ProBank Austin

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Impact of Coronavirus (COVID-19) on the State of the Banking Industry

This white paper provides data and analysis on the current state of the banking industry in the midst of the COVID-19 pandemic.

1. Early 1Q 2020 Environment:

For the 5,177 FDIC-insured commercial banks and savings institutions, full year 2019 net income measured the second highest in the history of the banking industry, with cumulative earnings of $233.1 billion, down $3.6 billion or 1.5%, from the record performance in 2018. Industry return on average assets (ROA) measured 1.29% in 2019, down modestly from 1.35% in 2018.

Although overall industry earnings remain strong, net interest margins came under pressure as the Federal Reserve lowered the fed funds rate three times during the year, 25 basis points each on August 1, September 19 and October 31. Industry net interest margins declined from 3.48% in 4Q 2018 to 3.28% in 4Q 2019. Net interest income in dollars declined 2.4% nominally between 4Q 2018 and 4Q 2019 even though aggregate assets increased 3.9% year-over-year to $18.6 trillion. The industry ROA was 1.20% in 4Q 2019, down 13 basis points from 4Q 2018.

Total loans increased 3.6% from 4Q 2018 to 4Q 2019, to $10.5 trillion, while deposits increased 4.8% over the same time period to $14.5 trillion. The only loan portfolio categories experiencing year-over-year declines were home equity lines (down 8.9%) and farm loans (down 4.4%). Net loan charge-offs to loans measured 0.52% in 2019, compared to 0.48% in 2018, and 0.50% in 2017. Noncurrent assets (90 days or more past due, nonaccrual loans and other real estate owned) to assets measured 0.55% at year-end 2019, down from 0.60% in 2018 and 0.73% in 2017, continuing a consistently improving trend since the Great Recession.

The number of FDIC problem institutions declined to 51 at year-end 2019, down from 60 in 2018, and represented the fewest number since 4Q 2006. There were four banks that failed during 2019 and one

additional failure in the first quarter of 2020. The Deposit Insurance Fund (DIF) increased to $110.3 billion at year-end 2019, and measured 1.41% of estimated total insured deposits.

The cumulative industry Tier 1 leverage capital ratio equaled 9.66% at December 31, 2019. The industry Tier 1 leverage ratio has measured between 9.40% and 9.70% since 2013.

2. Impact of COVID-19 and Market Volatility

The coronavirus (COVID-19), which is believed to have initially surfaced in a Chinese seafood and poultry market in late 2019, has spread to at least 171 countries as of March 31, 2020, killing more than 43,000 and sickening hundreds of thousands of people worldwide in a matter of weeks. The World Health Organization has declared the situation a pandemic. The impact on financial markets has been devastating and swift.

On March 31, 2020, the DJIA closed at 22,157 and the S&P 500 closed at 2,605, reflecting 22% and 19% declines, respectively, from year-end 2019. The collapse in the bank equity market has been even more dramatic during these past three months, as the SNL Index of all publicly-traded banks and thrifts closed at 375 on March 31, 2020, down 41% in the first quarter.

Broad market averages have been whipsawed as investors search for stability in an environment where uncertainty dominates. The market sell-off has not centered on any specific industry, geography or asset class, although the financial and energy sectors have been particularly hard-hit.

Market volatility during March reached unprecedented levels as daily swings exceeded 5% an incredible eight consecutive trading days, and in eleven separate sessions, over the final three full weeks of March.

Epidemiology vs. Economics?

Volatility in the Dow Jones Industrial Average

Date	Point Change	% Change
03/09/20	-2,014	-8%
03/10/20	+1167	5%
03/11/20	-1,465	-6%
03/12/20	-2,353	-10%
03/13/20	+1985	9%
03/16/20	-2,997	-13%
03/17/20	+1049	5%
03/18/20	-1,338	-6%
03/19/20	+188	1%
03/20/20	-913	-5%
03/23/20	-582	-3%
03/24/20	+2113	11%
03/25/20	+496	2%
03/26/20	+1352	6%
03/27/20	-915	-4%

Source: S&P Global Market Intelligence, a division of S&P Global.

There is no historical precedent for how long it will take to recover from a self-induced recession. Recessions are typically the result of gradually deteriorating market conditions, not immediate shocks. Consensus expectations currently assume a brutal 2Q. Goldman Sachs initial forecast of a 24% decline in 2Q GDP was recently revised to a steeper 34% drop, more than triple the prior record 10% slump recorded in

1Q 1958. Market experts are preliminary projecting unemployment estimates that range between 10% and 20% during 2020, approaching the 24.9% reported during the Great Depression approximately 90 years ago. The market is trying to assess when COVID-19 will be contained, when consumer confidence will return, and whether business engagement and consumer behavior will return to pre-crisis levels.

The depth and length of this COVID-induced recession is simply unknown at this point. Uncertainty dominates the landscape. Critical questions include the length of social interaction restrictions and mandated closings of “non-essential” businesses, and how quickly government assistance can get to individuals and small businesses.

The shape of the recovery will likely be driven by advances in medical treatment options to fight the virus and the ultimate development of an effective vaccine. The timing of this, of course, is unknown. Essentially there are four potential recovery scenarios:

- **V-shaped**: sharp decline but then a sharp recovery. This can be achieved if the economy can be reopened relatively soon and consumers quickly return to normal spending habits. With social distancing initiatives extended until at least April 30, this scenario is increasingly less likely.
- **U-shaped**: sharp decline, with trough lasting multiple quarters, before a sharp recovery in late 2020. With ongoing efforts to “slow the spread”, coupled with the injection of significant economic relief/stimulus, the markets are hopeful.
- **L-shaped**: sharp decline, creating lasting economic damage that reduces the outlook for 2021 and possibly beyond. This scenario becomes more likely the longer it takes to develop a reliable medical solution against the virus, and could still be possible if employers delay re-hiring due to prolonged cautious consumer sentiment and restrained spending.
- **W-shaped**: series of sharp declines and sporadic recoveries over an extended time period as the market finds its bottom, which would largely mirror the experience from the Great Depression.

Many of the metrics used in the annual Fed-scripted CCAR “severely adverse” hypothetical economic scenario (bottoming of Treasury yields, oil prices in a tailspin, GDP collapsing, dramatic increase in the Volatility index, significant plunge in the equity markets, etc.) are already playing-out. With initial jobless claims of 3.3 million for the week of March 21 and 6.6 million for the week of March 28 (compared to the previous weekly record of 695,000 in October 1982), a massive and quick surge in unemployment will be the next domino to fall.

It is estimated that approximately 10 million people are now out of work, implying that the official unemployment rate already matches the 10% threshold of pain reached in the 1981-82 and 2007-09 recessions. In previous deep recessions, most notably in 1980 and 2008, initial claims during the worst four weeks of the recession approximated 2 million; this means the shock from COVID-19 has compressed a significant deterioration in the labor market into a much shorter period relative to previous contractions.

The rapid spread of the coronavirus has led to massive business disruptions in the U.S. over the past several weeks, as a growing number of states across the country ordered residents to "shelter in place," and non-essential businesses such as sit-down restaurants and retail stores have been forced to shut their doors, resulting in both a dramatic and swift surge in layoffs nationwide. It is estimated that approximately 87% of the U.S. population is currently under a stay-at-home order.

The Fed has slashed interest rates close to zero and is overseeing a new quantitative easing program, but monetary policy is not meant to encourage people to go out and buy items, so the Fed is tapping its lending power capabilities, as well. It appears obvious that no policy or set of policies can work unless the public health issue is resolved first, and in the process enables the U.S. economy to avoid an extended downturn.

3. Legislative and Regulatory Support

Legislative and regulatory action to counter the effect of the economic challenges related to COVID-19 has been dramatic. Bipartisan efforts in Congress led to the passage of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was signed into law on March 27, 2020. This unprecedented $2.2 trillion rescue package includes:

- Approximately **$1 trillion** to extend the amount and duration of unemployment insurance; direct payments to households dependent on income levels; direct aid to states dependent upon population size; a variety of tax benefits for businesses which would include deferrals and deadline extensions; and, grants for passenger, cargo air carriers and contractor wages
- Approximately **$850 billion** toward small business forgivable loans; additional loans and other aid (including direct equity stakes) to businesses, states and municipalities; backstop losses in programs established/expanded by the Fed; and, aid to cargo and passenger airlines as well as businesses deemed critical to "national security"
- Approximately **$350 billion** in supplemental aid to hospitals, healthcare, veterans care, public transit and other discretionary needs

For the nation's Banking sector, key components of the CARES Act include:

- **FDIC Institution Debt Guarantee Program:** The FDIC is authorized to establish a program to guarantee the debt obligations of solvent insured depository institutions and their affiliates, including deposit accounts
- **Temporary Deposit/Share Account Insurance Increase:** The FDIC and NCUA are authorized to increase the insurance coverage on any noninterest-bearing transaction accounts
- **Temporary Lending Limit Relief:** The OCC is authorized to waive single borrower lending limits for national banks and federal savings associations
- **Temporary Community Bank Leverage Ratio Relief:** Reduce the minimum required community bank leverage ratio (CBLR) from 9% to 8%
- **Temporary Relief from Troubled Debt Restructuring Requirements:** Financial institutions are permitted to suspend requirements under GAAP for loan modifications relating to the COVID-19 pandemic that would otherwise be characterized as troubled debt restructuring (TDR)
- **Temporary Relief from CECL:** All insured depository institutions, bank holding companies or affiliates thereof are exempted from complying with the Current Expected Credit Losses methodology
- **Money Market Guarantee Program:** The Treasury is permitted to establish a guarantee program for the U.S. money market mutual fund industry, although any such guarantee must terminate by year-end.

The banking industry's role in the **Paycheck Protection Program ("PPP")** is critical to the support of small businesses. The first round of PPP allocated $349 billion of funds to be provided through a special SBA program. If implemented and managed properly (by both the SBA and banks) the result could help mitigate credit issues, as well as provide much needed fee income as margins continue to compress.

The Federal Reserve has been at the forefront of proactive strategies to mitigate the economic impact of the COVID crisis. Specific actions include:

- Fed drops rates to near zero, with a Sunday night (March 15th) cut of 100 basis points; this was the largest single reduction on record, surpassing the 75 basis point cut during the Financial Crisis
- Announced initial intent on March 15th to purchase at least $500 billion of Treasuries; revised on March 23rd to “unlimited purchases”
- Announced initial intent on March 15th to purchase at least $200 billion of agency MBS; revised on March 23rd to “unlimited purchases”
- Fed eliminated the reserve requirement, and encouraged banks to access the discount window
- Fed signals intent to cut-back on bank exams during the coronavirus pandemic, particularly for community banks
- Plans for extended resolution timeframes with regard to “non-critical” supervisory findings
- Interagency guidance supporting loan modification programs to assist borrowers “in times of natural disaster and other extreme events”
- Flexibility in Past Due reporting for loans granted with deferrals as designated in connection with COVID-19
- Potential short-term relief in the traditional reporting requirements for Nonaccrual status and Charge-offs, given the fluidity of the current environment
- “Restructured” loans under this interagency guidance will continue to be eligible (based on usual criteria) as collateral at the Fed’s discount window

4. Bank Equity Markets

While significant unknowns continue to exist, driving turmoil and volatility in the markets, banks entered this "pandemic crisis" in much better shape than before the Great Recession. As noted below, capital, liquidity and reserves are all stronger today than at the end of 2007:

Selected Median Ratios					
	Leverage Ratio	Risk-Based Capital Ratio	Liquidity Ratio	ALLL/ Total Loans	NPAs/ Total Assets
Pre-Coronavirus Crisis (as of 12/31/2019)	10.93%	16.60%	21.52%	1.18%	0.43%
Pre-Financial Crisis (as of 12/31/2007)	9.78%	14.57%	18.94%	1.16%	0.54%
Basis Point Difference: 2019 vs. 2007	**115**	**203**	**258**	**2**	**11**

Source: S&P Global Market Intelligence, a division of S&P Global. Based on all banks and thrifts.

The median data presented above – as compared to aggregate banking industry statistics presented at the beginning of this paper – imply that community banks hold more capital, more liquidity and better asset quality than their larger, money center bank counterparts.

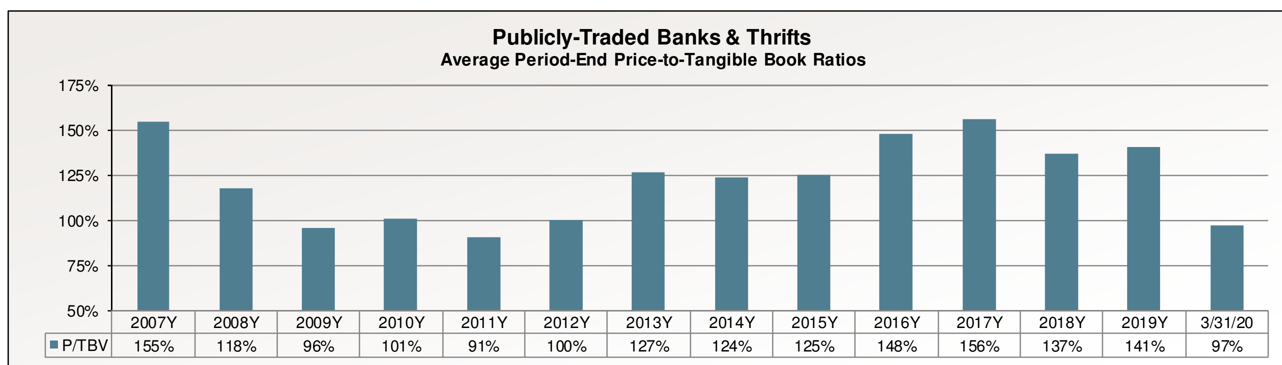
Financial stocks have been hit significantly harder than most other sectors. During 1Q 2020, bank stocks were down +/- 40% compared to the broader market declines of +/-20%. Bank stocks are now trading, on average, at less than tangible book value (97%) and less than 9 times trailing EPS:

	Index Performance				Valuation Metrics	
	DJIA	S&P 500	SNL Bank & Thrift	NASDAQ Bank	Average P/TBV	Median P/E
12/31/2019	28,538.4	3,230.8	632.2	3,968.8	141%	12.8
03/31/2020	21,917.2	2,584.6	375.3	2,442.9	97%	8.8
% Change 12/19 - 03/20	**-23.2%**	**-20.0%**	**-40.6%**	**-38.4%**	**-31.2%**	**-31.3%**

Source: S&P Global Market Intelligence, a division of S&P Global.
Note: Index values based only on price (does not include impact of dividends) and are market cap weighted. SNL Bank & Thrift Index includes banks and thrifts traded on Major Exchanges (NYSE, NYSE American, NASDAQ) in SNL's coverage universe (382 component companies as of March 31, 2020). The NASDAQ Bank Index includes NASDAQ-listed banks (333 component companies as of March 31, 2020).

Depending upon asset size and relative trading liquidity, larger banks (over $1 billion of assets) have quickly moved from ~150% of TBV to hovering near their tangible book values, while smaller financial institutions (under $1 billion of assets) are now on average trading at varying discounts to tangible book value.

The industry average price-to-tangible book value (P/TBV) multiple has declined 31% since December 31, 2019, from 141% to 97%, as valuations approach the lows coming out of the Great Recession:



Source: S&P Global Market Intelligence, a division of S&P Global.

The chart below reflects the reduction in P/TBV trading multiples registered during the Great Recession as compared to the current Coronavirus Crisis. The decline in P/TBV multiples from 205% to 98% during the Great Recession, which took place over 9 quarters (4Q 2006 to 1Q2009 peak-to-trough), compares to the Coronavirus Crisis decline from 141% to 97% in a single calendar quarter.

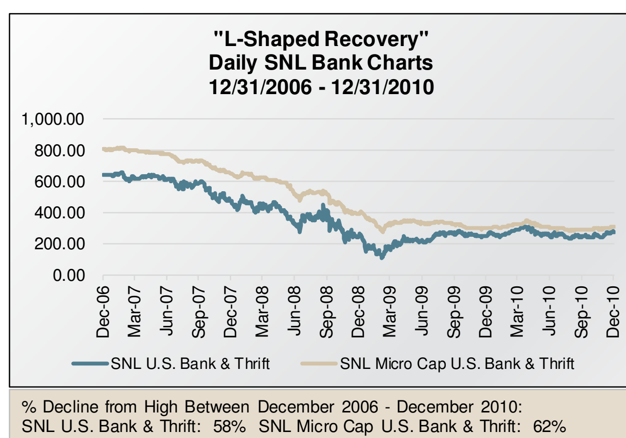
Quarterly Valuations: Price/Tangible Book Ratios (Average)

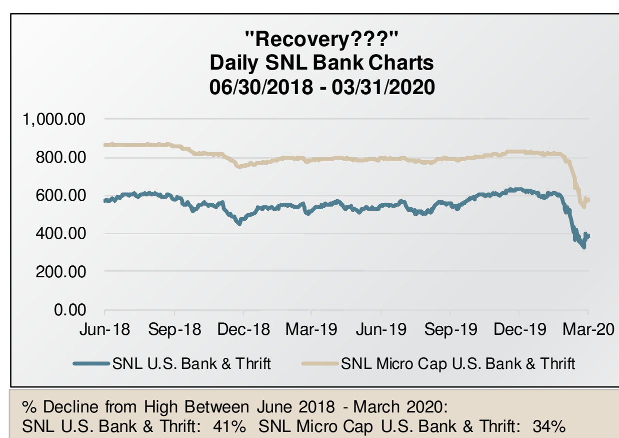
	2006	2007				2008				2009				2010			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
< $1 Billion	175%	169%	162%	153%	137%	129%	117%	108%	96%	88%	91%	89%	82%	88%	85%	82%	82%
> $1 Billion	266%	246%	233%	225%	190%	184%	150%	185%	158%	116%	120%	126%	117%	131%	123%	118%	130%
All B&T's	**205%**	**194%**	**186%**	**177%**	**155%**	**148%**	**128%**	**135%**	**118%**	**98%**	**101%**	**103%**	**96%**	**105%**	**99%**	**96%**	**101%**

9 Quarters

Source: S&P Global Market Intelligence, a division of S&P Global.
Note: Price/TBV ratios based on all publicly traded banks and thrifts at each selected date.

Importantly, the market lows during the Great Recession continued for at least 7 quarters, as the industry P/TBV multiple remained near 100% through 4Q 2010. The speed and magnitude of the anticipated coronavirus recovery will dictate how quickly bank stocks return to “normal” multiples:





Source: S&P Global Market Intelligence, a division of S&P Global.
Note: Index values based only on price (does not include impact of dividends).

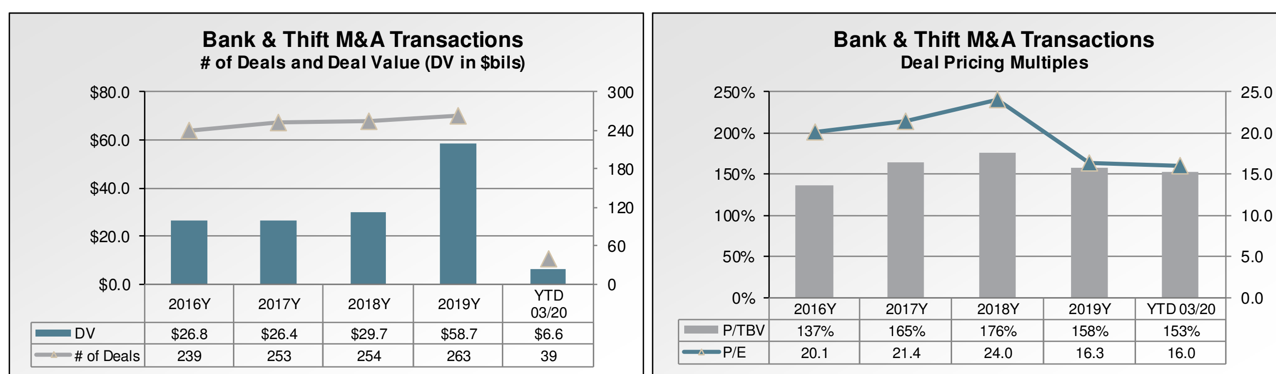
With industry headwinds related to margin pressure, late cycle slowing loan growth, and funding challenges existent before the coronavirus pandemic, most forecasts were already pegging flat-to-declining EPS estimates for 2020. In the current environment, budgets are being reevaluated, loan loss reserves are being reassessed and EPS forecasts are being revised downward.

With bank stocks trading at depressed levels, the market appears to have deeply discounted valuations in anticipation of future credit losses and possible capital needs as the industry moves through the unknown.

We believe the emphasis has firmly shifted toward long-term strategic considerations, capital preservation, and how to best position organizations for future value creation, as the next few quarters have already been "written-off" by investors.

5. Expectations for Bank M&A and Problem Bank Levels

M&A activity has come to a grinding halt. Bank M&A has averaged about 250 transactions annually since 2016, or slightly more than 20 deals per month. For 1Q 2020, 21 deals were announced in January, followed by 10 in February and 8 in March. Only transactions in the process of negotiation reached a contract in February and March; while many prospective deals have been subsequently derailed. We expect virtually no M&A during 2Q 2020, which may likely extend to the remainder of the year given lead times for comprehensive due diligence efforts and contract negotiation. At this time, most banks are focusing internally and managing customer requests to renegotiate loan terms, while exploring Fed initiatives and SBA programs designed to assist struggling businesses in many communities. Bank equities will likely remain "undervalued" relative to historic multiples, and logical cash buyers will be inclined to hoard capital to combat the crisis. We do not expect traditional levels of bank M&A activity to resume until 2021:



Source: S&P Global Market Intelligence, a division of S&P Global. (Excludes terminated deals)
Note: Price-to-tangible book value based on average results and price-to-earnings multiples based on median results.

Given the overall strength of the banking industry's balance sheets and capital levels, we also anticipate very few failures this year. The length and depth of the downturn will dictate future problem bank levels; however, regulatory flexibility in managing troubled loans will mitigate delinquency rates and extend potential charge-offs. This will assist banks in managing significant credit issues typical in a recession.

Conclusion

Our view is that the banking industry is in a very strong position to minimize the fallout from COVID-19 and contribute to a post-crisis economic recovery. Legislative and regulatory initiatives have been virtually immediate and dramatic in scope to support the industry. As the curve flattens – and then recedes, medical treatment breakthroughs are developed, and America gets back to work, the banking system will demonstrate its crucial role in securing the economic future of the country.

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