Banking

U.S. banking outlook 1Q21: Fair winds from pandemic control and policy support

Filip Blazheski / Nathaniel Karp

February 26, 2021

Despite the unprecedented economic contraction in the first half of 2020, banks fared better than initially anticipated largely due to the massive monetary and fiscal stimulus that the Federal Reserve (Fed) and the government deployed. At the onset of the crisis, fearing large loan losses, banks provisioned aggressively but loan loss provisions moderated in the second half of 2020, with some banks even releasing reserves in 4Q20. With the ongoing economic recovery, the banking outlook will continue to improve in 2021. In fact, the pace of growth will further gather steam as households and businesses receive additional fiscal stimulus, vaccinations cover a greater share of the population, service sectors continue to normalize, and the Fed maintains considerable monetary accommodation. However, economic output and employment still have a way to go before reaching pre-Covid trends while potential new waves and mutations of the SARS-COV-2 virus impose downside risks to the outlook.

Our baseline scenario assumes that while new loan origination in 2021 will be strong, the increase in outstanding loans will moderate, as a significant amount of PPP loans will be forgiven and repaid, and newly originated residential mortgages are not likely to be held on banks' balance sheets. Meanwhile, banks will benefit from elevated deposit levels, although a stronger recovery could mean that businesses tap these resources to fund investments rather than increase borrowing. Banks also face an upside from increasing long-term interest rates and lower provisions, which will ensure that the industry maintains solid profitability.

The pandemic's effect on operations: Acceleration of pre-existing trends

The shutdowns that resulted from the pandemic as well as the clients' changes in behavior led not only to changes in financial performance, but also in operations and service delivery. While some changes were modest, such as employment and number of branches, others were significant, particularly the increase in mobile banking usage.

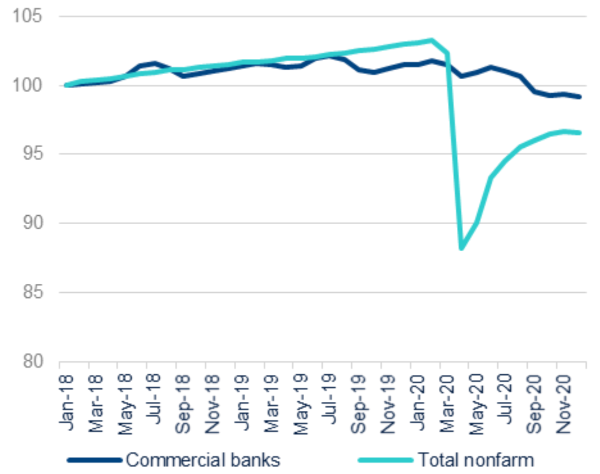
Bank employment proved to be particularly resilient relative to the decline in overall employment (Figure 1), and while the number of branches continued to gradually decline -a long-term trend driven by new technology and preferences- banks closed less branches between mid-2019 and mid-2020 than in the previous 12-month period. In fact, net branch openings were positive in some fast-growing markets like Texas, Georgia, Colorado, South Carolina, South Dakota, Washington, DC and Arkansas (Figure 2).

At the same time, the shutdowns increased consumers' reliance on mobile banking. Surveys conducted by S&P[1] found that 44.5% of respondents used their banking apps more frequently than before the pandemic (Figure 3). Customers used their apps mostly for money transfers, bill payments and digital deposits (Figure 4). Not surprisingly, younger clients were more likely to replace some of the in-branch services with their bank's digital offering, while baby boomers and seniors tended to continue relying on branch services. The increased exposure to mobile banking, which accelerated during the pandemic, implies that banks will have to invest a large amount of resources to maximize the transition from the physical to the digital service delivery channel. These investments in new technologies –including machine learning, data analytics and AI-, are also needed to improve internal processes such as fraud prevention, risk management, and client acquisition, among others. Nonetheless, branch

[1] S&P. 2020 U.S. Mobile Banking Report

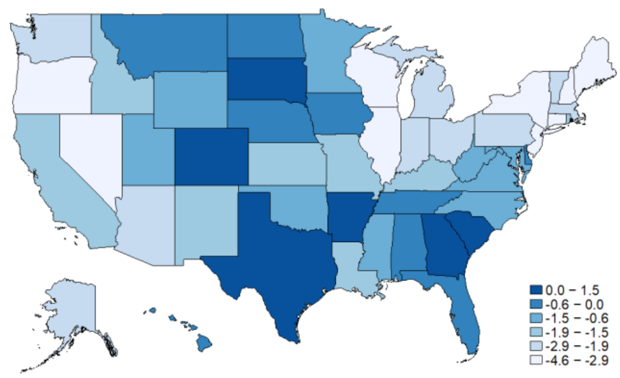
networks will remain relevant, especially for older customers that tend to be wealthier and to support the delivery of more complex services.

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



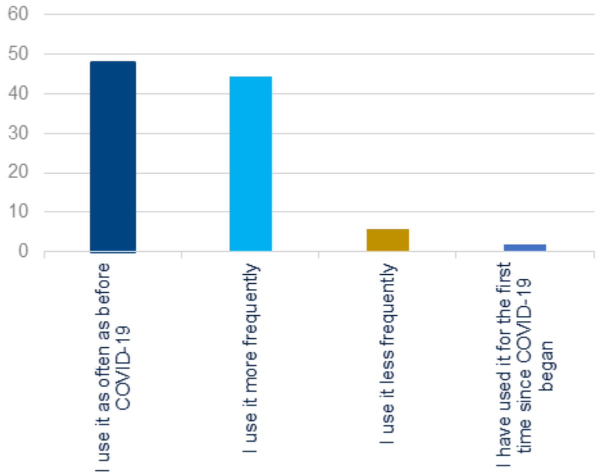
Source: BBVA Research and BLS

Figure 2. **CHANGE IN COMMERCIAL BANK BRANCHES** (JUNE 30, 2020, % YoY)



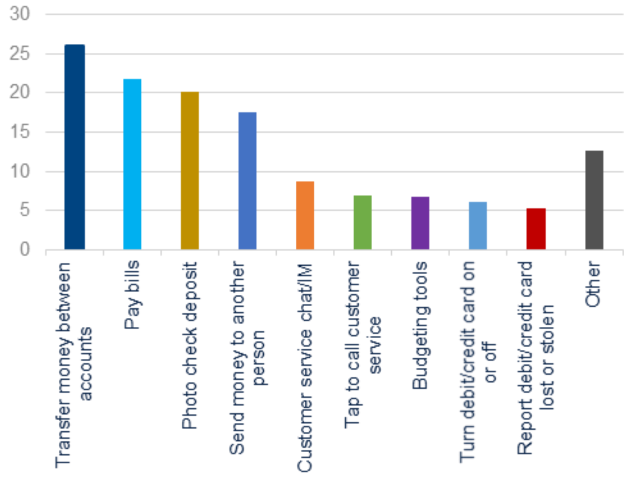
Source: BBVA Research and S&P

Figure 3. **BANK APP USAGE SINCE COVID PANDEMIC START** (% OF RESPONDENTS)



Source: BBVA Research and S&P

Figure 4. **APP USES SINCE COVID PANDEMIC START** (% OF RESPONDENTS)

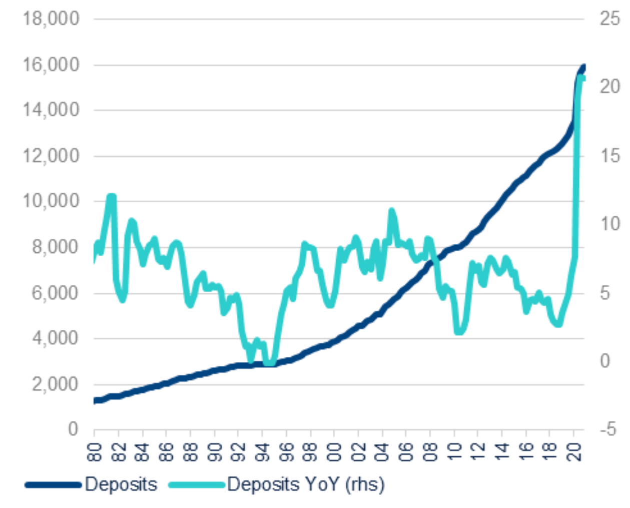


Source: BBVA Research and S&P

Monetary and fiscal policy: Impact on banks

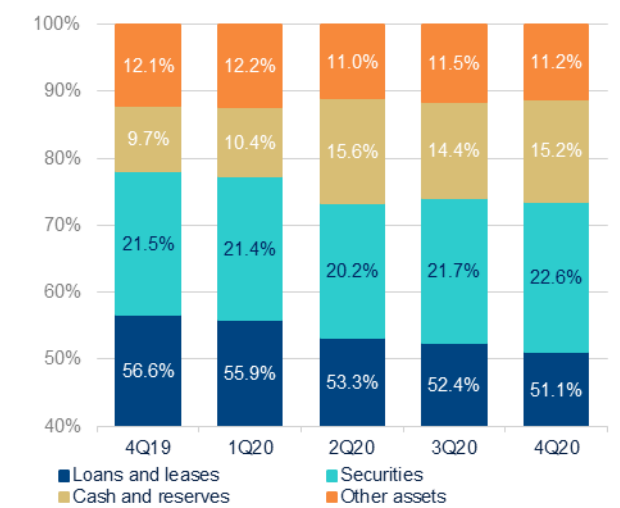
The massive expansion of the Fed's balance sheet since early 2020, primarily through purchases of Treasury and MBS securities, as well as lending and funding facilities, was a liquidity injection that ensured smooth functioning of financial markets. This avoided large market participants facing a credit crunch, which would have generated a financial crisis. These measures, along with the FOMC's strategy to keep the policy rate close to 0%, helped corporate borrowers and many homeowners refinance their obligations at affordable terms. The expansion of the M1 and M2 monetary aggregates (63% and 23% between February and December) and bank reserves had major implications for banks. First, deposits increased dramatically and in December stood 21% higher YoY (Figure 5). Second, banks' cash assets positions increased from 10% of total assets at the end of 2019 to over 15% throughout the rest of the year (Figure 6), primarily due to the increase in reserve balances at the Fed (89% YoY at the end of 2020). Third, the share of securities held by banks in total assets increased, as institutions sought to deploy part of the new liquidity. In December, this balance sheet line item was 22% higher YoY. In comparison, total loans were only 3% higher YoY, resulting in their relative share of total assets declining by 5.5 percentage points, as other asset categories increased at a faster pace.

Figure 5. **BANK DEPOSITS ($BN and % YOY)**



Source: BBVA Research and Federal Reserve

Figure 6. **COMPOSITION OF BANK ASSETS (%)**



Source: BBVA Research and Federal Reserve

The fiscal policy's boost in 2020, primarily delivered through the $2tn CARES Act, also had a significant effect.[2] The most direct impact on loan growth came through the Paycheck Protection Program (PPP). In the first and second rounds of PPP that ended last August, banks and other financial institutions channeled $525bn in loans to eligible businesses, which contributed to C&I loan balances swelling by almost 30% between February and May. To avoid an economic relapse, at the end of 2020 Congress also passed the Coronavirus Response and Relief Supplemental Appropriations Act, which included around $900bn in Covid relief. This package includes support for small businesses, mostly in the form of PPP loans, enhanced federal unemployment benefits, support for specific hard-hit industries and school districts, as well as relief for hard-hit and low-income households. Funds have already started flowing and, as was the case with previous stimulus packages, banks remain partners in delivering assistance to the economy. The current PPP funds will amount to another $284bn and are again expected to positively impact C&I loan balances in 2021.

More fiscal stimulus is on its way. On February 5, Congress passed a budget resolution eying an additional round of stimulus through the American Rescue Plan, weighing $1.9tn, equivalent to 9% of GDP. If enacted, this package will significantly boost growth this year and next, supporting credit growth and asset quality in the banking sector.

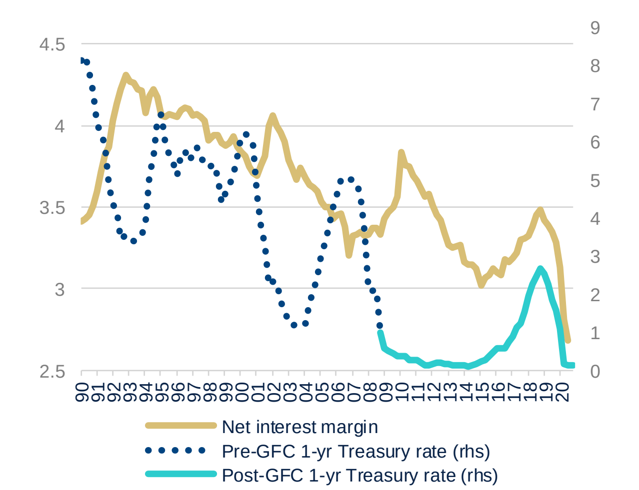
[2] Congress also passed the Coronavirus Preparedness and Response Supplemental Appropriations Act ($6.9bn), the Families First Act ($212bn), the PPP & Health Care Enhancement Act ($627bn), the Emergency Aid for Returning Americans Act ($9bn), and the September 2020 Continuing Resolution ($32bn)

An additional infrastructure package later in the year, as proposed by the Biden administration, would boost business investment and loan demand in the following years.

Fiscal policy will also support consumer and real estate loan growth, which will also benefit from accommodative financial conditions. Banks will also continue assertively growing their securities portfolios to offset the runoff of loans from PPP loan forgiveness and sales of newly originated mortgages to GSEs. In regards to deposits, although the Fed's balance sheet will continue to grow, its pace will moderate relative to 2020, contributing to a slower growth rate.

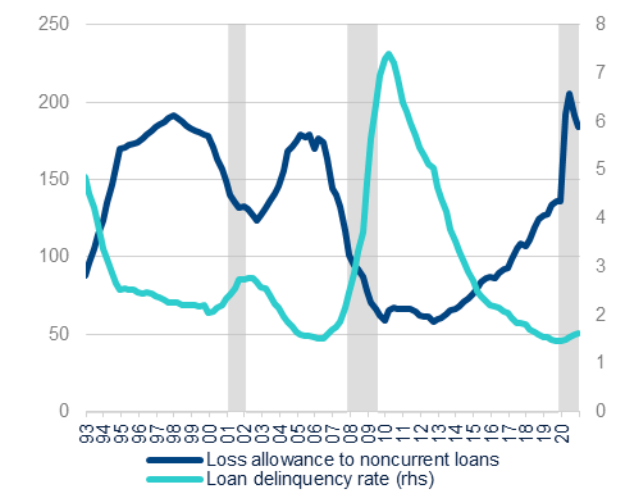
The changes that have occurred in banks' balance sheets will affect profitability. First, a large share of commercial banks' assets will remain in the form of reserves with the Fed continuing to earn the Interest Rate on Excess Reserves, currently set at 0.1%. While this is a risk-free asset, its increased relative share will weigh down on the industry's return on assets. Second, interest rates close to the zero lower bound will pressure net interest margins (Figure 7); this will be offset to a large extent by the increase in longer-term yields, especially if the economy overheats and inflation increases significantly. Moreover, accommodative financial conditions and assertive fiscal policy will continue to keep a ceiling on credit risk, which together with the relative over-provisioning from 1Q20-3Q20 (Figure 8) will allow banks to maintain low provisions and release reserves, which would boost net income and profitability.

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



Source: BBVA Research, FDIC and Federal Reserve

Figure 8. **LOSS ALLOWANCE AND DELINQUENCY RATES** (%)



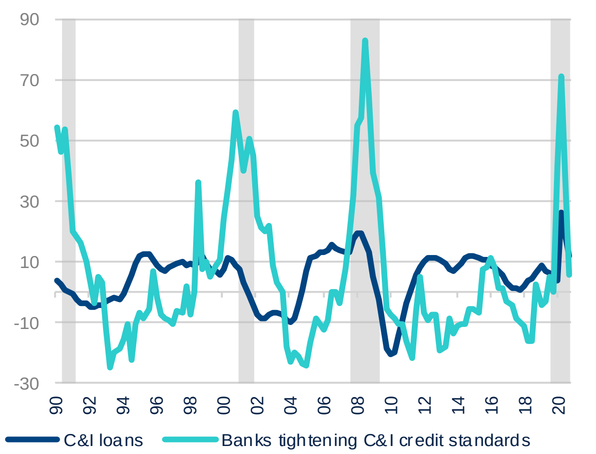
Source: BBVA Research, FDIC and Federal Reserve

Loans: Adjustment and normalization

In 2020, C&I loans posted the highest growth rates after the boost from PPP. Meanwhile, CRE loan balances also grew at a solid pace, especially in light of the structural challenges that this sector has faced from telework and online shopping, which were significantly amplified by the Covid crisis. Residential loan portfolios were flat, despite strong origination activity, while consumer loans contracted due to credit card debt payoffs.

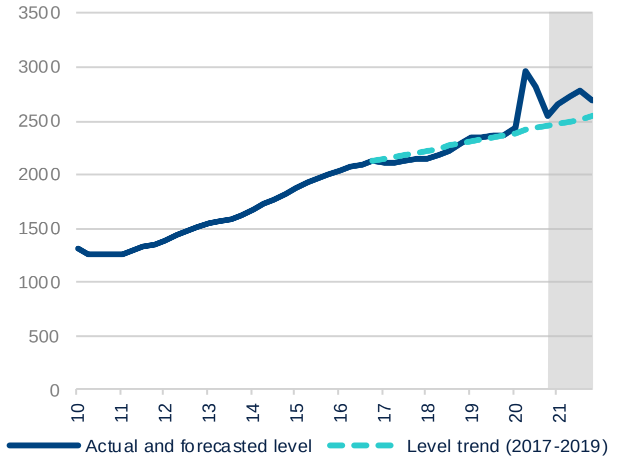
Looking forward, we expect loan growth in 2021 to be solid. However, a number of idiosyncrasies due to the nature of the crisis and government intervention will have a significant impact. For example, in the absence of the stimulus package and the new round of PPP loans passed last December, we would have expected C&I loan growth to be negative for some time due to tighter credit standards and businesses deleveraging, as in previous recessions (Figure 9). However, with the passage of the latest package and the imminence of additional fiscal stimulus this year, business borrowing at attractive terms is expected to boost C&I loan growth (Figure 10), with any deleveraging being moderate and spread out over time. New rounds of PPP lending will maintain the level of C&I loans on banks' balance sheets above pre-crisis trends, despite loan forgiveness and repayments. C&I loan growth will be particularly pronounced if, in addition to fiscal stimulus, growth picks up more quickly than expected, particularly in the services sector, due to Covid control and a successful vaccine rollout.

Figure 9. **C&I LOANS AND CREDIT STANDARDS (% YOY AND NET % RESPONDENTS)**



Source: BBVA Research and Federal Reserve

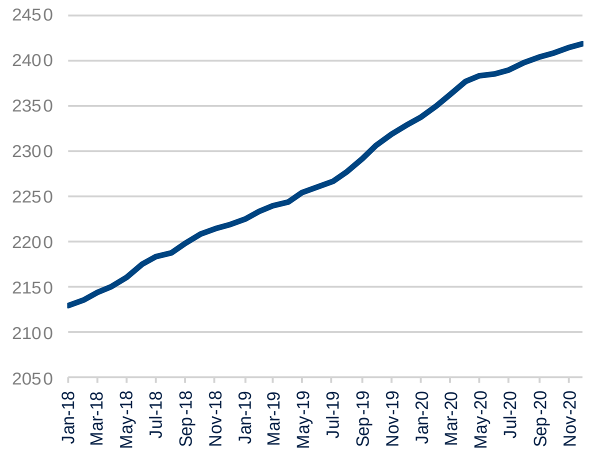
Figure 10. **C&I LOANS ($BN)**



Source: BBVA Research and Federal Reserve

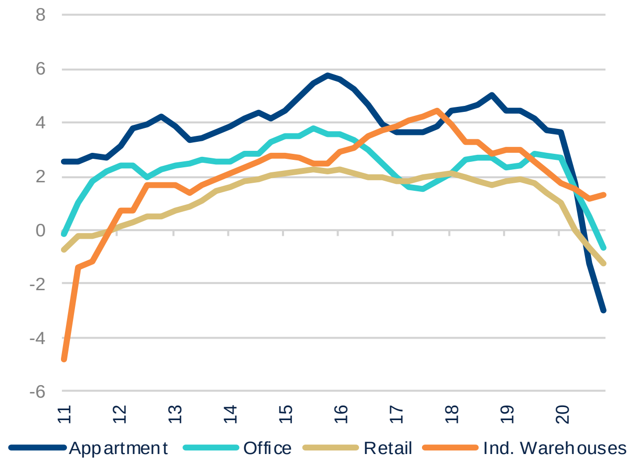
Growth in CRE loans slowed in the second half of 2020 (Figure 11) and will remain under pressure even during the economic rebound, due to high vacancies in the retail and office segments. Apartments are also starting to experience significant declines in effective rents (Figure 12) due to high inventory from strong new construction before the Covid crisis (Figure 13) in addition to the effects of the recession itself. Despite aggressive promotions, many younger renters are not renewing leases, as they are either moving back with their parents or buying single-family homes if they are starting or already have a family. Industrial CRE, however, is benefiting from solid demand, particularly for warehouses and distribution centers from e-commerce firms. Vacancies will continue to increase for some time, except for warehouses, leading to a temporary decline in prices in most CRE categories and overall indexes. The CRE challenges are somewhat mitigated by the massive fiscal support and monetary policy actions that allow for refinancing and restructuring of outstanding liabilities. As a result, we expect bank lending for CRE projects to decline moderately in 2021 (Figure 14), before recovering towards the end of the year and in 2022. Over the mid-term, the number of new construction CRE projects will be low to allow for the excess capacity in the market to be absorbed. One exception will be repurposing of existing properties, which is expected to gain traction. The apartments sector, despite challenges over the short-term, remains well-positioned to capitalize on the economic rebound and the demand for housing due to still positive population growth, albeit with a large degree of variation depending on location. This outlook could get a significant boost over the long-run if the new administration can implement its campaign promises of upgrading 4M buildings and weatherizing 2M homes, and investing billions of dollars in power, transit, and basic infrastructure.

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



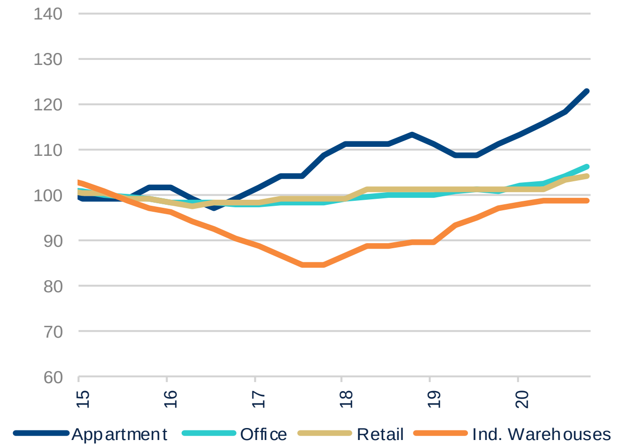
Source: BBVA Research and Federal Reserve

Figure 12. **CRE PROPERTIES, EFFECTIVE RENT** (% YOY)



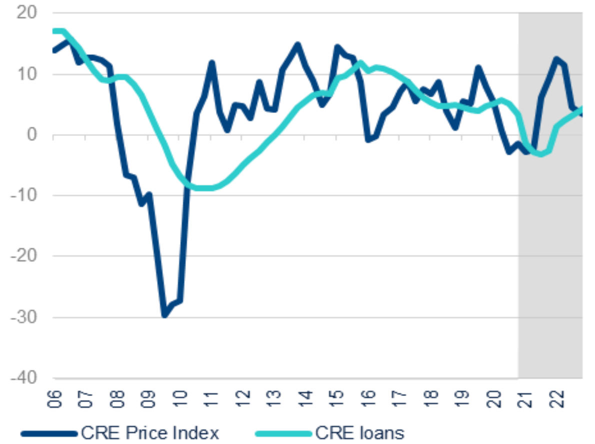
Source: BBVA Research and REIS

Figure 13. **CRE PROPERTIES, VACANCY RATES** (INDEX, 2015 AVERAGE=100)



Source: BBVA Research and REIS

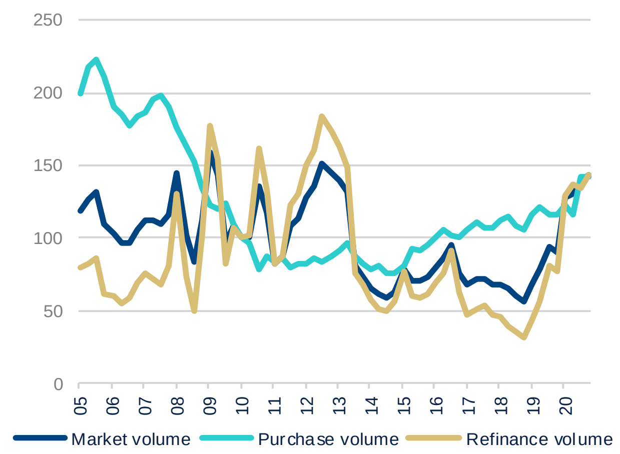
Figure 14. **CRE OUTSTANDING LOANS AND PRICES** (% YOY)



Source: BBVA Research and Federal Reserve

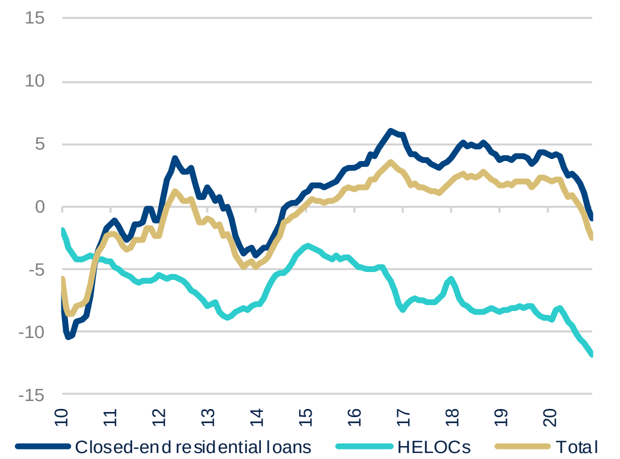
Despite the economic downturn, banks' residential real estate lines of business benefited from a resilient housing market. In December, mortgage applications for purchase stood 24% higher YoY, while home prices increased by around 9% YoY, the fastest pace since 2013. With favorable housing market conditions persisting throughout 2021, we expect mortgage applications and home price appreciation to remain strong. First, a significant segment of households has deleveraged and fared well during the K-shaped pandemic, implying that potential buyers have access to low fixed-rate interest mortgages, despite some increase in mortgage rates since the beginning of this year. Second, the supply of existing homes for sale remains limited, as Baby Boomers keep postponing downsizing, and Gen X-ers have locked in low mortgage interest rates that finance a strongly appreciating asset, at least for the time being. Third, the housing market is benefiting from the increase in telework, which will remain widespread even after the pandemic ends. Last, and probably most importantly, housing is supported by highly favorable demographics as Millennials are already in their prime home-buying years, while the Covid crisis has increased the attractiveness of single-family homes in affordable MSAs away from the two coasts. We also expect solid refinance originations, albeit lower than in 2020 (Figure 15), at least in the first half of 2021. That said, just as strong originations did not lead to a dramatic increase in banks' mortgage portfolios last year (Figure 16), they are not likely to do so in 2021 either. Banks will continue to favor originating GSE-eligible mortgages and sell most of them due to their low interest rates, which present high duration risk in case interest rates increase as a result of a strong recovery that is aggressively supported by fiscal and monetary policy actions.

Figure 15. **MORTGAGE APPLICATIONS (INDEX, 1Q10=100)**



Source: BBVA Research and MBA

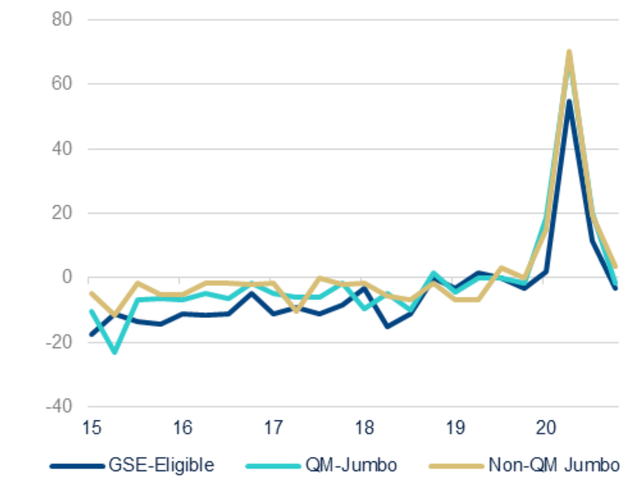
Figure 16. **RESIDENTIAL LOANS OUTSTANDING (% YOY)**



Source: BBVA Research and Federal Reserve

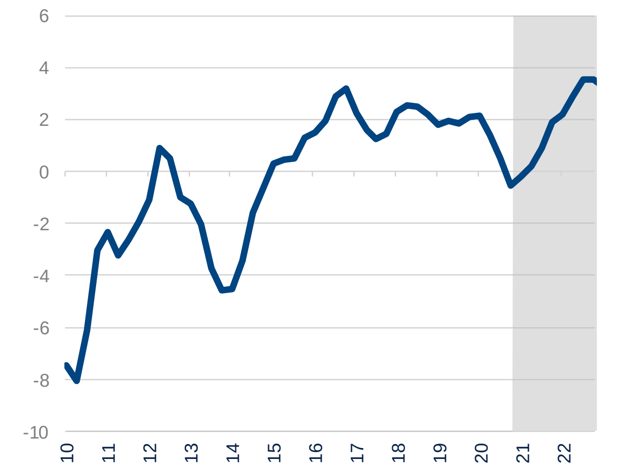
According to the latest Senior Lending Officers Opinion Survey (SLOOS), banks started loosening credit standards at the end of last year for GSE-eligible and qualifying jumbo mortgages (Figure 17), a trend that will continue in coming quarters. While standards have not started loosening for other types of mortgages, they are likely to do so in the near future, except for subprime mortgages. At the same time, the long-term decline of HELOC balances will continue, unless the economy overheats and another speculative housing bubble starts, which is not likely under current conditions. Overall residential loan balances growth is expected to pick up this year after dropping 2.45% YoY in December 2020 (Figure 18).

Figure 17. **SLOOS, NET RESPONDENTS REPORTING TIGHTENING STANDARDS** (%)



Source: BBVA Research and Federal Reserve

Figure 18. **TOTAL RESIDENTIAL LOANS** (% YOY)

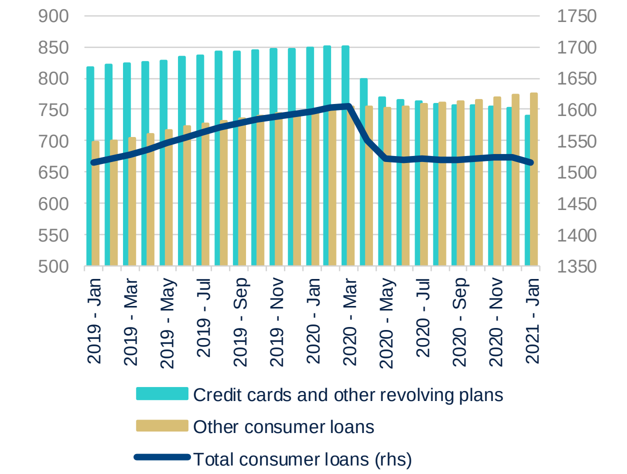


Source: BBVA Research and Federal Reserve

Unlike residential loans, consumer loans contracted sharply at the onset of the crisis (Figure 19) and stood at -4.3% YoY in December, remaining suppressed to date. The primary cause was the decline of $65bn in credit card balances outstanding between the end of March and the end of April, and another $20bn by the end of May. The timing of the drop in credit card balances coincides with the disbursement of economic impact payments from the CARES Act and the collapse in credit card spending due to the shutdowns, which helped households lower their credit card debt. The elevated savings rate since the start of the pandemic also meant that households kept credit card balances low.

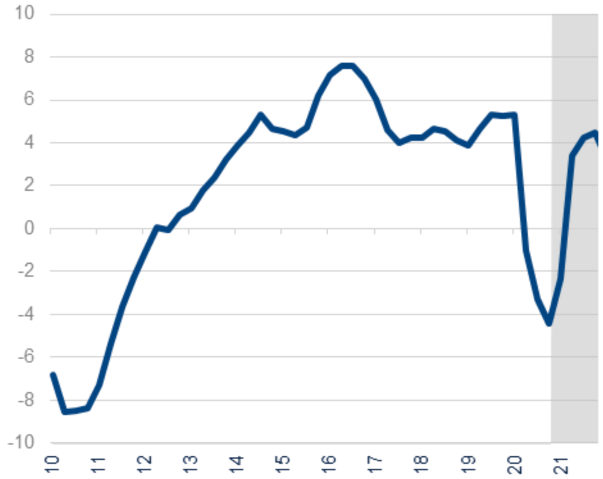
Auto loans, the other major category of consumer loans, also declined in April, but more modestly compared to credit cards, and reverted to solid growth starting in mid-May, as some households took advantage of steep discounts to purchase vehicles, which remain a necessity compared to general credit card spending. Auto loans also come with lower interest rates relative to credit card debt. Going forward, reopening, fiscal stimulus and gains in employment will counterbalance consumers' heightened sense of caution after last year's economic contraction. We expect households to start spending more and grow credit card balances again. In addition, new vehicle sales will continue recovering, while used car prices will maintain a solid rate of appreciation, albeit lower from the current 10% YoY. Banks are already loosening credit standards on credit cards and reporting an increase in willingness to provide installment loans. All this will lead to a pickup in growth in consumer loans over the next several quarters (Figure 20).

Figure 19. **CONSUMER LOANS OUTSTANDING** ($BN, SA)



Source: BBVA Research and Federal Reserve

Figure 20. **CONSUMER LOANS OUSTANDING** (% YOY)

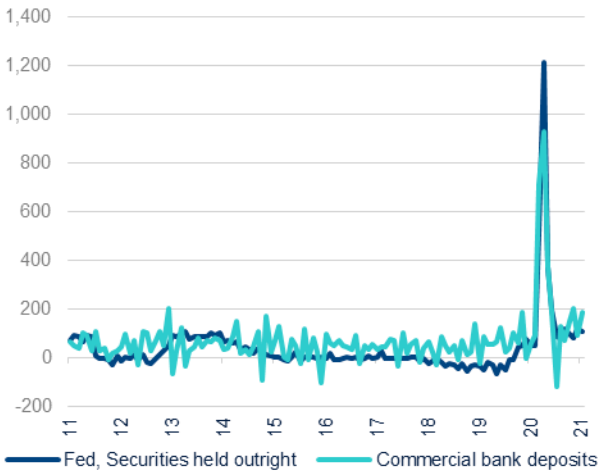


Source: BBVA Research and Federal Reserve

Deposits: Moderating growth

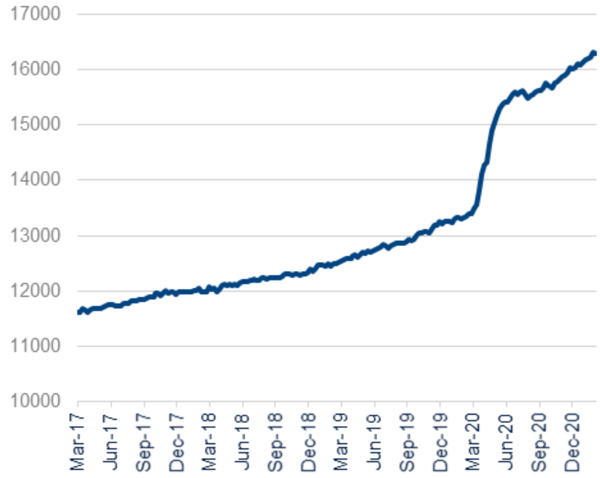
The Fed's balance sheet expansion through security purchases led to a strong jump in deposits (Figure 21). Between mid-March and mid-May, total deposits grew by an average of almost $200bn per week, resulting in a $2.3tn or 17% increase between the end of February and the end of July. In the second half of the year, the growth in deposits reverted to a more normal rate (Figure 22) of around 7% in annualized terms. Most of the increase occurred in demand deposits and savings deposits, of which Money Market Deposit Accounts (MMDAs) are a large part. At the same time, time deposits contracted (Figure 23) as households rebalanced their portfolios away from low yielding savings toward more liquid options. We expect the ongoing security purchases by the Fed, elevated savings rates by households, and increased preference for liquidity by businesses resulting from the supply chain disruptions over the last year, to be supportive of demand deposits, which have a balanced distribution of holders (Figure 24). In contrast, the downward trend in time deposits is expected to continue in the future as low interest rates and abundance of funds will keep time deposit rates low, leading to households, the primary holders of these instruments (Figure 25), to look for alternatives after their current time deposits mature. As a result, we expect demand deposits to increase by 12.2% and 5.2% and time deposits to decline by 10% and 0.1% in 2021 and 2022, respectively. MMDAs will benefit from the decline in time deposits and are expected to increase by 19.1% and 5.6% over this two-year period.

Figure 21. **SECURITIES HELD OUTRIGHT BY THE FEDERAL RESERVE AND BANK DEPOSITS** (MONTHLY CHANGE $BN, SA)



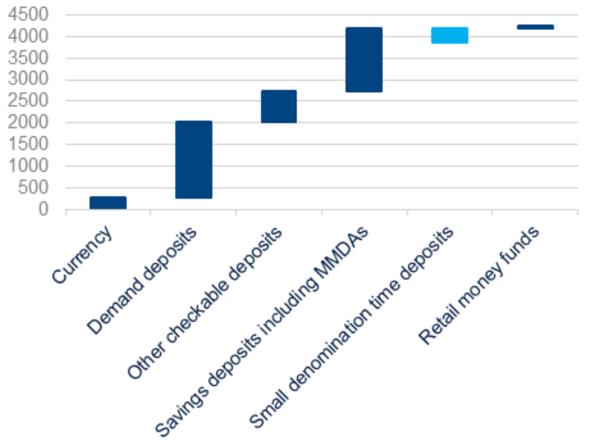
Source: BBVA Research and Federal Reserve

Figure 22. **TOTAL BANK DEPOSITS** ($BN, SA)



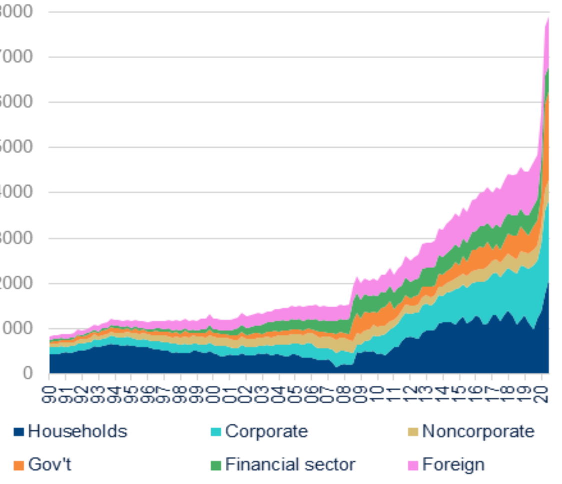
Source: BBVA Research and Federal Reserve

Figure 23. **CHANGE IN M2 SINCE FEBRUARY 2020** ($BN)



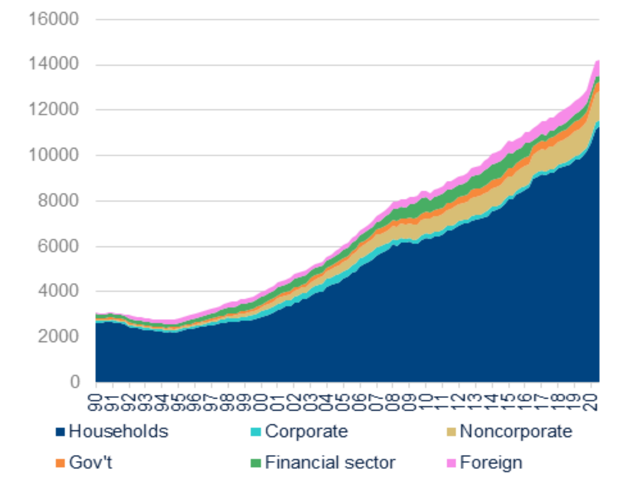
Source: BBVA Research and Federal Reserve

Figure 24. **CHECKABLE DEPOSITS AND CURRENCY BY HOLDER** ($BN)



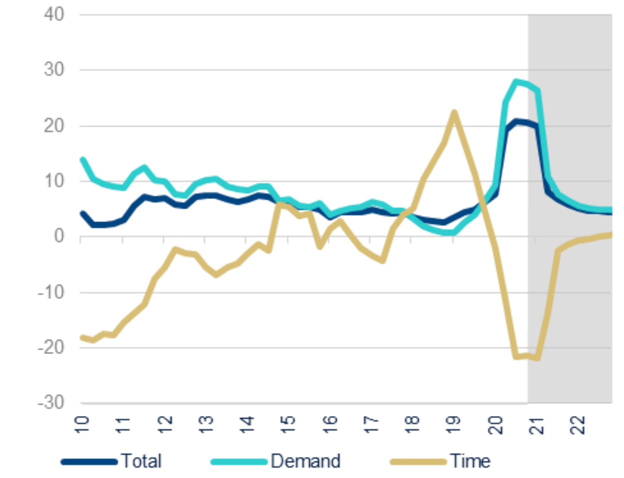
Source: BBVA Research and Federal Reserve

Figure 25. **TIME AND SAVINGS DEPOSITS BY HOLDER** ($BN)



Source: BBVA Research and Federal Reserve

Figure 26. **BANK DEPOSIT FORECASTS** (% YOY)



Source: BBVA Research, FDIC and Federal Reserve

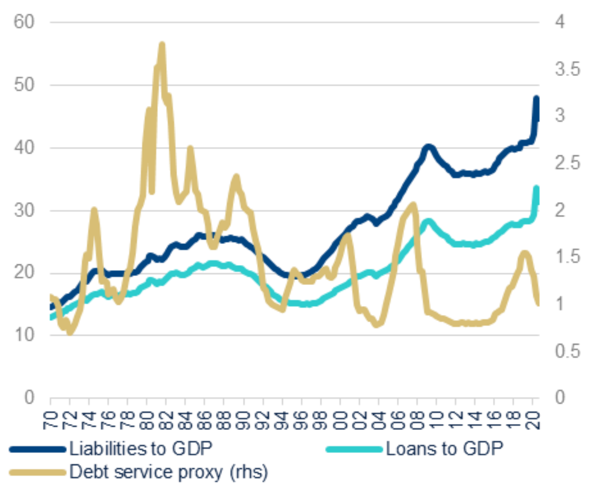
Credit quality: Much better than expected

The downturn had a negative impact on delinquencies and charge-offs, but its severity was dramatically limited by fiscal and monetary policy support. Additionally, underwriting practices over the last ten years were solid, particularly in the areas of residential mortgages and CRE loans, which means that the vast majority of current borrowers will be able to repay debt obligations if the economic recovery continues. Last but not least, delinquencies have started to increase from a low level, and in the case of credit cards, they dropped after households repaid credit card debt in 2Q20. As a result, delinquencies and charge-off rates stand at unusually low levels for a deep recession like the one experienced in 2020. The overall delinquency rate has increased modestly between the cyclical low in 4Q19 and 4Q20, from 1.45% to 1.62%, unlike in previous instances. For example, even in the mild recession of 2001, delinquencies increased from 2.42% to 2.75% over a comparable period.

While the credit quality deterioration in the second half of last year was significantly lower than previously anticipated, the aftereffects of the crisis are still expected to exert upward pressures on delinquencies and charge-offs in 2021, especially if fiscal policy support does not materialize as planned, or the pandemic takes a turn for the worse. In the mid-term, when fiscal and monetary policy support is gradually withdrawn, credit quality will be sustained by improved economic conditions and stable prospects, assuming no new exogenous shocks such as was the Covid crisis in 2020.

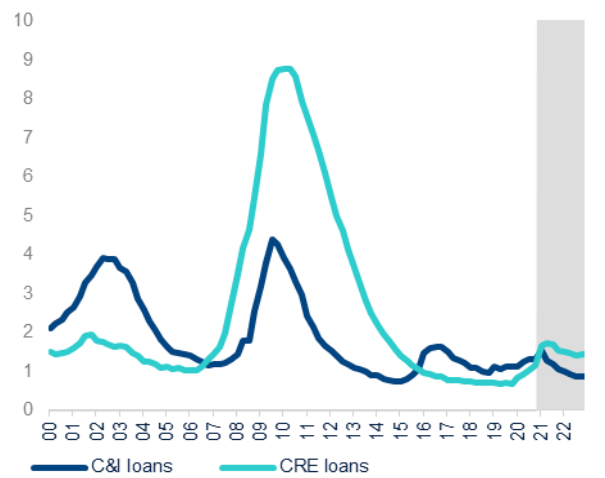
Commercial delinquencies will be driven by the disruption in discretionary service industries such as leisure and hospitality, restaurants, and air travel. Oil and Gas industry clients also have the potential to drive up delinquencies if the current recovery in oil prices is not persistent; for example, if OPEC+ output cuts are not appropriately sustained and managed. In any case, the increase in delinquencies will be more modest compared to prior recessions, as many companies have taken advantage of accommodative financial conditions to refinance debt, while smaller businesses have used the PPP lifeline. Moreover, borrowers are facing a highly positive outlook when economic growth accelerates later in the year. Low interest rates will continue to keep debt service costs low for some time, despite the high degree of business leverage built up before the pandemic (Figure 27). Between 4Q19 and 4Q21, C&I delinquencies increased modestly from 1.1% to 1.3%, and are expected to peak at 1.6% in 1Q21, before declining gradually thereafter (Figure 28). Although higher interest rates could exert some potential pressures over the mid-term, higher inflation will provide a cushion to business margins and profitability. CRE loan delinquencies increased from 0.7% to 1.2% between 4Q19 and 4Q21 and are expected to peak at 1.7% in 2Q21. The gradual decline in CRE delinquencies will be much slower compared to C&I, as the sector remains challenged structurally, particularly in the office and retail segments.

Figure 27. **LEVERAGE AND DEBT SERVICE BURDEN[3], NONFINANCIAL NONCORPORATE BUSINESSES** (%)



Source: BBVA Research and FRB

Figure 28. **COMMERCIAL LOANS DELINQUENCY RATES** (%)

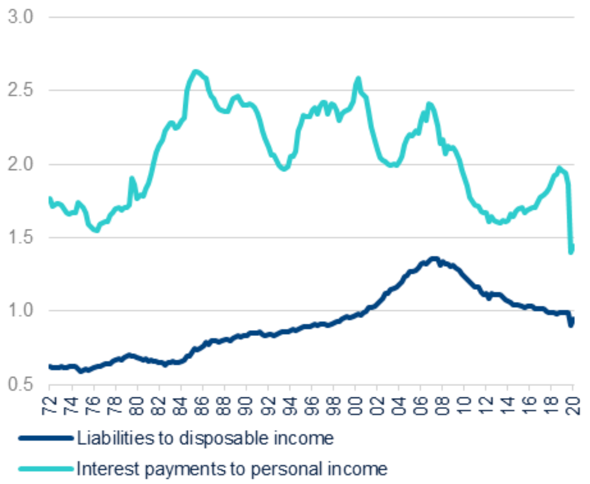


Source: BBVA Research and FRB

On the retail side, households remain solid borrowers. First, they reduced their leverage ratios over the last 10 years, and second, they face low debt service burdens due to low interest rates (Figure 29). That said, the pandemic downturn has impaired the ability of some households to keep up with their mortgage payments, and as a result, the residential loan delinquency rate has increased from 2.4% to 2.7% between 4Q19 and 4Q20. We expect the residential loan delinquency rate to increase to 3% in 1Q21 even though the government will continue to support rental payments, forbearance and foreclosure moratoriums. Consumer loan delinquencies, unlike the other types, actually declined from 2.4% to 2.0% between 4Q19 and 4Q20, due to households paying off credit card debt and remaining cautious with new spending. Nevertheless, we expect consumer loan delinquencies to increase to 2.3% in the first half of 2021, but then recede once the economy gains traction and labor market conditions improve.

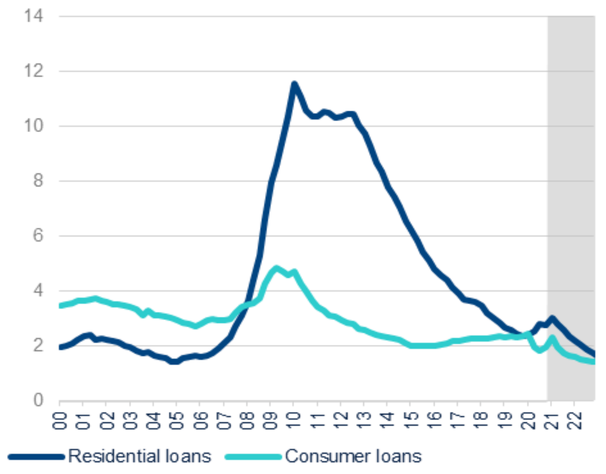
[3] Debt service burden proxy is calculated by multiplying the loans outstanding with the bank prime rate and dividing the result with nominal GDP

Figure 29. **HOUSEHOLDS' LEVERAGE AND DEBT SERVICE BURDEN** (%)



Source: BBVA Research and FRB

Figure 30. **RETAIL LOANS DELINQUENCY RATES** (%)

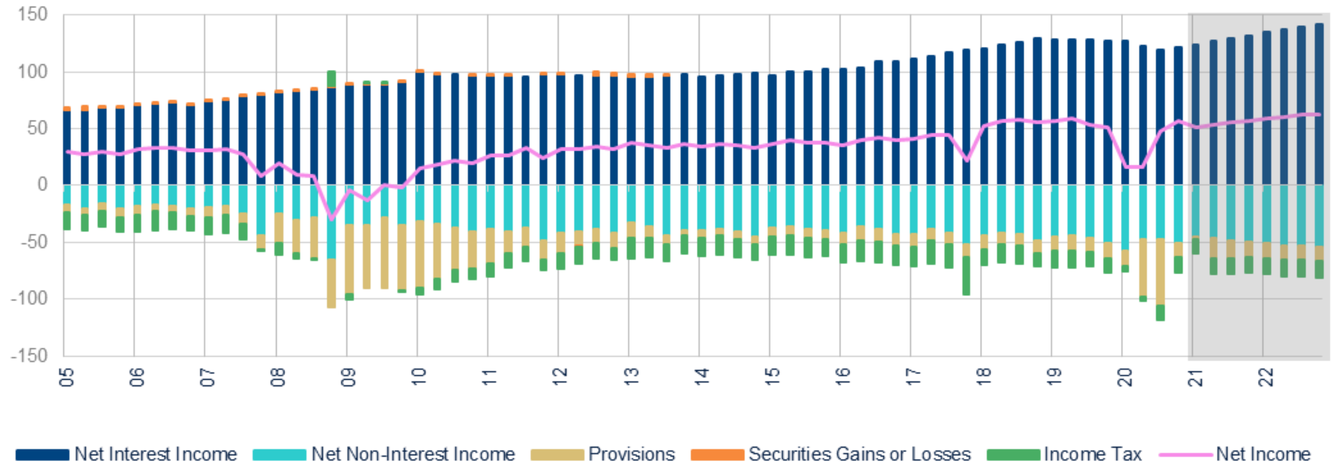


Source: BBVA Research and FRB

Profitability: Accelerated recovery in earnings

The Covid crisis resulted in a dramatic increase in provisions in the first half of last year, significantly cutting down profits. However, with credit quality deterioration not as high as anticipated, banks lowered provisions in the second half of the year. Based on individual quarterly reports, some banks even released reserves in 4Q20 due to the better-than-expected quality of their commercial portfolios, thereby boosting profit margins. In fact, commercial banks' net income reached $56bn in 4Q20, 3.5 times higher than in 2Q20 and 9% higher than in 4Q19. RoA in the last quarter of 2020 reached 1.11% after dipping to 0.33% in 2Q20, and while it was slightly lower than the 1.19% reached in 4Q19, it was similar to the 2011-2019 average. Going forward, banks will benefit from a strong economic recovery and steepening yield curve. Banks will continue to look for alternative ways to boost non-interest income and reduce costs, particularly through efficiency gains and technological advances. Under a baseline scenario, assuming a strong economic recovery and support from monetary and fiscal policy measures, we expect the industry to return to pre-recession profitability levels relatively quickly (Figure 31). Moreover, if economic growth accelerates significantly, banks could experience one of their best decade in a long period.

Figure 31. **COMMERCIAL BANKS, INCOME AND EXPENSE, QUARTERLY** ($BN)



Source: BBVA Research and FDIC

Bottom line

The resilience of the banking system and its socio-economic role proved critical in 2020 and led to improved public perception of the industry. After the roller-coaster of last year, banking aggregates will normalize in 2021. Virus control will gain traction, highly impacted sectors will gradually reopen, and the overall economic recovery will solidify with the support of policymakers. This environment will support strong loan origination and easing of credit standards. Deleveraging, a feature of post-recessionary periods, will be largely averted. Deposit growth will also remain solid throughout 2021 as the Fed continues purchasing assets and the economy expands further. Last year's large influx of deposits will remain in the system, leading to banks operating with higher deposits to loan ratios. Credit quality will remain satisfactory and profitability will be good. Over the mid- to long-term, profitability will remain favorable, especially for those institutions that can successfully implement a digital transformation to boost efficiency and meet the increasing demand for digital services. Banks that significantly increase small business lending, financing of business investment in new technologies, and support the transition to a sustainable economy, will not only effectively serve their purpose, but also support a robust economic expansion and meet the preconditions to maintaining strong financial performance over the long run.

DISCLAIMER