**Banking**

# U.S. banking outlook 3Q20: Interesting times

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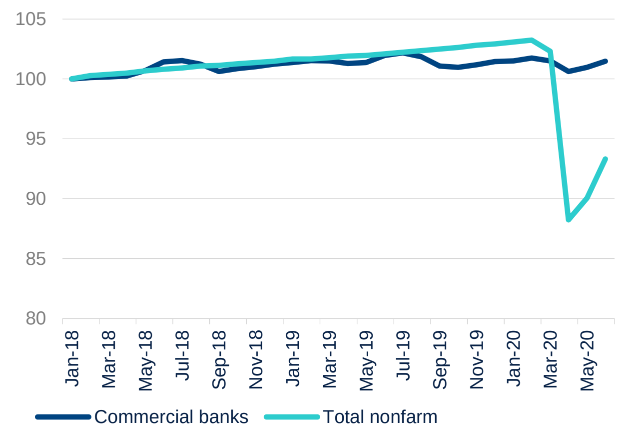
The speed and magnitude of the economic collapse that followed the Covid-19 pandemic resulted in the sharpest contraction since World War II and pushed policymakers, financial institutions, businesses, and households to take unprecedented actions. On the policy front, the Federal Reserve (Fed) responded with a battery of interventions totaling $5.7tn in firepower. Since March, the Fed has disbursed $2.5tn, equivalent to 12% of GDP, mainly through the purchase of $1.8tn in Treasury securities and $0.6tn in mortgage-backed securities. Congress also passed eight pieces of legislation providing massive fiscal support, primarily through the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Paycheck Protection Program and Health Care Enhancement Act (PPPHCE), which together authorize roughly $3.5tn, equivalent to 16% of GDP.[1]

The CARES Act allowed the Fed to work hand-in-hand with the Treasury Department to put in place facilities that provide targeted liquidity not only to the banking sector but also to the non-bank financial sector and non-financial businesses. The size of the monetary and fiscal stimulus has helped to soften the blow from the collapse of economic activity during the first half of the year through a decline in financial stress, credit and lending facilities, tax relief, welfare support and aid to industries, states, and local governments, albeit amid elevated uncertainty. Despite this, many industries such as hospitality, air travel, restaurants, oil and gas, and brick-and-mortar retail, remain disproportionately affected by the downturn. Business bankruptcies are on the rise across-the-board and the longer the current conditions last, the larger the number of establishments that are going to have to shut down permanently.

Throughout the crisis, commercial banks responded vigorously to address the challenges even with the majority of bank employees working remotely. Initially, banks met successfully the spike in credit demand from businesses in the second half of March, as companies rushed to draw on their lines of credit to boost liquidity. Since April, banks successfully supported the Government in underwriting $517bn in loans[2] through the Paycheck Protection Program (PPP). This amount represents over 20% of total C&I loans that banks held on their balance sheets at the end of last year and provided emergency liquidity to many small and mid-size businesses. Throughout this period, banks have coped with the inevitable credit risk increase that occurs during economic downturns, which has already resulted in large loan loss provisions. Nonetheless, despite the decline in profits in the first half of the year, commercial bank employment has remained relatively steady (Figure 1), branch openings continued and net closings were lower than in the same period last year (Figure 2). Moreover, banks successfully managed the massive migration toward digital and mobile banking. According to Fidelity National Information Services, there was a 200% increase in new mobile banking registrations and 85% more mobile banking traffic in early April.

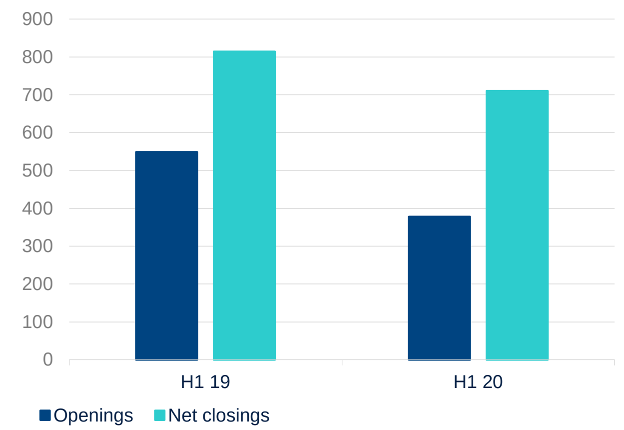
1: The combined fiscal authority is around $3.7tn (17% of GDP), which includes $200bn from the initial two bills (CPRSA and FFCR).
2: SBA. Paycheck Protection Program (PPP) Report. Approvals through 07/10/2020. https://bit.ly/3jtQanQ

Figure 1. **PAYROLL EMPLOYMENT (INDEX, JANUARY 2010=100)**




Source: BBVA Research and BLS

Figure 2. **BANK BRANCH OPENINGS (NUMBER)**




Source: BBVA Research and S&P

## Monetary conditions: Never say never

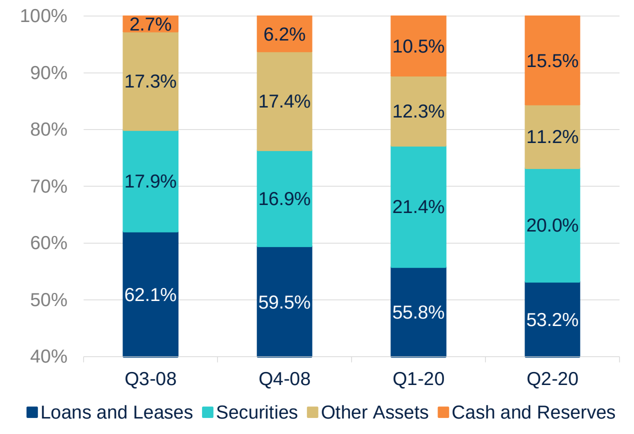
The massive expansion of the Fed's balance sheet in 2Q20 confirms that in an environment characterized by large debt levels and historically low interest rates, and an economy facing a sharp contraction, the once "unimaginable" expansion of the monetary base has turned into "unavoidable". This large liquidity injection has substantial implications for banks.

First, the Fed's purchases of securities have increased banks' cash assets positions, which are now almost completely consisted of reserve balances at the Fed. This means that around 15% of commercial banks' assets (Figure 3) are earning the Interest on Excess Reserves rate, which is currently set at 0.1%. While this asset is risk-free, its increased share in banks' balance sheets will weigh down on the industry's return on assets going forward.

Second, the massive monetary and fiscal stimulus, coupled with a flight to safety, has resulted in a massive $1.7tn increase in bank deposits (Figure 4), leaving banks flush with funds and an elevated deposits-to-loans ratio (Figure 5). Part of the increase in deposits between March and June has been used to fund PPP loans. However, the majority of these loans will be forgiven, leading to banks exercising the explicit Small Business Administration (SBA) guarantee and receiving reimbursement. This raises two essential questions: what is the extra liquidity going to be used for, and how will it affect banks' profitability. In principle, banks can use their deposits to increase lending, which after all, is part of the objective behind the expansion of the Fed's balance sheet. However, deposit transformation and loan origination will depend on the willingness to lend and borrow, borrowing capacity, pressures to deleverage, and damages and bankruptcies in specific industries. Meanwhile, once consumption and investment begin to normalize, excess deposits should wane down and loans edge up but the transition will take some time, particularly if consumption and investment recover at a slow pace and demand for loans remains low. While we assume that loan growth will eventually outpace deposit growth, the transition implies a prolonged period of elevated deposits-to-loans ratio. Therefore, the most likely scenario in the short- to medium-term is for banks to increase their positions in government and agency securities, resulting in a higher share of securities in total assets and a lower share of loan balances. This is what banks did in the early 1990s[3] (Figure 6), after the nonfinancial

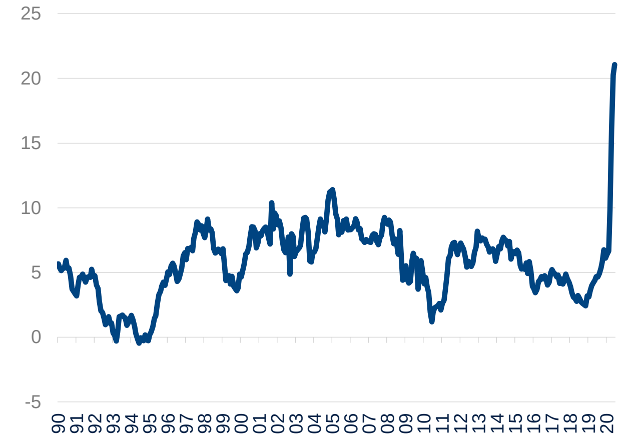
3: Rodrigues, P. A. (1993). FRBNY Quarterly Review. https://nyfed.org/2OQZvrL business sector had to deleverage, following the period of progressive increases in business leverage in the second half of the 1980s that came to an end with the collapse of the junk-bond market.

Figure 3. **COMPOSITION OF BANK BALANCE SHEETS** (%)



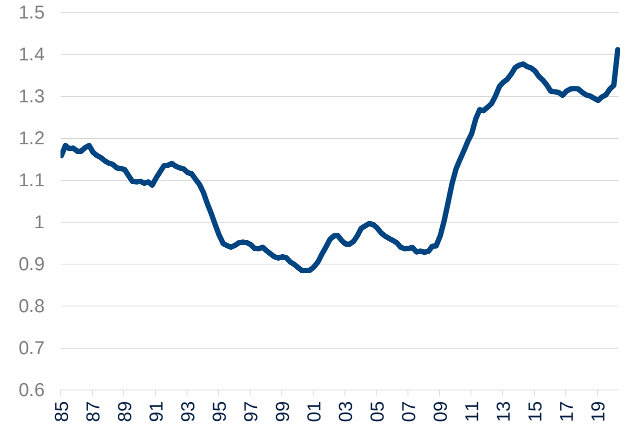

Source: BBVA Research and Federal Reserve

Figure 4. **BANK DEPOSITS** (% YOY)



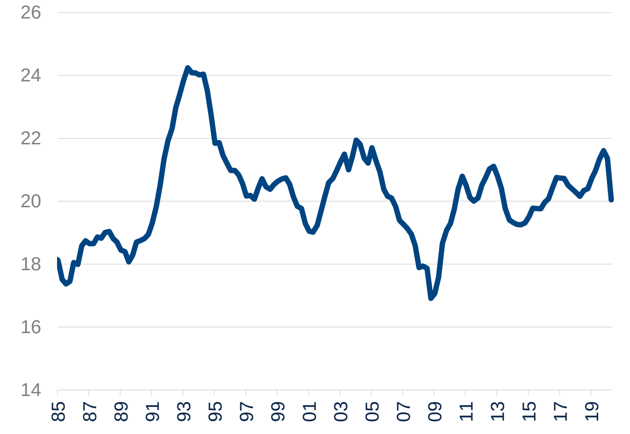

Source: BBVA Research and Federal Reserve

Figure 5. **DEPOSITS TO LOANS** (RATIO)




Source: BBVA Research and Federal Reserve

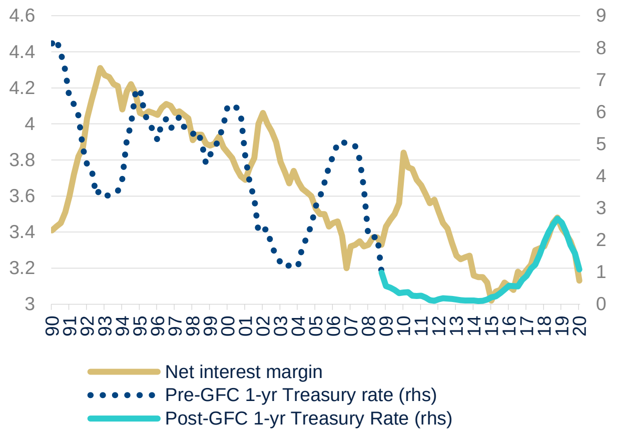
Figure 6. **SECURITIES AS A SHARE OF TOTAL ASSETS** (%)




Source: BBVA Research and Federal Reserve

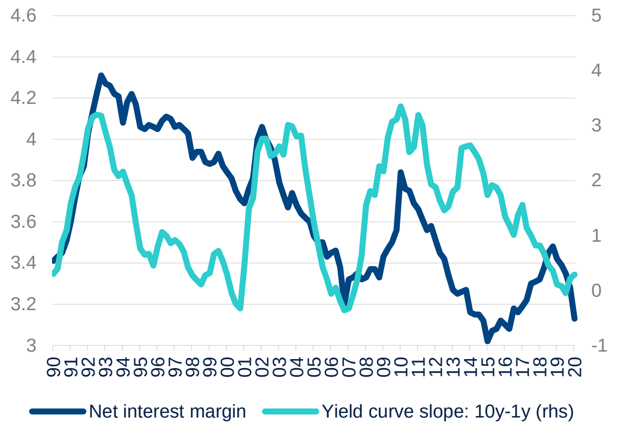
Most importantly, current monetary conditions of low interest rates and a flat yield curve are likely to remain in place for a long period. When interest rates are close to the zero lower bound, as has been the case in most of the period since the Great Financial Crisis (GFC), banks' net interest margins come under pressure since deposit interest rates cannot effectively move into negative territory. This means that the 2016-2019 episode of higher net interest margins (Figure 7) will not recur in the short- to mid-term. Moreover, the flat yield curve will also pressure banks' net interest margins as the upside from funding long-term assets with short-term liabilities will be constrained (Figure 8).

Figure 7. **NET INTEREST MARGIN, COMMERCIAL BANKS, AND SHORT-TERM INTEREST RATES** (%)




Source: BBVA Research, FDIC and Federal Reserve

Figure 8. **NET INTEREST MARGIN, COMMERCIAL BANKS, AND YIELD CURVE SLOPE** (% AND PP)



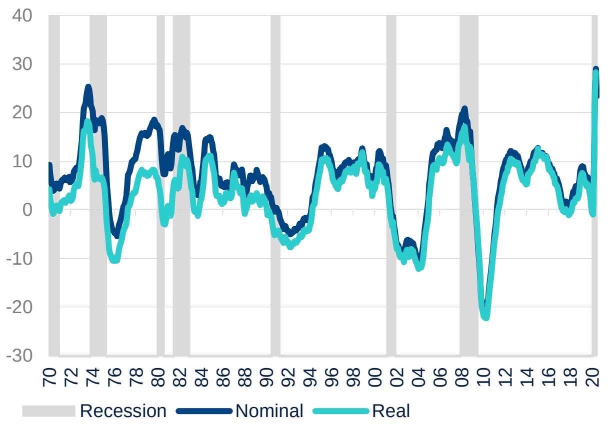

Source: BBVA Research, FDIC and Federal Reserve

## Loans: Idiosyncrasies galore

Total loans and leases increased by 3.5% MoM in both April and May – the strongest monthly expansion since 1958. The increase was primarily due to C&I lending supported by the PPP in addition to companies withdrawing funds from their lines of credit. This growth was partially offset by declining consumer loan portfolios. Although the level of total loans and leases pulled back somewhat in June on a MoM basis, it still stood 8.1% higher YoY.

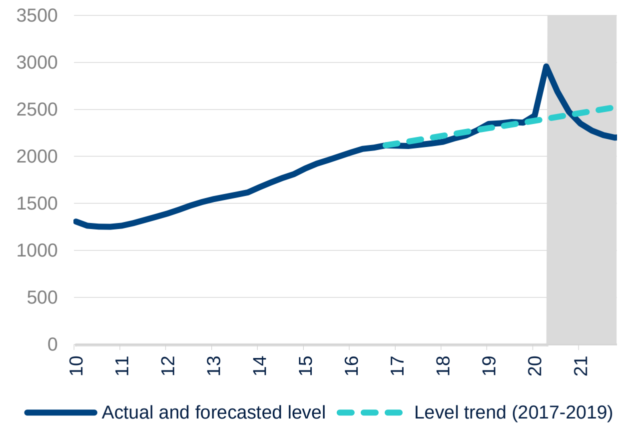
C&I loan growth is expected to slow significantly over the coming quarters as the overwhelming majority of the outstanding PPP loans on the banks' balance sheets is repaid by the SBA. Moreover, even assuming the passage of an additional PPP round and a gradual recovery in loan demand, we expect business deleveraging to gain traction, as has been the case in previous post-recession periods (Figure 9). As a result, the level of outstanding C&I loans is expected to fall below their pre-recession trend (Figure 10) and remain below this threshold in the

Figure 9. **C&I LOANS GROWTH AND THE BUSINESS CYCLE** (% YOY)




Source: BBVA Research, Federal Reserve and BEA

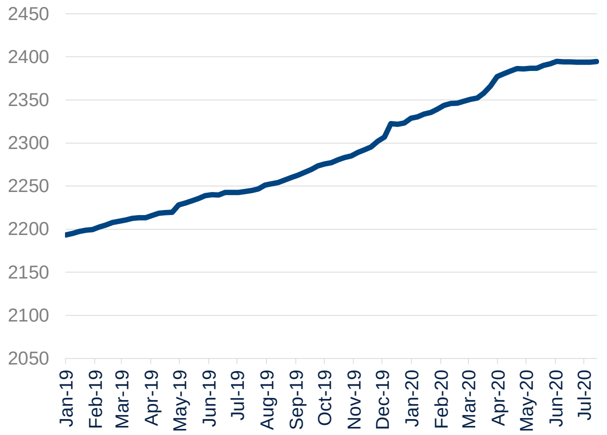
Figure 10. **C&I LOAN GROWTH** ($BN)




Source: BBVA Research and Federal Reserve short- to medium-term. However, if Congress passes a large package supporting business borrowing with attractive terms, the decline will be offset and the process of deleveraging pushed back into the future. If, in addition, economic growth rebounds strongly, the deleveraging process will be significantly less acute and C&I loans could remain near the pre-crisis trend.

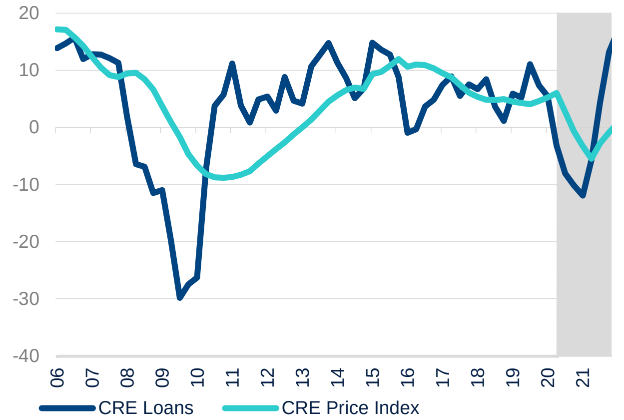
Commercial Real Estate (CRE) loans outstanding have plateaued since June (Figure 11), but still stand 6.7% higher YoY. CRE is one of the most adversely affected sectors during the current recession, with hotel properties and retail developments being the most at-risk market segments. Meanwhile, apartments are experiencing a more moderate impact and industrial CRE is benefiting from strong demand for distribution centers from e-commerce firms. The difficulties faced by CRE operators are somewhat mitigated by the massive fiscal support, monetary policy actions, and favorable financial conditions, which allow for the refinancing and restructuring of outstanding liabilities. That said, vacancies are expected to increase across-the-board, leading to a temporary decline in rents and prices. For this reason, we expect bank lending for CRE projects to decline moderately over the coming quarters (Figure 12), before starting to recover towards the end of 2021.

Figure 11. **CRE OUTSTANDING LOANS** ($BN, SA)




Source: BBVA Research and Federal Reserve

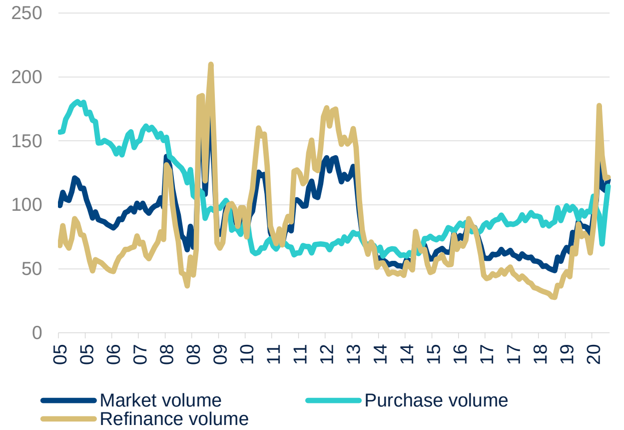
Figure 12. **CRE OUTSTANDING LOANS AND PRICES** (% YOY)




Source: BBVA Research and Federal Reserve

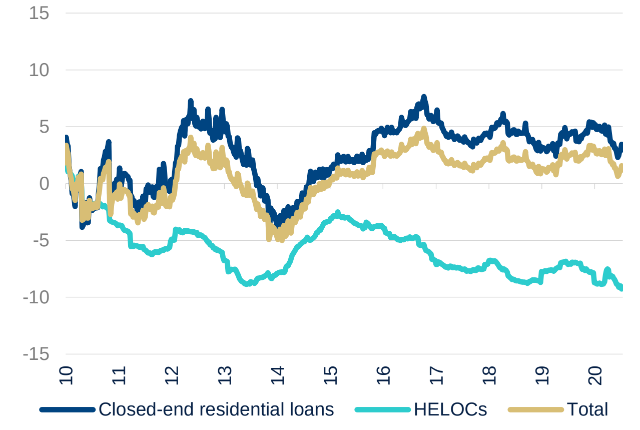
Banks' residential real estate loan portfolios have so far benefited from a resilient housing market, despite the economic downturn. In June, mortgage applications for purchase stood 16% higher YoY. The first reason for this is the underlying strength of the market where limited supply meets a segment of somewhat deleveraged consumers armed with low interest rate mortgage pre-approvals. The second reason is pent-up demand resulting from a handicapped spring buying season that saw originations for purchase in April down 30% YoY due to the widespread shelter-at-home orders. Moreover, mortgage applications for refinance also remain strong, albeit down from their March levels, which then reached the highest since 2013 (Figure 13). The strong originations activity is supporting banks' mortgage holdings (Figure 14).

Figure 13. **MORTGAGE APPLICATIONS** (INDEX, JANUARY 2010=100)




Source: BBVA Research and MBA

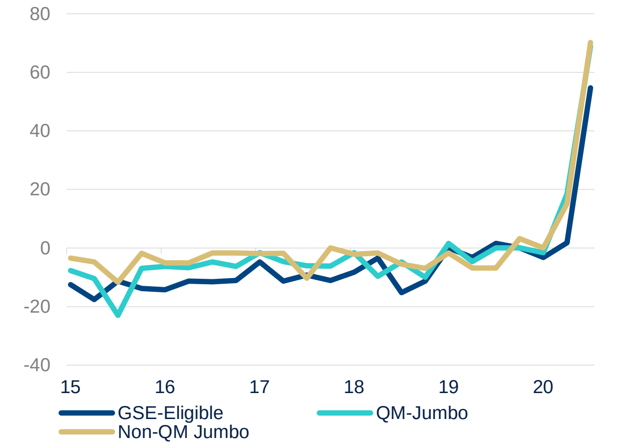
Figure 14. **RESIDENTIAL LOANS OUTSTANDING** (% YOY)




Source: BBVA Research and Federal Reserve

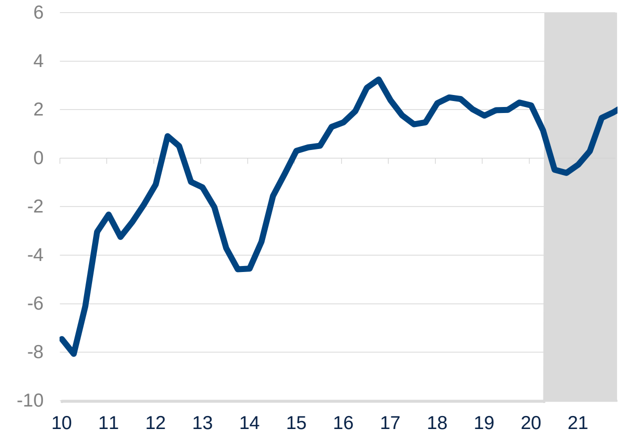
However, with the scaling down of fiscal support in the second half of the year, limited upside from further declines in mortgage rates, and a high level of unemployment, we expect a slowdown in housing market activity. Home prices will experience a temporary plateau in some markets and modest declines in others, while existing home sales will remain below comparable levels from last year. In fact, despite a strong increase in June, existing home sales were 11% below a year ago. Moreover, banks will remain cautious in underwriting non-GSE eligible mortgages, as the Senior Lending Officers Opinion Survey (SLOOS) suggests (Figure 15). Banks are more likely to carry on their balance sheets mortgages that are not eligible for Government Sponsored Entities (GSE) financing. In sum, we expect a small contraction of the banks' residential loan portfolios due to the softening of the housing market in the second half of 2020 and the beginning of 2021, as well as the long-term decline of HELOC balances. Residential loan balances growth is expected to pick up again in the spring of next year (Figure 16).

Figure 15. **SLOOS, NET RESPONDENTS REPORTING BANKS TIGHTENING LENDING STANDARDS** (%)




Source: BBVA Research and Federal Reserve

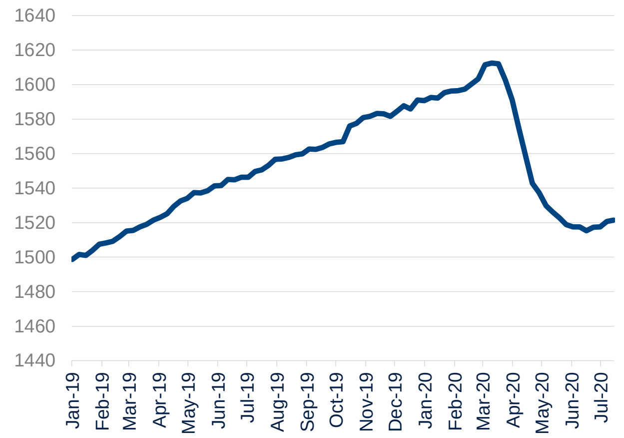
Figure 16. **TOTAL RESIDENTIAL LOANS** (% YOY)




Source: BBVA Research and Federal Reserve

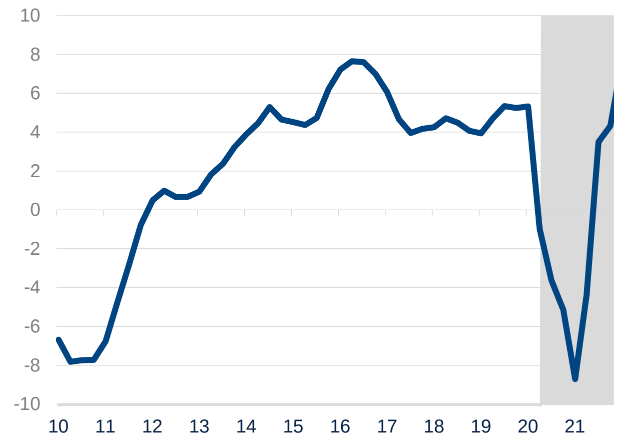
Unlike residential loans, consumer loans contracted sharply at the onset of the crisis (Figure 17) and remain suppressed. Credit card balances outstanding declined by $65bn between the end of March and the end of April, and another $20bn by the end of May. Some households might have also used their economic impact payments to lower their credit card balances. While auto loan balances also declined in April, the change was much smaller relative to credit cards, and have been on the rise again since mid-May. These developments suggest that households' finances were relatively healthy at the onset of the crisis and a major deleverage adjustment process, as the one following the housing meltdown, is unwarranted.  Nonetheless, due to consumers' increased caution, elevated levels of unemployment, tighter credit standards and lower willingness to provide installment consumer loans—documented in the latest SLOOS—we expect ongoing weakness in consumer lending over the next several quarters (Figure 18).

Figure 17. **CONSUMER LOANS OUTSTANDING ($BN, SA)**




Source: BBVA Research and Federal Reserve

Figure 18. **CONSUMER LOANS OUSTANDING (% YOY)**




Source: BBVA Research and Federal Reserve

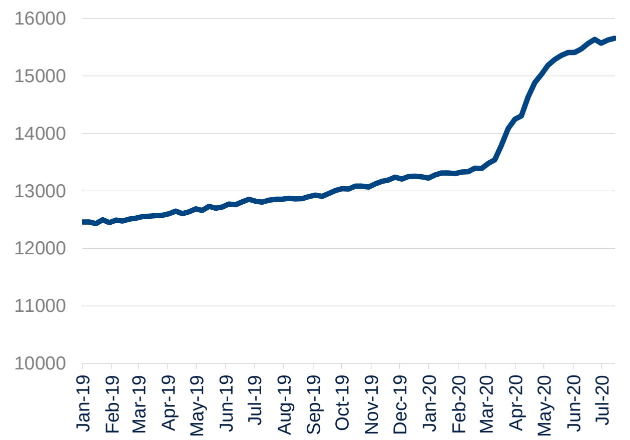
## Deposits: Flush with cash

Bank deposits increased dramatically (Figure 19) as the Fed flooded the financial system with liquidity by purchasing securities and through the deployment of emergency credit and lending facilities. In addition, the personal savings rate spiked to 32.2% in April from 8.4% in February, and although it dropped to 19% in June, it remains elevated. A higher savings rate mainly reflects a drop in consumption due to voluntary and involuntary lockdowns, as well as an increase in government transfers (stimulus checks, extension of unemployment benefits, etc.). Additional fiscal stimulus would increase income and the savings rate, albeit temporarily. Thus, as long as spending recovers, the savings rate will edge down to more stable levels. However, it is likely to remain above average due to increased caution from consumers and weak labor market conditions, thereby implying a high level of households' deposits.

Between mid-March and mid-May, total deposits grew by an average of almost $200bn per week, resulting in a $2.3tn (17%) increase between the end of February and the end of July. During the last month, the growth rate has reverted to a somewhat more normal level and we expect this trend to continue going forward. Due to the low interest rate environment and abundance of funds, interest rates on deposits are not going to be supportive of term deposits, an instrument primarily held by households (Figure 20). On the other hand, an increased preference for liquidity will be supportive of demand deposits, which have a more balanced distribution of holders (Figure 21).

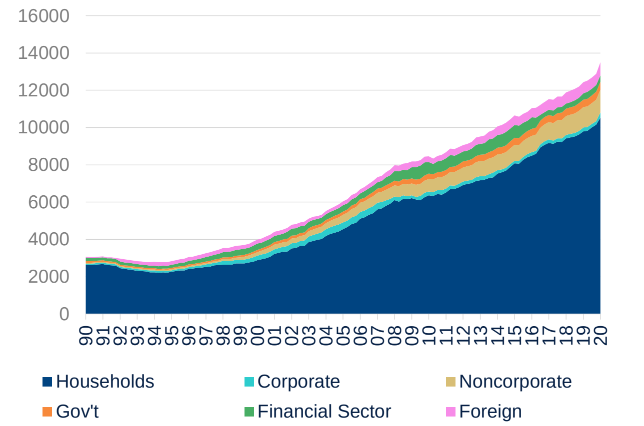
While we expect term deposits to contract over the coming year, demand deposits are expected to end the current quarter 30% higher YoY (Figure 22), marking the highest growth rate on record and likely going back to World War II. As was the case over the last decade, a large share will be held in Money Market Deposit Accounts.

Figure 19. **TOTAL BANK DEPOSITS** ($BN, SA)



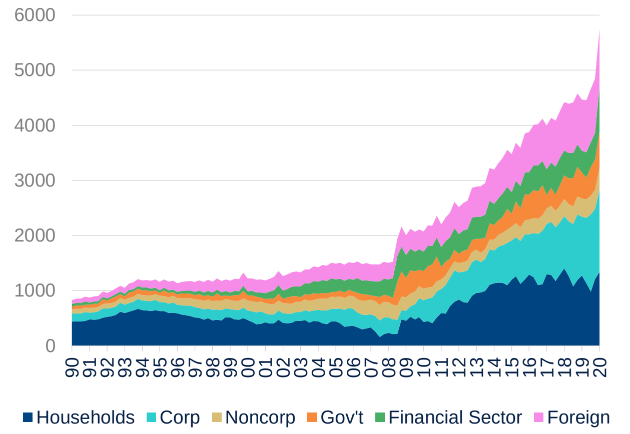

Source: BBVA Research and Federal Reserve

Figure 20. **TIME AND SAVINGS DEPOSITS BY HOLDER** ($BN)



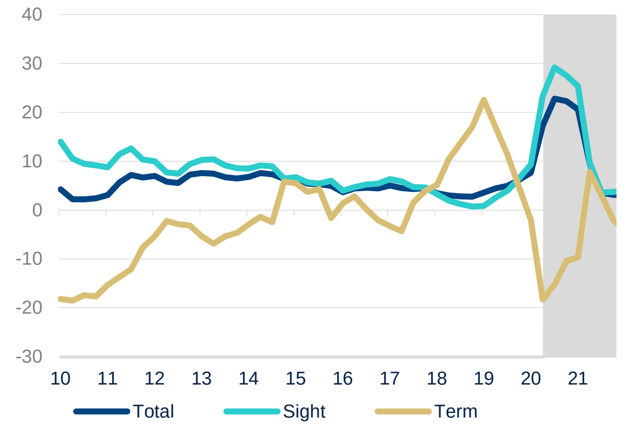

Source: BBVA Research and Federal Reserve

Figure 21. **CHECKABLE DEPOSITS AND CURRENCY BY HOLDER** ($BN)




Source: BBVA Research and Federal Reserve

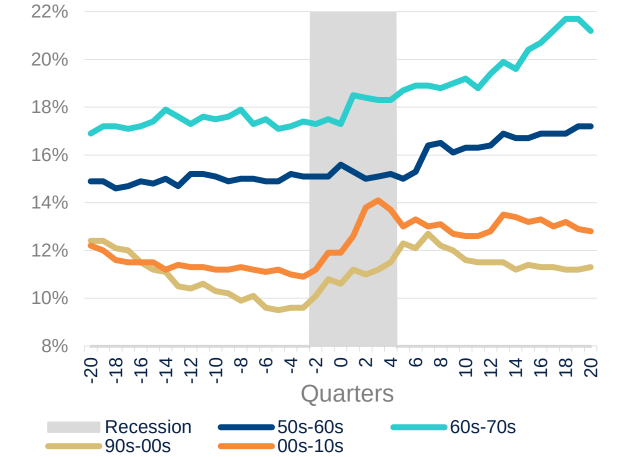
Figure 22. **TOTAL BANK DEPOSITS** (% YOY)




Source: BBVA Research, FDIC and Federal Reserve

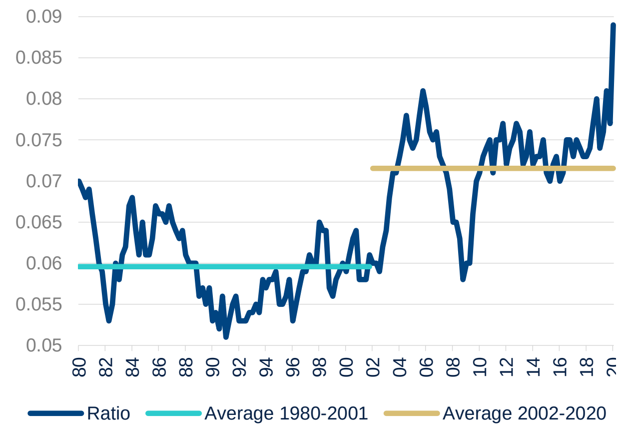
During recessions, households' rebalancing of financial assets favors deposits, while the realignment during the subsequent recoveries tends to occur slowly. As has been the case multiple times in the past (Figure 23), we expect households' deposit holdings to remain elevated for some time, despite low interest rates. Meanwhile, businesses have been operating with relatively higher levels of deposits (Figure 24), especially after the GFC prompted higher demand for safe-liquid assets. This trend will continue as businesses prepare to absorb supply chain disruptions, elevated financial volatility, policy uncertainty, and tighter credit conditions.

Figure 23. **DEPOSITS AS A SHARE OF FINANCIAL ASSETS OF HOUSEHOLDS** (%)




Source: BBVA Research and Federal Reserve

Figure 24. **DEPOSITS TO TOTAL LIABILITIES OF BUSINESSES** (RATIO)




Source: BBVA Research and Federal Reserve

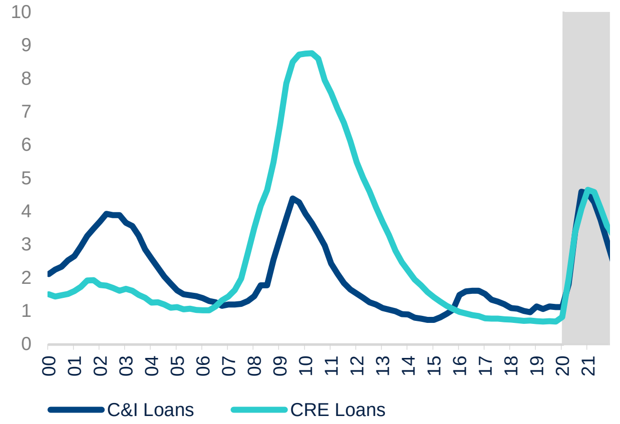
## Credit quality: Not as bad as it could be

The current downturn will obviously have a severe and negative impact on credit quality metrics such as delinquencies and charge-offs. The adverse effect of the crisis will be primarily offset by the massive monetary and fiscal stimulus that is being provided to the economy, as well as the solid underwriting practices over the last ten years, particularly in the areas of residential mortgages and CRE loans. Last but not least, delinquencies are increasing from a particularly low starting point. The overall delinquency rate in 1Q20 stood at 1.5%, which is below the lowest point reached in the previous cycle. Meanwhile, net charge-offs to total loans stood at 0.5% in 1Q20, below the metric's historical average, albeit likely to increase in the coming quarters. Overall, we expect a substantial negative impact from credit quality deterioration, but while total delinquencies will reach 4% in 1H21 in a baseline scenario, they will remain below the peak levels in the wake of the GFC. Nonetheless, this implies that banks will have to continue with high loan loss provisioning, as was the case in the first half of the year, when the ratio of provisions to assets reached 1.1% in 1Q20, the highest level since 2Q10. This will have a sustained effect on profitability ratios. Moreover, risks remain tilted to the downside, especially if the recovery stalls.

Commercial delinquencies (Figure 25) will be mainly driven by the unprecedented disruption that Covid-19 inflicted on discretionary services such as leisure and hospitality, restaurants, and air travel. In addition, the high degree of business leverage that was built up before the pandemic will also exert its toll on business delinquencies, particularly if the highly leveraged firms find it more difficult to access liquidity and refinance their debt. Therefore, we expect C&I delinquencies to surpass the levels reached in the last two recessions and peak at around 4.5% at the beginning of 2021. CRE loan delinquencies, although starting from a record low level in 4Q19, will increase more than fivefold over one year.

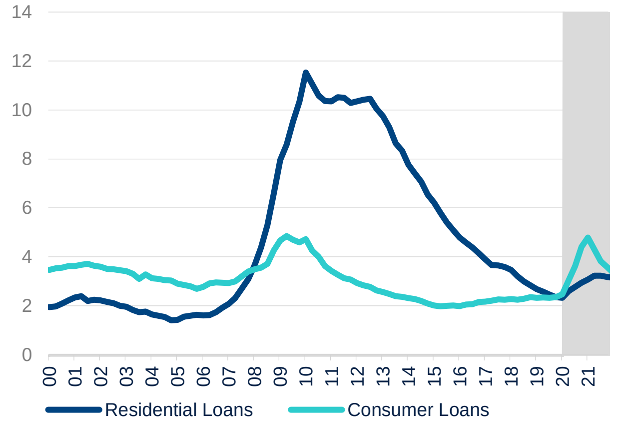
On the retail side (Figure 26), the residential loan delinquency rate will increase by one percentage point from the current level and peak at 3.3%, which is above the level reached in the 2001 recession but significantly below the highs reached after the subprime mortgage crisis of 2008. This reflects the healthy level of household leverage, a modest expected home price decline over the next twelve months, ample fiscal support and a small degree of subprime mortgage originations generated during the last expansion. Meanwhile, consumer loan delinquencies are expected to match the levels reached in the wake of the GFC, but fall relatively quickly once the economy gains traction and labor market conditions show a significant improvement.

Figure 25. **COMMERCIAL LOANS DELINQUENCY RATES** (%)




Source: BBVA Research and FRB

Figure 26. **RETAIL LOANS DELINQUENCY RATES** (%)

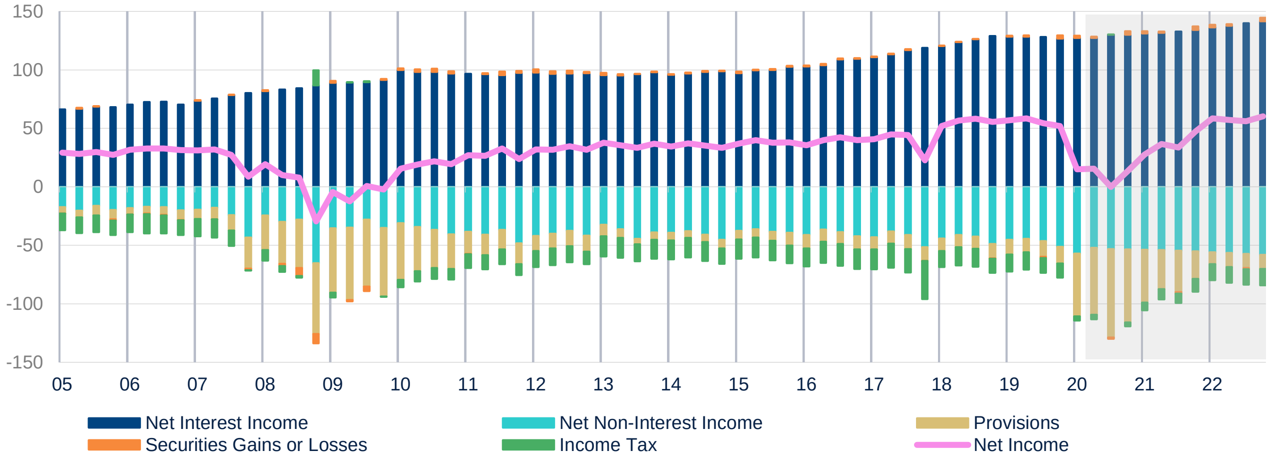



Source: BBVA Research and FRB

## Profitability: Silver linings amid an abundance of challenges

Before the Covid-19 crisis occurred, banks benefited from stable loan growth, solid loan portfolio quality, and lower corporate tax rates. In fact, quarterly profits remained near historical highs. However, the current crisis is resulting in an upending in banks' assets and credit quality deterioration. Moreover, banks are facing a challenging interest rate environment of low short-term interest rates and a flat yield curve, which is likely to persist for a number of quarters, thereby limiting net interest income growth. In 1Q20, the return-on-assets and return-to-equity ratios dropped to their lowest level since 2009 at 0.4% and 3.4%, respectively. Quarterly results for the largest banks confirm that these trends continued in 2Q20 as banks built up record levels of loan loss provisions. In response to these pressures, banks are likely to look at alternative ways to boost non-interest income and reduce costs, particularly through efficiency gains associated with technological advances. That said, under a baseline scenario and with the economy supported appropriately by monetary and fiscal policy measures, we do not expect the industry to post major quarterly losses as it did in 2008 (Figure 27). Barring a double-dip recession induced by a large second wave of infections and/or major policy mistakes, the banking industry will revert to pre-recessionary earnings levels in 2022. However, the degree of uncertainty around this forecast remains high.

Figure 27. **COMMERCIAL BANKS, INCOME AND EXPENSE, QUARTERLY** ($BN)




Source: BBVA Research and FDIC

## Bottom line

After the immediate and towering increase in loans and deposits that occurred between March and June, the growth of the banking aggregates is slowing down. Notwithstanding a possible large second round of fiscal stimulus, including additional PPP-type lending and further monetary accommodation, total loan growth will moderate by the end of the year. This expectation assumes significant deleveraging across some sectors of the economy and tighter credit standards. Deposit growth is already reverting to normal rates and will remain on this trajectory, even if additional stimulus results in another transitory increase in personal savings and businesses' cash positions. That said, banks will operate with higher deposits relative to loans going forward due to this year's massive monetary policy intervention.

While banks are building record loan loss reserves, credit quality will continue to deteriorate and profitability will edge down, but systemic risks remain contained. In fact, the resilience of the banking system, which improved significantly during the last ten years, contributes to the industry's ability to properly serve its clients in this critical period. Moreover, banks have been meeting effectively their societal purpose throughout the current crisis, thereby supporting the wider economy and leading to an improved overall image of the industry.

## DISCLAIMER