S&P Global
Market Intelligence

2018 US Bank Market Report Executive Summary

- Rising interest rates will support stronger net interest margins at U.S. banks, but tax reform will offer a bigger earnings boost in 2018 and push returns on equity well into the double-digits, even against elevated capital levels.
- In our baseline scenario, which does not include the impact of an upcoming change in banks' reserve methodology, returns on average assets and average equity will expand due to a lower corporate tax rate and interest rate increases, pushing the industry's ROAA and ROAE as high as 1.25% and 11.29%, respectively, in 2019. But credit costs will rise shortly thereafter and serve as a considerable earnings headwind to the industry.
- Asset quality should remain strong in the near term, with tax cuts supporting the current credit cycle. However, the rush to lever tax reform's windfall will spark more intense competition for loans, preventing yields from rising to previously expected levels.
- Before credit quality sours, banks will start seeing more significant increases in deposit costs. Deposit betas, or the percentage of rate increases that institutions pass on to their customers, rose modestly in 2017 and should double in 2018 as the market digests higher interest rates and banks' funding needs grow.
- Competition will increase as the Trump administration achieves some level of regulatory relief, which could eventually lead to a slippage in underwriting standards. Less prudent lending practices could coincide with further increases in interest rates, causing more borrowers to default.
- The adoption in 2020 of a new accounting standard that changes the way banks reserve for loan losses could come right as credit quality begins to turn.
- That accounting standard, dubbed the Current Expected Credit Loss model, or CECL, will result in a sizable, onetime capital hit for the banking industry.
- Most banks should have ample capital to withstand the blow, but CECL could slow balance sheet growth as some institutions raise rates on loans, while others look to rebuild their capital bases.

Bank profitability is poised to improve in the near term

	2017A	2018P	2019P	2020P	2021P	2022P
ROAA (%)	0.96	1.25	1.25	1.16	1.00	0.96
ROAE (%)	8.55	11.18	11.29	10.41	8.80	8.42
Efficiency ratio (%)	57.63	58.14	57.25	56.08	55.68	55.70
Net interest margin (%)	3.21	3.24	3.28	3.34	3.34	3.32

Sources: S&P Global Market Intelligence, proprietary estimates

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Outlook

Additional margin expansion lies ahead for the banking industry. That expansion, coupled with a lower corporate tax, should allow profitability to nearly reach pre-crisis levels.

We expect that to occur in our baseline scenario, which excludes the impact of a new reserve methodology, known as CECL, that banks will adopt in 2020. When including the impact of CECL, we project that while the banking industry will record slightly higher net interest margins, it should report lower capital ratios and experience greater earnings volatility. S&P Global Market Intelligence created a baseline scenario as well as a separate outlook including the impact of CECL to offer an apples-to-apples comparison between results before and after the adoption of the accounting standard. Projections in this report reflect our base case unless otherwise noted.

Assuming interest rates increase as expected, the banking industry's earnings are projected to jump 36.3% in 2018. Earnings should rise 4.2% in 2019 as higher interest rates continue to bolster profitability.

S&P Global Market Intelligence sees earnings falling in 2020 as credit quality begins deteriorating. The projections also assume that in 2020, GDP growth will begin to slow and the unemployment rate will move modestly higher. The benefits of higher interest rates should also wane as funding costs catch up with the expansion in earning-asset yields.

Tax reform offers a large boost to bank earnings

The lower tax rate stemming from tax reform and the benefit of being compared to a lower earnings base in 2017 should allow earnings to grow significantly in 2018.

U.S. banks plan to share some of the windfall created by tax reform with their employees and customers, but the industry stands to retain more than 75% of the savings.

A number of banks, including industry giants Bank of America Corp., Wells Fargo & Co., U.S. Bancorp, Capital One Financial Corp. and PNC Financial Services Group Inc., announced plans to use some of the windfall to increase their hourly minimum wage to $15. Some of those institutions and others are paying one-time bonuses to certain employees and have unveiled plans to make sizable charitable donations.

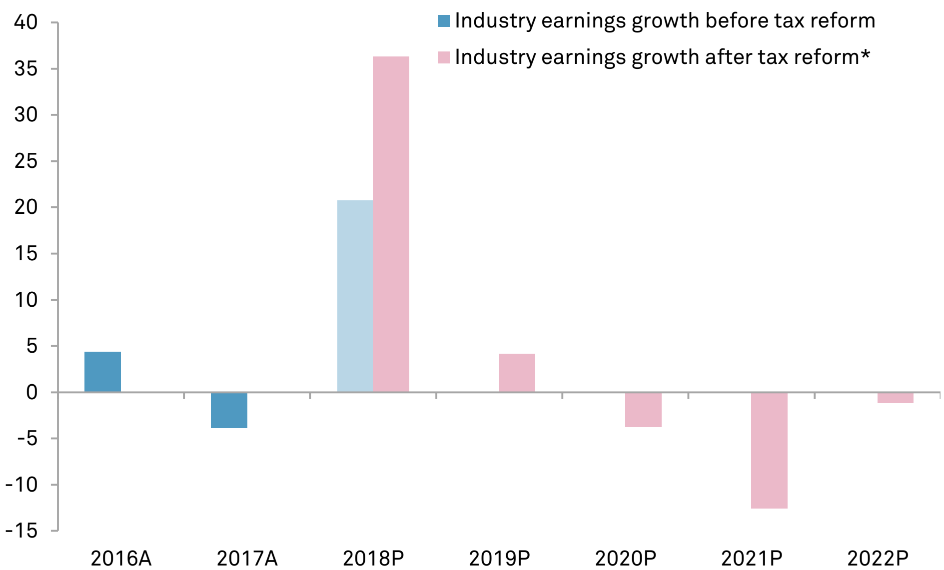
S&P Global Market Intelligence estimates that the total cost of such plans will amount to just 1.75% of the banking industry's noninterest expenses in 2018. We believe expenses could remain elevated in the years after that as banks reinvest in their franchises.

The windfall from tax reform will serve as an effective capital raise for banks, many of which already believe they have excess capital. Absent a notable increase in economic growth, banks likely will not be able to fully deploy the additional funds generated by tax reform. Many banks will use the newfound capital to go on the offensive and look to take market share.

Credit quality not a near-term problem

Against this backdrop, while credit quality should remain relatively strong in the near term, credit costs will emerge as a greater headwind to bank earnings. Banks will build reserves modestly over the next few years before incurring larger increases in 2020 when credit begins to deteriorate as banks compete more aggressively to win new business.

Tax reform to offer a big boost to bank earnings (%)



* Assumes a 21% corporate tax rate and potential changes to expenses that will come from reinvestment of tax reform windfall, beginning in 2018.
Sources: S&P Global Market Intelligence, proprietary estimates

Banks will likely compete on price but could also ease terms and conditions to entice borrowers. Changes in the competitive environment could come right as regulatory pressures ease. The current presidential administration and Republican-controlled Congress have pushed to soften a number of regulations enacted shortly after the credit crisis. Even if logical, the change likely could open the door to further easing of underwriting standards.

And this will occur as interest rates move higher, increasing the cost of debt service for borrowers. The higher costs could be enough to push some borrowers to the brink or, even worse, into default.

CECL looming on the horizon

Reserves are expected to rise even more beginning in 2020, when institutions must adopt a new methodology for calculating the allowance for loan and leases losses. The new provision is called the current expected credit loss model, or CECL.

CECL will mark a considerable shift in how banks reserve for losses. Today, banks record losses when it becomes probable that a loan will be impaired, meaning reserves are dispersed over time. The process will change under CECL when banks significantly build their allowance for loan losses on the date of adoption.

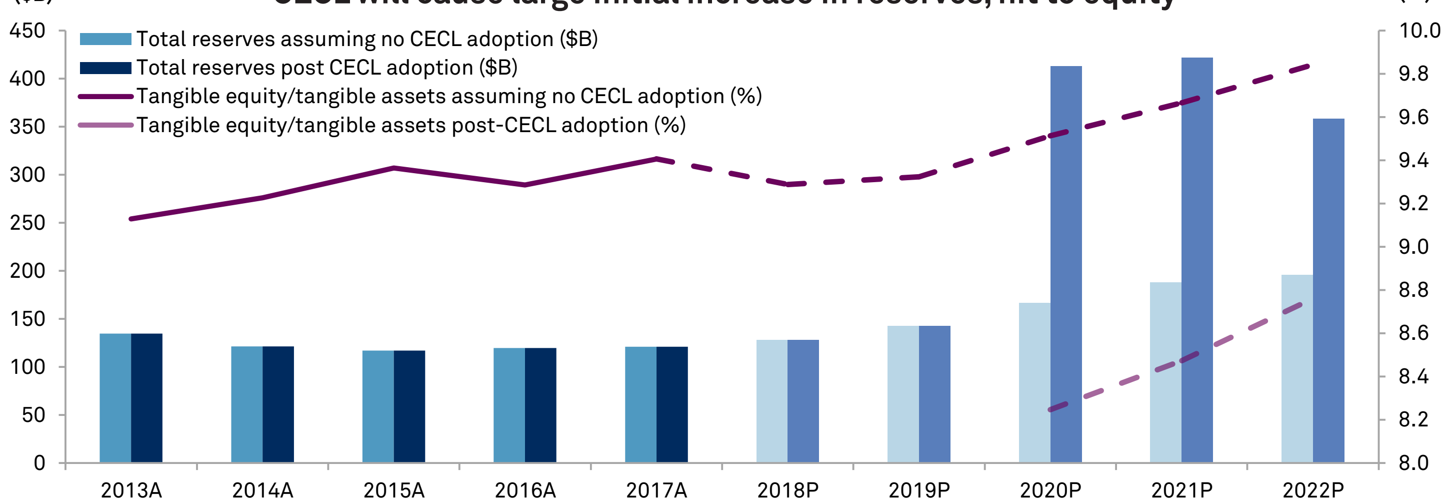
S&P Global Market Intelligence has developed a scenario to estimate CECL's impact on the industry. In our analysis, we assumed all loan portfolios had terms of three and a half years, based on the current loan composition across the industry. We further assumed that reserves would equal cumulative net charge-offs in the three and a half years after adoption.

We assumed uniform adoption by all banking subsidiaries at Jan. 1, 2020, and based the scenario on our longer-term outlook for credit quality. That outlook projects that loan portfolios will begin deteriorating more significantly in 2020, with net charge-offs eventually peaking at 1.36% of average loans in 2022. While the expected level of losses marks a considerable increase from current levels, peak losses are projected to be about half the level witnessed during the Great Recession.

Under that scenario, if CECL reserves match charge-offs over the period beginning in 2020, the required reserve build for the industry could reach $246.4 billion, or about 1.5x the level of reserves projected under our baseline scenario.

That scenario assumes that banks continue operating under the existing incurred loss model. The increase in reserves would result in a considerable capital hit to banks, reducing the industry's tangible equity-to-tangible assets ratio by 127 basis points in 2020.

CECL will cause large initial increase in reserves, hit to equity



CECL = Current Expected Credit Loss Model, a new reserve methodology most banks must implement beginning in 2020.
Analysis assumes uniform adoption of CECL by all banking subsidiaries at Jan. 1, 2020.
Assumes all loan portfolios have average life of 3.5 years based on current portfolio composition across the banking industry.
Required reserves under CECL assume reserves equal cumulative net charge-offs in the 3.5 years after adoption.
Net charge-off projection based on a longer-term outlook for credit quality, which assumes losses peak in 2022 and then decline.
Sources: Federal Reserve, Fannie Mae, Freddie Mac, S&P Global Market Intelligence, proprietary estimates

We expect banks to react to the change and raise rates on newly originated loans, particularly longer-dated real estate credits that will require a larger reserve build under CECL. We also assumed that loan growth will be slower than it would have otherwise been as banks with thinner capital ratios hoard cash and work to rebuild their capital bases.

The industry as a whole is expected to do that through the normal course of operations and should earn back a considerable amount of the capital hit from CECL several years after adoption. Since CECL requires banks to reserve for the full life of loans at the date of adoption, much of the required reserves in future years will have already been set aside in 2020. That means additional increases in the allowance for loan losses would be minimal in 2021 and 2022, resulting in lower provisions for loan losses than would have been recorded under the current reserve methodology.

Given that change, earnings would jump in 2022 under our CECL scenario, causing capital ratios to rebound right as credit losses are peaking.

Deposit competition heating up as rates and funding needs rise

Funding costs at U.S. banks are beginning to diverge significantly, setting the stage for more considerable deposit competition next year.

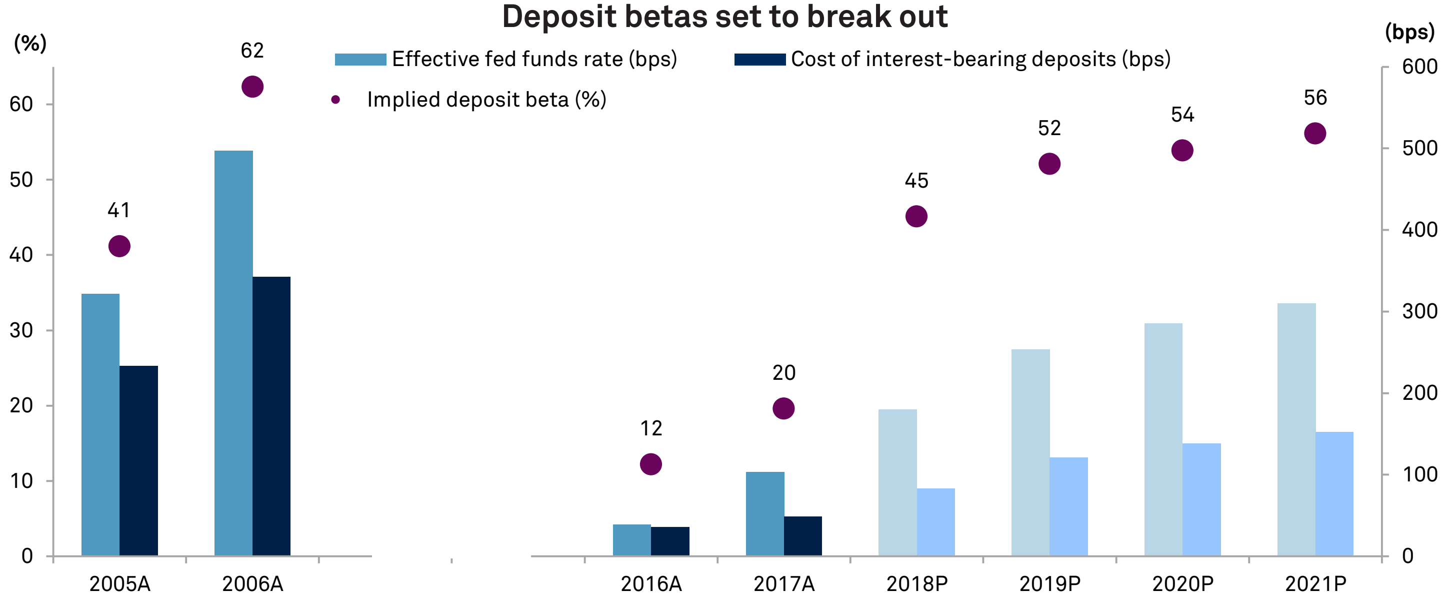
Deposit betas, or the percentage of changes in market rates that banks pass on to their customers, climbed to 19.6% in 2017 from 13.5% in the first half of the year and 12.2% in 2016. While the fed funds rate did not increase much in the fourth quarter of 2017, the industry's deposit beta was 72.5% in the period.

In 2017, 13 of the top 100 banks by deposits recorded betas exceeding 41%, the same level recorded by the industry in 2005, which was the first full year during the last rate tightening cycle. Economists expect the Fed to raise rates three more times in 2018, and we expect the industry's overall beta to rise to 45% as depositors digest recent increases in short-term rates and banks' funding needs grow.

Rising deposit betas will limit how much banks' net interest margins expand in 2018. Some of the benefits of higher interest rates will be further mitigated because banks have reached further out of the yield curve in both their securities and loan portfolios, with hopes of bolstering income.

Still, stronger loan growth, modest margin expansion and a lower corporate tax rate should cause earnings to jump in 2018. Earnings growth should slow in 2019 as deposit costs increase at an even quicker pace and credit costs begin to rise.

Deposit betas set to break out



Figures for the federal funds rate through 2019 are based on 3-point averages including estimates provided in The Wall Street Journal's monthly survey of more than 60 economists. Figures for 2020 and 2021 are estimates from the Congressional Budget Office.
Actual reported figures used when available.
Sources: S&P Global Market Intelligence, proprietary estimates

The full 2018 US Bank Market Report contains our full five-year outlook and historical data. It is available to S&P Global Market Intelligence subscribers, along with supplementary data exhibits and an industry projections template that allows for different growth assumptions in each year. Contact us for more information.

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