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Ten Years Post Crisis, U.S. Banks Eye Continued Growth

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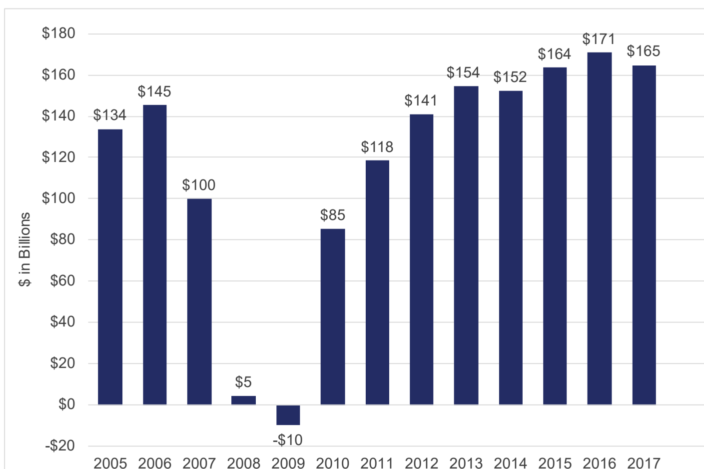
Ten years removed from its near-death experience, the U.S. banking industry is on decidedly more solid footing (see Figure 1), and Conning's sector outlook is stable over a 12-month horizon. There are still areas of concern, however, and pending bank management decisions and regulatory actions may have long-term impact on the sector, the largest of the corporate bond index and a key component of many insurance company portfolios.

Figure 1 U.S. Bank Annual Net Income, 2005-2017



Prepared by Conning, Inc. Source: FDIC Quarterly Banking Profile

A pivotal reform activity that helped solidify banks' balance sheets and rebuild critically important capital and investor confidence has been the U.S. Federal Reserve's (the Fed) annual Comprehensive Capital Analysis and Review, known as the "stress tests." These tests compelled banks to implement risk management practices that were historically applied inconsistently across the industry. Just as important was the wide publicity surrounding the tests, which helped restore the general public's and capital markets' confidence in the banks and their lending and trading practices.

Improved profitability and lower corporate tax rates have contributed to banks' robust internal capital generation, allowing them to further expand lending capacity – a key source of growth – in a disciplined manner. Growth is expected to continue well into 2019, and with interest rates expected to rise as well, most banks will likely augment their net interest income. Thus far in this cycle, lending rates and associated loan balances have grown and bank margins have improved, as the rates they pay on their deposits and other liabilities have risen at a much slower rate.

The sector is now facing important issues, however. Bankers believe some elements of regulation are still more restrictive than needed at this stage, but many lawmakers are hesitant to support further change, especially at this point in the credit cycle. Competition remains intense, as does pressure to weaken lending terms, potentially sowing the seeds for higher levels of future credit losses. Trade wars could impact banks' trading results and impair the quality of some international loans. Also, many banks have recently increased dividends and share repurchases with the blessing of the Fed, a trend Conning will monitor to ensure that bank capital ratios remain comfortably above regulatory minimums.

Fallout of Fall '08

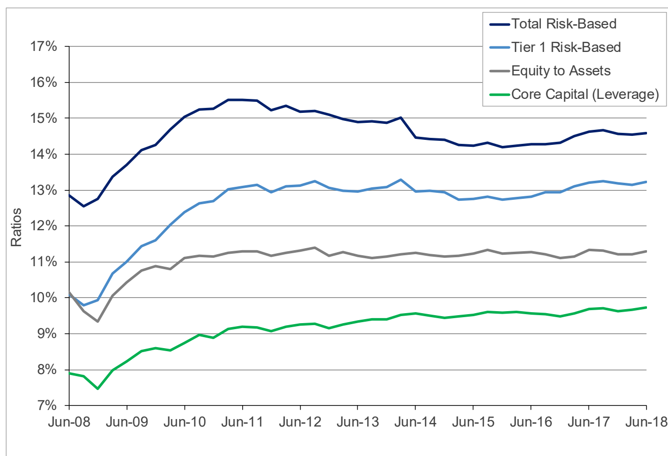
The year 2008 was the nation's worst for bank failures in terms of total dollars, and the experience left an indelible mark on the global financial landscape.

According to the FDIC, bank failures amounted to $371 billion in lost assets that year, with 91% due to just two: IndyMac Bank and Washington Mutual. Other well-known financial institutions also faced a cruel reckoning as Lehman Brothers failed, struggling Bear Stearns and Wachovia were taken over by other institutions, and collapsing Fannie Mae and Freddie Mac were taken over by the federal government. AIG was taken over as well, but has returned to private hands.

The bursting of the U.S. housing market bubble had exposed many banks' weak risk-management prac-

tices via their concentrated exposures to riskier mortgages. In response, the federal government implemented the Troubled Asset Relief Program (TARP) which originally authorized $700 billion to buy "toxic" assets from banks to free up capital and encourage lending – and prevent further erosion in market confidence.

Figure 2 U.S. Bank Capital Ratios, 2008 - 2018



Prepared by Conning, Inc., Source: FDIC Quarterly Banking Profile: First Quarter 2018

Funding for new loans was also squeezed as banks became tight-fisted, further hampering a struggling economy. The Federal Deposit Insurance Corporation responded by temporarily guaranteeing all newly-issued senior debt from its member institutions, easing liquidity concerns by supporting an orderly refinancing of maturing debt.

While these policy moves were criticized by many at that time, in retrospect, they were crucially important, timely, and, in our opinion, well conceived. About $434 billion in TARP-related funds were ultimately disbursed, with the U.S. Treasury reporting that by latter 2016 it had recovered more from TARP than had been disbursed, if its AIG investment profits are included. Financial catastrophe was averted, and the rescue efforts helped banks stabilize their balance sheets and start along the road to recovery.

Stress Tests – and a Real Market Test

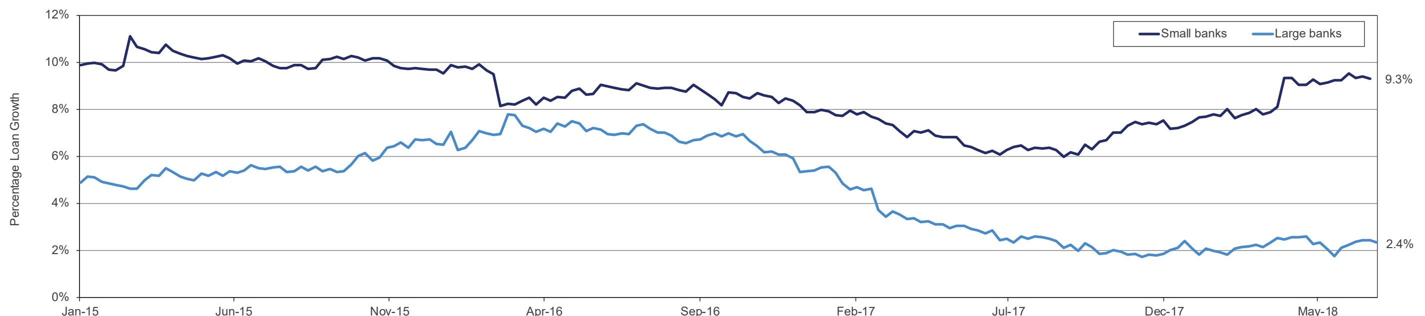
The stress tests were a key step in the rehabilitation and re-capitalization of U.S. banks. First conducted in March 2009 to measure any lingering bank balance-sheet vulnerabilities and capital deficiencies, the tests were later incorporated into the broad financial services reform legislation of 2010 known as Dodd-Frank.

The tests helped drive more consistent risk-management practices within banks, while assuring they maintained adequate capital under extremely adverse economic and market scenarios. While there was an initial concern that the 2009 tests would expose issues and hurt confidence, they instead proved to be positive and helped repair market confidence. In fact, most banks' initial tests resulted in issuance of more equity and building of greater capital, a virtuous scenario.

The Dodd-Frank legislation codified the view that systemically important financial institutions, or SIFIs, needed to be closely monitored, as a failure of even only one could reverberate across worldwide capital markets and economies. Dodd-Frank initially labeled any firm with $50 billion or more in assets as a SIFI, which covered about three dozen banking institutions.

Strong "prudential" regulatory oversight ("overbearing" to some) led to lending discipline and prudent sector concentrations, which soon had a real-market validation. Oil and other commodity prices fell drastically in late 2015, and the banks' manageable lending exposure to the energy industry was in sharp contrast to the 1980s when many failed due to energy loans. While some energy bonds fell to distressed levels, there was never a material impact to bank earnings or their all-important regulatory capital.

Figure 3 U.S. Loan Growth by Bank Size, 2015 - 2018



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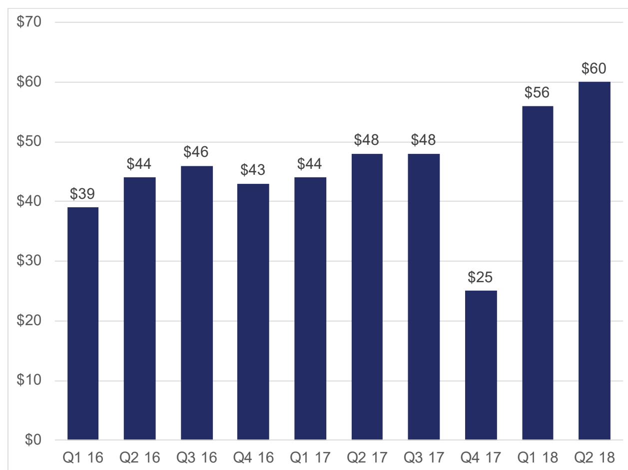
Slow, Steady Progress

While the number of bank failures continued to rise after 2008 and reached a peak in 2010, the sector has demonstrated significant improvement during the past decade. Capital levels are now well above pre-crisis levels (see Figure 2), although ratios have likely peaked. Banks continue to grow their loan portfolios, with the larger firms still growing more slowly (see Figure 3).

In addition, U.S. bank profits have risen steadily over the past five years and the federal tax cuts of 2017 have spurred it further, as evidenced by the 2018 year-to-date results (see Figure 4). Even without tax reform, the FDIC estimates that second quarter 2018 year-over-year growth in net income was a very healthy 11.7%.[1]

Figure 4 U.S. Bank Quarterly Net Income, 2016-2018



Prepared by Conning, Inc. Source: FDIC Quarterly Banking Profile, Second Quarter, 2018

Challenges Remain

There is still moderate room for improvement in earnings without a material increase in risk-taking.

New legislation introduced in May is intended to ease regulatory compliance burdens, especially for smaller and medium-sized banks, while helping them accelerate loan growth and further stimulate the economy. It raises the SIFI threshold to $250 billion in assets, reducing the number of SIFIs by about two thirds from the current 35. Banks in the $100 billion to $250 billion range would still be subject to stress tests, but likely less frequently and with tests tailored to their specific risk profiles (we await final guidelines).

Banks in the $50-$100 billion category would have an even lighter regulatory touch and no annual Fed-managed stress tests. This could lead some to be overly aggressive again, ultimately leading to negative credit implications. Conning intends to monitor closely any divergence in capital and credit policies in the smaller banks.

The regulatory changes banks are seeking are more of a shift in tenor – such as refining the compliance requirements for the Volcker Rule, which governs proprietary trading – and not a rollback of all of Dodd-Frank. While a material loosening of controls could generate a recurrence of bad behavior, Conning views this as a relatively remote probability, as we believe a robust regulatory framework is fully and permanently in place. Credit metrics, particularly all-important capital and liquidity measures, may decline modestly from current, very robust levels. While we expect somewhat softer oversight from President Trump's appointees, we do not expect a material impact on credit ratings.

Equally as importantly, we believe that a crucial change in the mindset of large bank managements, supported by each bank's extensive internal risk management infrastructure, is now in place. It is no guarantee that banks won't suffer increased losses when the credit cycle turns, as they likely will. But Conning's confidence in the largest U.S. banks' ability to avoid catastrophic, capital-depleting losses in the next recession is relatively high at this time.

As with any sector, a careful analysis of the individual issuers is often key to successful investment strategies, as not all securities in an improving sector may perform as expected. Insurers would be wise to leverage the expertise of investment managers with both a long history in the study of any asset class and with a deep understanding of the unique needs of insurance portfolios.

[1] https://www.fdic.gov/news/news/speeches/spaug2318.html

About Conning

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