U.S. Banks Outlook 2024

Growth and Earnings to Face Increasing Headwinds

Fitch's Sector Outlook: Deteriorating

Fitch Ratings has maintained a deteriorating sector outlook for U.S. banks in 2024. Fitch expects pressure on the sector's core credit drivers of asset quality and operating profits, in particular, to be sustained in 2024. This reflects our expectations for weaker economic growth and labor market in 2024, higher interest rates for longer, and reduced credit supply and demand. While the impact of the Federal Reserve's unprecedented monetary tightening since 1Q22 has resulted in a drop in core inflation, it remains above target and banks have been challenged by higher deposit costs and unrealized losses on securities portfolios, trends that are unlikely to reverse materially in 2024.

Banks will continue to face headwinds in 2024, including net interest margin (NIM) compression, decelerating loan growth and credit normalization as delinquencies and chargeoffs, except for auto loans, remain below pre-pandemic levels. In addition to a weaker economy, we expect a tightening of lending standards and balance sheet optimization in preparation for upcoming regulatory enhancements to also contribute to lower loan growth.

In light of these challenges, the financial performance of individual U.S. banks will continue to diverge depending on their level of exposure to weaker segments, such as retail and CRE, funding mix and deposit betas, interest rate sensitivity and capital markets exposure. The impact of U.S. regulator's proposed long-term debt requirements for U.S. banks with over $100 billion in assets and Basel III end-game will also pressure funding costs and weigh on loan growth.

Rating Outlook Distribution

The majority of U.S. banks have a Stable Rating Outlook (79%) heading into 2024. However, we could see rating activity biased toward the downside given the paradigm shift in funding coupled with normalization in asset quality. Nevertheless, most banks, particularly global systemically important banks (G-SIBs), can withstand a modest deterioration in credit fundamentals given decent ratings headroom. The proportion of banks on Positive Outlook/Watch as of Oct. 31, 2023 declined relative to the previous year as five banks were upgraded and have Stable Outlooks.

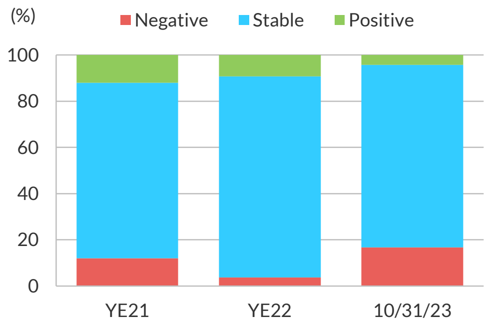
What to Watch

- Impact of higher interest rates for longer on liquidity and margins.
- Extent of credit losses and tightening of loan underwriting standards due to weaker U.S. economy and labor market.
- Strategic balance sheet optimization in light of upcoming changes to the regulatory regime.
- Commercial real estate (CRE) exposure, particularly at regional and mid-sized banks.
- Level and growth of non-interest income.

Theresa Paiz Fredel, Senior Director

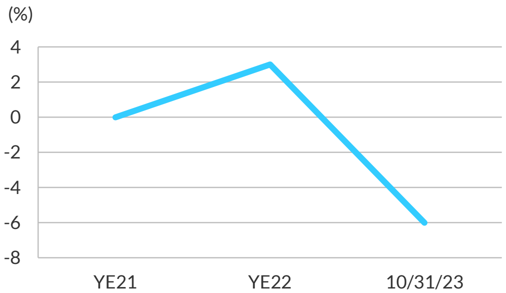
"Fitch expects U.S. banks' core credit drivers to remain pressured against a backdrop of a weaker U.S. economy, higher rates for longer and regulatory uncertainty. However, should the Fed begin to cut interest rates as anticipated in 2H24, there could be some upside for the sector outlook."

U.S. Banks — Rating Outlooks/Watch



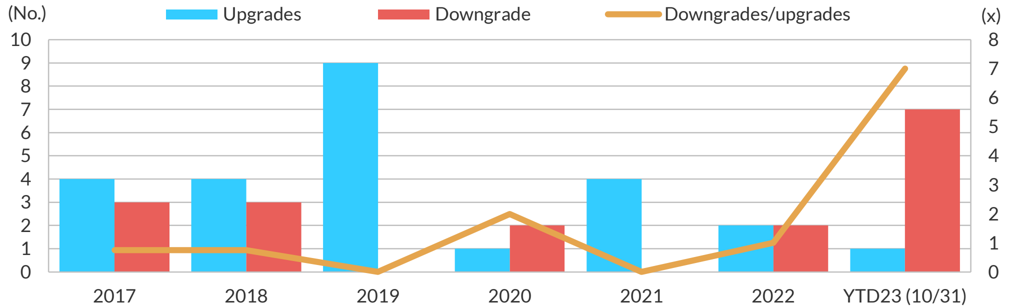
Source: Fitch Ratings

U.S. Banks — Net Outlook Balance



Source: Fitch Ratings

U.S. Banks — Rating Changes



Source: Fitch Ratings

The Rating Outlooks chart shows the percentage of ratings that have a Negative, Stable or Positive Outlook. The Net Outlook Balance chart shows the difference between Negative and Positive Outlooks; a Negative Outlook balance is displayed as a negative number.

What to Watch — Higher Interest Rates for Longer

While Fitch expects rate cuts to commence in mid-2024, interest rates will remain high relative to recent historical levels. This will result in increased margin pressures from deposit migration, as well as higher loan impairments and credit costs. Fitch expects long-term interest rates to remain above trend in 2024. Additionally, it will take longer to reverse unrealized losses on securities portfolios.

As expected, deposit betas increased significantly in 2023, and 3Q23 bank earnings suggest NIMs have peaked. Therefore, NIM compression is likely in 2024. Although we expect lower rates in 2H24, banks will be challenged to lower rates while retaining deposits, as depositors will continue to seek higher yields given increased competition from money market funds and other higher yielding alternatives. While most deposit outflows or shifts in banks' deposit mix toward higher interest-bearing accounts have already occurred, this trend is expected to continue in 2024. Lending rates have more than doubled since mid-2022. Higher rates will naturally cool loan demand and weaken borrower repayment capacity, which will result in higher impairments and credit costs.

What to Watch — Credit Loss Trends

In general, businesses and consumers have yet to feel the full impact of tighter monetary policy as both delinquencies and chargeoffs remain substantially below the 40-year average for most credit products. However, this resilience is unlikely to carry into 2024 given the downturn in profit growth, as well as decelerating employment growth and reduced labor demand this year, which in turn affects wage growth. All of these factors will weigh on repayment capacity and suggest that delinquency and chargeoff rates will increase toward historical levels, resulting in higher provisioning expenses. Some segments, like credit cards and auto loans, could potentially deteriorate beyond historical levels in light of our expectations for a much weaker economy in 2024, despite benign forecast unemployment rates.

Rapid consumption growth underpinned by the drawdown of pandemic savings buffers and robust nominal household income growth have pushed household debt higher. Credit card balances, in particular, reported the highest yoy increase since 2010. While credit card delinquencies are similar to pre-pandemic levels, these remain slightly below the average level of the past 40 years. We expect credit card delinquencies and credit losses to increase further in 2024 as pandemic savings buffers will be largely exhausted and nominal wage growth declines. Additionally, the debt service burden on consumer credit has increased due to higher household indebtedness, the sharp increase in interest rates, and the end of student loan repayment forbearance.

Additional Key Sector Issues

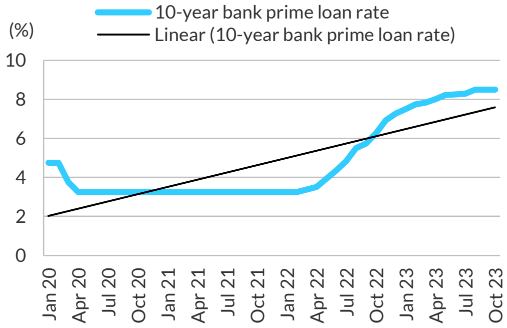
- Heightened geopolitical risks.
- Competitive threats and potential contagion effects from private capital.

NIM Compression Varies by Bank Size

Assets

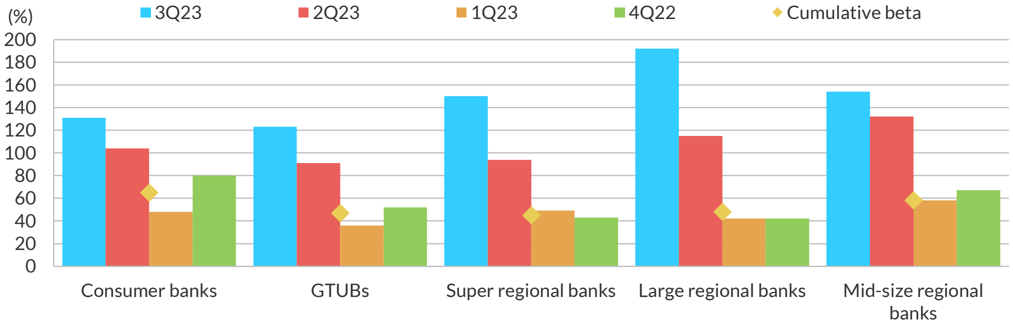
Source: Fitch Ratings, FDIC

10-Year Bank Prime Loan Rate



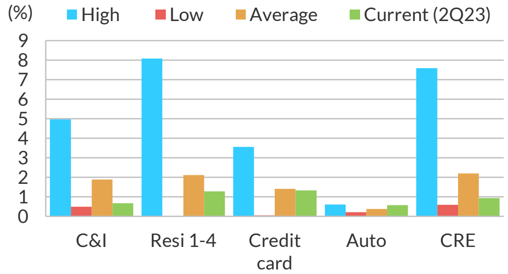
Source: Fitch Ratings, St. Louis Fed

Sequential Deposit Betas



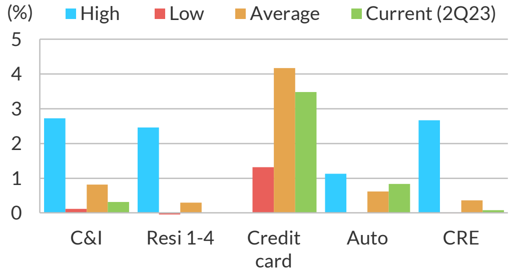
Source: Fitch Ratings, Company filings

Delinquency Rates Below Historical Averages[a]



[a]Period between 1Q84 and 2Q23; Loans > 90 days past due and in non-accrual status
Source: Fitch Ratings, FDIC

Chargeoff Rates Below Historical Averages[a]



[a]Period between 1Q84 and 2Q23. Note: High credit card chargeoff rate exluded for scale purposes (13.21%)
Source: Fitch Ratings, FDIC

What to Watch — CRE Exposure

Fitch expects CRE sector stress to continue in 2024; this will need to be monitored particularly at the regional and mid-sized banks, which tend to have higher exposure as a proportion of assets or capital to this sector. Based on current trends, we expect continued weakness in office CRE due to declining values and rising vacancy rates. While office CRE prices experienced one of the steepest drops YTD in September 2023, the declining trend carried across most CRE categories. Asset quality indicators could be pressured, especially at regional and mid-sized banks that have outsized exposure relative to total loans. However, most of Fitch-rated banks have sufficient profits and provisions to absorb any potential losses at current rating levels.

What to Watch — Balance Sheet Optimization

Regulatory uncertainty will contribute to a de-risking of balance sheets as banks become more cautious. While proposed rules are not final and, therefore subject to change, we believe capital requirements will be increased. As such, banks will likely exit some segments that will no longer be economically viable and execute loan sales to private equity and/or credit risk transfers in an effort to reduce risk-weighted assets. This will be most evident for those banks with assets that exceed $100 billion as they will be required to compute risk weighted assets (RWAs) for operational risk and credit valuation adjustment (CVA), which will result in a material increase in RWAs. Fitch expects banks to manage toward higher capital requirements without much difficulty; however, the ramp up in RWAs will likely maintain lower loan growth in the near term.

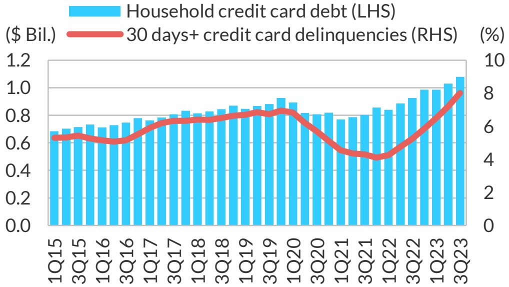
The implementation of long-term debt requirements for banks with assets of $100 billion or more to hold minimum eligible outstanding long-term debt based on specific criteria will contribute to modestly higher funding costs for regional banks when earnings are already under pressure. As the RWA threshold will likely be the binding constraint for most banks subject to this requirement, this will also weigh on loan growth, particularly for those products that could potentially see increased bank capital charges in the final version of the Basel III end-game rules.

What to Watch — Non-Interest Income Trends

As market volatility declines, banks will see lower trading income. However, banks with a strong presence in the corporate banking, underwriting and advisory business will have more upside potential for fee revenues as the rising cost of debt is likely to increase demand for IPOs and equity issuance. Additionally, Fitch expects M&A and LBO activity to more visibly recover in 2024, which will also help non-interest revenue. Demand for restructuring services is also likely to increase given weaker profits and the anticipated economic slowdown.

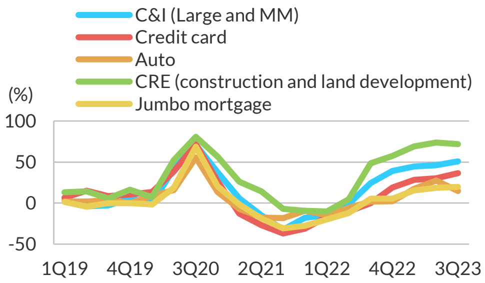
The Consumer Financial Protection Bureau's (CFPB) proposal to reduce credit card late fees will also be incrementally negative to revenue and earnings, particularly for monoline credit card issuers; however, the extent of the decline will depend on mitigating actions by issuers. Fitch expects a sustained deceleration in mortgage banking to weigh on fee income as well. Macroeconomic uncertainty remains high, underpinned by rising geopolitical tensions. This could result in exogenous risks like market volatility that causes outsized counterparty losses.

Total Credit Card Debt and Delinquencies on the Rise



Source: Fitch Ratings, New York Fed Consumer Credit Panel/Equifax

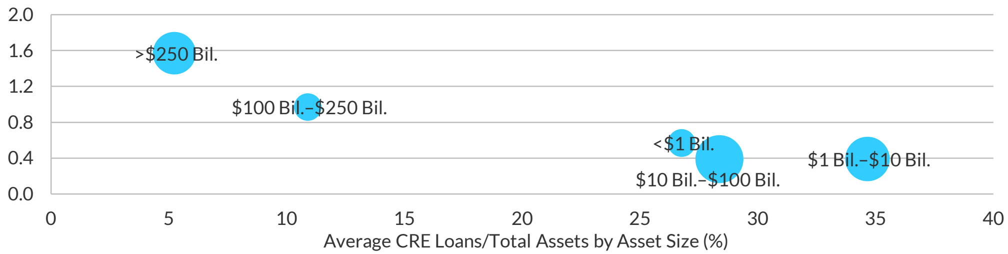
Net % of Domestic Banks Tightening Standards



Source: Fitch Ratings, Federal Reserve Senior Loan Officer Opinion Survey

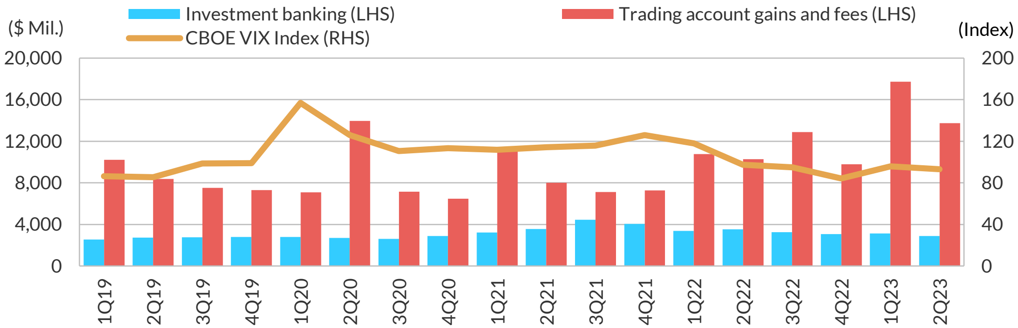
Bank CRE Exposure by Asset Size

(Nonconcurrent CRE Loans/Total CRE Loans[a], %)



[a]Noncurrent CRE loans include all nonfarm nonresidential loans, multifamily, and construction that are >90 days past due or on non-accrual status. Size of bubble represents total CRE exposure in $ by asset size.
Source: Fitch Ratings, FedFis

Market Volatility vs. Non-Interest Revenues



Source: Fitch Ratings, FDIC, Haver Analytics

Appendix

2024 Fitch Expectations (vs. 2023)

	Base Case	Comments
Net Chargeoffs	↗	Net chargeoffs are expected to rise for both consumer and commercial loans as the U.S. economy slows. Weaker repayment capacity as a result of declining profits for businesses, lower wage growth for consumers and an increasing debt service burden will also contribute to higher losses. Credit losses will likely accelerate in 2024.
Loan Loss Provision	↑	Loan loss provisions will be driven upward by deteriorating economic conditions and should move higher in advance of loan losses. The increase will also be driven by the level of exposure to consumer and CRE, specifically office real estate, loans.
Net Interest Income	↘	Expected to decline next year, based on low loan growth and sustained NIM compression due to a shift in both the loan/securities portfolio mix and deposit mix.
Non-Interest Income	↔	Decelerating economic growth, higher rates for longer and a potential reduction in credit card fees will weigh on retail fee income. However, this is likely to be offset by corporate banking, underwriting and advisory business revenues.
Operating Expenses	↘	Operating expenses likely to be adjusted down to accommodate higher credit costs and weaker revenue growth.
Operating Profitability	↘	Although highly dependent on the economic growth trajectory, higher loan loss provisions as delinquencies continue to normalize will likely exceed revenue growth and result in lower profitability relative to 2023.
Loan Growth	↘	We expect a continued moderation of loan growth as the effects of the Fed's tightening monetary policy result in slowing economic growth and banks tighten their underwriting standards.
Deposit Growth	↘	The effects of the Fed's tightening of monetary policy, including quantitative tightening, are expected to result in higher outflows and net shrinkage in bank deposits, though to a lesser extent than in 2023, as customers redeploy excess cash into higher yielding alternatives.
Capitalization	↗	U.S. banks' risk-based capital ratios are expected to increase slightly in 2024 as banks conserve capital in light of current regulatory uncertainty.
Funding and Liquidity	↘	Loan to deposit ratios are expected to increase further in 2024 and net outflows of bank deposits could lead to a higher reliance by some banks on less stable brokered deposits and wholesale funding sources.

Source: Fitch Ratings

Sector outlooks are a general forward-looking assessment of the underlying operational and business conditions of the sector compared to the previous calendar year. A neutral outlook is an assessment that these conditions will remain mostly unchanged. Sector outlooks are distinct from Rating Outlooks.

Outlooks and Related Research

2024 Outlooks
Global Economic Outlook
U.S. Bank 3Q23 Results Highlight Regionals' Funding, Growth Challenges (November 2023)
U.S. Large & Super Regional Banks -Peer Review 2023 (November 2023)
U.S. Bank Deposits, Funding Costs Stabilize as Betas Near Terminal Levels (October 2023)
Bank Facilities, Exposures to Unrated Entities Face Increased Capital Charges (September 2023)
Proposed US Regional Bank Debt Requirements to Drive Mixed Rating Actions (September 2023)
U.S. Banks' 2Q23 Performance Challenges to Persist (August 2023)
Global Banks Mid-Year Outlook 2023 (June 2023)
U.S. Banks' Near-Term Deposit Challenges to Pressure Profitability, Credit and Capital (May 2003)

Analysts

Theresa Paiz Fredel
+1 212 908 0534
theresa.paiz-fredel@fitchratings.com

Christopher D. Wolfe
+1 212 908 0771
christopher.wolfe@fitchratings.com

Mark Narron, CFA
+1 212 612 7898
mark.narron@fitchratings.com