BBVA Research

Banks

Banking outlook 2019

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- **Despite solid profitability trends, banking conditions could become somewhat more challenging**
- **Sustainable loan growth, higher funding costs and credit risks will be the primary areas of concern**
- **Customer service, digital tools and economies of scale are key for success**

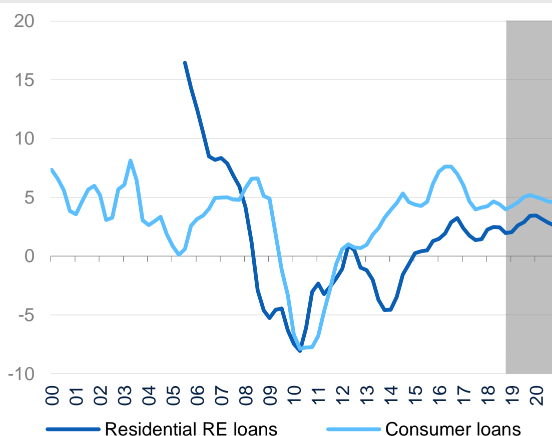
Faster economic growth, interest rate hikes and a lower corporate tax rate proved very favorable for commercial banks in 2018. Loan growth was stable and net interest margins increased, while provisions for loan losses and corporate tax expenses declined. As a result, net income increased by 45% compared to 2017, return on average assets reached almost 1.35%, the highest since 2003, and return on average equity reached 11.75%, the highest since 2006. The primary challenge that banks faced last year was the slowdown in deposit growth, which reflected an increase in the opportunity cost to hold some types of deposits, particularly in non-time instruments.

Loans

Average loans and leases in bank credit increased by 4.1% in 2018, following an increase of 4.0% in 2017. Loan growth has been strengthening after bottoming out at the end of 2017, supported by strong economic growth. We expect this momentum to continue in the first half of 2019, after which loan growth should moderate. Loan and lease balances will increase 5.4% in 2019 and 4.8% in 2020. The largest contribution to growth in 2019 will come from commercial and industrial (C&I) loans, which will be driven by solid business investment, expected to remain firm at least during the first half of 2019.

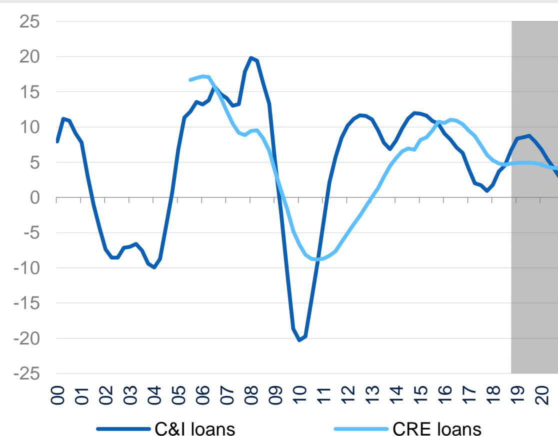
While residential real estate loans increased only 2.3% in 2018, this figure still represents the second strongest showing since the Great Recession. Growth was higher in the first half of the year, when the housing market was still in a relatively strong expansion mode, but slowed in the second half due to rising mortgage interest rates. However, with mortgage interest rates declining after a peak in November, the housing market activity has shown signs of recovery. We expect mortgage purchase originations to continue increasing, supported by ongoing home price gains, and the level of existing home sales and the volume of originations for refinance to stabilize. This will result in an increase in residential real estate loans on the banks' balance sheets of 2.7% in 2019.

Figure 1: Retail loans growth (% YoY)



Source: BBVA Research and FRB

Figure 2: Commercial loans growth (% YoY)

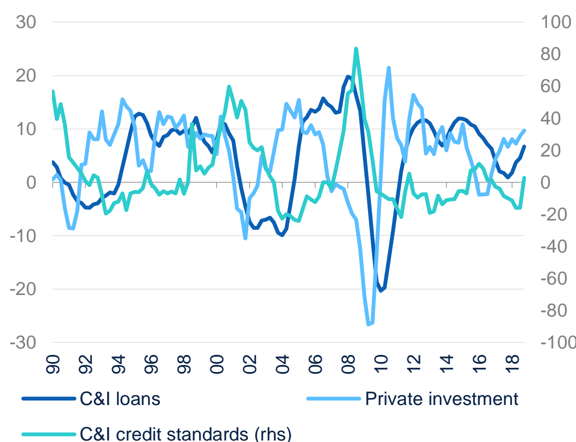


Source: BBVA Research and FRB

Consumer loan growth moderated to 4.3% in 2018, compared to 4.7% a year earlier. Tighter credit standards in the credit cards segment, ongoing caution in auto lending, as well as increased competition from non-bank entities were contributing factors. Credit unions were particularly aggressive in 2018, with a 13% growth in consumer loans. Still, we expect banks' consumer loans to increase 4.8% in 2019. Demand will be supported by ongoing gains in employment and wage income, which will drive consumer spending. Despite an upward trend in delinquencies, credit quality is still relatively solid, and since these products are highly attractive, financial institutions will be meeting the demand, particularly in the personal loans segment.

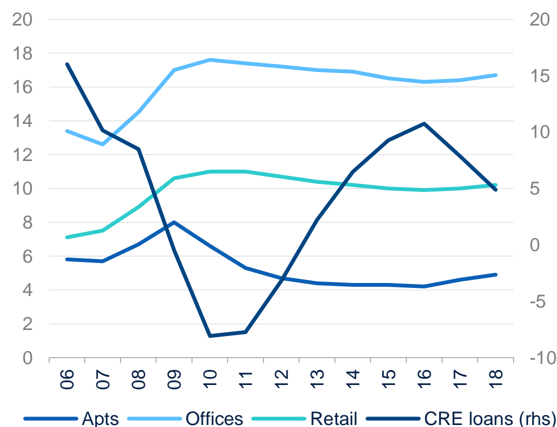
On the commercial side, C&I loans increased by 4.2% 2018. This gain was smaller than expected considering that credit standards eased, business investment increased –spurred by the Tax Cuts and Jobs Act- and commodity prices recovered (Figure 3). This underperformance reflected a higher opportunity cost of holding cash and the solid cash positions of many companies resulting from lower corporate tax rates. However, the pressure to use some of the cash on-hand before engaging in new borrowing faded in the second half of the year, when C&I borrowing increased. In fact, in February 2019, C&I loan growth reached 9.1% YoY, the strongest pace in three years. While the momentum in C&I loan growth could start to slow as 2019 progresses, it will nevertheless remain solid. C&I loans are expected to increase on average 8.4% in 2019 and 4.8% in 2020. Commercial Real Estate (CRE) loan growth will grow 4.9% YoY this year, a similar pace to last year, and 4.3% in 2020. Although CRE borrowers will benefit from solid economic conditions, they will continue to face headwinds: tighter lending standards, increased vacancy rates in locations that have experienced a great deal of new construction, and structural changes in the retail segment. In fact, CRE vacancies bottomed out in 2016 and have been on a modest upward trend since then. Vacancies are inversely correlated with loan growth (Figure 4) since they discourage new construction.

Figure 3: C&I loan growth, gross private investment growth and credit standards (%YoY and %)



Source: BBVA Research, BEA and FRB

Figure 4: Vacancy rates and CRE loan growth (% and %YoY)



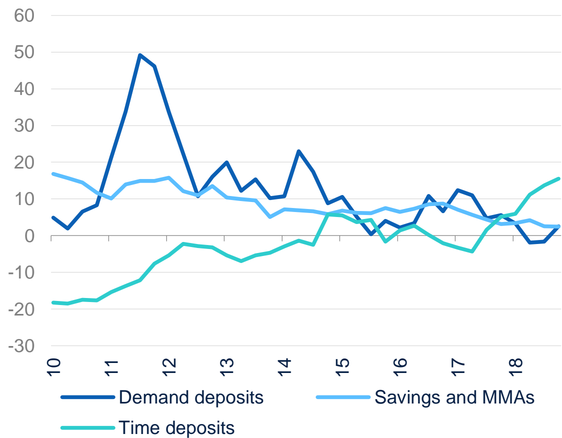
Source: BBVA Research, REIS and FRB

Deposits

Bank deposits increased by 3.0% in 2018 compared to 4.6% in 2017, significantly below the rates of around 7% during 2013-2014. The slowdown over the last four years matches historical patterns in late-stage economic expansions when the relative attractiveness of savings alternatives such as retail money market funds, money market mutual funds and brokerage accounts increases in line with higher short-term interest rates (for more detail see brief). In addition, during 2018 there was a substitution of demand deposits with time deposits, which experienced acceleration in their growth rate (Figure 5). While banks were able to meet loan demand by rebalancing assets and increasing their loan-to-deposit ratios, the scope of this strategy remains limited and depends on each bank's core deposit characteristics, its ability to manage liquidity and funding alternatives. In order to continue expanding lending under the existing regulatory constraints, some banks have increased deposit collection by competing more aggressively on interest rates. While this strategy will allow banks to sustain lending

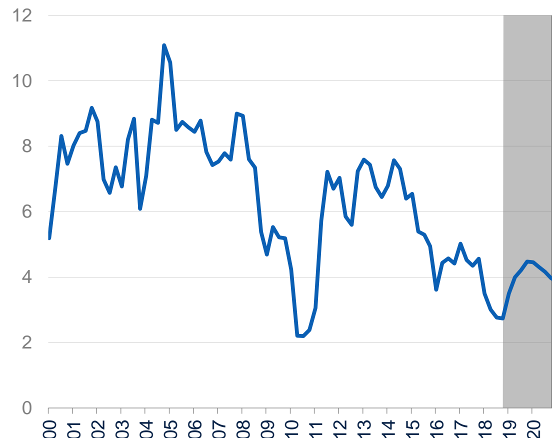
activity, it will also lead to higher funding costs. This will be one of the biggest challenges for the industry over the next 12-24 months. Although net interest income reached an all-time high of $129bn in 4Q18, the ratio of net interest income to total interest expense was the lowest in nine years at 3.8. We expect deposits to increase 4.0% and 4.2% in 2019 and 2020, respectively (Figure 6).

Figure 5: Bank deposits growth (% YoY)



Source: BBVA Research and FDIC

Figure 6: Total bank deposit growth (% YoY)



Source: BBVA Research and FRB

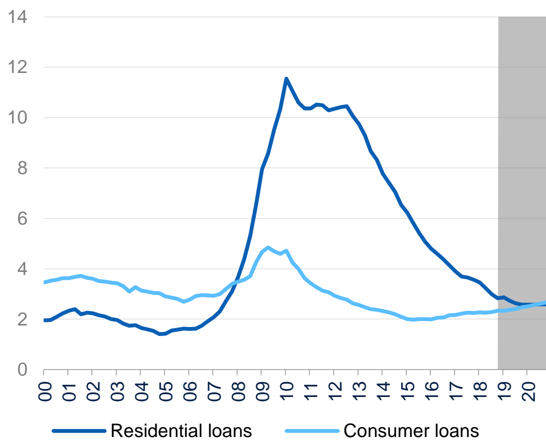
Credit quality

Solid underwriting standards and the economic expansion over the last 9.5 years have led to strong loan portfolio quality. The overall delinquency rate stood at 1.53% in 4Q18, compared to a median of 2.7% and an average of 3.5% since 1985. Given that residential loan delinquency rates are still recovering from the effects of the Great Recession, the low overall delinquency rate looks even more impressive. We expect overall delinquencies to remain stable in 2019 and to increase somewhat in 2020.

The residential loan delinquency rate will continue edging down, supported by further declines in foreclosure rates, ongoing home price appreciation, which helps reduce the number of "underwater" mortgages, and an increasing share of loans originated after the mortgage crisis using prudent underwriting standards. Although the delinquency rate for consumer loans will continue increasing, following a trend that started in 2Q16 (Figure 7), it will remain below the lowest point reached in the previous cycle. The reasons for this are tighter credit standards maintained throughout the current expansion, as well as ongoing gains in employment and personal income.

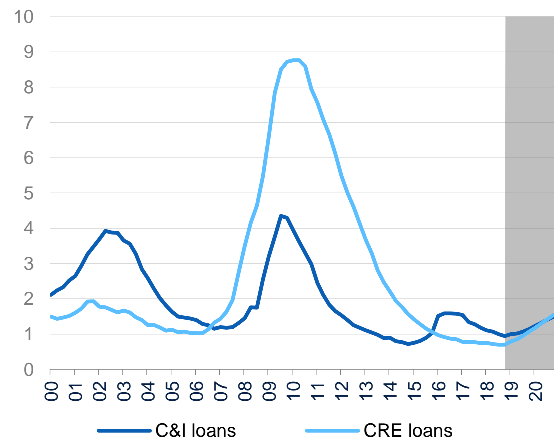
On the business side (Figure 8), C&I delinquencies continued declining in 2018, as the shock from lower oil prices abated and the oil and gas industry recovered. We expect the C&I delinquency rate to start increasing at a moderate pace going forward, as the effects of higher interest rates start to pressure financial ratios (see brief on corporate debt here). That said, the positive economic backdrop lowers the potential for major negative surprises in the short-term. Higher interest rates will also affect CRE, where the delinquency rate is expected to bottom out and start increasing in the first half of 2019. Nonetheless, from a historical perspective, business delinquency rates are going to remain relatively benign. This implies that to the extent that there is an increase in loan loss provisions, it will be modest and thus, will not have a major impact on the profitability of the industry, at least in the short term.

Figure 7: Retail loans delinquency rates (%)



Source: BBVA Research and FRB

Figure 8: Commercial loans delinquency rates (%)

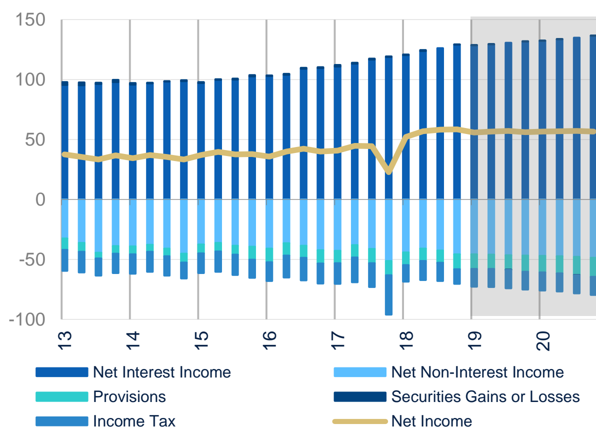


Source: BBVA Research and FRB

Profitability

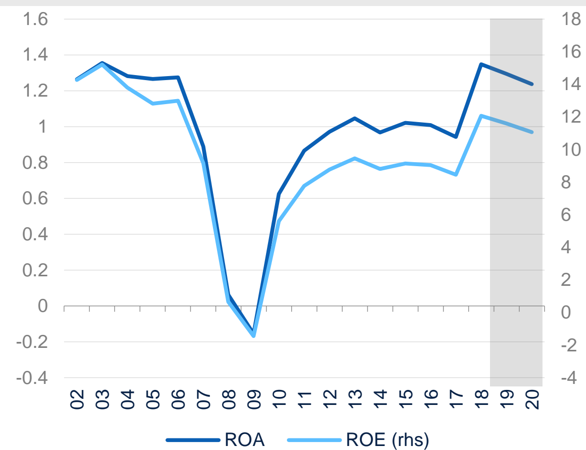
Solid loan portfolio quality, stable loan growth, higher interest rates and particularly lower corporate tax rates significantly improved bank earnings in 2018. In fact, net income reached a record-high level of $222bn and for the first time surpassed 1% of GDP. We expect some of the positive effects to persist in 2019, albeit without the one-off boost from the corporate tax cut (Figure 9). Therefore, while profits are going to remain strong, they may not increase materially, as net interest margins will come under pressure from a pause in interest rate hikes by the Federal Reserve and an increase in funding costs due to more intense competition for deposits. Furthermore, loss provisioning, while still modest, will increase. As a result, both return on assets (RoA) and return on equity (RoE) are expected to decline somewhat from the record levels reached in 2018, while nevertheless remaining still high (Figure 10). On the one hand, potential regulatory changes aimed at reducing the cost of compliance and opening new profit pools could add an additional upside to these projections. On the other hand, slower economic growth and a flatter yield curve could limit the growth of net earnings.

Figure 9: Industry income and expense, quarterly ($bn)



Source: BBVA Research and FRB

Figure 10: Industry RoA and RoE (%)



Source: BBVA Research and FRB

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Bottom line

While the industry may not be able to post an increase in profitability ratios such as last year, it will nevertheless enjoy a solid period over the next one to two years, barring unexpected negative shocks. The headwinds will come from slower economic growth, a flatter yield curve and a cyclical increase in delinquencies. In this environment, banks' focus will turn to maintaining profitability levels while sustaining loan growth and managing the risks related to the increase in funding costs, higher credit risks, and a possible turning point in the credit cycle. Over a longer horizon, the threat of disruption from non-banks remains in place. Therefore, banks will seek opportunities to further streamline operations, improve customer service, and leverage technology and digital tools to boost efficiency, improve risk management and enhance customer experience. These trends support ongoing mergers and acquisitions activity, and further industry consolidation to advance the benefits of economies of scale. In addition, we expect a rapid growth of partnerships with nonbanks, as a way to incorporate new tools and paradigms in bank service portfolios.

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