assets, annualized, commercial banks** (%)



Source: BBVA Research and FDIC

Longer-term developments and changes

Apart from the short-term challenges, the Covid-19 crisis will also precipitate some long-term changes and opportunities. The most obvious one will be the acceleration of the transition from banking through physical branches to greater reliance on digital tools. While branches will remain a critical part of the banks' service delivery, social distancing will lead to customers becoming more accustomed to using digital tools and will accelerate the process of branch network streamlining. Likewise, banks are quickly retooling and upgrading their mobile platforms to offer as many options to their customers staying at home. This faster migration to digital channels will require ever-larger investments in digital infrastructures and high-quality end-user experience. This trend will favor mid- and large-sized banks due to economies of scale and accelerate the process of consolidation in the industry.

The regulatory changes that were implemented in the wake of the Great Recession will be critical to the resilience of the banking industry going into this downturn. The success of the industry in meeting societal needs can lead to complacency after the economy reverts to expansion, so banks and regulators should work on strengthening measures that contributed to the industry's resilience, eliminating those that have not been effective and addressing the challenges that the downturn inevitably brings to light. As banks prove to be critical in delivering assistance to struggling businesses and consumers, they will improve their societal image, which was damaged in the aftermath of the subprime mortgage crisis, as long as the government does not pass the implementation burden of the stimulus to the banks. The improved image will be even more important in an era where societal considerations are ever more important to customers and the prevailing business model swings from a shareholder paradigm to a stakeholder one. Banks that perform best in supporting their clients with high-quality service, innovation, and flexibility during this downturn will benefit immensely from goodwill after the crisis and increased customer loyalty.

Bottom line

After an immediate increase in loans and deposits, the growth of banking aggregates is going to slow in the second half of the year. Lending will moderate as a result of weaker demand and tighter credit standards. Deposit growth will slow in response to the contraction in nominal GDP, but with a slight lag. Credit quality will deteriorate depending on the magnitude and duration of the macroeconomic shock and the effectiveness of the monetary and fiscal stimulus. Profitability, however, should not suffer as much as it did in the Great Recession.

The crisis will bring to light some weak links in the industry as well as the overall economy, thereby providing an opportunity to redefine the agenda for bankers and regulators over the next decade. The crisis will also accelerate the transition to digital banking, with branches remaining an important channel for delivering banking services. The resilience of the banking system, which was built up during the last ten years, contributes to the industry's ability to properly serve and help its clients. This ensures that banks meet their societal purpose by allocating credit timely and efficiently, thereby supporting the wider economy.