RBC Global Asset Management

Outlook for US Banks in 2025

January 2025

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A Wrap Up of 4Q24 Earnings Season for US Banks

US banks recently reported fourth quarter 2024 earnings, which provides another opportunity to survey the landscape and to assess sector fundamentals in the context of the changing economic and regulatory environment. We entered fourth quarter (4Q) earnings with a positive fundamental outlook for the US banks, especially as we look back to where we were nearly two years ago at the onset of the regional bank crisis. Away from bank fundamentals, we find ourselves at the beginning of a new regulatory paradigm with the Trump administration likely to establish a different approach versus his predecessor. While details are scant, 4Q bank earnings provided us one of the first opportunities to hear from management teams about the evolving regulatory landscape and the potential impact on banks' balance sheets. Concurrently, US bank sector valuations have gone through a meaningful change in the last year with sector spreads notably tighter over the last 12 months. As such, 4Q earnings provided us a good backdrop to reassess our views on the US bank space while considering an updated fundamental outlook, a potential change in the regulatory landscape, and less attractive valuations. What follows is our thoughts on some key themes to emerge from banks' 4Q24 earnings season.

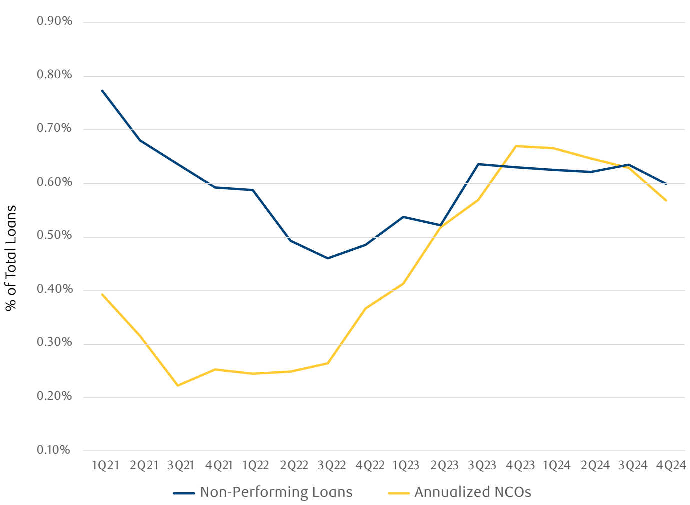
Interest rate changes make an impact

The change in the rate environment between the end of 3Q24 and 4Q24 was meaningful. The yield on 10-year Treasuries increased 79 basis points (bps) during the quarter while the markets' expectation for the number of Fed cuts through year end 2025 went from seven to less than two. For banks, the rate moves most directly impact their net interest income (NII) and net interest margins (NIM), as well as the valuation of fixed income securities that they hold. Fourth quarter results showed little impact to NII/NIM with most banks previously positioning themselves to be close to interest rate neutral. In point, NIMs largely inflected upward in the second half of 2024, with banks well positioned regardless of the rate environment. If anything, the steepening of the yield curve during the quarter and banks' asset sensitivity had a positive impact on NII and NIMs. At the same time, the repositioning of banks' securities portfolios and interest rate hedging programs have largely protected banks' NIMs with one of the bigger impacts going forward tied to loan growth. While loan growth estimates are tepid, the expectation is that NIMs should improve throughout FY25. The other aspect to higher rates has been the increased pressure on banks' Accumulated Other Comprehensive Income (AOCI) due to lower valuations within their securities portfolios. We were pleasantly surprised by the limited impact this had on banks' capital ratios this quarter, even among some of the more exposed regional banks.

Asset quality remains high

Given banks' lending activity across both commercial and consumer sectors, the state of their loan books provides good insight into the strength of the economy. We are happy to report that in 4Q banks' asset quality remained healthy with improving credit trends in consumer lending and mostly stable credit metrics on the commercial side. Notwithstanding headlines about rising credit card distress, metrics reported by US banks detail stable to gradual improvement in delinquency rates. Specifically, the rate of delinquency formation and roll rates from early- to late-stage delinquencies have continued to decelerate, pointing to an increasingly healthy consumer (Figure 1). Moreover, specific credit card companies even highlighted year-over-year declines in delinquency rates. Overall, the improved consumer asset quality trends are driven by continued low unemployment, tighter underwriting standards, and the seasoning of weaker loan vintages that were issued coming out of the pandemic. At the same time, we also see a continuation of good commercial asset quality metrics. Away from office commercial real estate (CRE), commercial loan delinquencies remain low with any credit quality issues seemingly due to idiosyncratic factors. Meanwhile, office CRE issues remain a challenge; however, the limited representation in banks' loan portfolios, laddered maturity schedules, robust reserves, and modest improvements in sector sentiment have helped this to become less of an issue compared to a year ago.

Figure 1: GSIB Asset Quality Performance 2021-2024



Source: Bloomberg Data and SEC filings
As of:12/31/2024

Balance sheets improve

Perhaps the biggest change in regional bank balance sheets coming out of the challenges in 2023 has been the improvement in liquidity positions and capital ratios. Across the board, banks this quarter demonstrated stability of deposits in both commercial and consumer accounts. No longer are there questions regarding a bank's level of uninsured deposits and the available liquidity backing them. Instead, the balance of liquid assets has grown; banks subject to regulatory liquidity coverage levels have shown better than required metrics, and confidence in the system has improved. An additional supporting factor is that the regional banks that failed during 2023 had dramatically different liquidity profiles and business models than the traditional regional banks in which we have invested. We've also seen growth in banks' capital positions with improved profitability, balance sheet optimization, and greater capital retention all helping to boost their capital ratios. These improved balance sheet conditions have been one of the primary factors behind the higher level of market confidence in regional banks versus a year ago.

Regulatory outlook appears promising

The changeover to the Trump administration looks likely to result in a lighter regulatory touch for US banks. Thus far, details are limited, and management teams have been reluctant or unable to provide much insight. However, the consensus view is that both the regulatory framework and the scale of regulation will likely be reduced. These anticipated changes will potentially have impacts on business models, required capital and liquidity ratios, and transaction volumes. In previous years, banks were optimizing and increasing their capital positions in anticipation of an enhanced Basel capital framework known as Basel III Endgame. Banks' dissatisfaction with the proposed rules, coupled with leadership changes at some of the regulatory agencies, has led to the possibility that plans for Basel III Endgame will be scrapped. In the years leading up to this we had seen banks building their capital ratios in anticipation of the new rules. However, we do not think that the demise of Basel III Endgame will result in materially weaker capital positions. Rather we surmise that banks will still maintain capital ratios well in excess of regulatory minimums as it is a necessity for them to compete on a global stage and they want to do nothing that would impair the markets' confidence in them. Additional regulatory changes that we would expect include a lighter touch towards mergers & acquisitions activity across all industries, which would benefit those banks that are active in Advisory and Investment Banking, plus reduced oversight from the Consumer Financial Protection Bureau (CFPB) which would impact those banks with a significant consumer focus.

Conclusion

Where does this leave us coming out of 4Q24 earnings? Banks' fundamental performance in 4Q was some of the strongest we've seen over the last several years. Balance sheets are in good shape, the earnings outlook is positive, and at this time we see few things on the immediate horizon that would disrupt the currently benign asset quality environment. This stands in contrast to where we were almost two years ago when several regional banks failed. The offset to this is that current valuations are unattractive, both on an outright basis and relative to the broader Investment Grade universe. Specifically, spread levels for generic 10-year GSIB (Global Systemically Important Banks) bank risk are within 10-15 basis points of historic tights and bank spreads are trading in line with the broader index. Hence, for now,we remain comfortable with bank sector fundamentals while waiting for a more attractive entry point to increase our exposure.

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