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2021 US Bank Market Report

Executive summary

- Unprecedented government stimulus and actions by the Federal Reserve to calm the credit markets have kept many borrowers afloat and bolstered credit quality, but banks have traded credit risk for pressure on net interest margins.
- Fed efforts to flood the markets with liquidity, along with record consumer savings rates driven by government stimulus, supported explosive growth in deposits in 2020. Deposits jumped more than 20% from year-ago levels, leaving banks flush with excess liquidity.
- Excess liquidity and historically low interest rates wreaked havoc on the banking industry's net interest margin, pushing the key profitability metric down 55 basis points to 2.77% in 2020.
- S&P Global Market Intelligence expects margins to remain well below historical levels in the near term, but the outlook for returns is far more favorable now than even a few months ago as credit costs should be significantly lower than previously expected.
- Returns on equity are expected to rise materially in 2021 as provisions for loan losses decline. As credit costs fall even more, returns on equity should reach double-digit levels in 2022.
- Few signs of credit deterioration have emerged to date, but asset quality is expected to slide in 2021 as relief efforts, including unprecedented forbearance provided by banks, have waned. Losses will be manageable and, in many cases, bank reserves stand well in excess of projected net charge-offs due to the adoption of a new reserve methodology dubbed the Current Expected Credit Loss model, that went in effect at the beginning of 2020 for institutions holding nearly 90% of the industry's assets. The provision requires banks to reserve for estimated losses over the life of a loan based on an economic forecast. Since CECL's initial adoption, the outlook for the economy has improved substantially.

Defining the industry

S&P Global Market Intelligence conducted an analysis highlighting banks' core balance sheet and income statement metrics as well as key capital, asset quality and performance ratios.

S&P Global Market Intelligence analyzed nearly 10,000 banking subsidiaries, covering the core banking industry from 2005 to 2020. The analysis includes all commercial and savings banks and savings institutions and historical institutions as long as they were still considered current at the end of a given year. It excludes several hundred institutions that hold bank charters but do not principally engage in banking activities, among them industrial banks, nondepository trusts and cooperative banks.

The analysis examined long-term performance over periods outside of the peak of the asset bubble from 2006 to 2007 to inform projections both in good and bad times. S&P Global Market Intelligence has created a model that projects the balance sheet and income statement of the entire industry and allows for different growth assumptions from one year to the next.

The examination divided the banking industry into five asset groups, using historically significant regulatory thresholds. S&P Global Market Intelligence looked at banks with assets of $250 billion or more; $50 billion to $250 billion; $10 billion to $50 billion; $1 billion to $10 billion; and $1 billion and below.

Trading credit risk for margin pressure

The coronavirus pandemic drastically changed the operating environment for the banking industry. Institutions grappled with the prospect of heightened credit losses, while struggling to put to work excess cash that filled their coffers amid government efforts to soften the economic blow of the pandemic.

Those efforts appear to have been successful to date and have significantly reduced credit risk, but they left bank balance sheets sodden with excess liquidity. The U.S. government's response to the pandemic has effectively propped up borrowers and lowered the prospect of heightened credit losses but in turn led to pressures on net interest margins.

Returns on average equity had returned to double-digit levels before the pandemic began, even against elevated capital levels. But returns came under pressure in 2020 due to lackluster margins and sizable reserve builds by institutions that were required to comply with CECL.

CECL became effective shortly before the pandemic began and marked a considerable shift in how banks reserve for losses. Under the longstanding prior reserve methodology, banks record losses when it becomes probable that a loan will be impaired, meaning reserves are dispersed over time. CECL changed this approach, requiring banks to significantly build their allowance for loan losses on the date of adoption.

While banks deducted the initial CECL reserve build from equity, subsequent reserving came through normal provisioning for loan losses and accordingly served as a headwind to earnings. That headwind turned into a gale force as dire forecasts for the economy required banks that had adopted CECL to record sizable provisions in the first half of 2020. For some banks, those provisions were large enough to wipe out a quarter's worth of earnings.

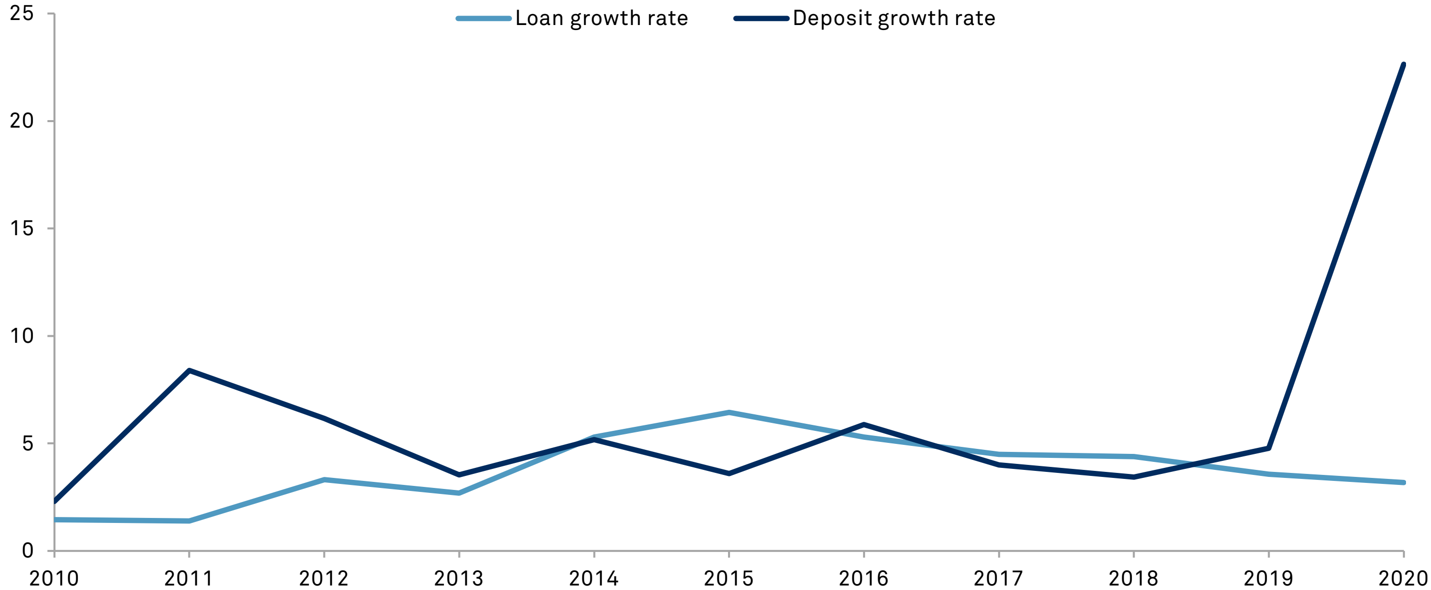
While provisions shot up at CECL banks, deposits continued to grow at elevated rates across the banking industry, leaving most institutions with too much cash and few attractive yield opportunities to put the funds to work. Banks recorded explosive deposit growth in 2020. But loan growth outside the government's Paycheck Protection Program, or PPP, remained hard to come by amid tightening underwriting standards and weak borrower demand.

Through the fourth quarter of 2020, deposits jumped 22.6% from a year earlier. Loan balances rose 3.2% year over year but actually declined when excluding loans made through the PPP.

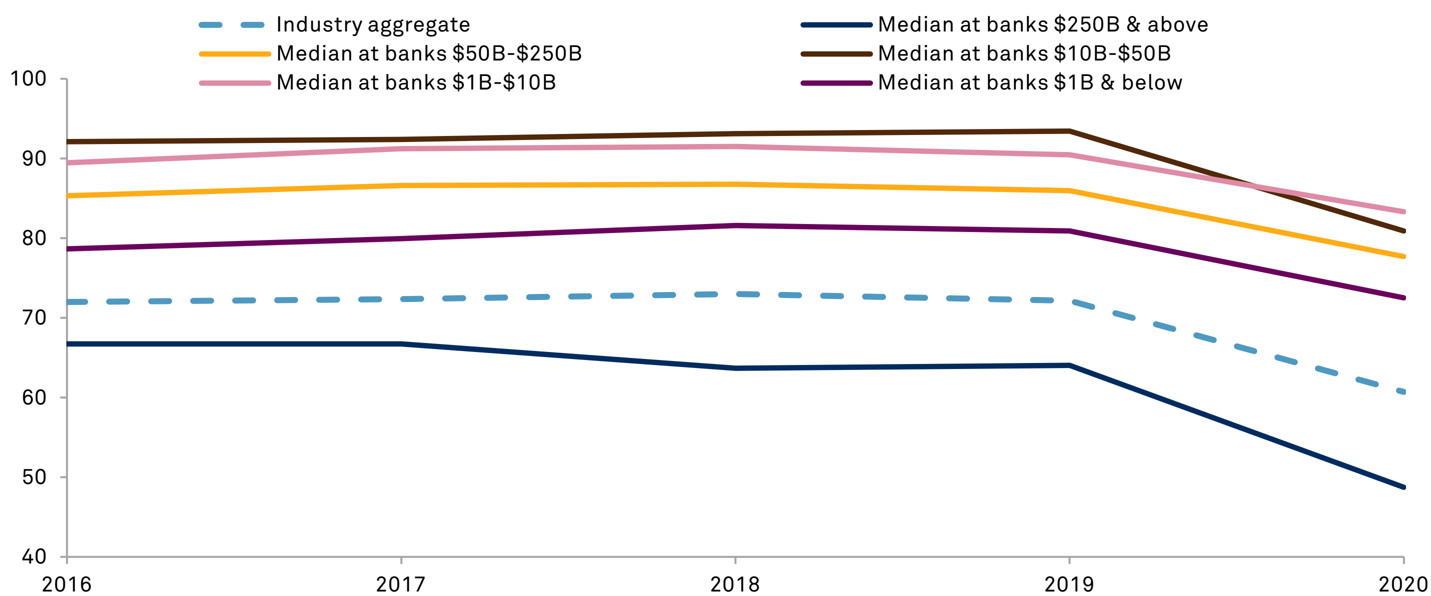
Some bankers had expected excess liquidity to abate late in 2020 as customers, including PPP borrowers, utilized deposit balances, but that did not happen. Since the end of the fourth quarter, the Federal Reserve's H.8 report, which tracks commercial bank balances, shows that deposits continued to grow through the week ending March 3, 2021, at a nearly 7% annualized rate.

Deposit growth has been supported by the Fed's efforts to flood the markets with liquidity through quantitative easing, which in turn has increased the level of reserves in the banking system. The Fed has maintained that it will continue asset purchases until its employment and inflation goals are met.

Deposit growth surges in 2020 amid government stimulus, actions to mitigate the pandemic (%)



Loan-to-deposit ratios plummet in 2020 (%)



Data compiled March 9, 2021.
Source: S&P Global Market Intelligence

Government stimulus has supported deposits as well, sending U.S. savings rates above 12% in every month since March 2020. Before the pandemic began, the monthly savings rate exceeded 10% just once since January 2000. Deposit growth also likely benefited as PPP borrowers and corporates that drew on existing lines of credit early in the pandemic parked the funds they received.

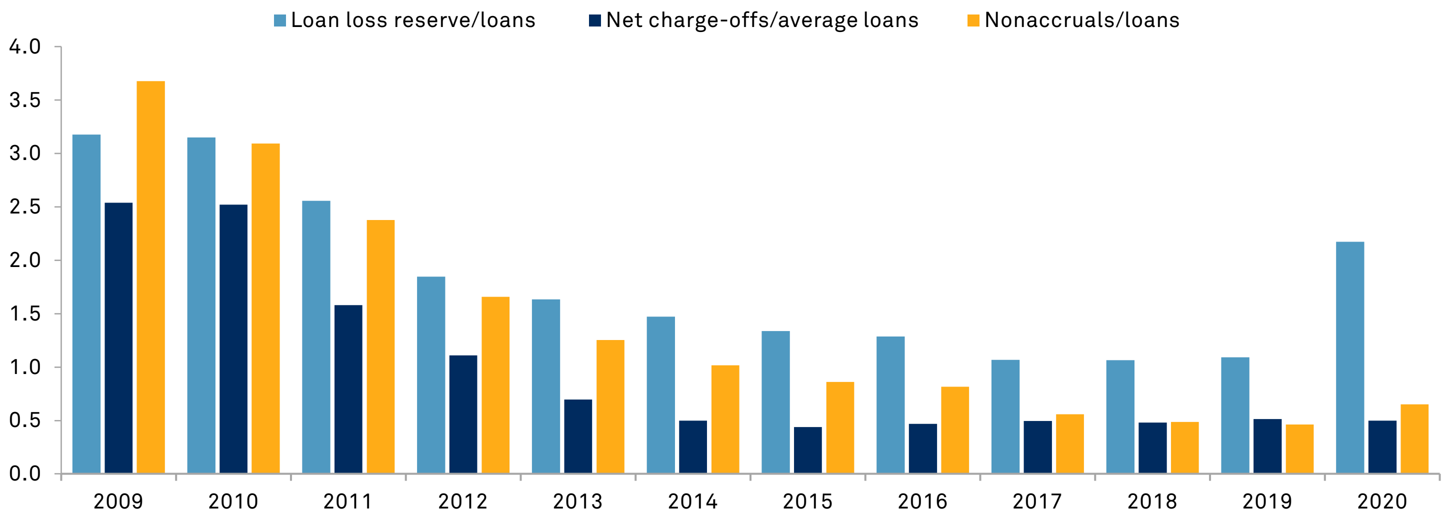
Banks have failed to put the influx of deposits to work, causing the industry's loan-to-deposit ratio to plunge to 60.72% from 72.18% a year earlier. The nation's largest banks — institutions with more than $250 billion in assets — have borne the brunt of the influx in liquidity, seeing their median loan-to-deposit ratio plunge to 48.76% in 2020 from 64.05% in 2019.

Credit quality deterioration minimal to date

While the pandemic led to the largest quarterly economic contraction since the Great Depression, banks' credit quality has largely held up to date.

Many borrowers have been kept afloat by government stimulus, expanded unemployment benefits, numerous lending facilities initiated by the Fed and unprecedented forbearance offered by banks.

While reserves jumped in 2020, few problem loans emerged (%)



Data compiled March 9, 2021.
Source: S&P Global Market Intelligence

The aggregate dollar figures associated with the pandemic-era government stimulus and Fed asset purchases and lending facilities are several multiples higher than the actions taken in the aftermath of the Great Recession.

The forbearance banks offered to borrowers through deferrals on loan payments has also been historic. Deferrals peaked in summer 2020 at an estimated $1.15 trillion, or 10.55% of the industry's loans, excluding loans made through the PPP. Deferrals have fallen steadily since then, decreasing to $443.5 billion, or 4.30% of the industry's ex-PPP loans at the end of the third quarter of 2020, and down further to $200.6 billion, or 1.94% of the industry's loans, excluding PPP loans, at the end of the fourth quarter of 2020. Banks said many borrowers resumed normal payments once their deferral period expired.

The Coronavirus Aid, Relief, and Economic Security Act, passed in late March 2020, permitted financial institutions to avoid classifying loan deferrals related to the COVID-19 pandemic as troubled debt restructurings, or TDRs. Since deferrals were not classified as TDRs, banks were not required to test them for impairment. That provision was originally set to expire Dec. 31, 2020, but was extended to Jan. 1, 2022, in the recent stimulus package.

Several trillion dollars in government stimulus and more than $500 billion in government guaranteed loans through the PPP no doubt propped up many borrowers during 2020 as well.

Credit quality slid to some extent in 2020 but not nearly as badly at the investment community had expected in the early days of the pandemic. Nonaccruals rose to 0.65% of loans in 2020 from 0.46% in 2019, while net charge-offs dipped to 0.50% of average loans from 0.51% in 2019.

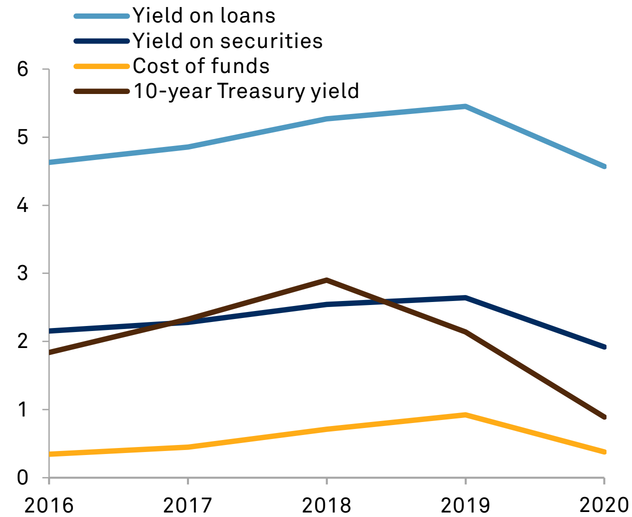
Banks seeking scale to compete in challenging environment

As the industry has faced a challenging operating environment marked by low interest rates, soft loan demand and the prospect of higher credit costs, more regional banks have pursued sizable acquisitions to better serve their customers and drive earnings higher.

Three of the five largest bank deals in the last decade have emerged since November 2020, and investors have responded with enthusiasm. M&T Bank Corp. recently joined the ranks of larger institutions returning to the M&A game, announcing plans to purchase People's United Financial Inc. for $7.56 billion, which represents the fourth-largest bank transaction since 2011. Two other large deals — PNC Financial Services Group Inc.'s planned $11.57 billion purchase of BBVA USA Bancshares Inc., unveiled in November 2020, and Huntington Bancshares Inc.'s $5.95 billion merger with TCF Financial Corp., announced in December 2020 — also involved larger regional acquirers. Few large, regional banks announced acquisitions in the aftermath of the global financial crisis in 2008, but that appears to be changing as institutions seek scale to leverage past technology investments or improve efficiency.

Buyers expect the deals to produce considerable earnings accretion after projected cost savings are fully realized, ranging from 7% to 8% at the low end in the M&T/People's deal to 50% at the high end in the First Citizens/CIT transaction. That is particularly attractive given the pressure facing net interest margins, which have plummeted as excess liquidity flooded large institutions' balance sheets.

Fed actions to stabilize credit markets put pressure on yields (%)



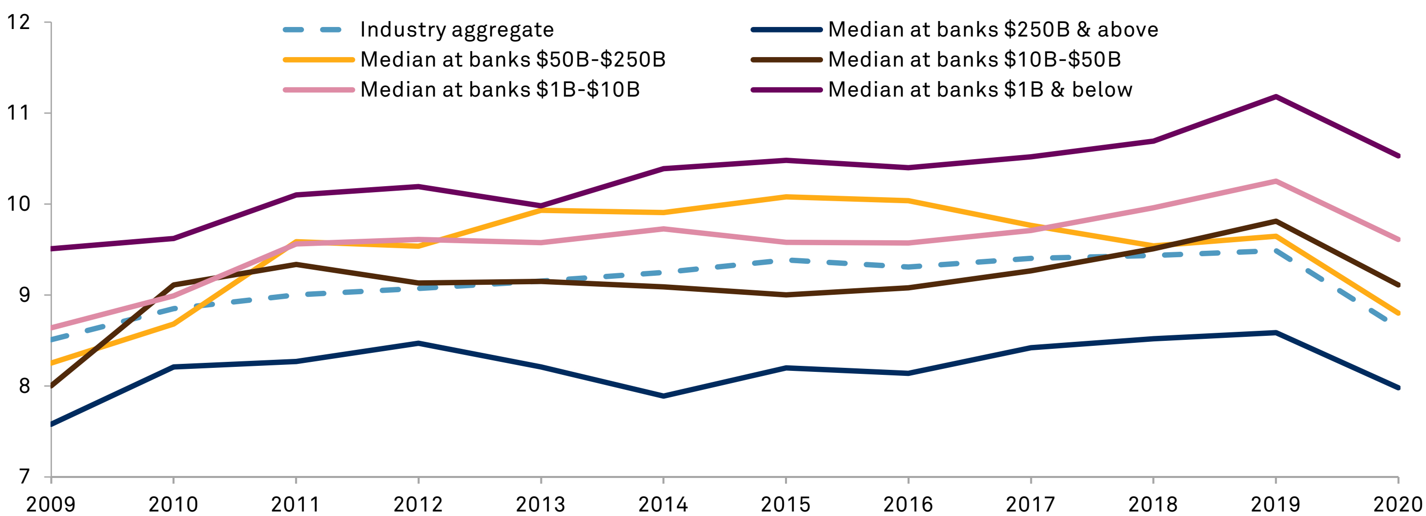
Data compiled March 9, 2021.
Source: S&P Global Market Intelligence

While any buyer still needs to reconcile with a target's credit quality, larger banks are arguably in a better position to pursue deals now than they have been in past cycles. The institutions boast some of the strongest capital ratios in the industry and importantly, also trade at higher valuations than their smaller counterparts.

Banks also have the capital wherewithal for M&A as capital levels remain near record highs. Tangible equity ratios dipped modestly in 2020 simply because of balance sheet growth driven by cash flooding into the system, but much of the expansion came in assets with little to no risk, such as cash held at the Fed.

Capital levels decline as flood of liquidity drives balance sheet growth

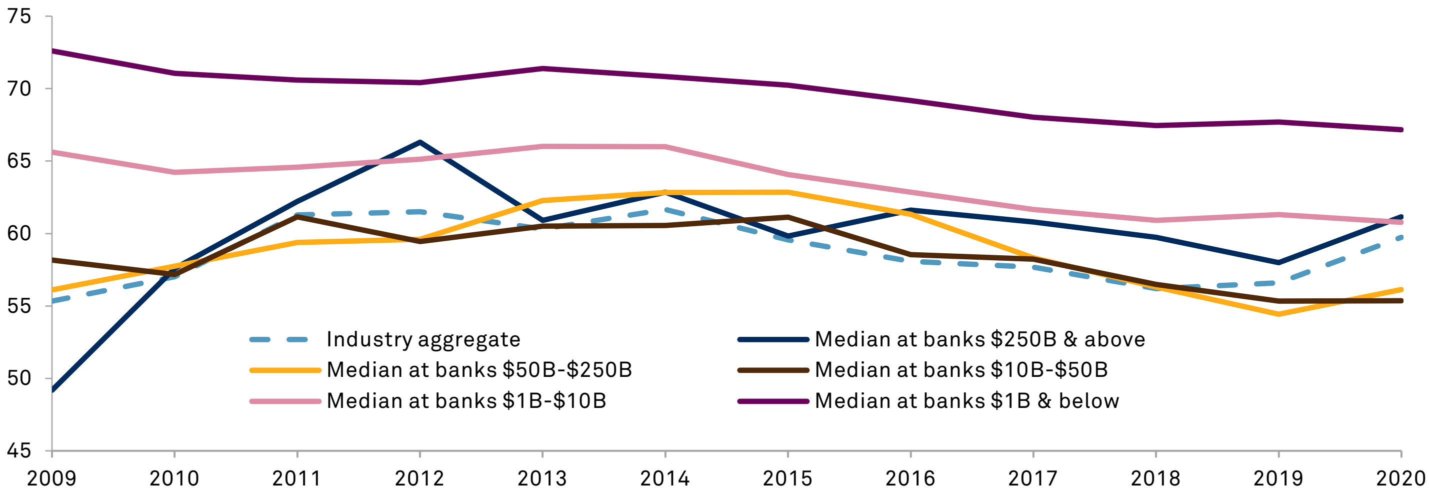
Tangible equity-to-tangible assets ratio (%)



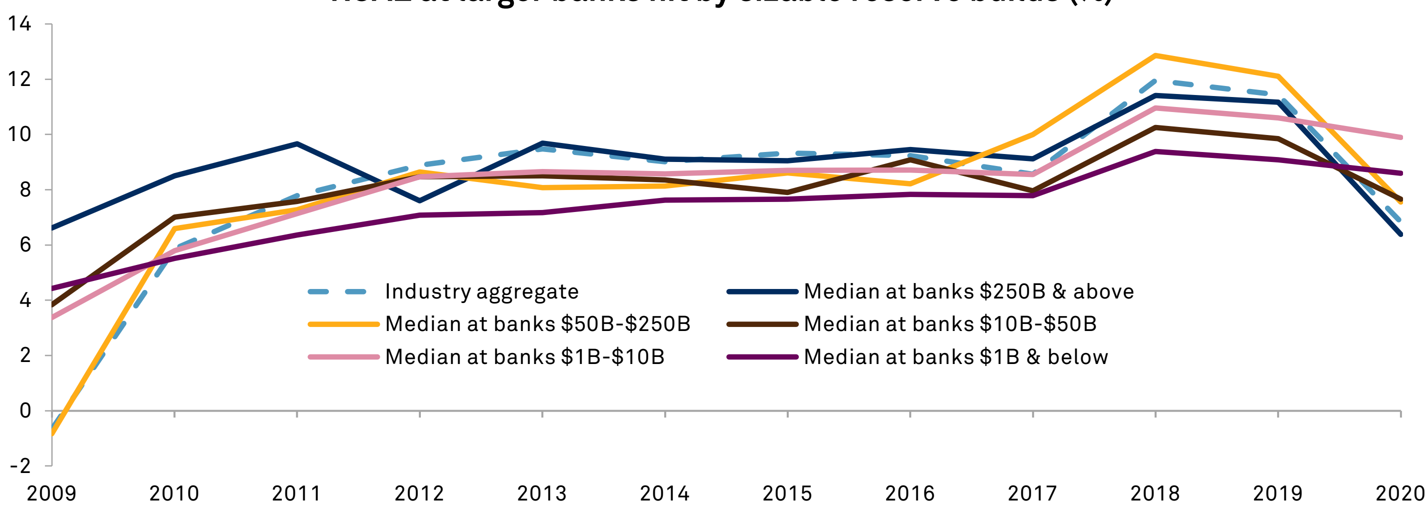
Data compiled March 9, 2021.
Source: S&P Global Market Intelligence

Putting cash to work in those assets has added to pressure on margins and contributed to efficiency ratios rising at many banks over the last year. The increase has been greatest at the largest banks, which have seen the most deposit growth.

After years of improvement, net interest income pressures cause efficiency ratios to rise (%)



ROAE at larger banks hit by sizable reserve builds (%)



Data compiled March 9, 2021.
Source: S&P Global Market Intelligence

Outlook

Historically low net interest margins and elevated credit costs hindered bank profitability in 2020, but a rebound is in the offing.

S&P Global Market Intelligence projects that the banking industry's earnings will jump 40% in 2021 as provisions fall substantially from year-ago levels. We see earnings growing nearly 17% in 2022 as credit quality improves and margins expand.

Higher tax rates would limit that continued growth in earnings. President Joe Biden campaigned on increasing the corporate tax rate to 28% from the current 21%. As of late March, the Biden administration was reportedly considering a tax hike to support a plan that includes $1 trillion in infrastructure spending. If the corporate tax rate rose to 28% beginning in 2022, all else being equal, bank earnings would rise just 6.6% from 2021.

Bank industry aggregate profitability metrics (%)

	2020A	2021P	2022P	2023P	2024P	2025P
Efficiency ratio	59.74	61.36	60.52	58.72	57.64	57.05
Net interest margin	2.77	2.80	2.84	2.95	3.03	3.08
ROAA	0.71	0.92	1.04	1.12	1.32	1.23
ROAE	6.83	8.99	10.05	10.78	12.63	11.85

Adjusted for potential tax increases — assumes 28% tax rate beginning in 2022

	2020A	2021P	2022P	2023P	2024P	2025P
ROAA	0.71	0.92	0.95	1.02	1.20	1.12
ROAE	6.83	8.99	9.18	9.88	11.61	10.92

Data compiled March 23, 2021.
A = actual; P = projected
Sources: S&P Global Market Intelligence; proprietary estimates

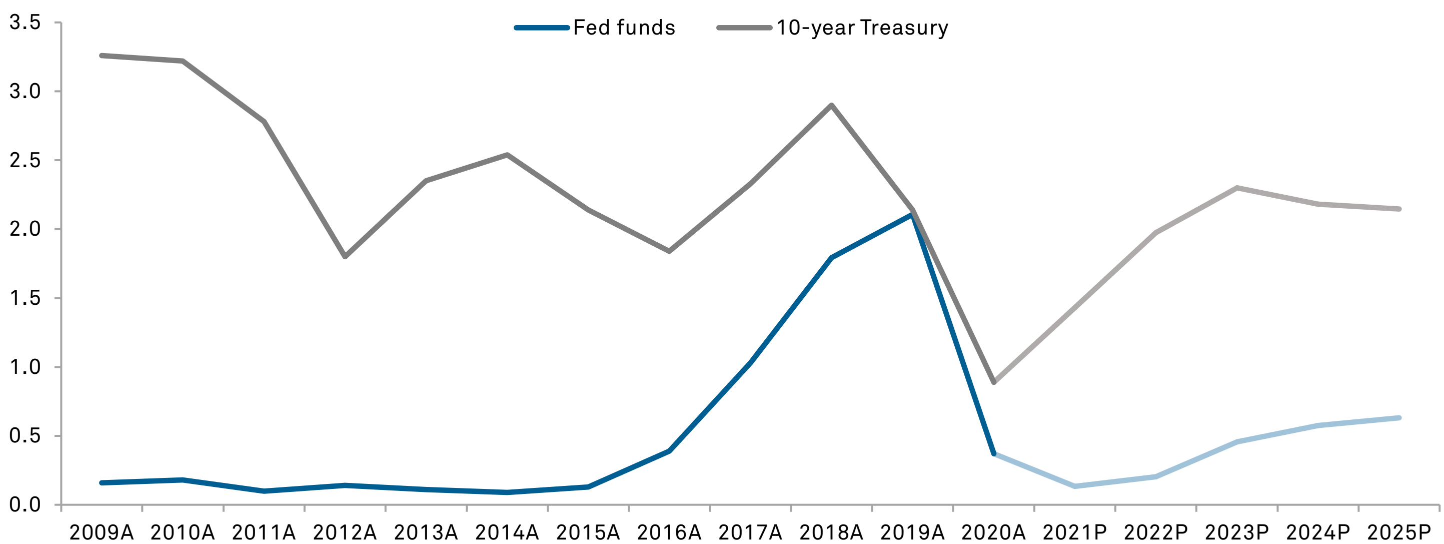
We acknowledge the likelihood for market-changing events to occur over a five-year period but have created projections for 2021 through 2025 based in part upon economists' consensus expectations for interest rates, unemployment and economic growth. S&P Global Market Intelligence reserves the right to update or revise the projections at any time as developments warrant, particularly when material changes occur.

The projections are intended for consideration as a baseline for the industry and may not necessarily be applicable at the individual bank, state or regional levels.

Projections are based on management commentary, discussions with industry sources, regression analysis, and asset and liability repricing data disclosed in banks' quarterly call reports. While taking into consideration historical growth rates, S&P Global Market Intelligence often excluded from its analysis the significant volatility experienced in the years around the credit crisis.

The projections assume future fed funds rates and 10-year Treasury yields based on a monthly survey of more than 60 economists conducted by *The Wall Street Journal.* Interest rate assumptions for 2022 are based on 3-point averages of estimates in the Journal survey. The 2023 figures blend figures from *The Journal* and estimates provided by the Congressional Budget Office, while the 2024 and 2025 figures are based on CBO estimates. S&P Global Market Intelligence does not forecast changes in interest rates or macroeconomic indicators. We project what the banking industry should look like if the future holds what most economic observers expect.

Interest rate assumptions based on external sources (%)



Data compiled March 10, 2021.
A = actual; P = projected
Figures for the federal funds rate and 10-year Treasury yield through 2022 are based on 3-point averages including estimates provided in The Wall Street Journal's monthly survey of more than 60 economists. The 2023 figures blend figures from the Journal and estimates provided by the Congressional Budget Office, while the 2024 and 2025 figures are based on CBO estimates.
Actual reported figures used when available.
Sources: S&P Global Market Intelligence; The Wall Street Journal; Congressional Budget Office

Earnings rebound on the horizon

While banks are expected to remain sodden with excess liquidity, the outlook for credit quality is far more favorable than even a few months ago and should allow banks to begin releasing reserves.

Loan growth, meanwhile, will remain hard to come by while deposits continue to move into the banking system. This dynamic will keep pressure on net interest margins even as long-term interest rates have returned to pre-pandemic levels.

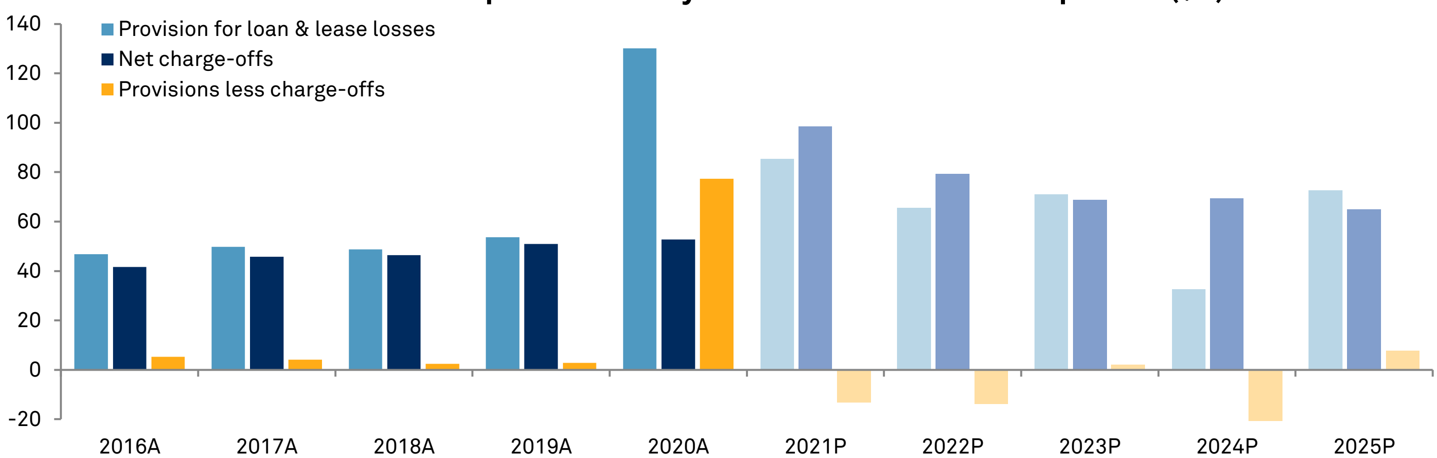
S&P Global Market Intelligence expects noninterest income and noninterest expense to hold fairly steady as a percentage of average assets. While banks work to improve efficiency by utilizing scale and technology, costs are likely to rise as institutions invest in credit workout teams and consultants to manage higher problem loans.

Credit costs poised to rise but not as high as previously expected

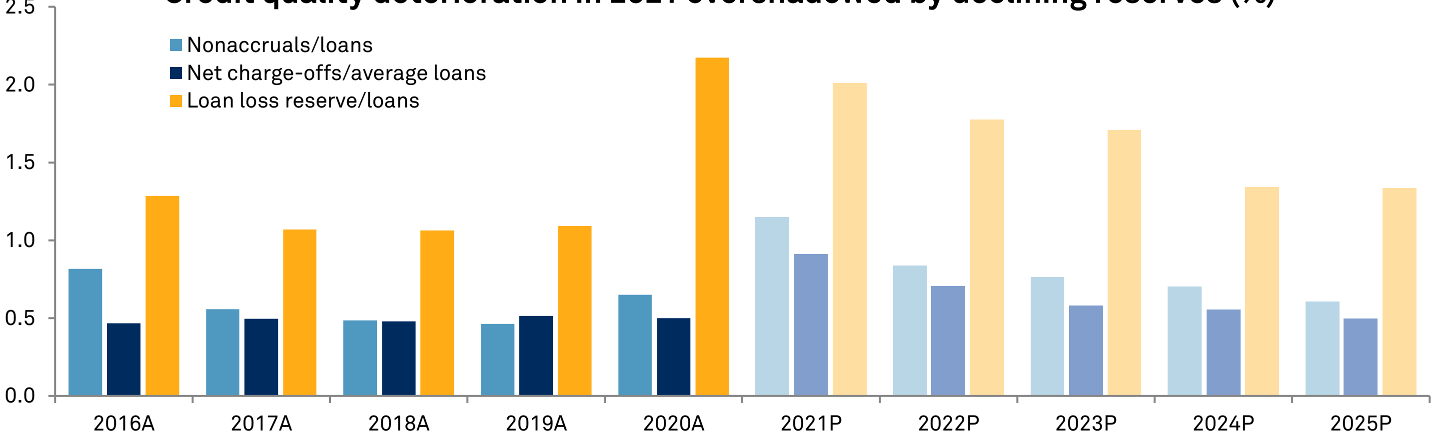
After building reserves dramatically in 2020, banks will release reserves this year as the economic outlook has improved. As of summer 2020, unemployment was expected to remain above 8% through 2021, but now the consensus among more than 60 economists is for unemployment to fall to 5.80% in 2021.

The massive reserve builds through 2020 will prove more than ample to cover realized credit losses in 2021, allowing institutions to substantially reduce provisions for loan losses. The reduction in provisions will result in banks releasing reserves, which will fall to the bottom line.

Provisions will drop dramatically as credit outlook has improved ($B)



Credit quality deterioration in 2021 overshadowed by declining reserves (%)



Data compiled March 23, 2021.
A = actual; P = projected
Sources: S&P Global Market Intelligence; proprietary estimates

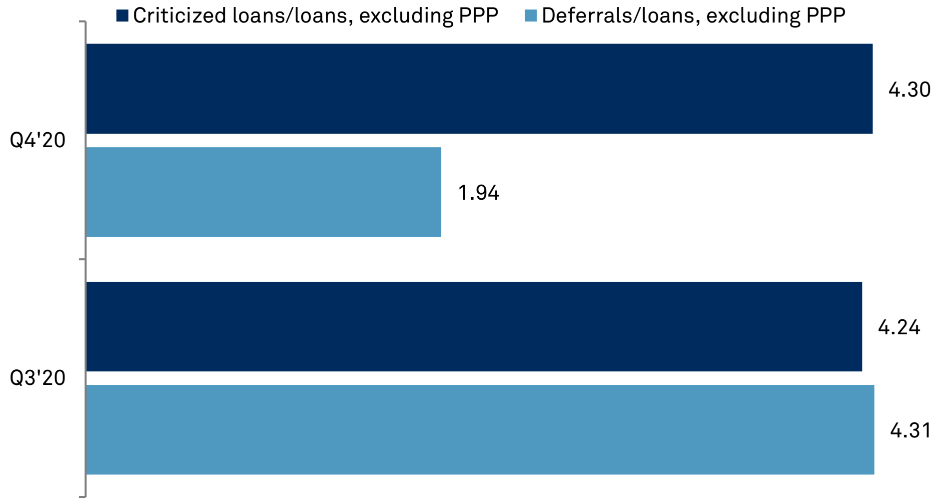
With few credit issues emerging and outlook for the economy improving, we expect reserves to fall to 2.01% of loans in 2021, down from 2.17% in 2020.

While the economic outlook has improved, problem loan indicators such as criticized loans — loans categorized by the company as special mention, substandard, doubtful or loss — have increased modestly. We estimate that criticized loans rose to 4.30% of ex-PPP loans at the end of the fourth quarter from 4.24% in the third quarter.

Various bankers say they have not seen criticized loans migrate into territory where they would produce losses, however. They recognize that stress exists in the market and that some losses will likely materialize, but they noted that many borrowers have shown they were more prudent heading into the pandemic and that far fewer have asked for additional deferral concessions.

Criticized loans climbed modestly late in 2020

Criticized loans, COVID-19 deferrals across the banking industry (%)



Data compiled March 24, 2021.
Criticized loans = Loans that are categorized by the company as special mention, substandard, doubtful or loss.
PPP = Paycheck Protection Program
Balance sheet metrics used in the analyses for Q4'20 and Q3'20 were based on their respective period ends.
Analysis based on disclosures of publicly traded banks.
The analyses for Q4'20 and Q3'20 were based on disclosures from more than 400 publicly traded banks.
Sources: S&P Global Market Intelligence; proprietary estimates

Some bankers say that risk ratings practices have differed from one institution to another and that regulators could soon pressure institutions to take more aggressive risk ratings.

Still, reserve levels should easily cover the amount of potential losses on criticized loans on banks' books, particularly given the considerable reserve builds in 2020 by larger banks through CECL.

Our outlook assumes that roughly 30% of criticized loans will eventually default. That estimate is based on the historical composition of criticized loans among special mention, substandard, doubtful or loss categories between 2011 and 2014. We assumed certain loss content would be associated with the loans based on necessary reserves that the Office of Inspector General found were required in adversely classified loans in a study of failed institutions. We then compared the aggregate loss content against banks' historical loss given default. We calculated a historical loss given default of approximately 56% based on banks' loss experience from 2007 to 2009 and an FDIC study on loss given default on assets at failed banks during the Great Recession.

Based on those assumptions as well as credit loss estimates driven by the outlook for unemployment and the aggregate of consensus expectation for net charge-offs among 200 publicly traded banks, we project that charge-offs will rise to 0.91% of average loans in 2021 from 0.50% in 2020. We then expect net charge-offs to dip to 0.71% of average loans in 2022 as the economic environment improves. Those loss expectations are down considerably from previous estimates published in the summer and fall of 2020.

Economists' and investors' expectations for a resurgence in economic growth supports the improved outlook and has been reflected in the bond market, with the 10-year Treasury yield rising back above 1.5% to pre-pandemic levels. When concerns about pandemic-related economic fallout were their greatest, the benchmark 10-year dropped below 0.60%.

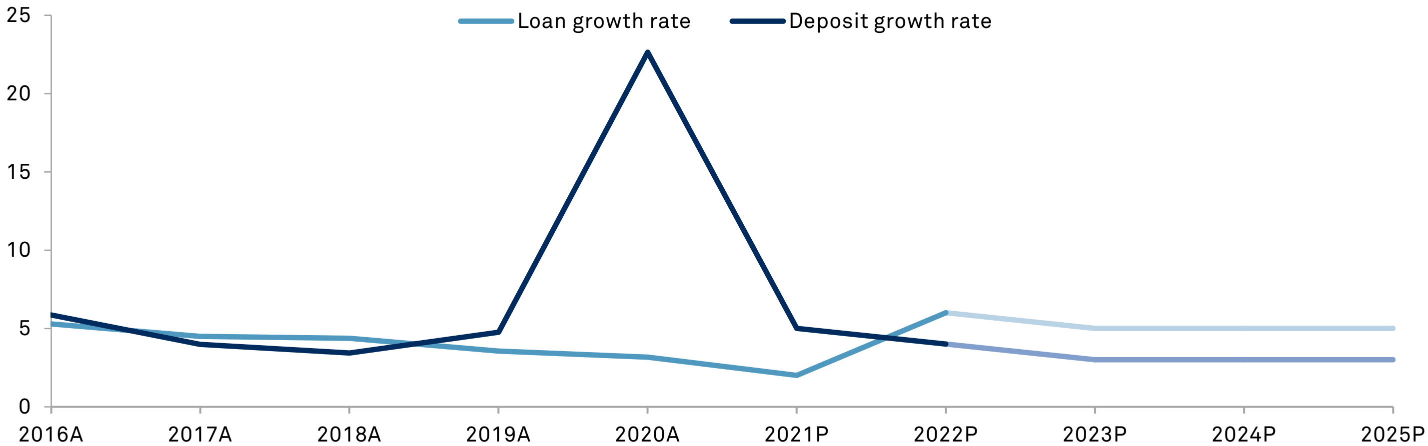
Economists now expect the benchmark yield to rise further and reach 1.78% by December 2021 — 50 basis points higher than the consensus estimate just a few months ago.

Banks drowning in excess liquidity

Excess liquidity continues to build on bank balance sheets as government stimulus has supported additional deposit growth, while loan demand has remained weak.

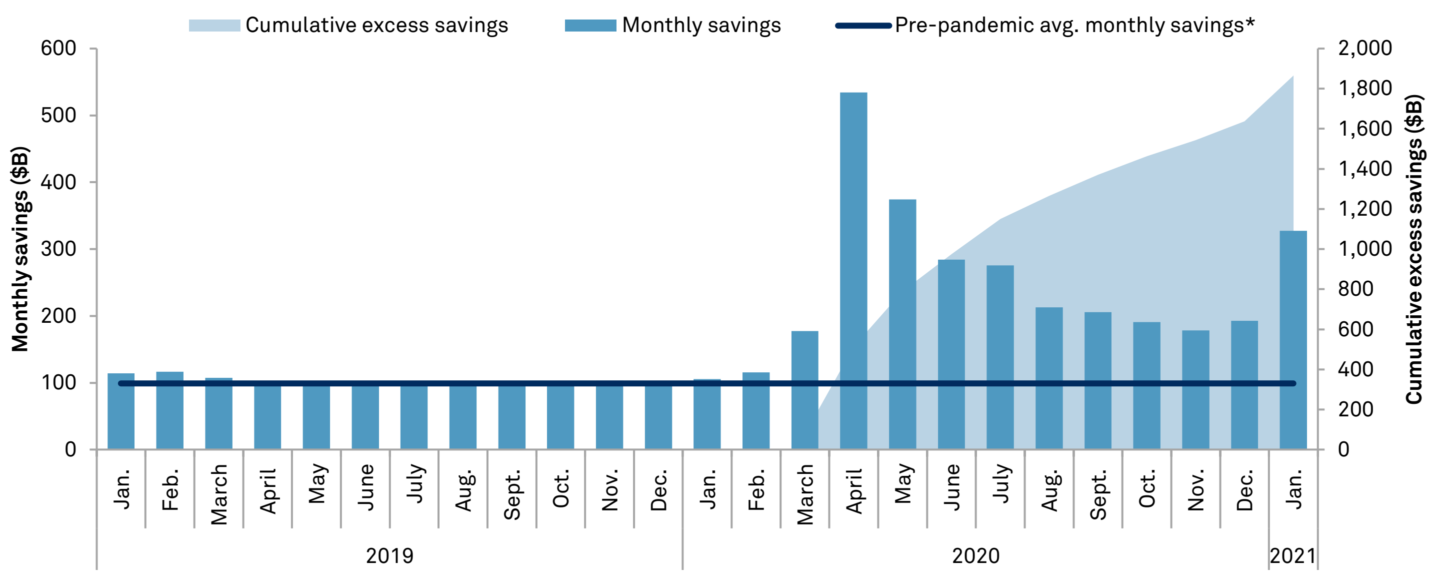
Federal Reserve data shows that loan balances have been flat through the first two months of 2021, but S&P Global Market Intelligence expects loans to grow modestly in 2021, climbing 2% from year-ago levels as economic activity resumes in the second half of 2021.

Excess liquidity will continue to build on bank balance sheets (%)



Data compiled March 23, 2021.
Sources: S&P Global Market Intelligence; proprietary estimates

Savings have exploded, jumping above the pre-pandemic, 3-year average

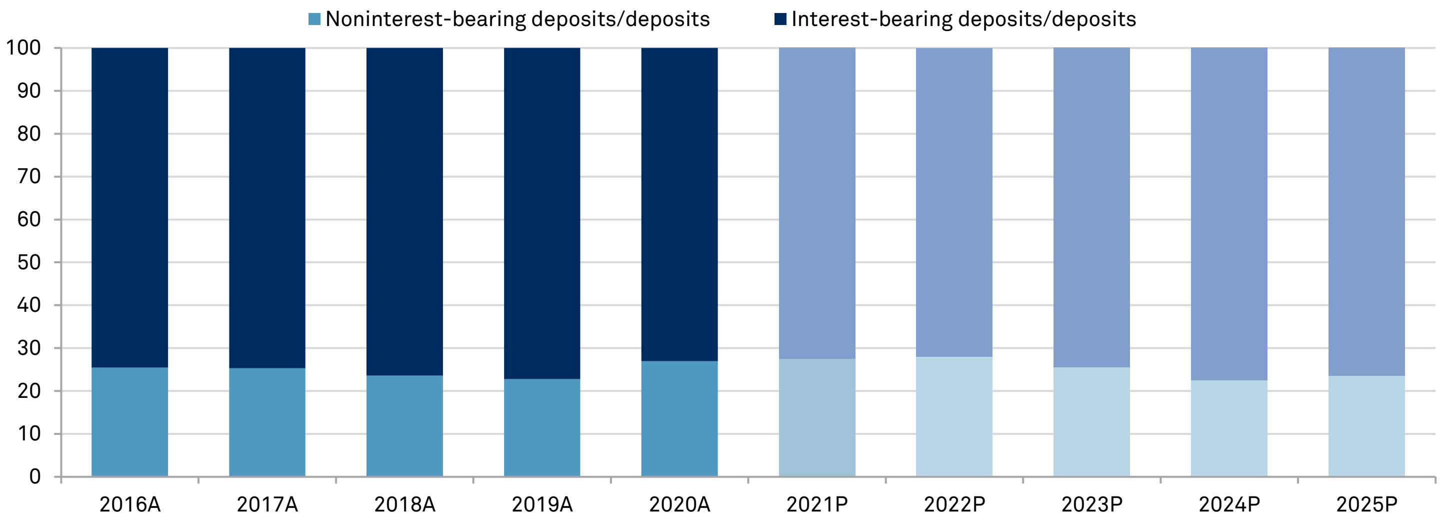


Data compiled March 9, 2021.
Data last revised on Feb. 26, 2021.
* Represents the average monthly savings from January 2017 through February 2020.
Excess savings represents dollars saved above the average monthly savings from January 2017 through February 2020.
Sources: Bureau of Economic Analysis; S&P Global Market Intelligence; proprietary estimates

Deposit growth should outpace loan growth but could wane from the elevated pace seen in the first few months of 2021 as consumers put excess savings to work. Consumers have recorded near-record savings rates over the last year, accumulating nearly $2 trillion in excess savings. We arrived at that figure by assuming every dollar over the monthly average savings between January 2017 and February 2020 was excess.

The savings rate spiked again to nearly 20% in January 2021 due to the passage of $900 billion in stimulus in December 2020. An even larger, $1.9 trillion stimulus package was signed into law in early March and likely will support further deposit growth in the near term. But the distribution of vaccines should allow economies to reopen, which in turn should cause consumer spending to increase.

For now, the explosive deposit growth has led to a positive shift in the composition of bank deposits as noninterest-bearing funds have become larger portions of banks' funding bases.



Data compiled March 23, 2021.
A = actual; P = projected
Sources: S&P Global Market Intelligence; proprietary estimates

Loan yields stabilizing

Loan yields across the banking industry plummeted in 2020 due to rate cuts by the Fed, the plunge in long-term rates and little loan demand outside of PPP borrowers.

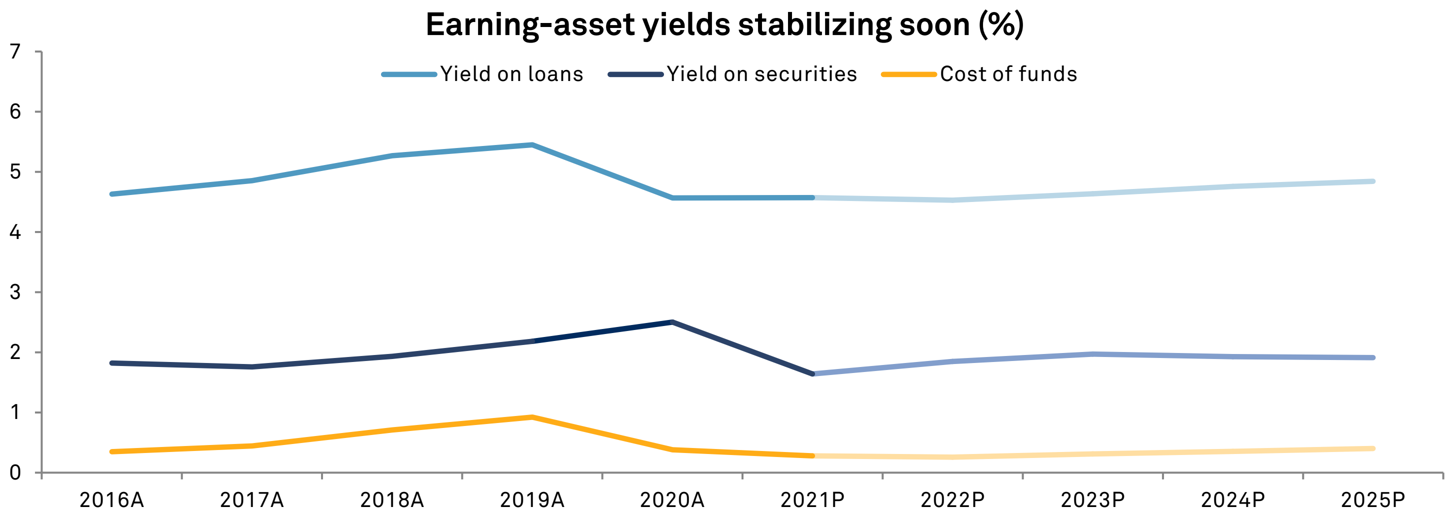
The fed funds rate remained near zero for much of 2020, and the average yield on the 10-year Treasury dropped in 2020 to 0.89%, down 125 basis points from the average in 2019.

Loan balances rose 3.2% year over year but actually declined when excluding loans made through the PPP. The fact that PPP drove loan growth is particularly noteworthy because the government guaranteed credits carry rates of just 1%.

The program offered small businesses low-rate, forgivable financing provided that borrowers use a majority of the funds for payroll. While the loans carry low rates, the credits are expected to bring fees of about 3% on average once loans are forgiven, but that process took longer than many bank watchers expected.

As the PPP forgiveness process began and long-term interest rates rose in the fourth quarter, loan yields stabilized.

S&P Global Market Intelligence expects the industry's loan yield to hold steady at 4.57% in 2021 and then dip to 4.53% in 2022.



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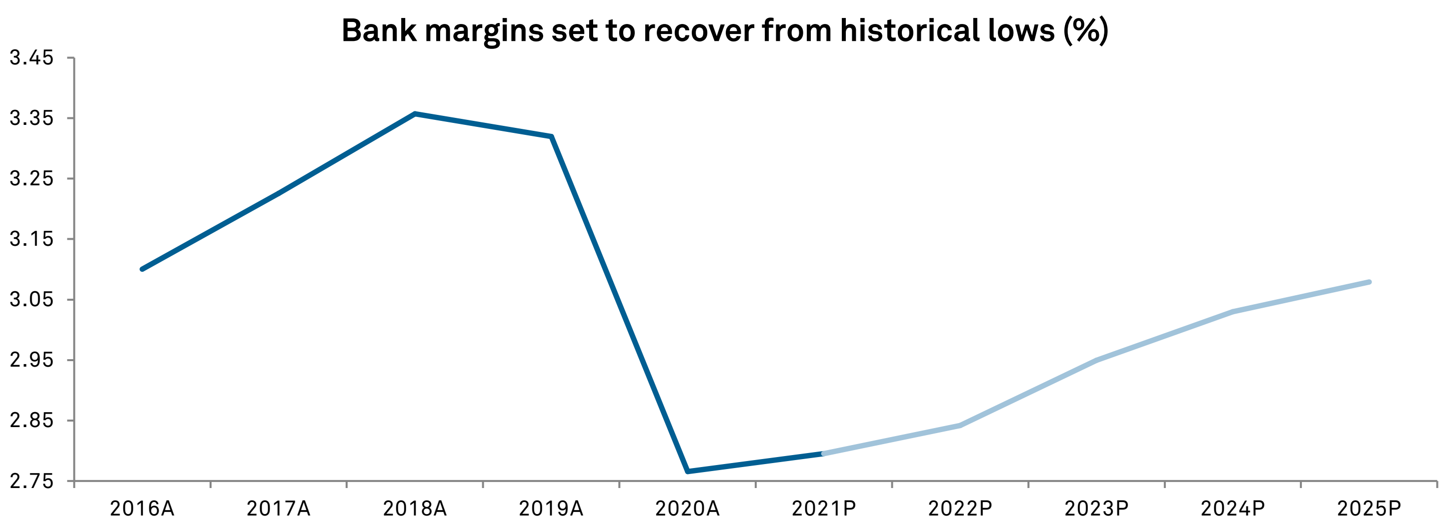
Banks have begun to reach further out the yield curve in their securities portfolios to combat the pressure of falling rates but will struggle to deploy the built-up liquidity on their balance sheets at attractive rates. S&P Global Market Intelligence projects the banking industry's security yield will dip to 1.90% in 2021 from 1.92% in 2020.

Banks have offset some of the pressure on earning-asset yields by lowering deposit costs, and that trend should continue, albeit at a slower pace as the cost of interest-bearing deposits has nearly reached historically low levels.

That dynamic should prevent margins from returning to pre-pandemic levels over the next few years.



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