S&P Global
Market Intelligence

2018 US Community Bank Market Report

Executive Summary

- Tax reform and interest rate increases will push returns on equity to the highest level since before the credit crisis. In our baseline scenario, which does not include the impact of an upcoming change to banks' reserve methodology, returns on average assets and returns on average equity will climb as high as 1.15% and 9.87%, respectively, in 2018.
- Asset quality should remain strong in the near term, supported by increased optimism and the windfall of profits coming from tax reform. The influx of cash should spark more competition for loans, preventing yields from rising to previously expected levels.
- Competition will intensify as the Trump administration achieves some level of regulatory relief, which could eventually cause underwriting standards to slip.
- Community banks will see changes in their deposit bases before asset quality sours. Deposit betas, or the percentage of changes in market rates that banks pass on to customers, at community banks have lagged those of their larger counterparts; that trend should continue in 2018.
- The adoption in 2020 of a new accounting standard that changes the way banks reserve for loan losses could come right as credit quality begins to turn.
- That accounting standard, dubbed the Current Expected Credit Loss model, or CECL, will result in a sizable, one-time capital hit for the banking industry.
- Most banks should have ample capital to withstand the blow, but CECL could slow balance sheet growth as some institutions raise rates on loans and others look to rebuild their capital bases.

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Community bank profitability will improve this year

	2017A	2018P	2019P	2020P	2021P	2022P
ROAA (%)	1.02	1.15	1.11	1.04	0.96	0.88
ROAE (%)	8.85	9.87	9.32	8.52	7.60	6.73
Efficiency ratio (%)	63.02	65.42	64.95	63.72	62.88	64.21
Net interest margin (%)	3.66	3.69	3.70	3.75	3.83	3.75

Sources: S&P Global Market Intelligence, proprietary estimates

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Outlook

S&P Global Market Intelligence anticipates that community bank margins and earnings will improve, buoyed by the passage of tax reform and continued increases in interest rates.

We expect that to occur in our base case scenario, which excludes the impact of a new reserve methodology, known as CECL, that banks will adopt in 2020. When including the impact of CECL, we project that while community banks will record slightly higher net interest margins, they will see lower capital ratios. S&P Global Market Intelligence created a base case scenario as well as a separate outlook including the impact of CECL to offer an apples-to-apples comparison between results before and after the adoption of the accounting standard. Projections in this report reflect our base case unless otherwise noted.

Assuming interest rates increase as expected, community bank earnings are projected to jump 19% in 2018. Earnings should dip modestly in 2019 as funding costs rise and impede margin expansion.

S&P Global Market Intelligence sees earnings falling again in 2020 as credit quality begins deteriorating. The projections also assume that in 2020, GDP growth will slow and the unemployment rate will move modestly higher. The benefits of higher interest rates should also wane as funding costs catch up with the expansion in earning-asset yields.

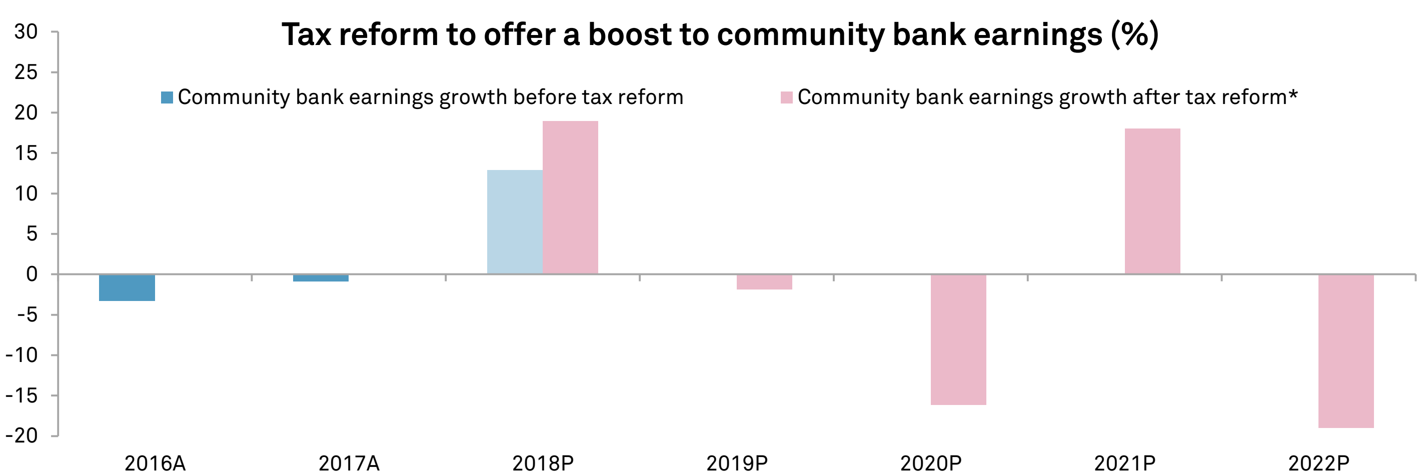
Tax reform offers a large boost to earnings

Tax reform resulted in a sizable hit to community bank earnings in 2017 but will boost results in 2018.

The federal tax overhaul lowered the corporate statutory tax rate to 21%, below the roughly 25% effective rate regularly recorded by community banks since the credit crisis. The legislation prompted banks to revalue their deferred tax assets, resulting in substantial write-downs that negatively impacted earnings.

The lower tax rate in 2018 will more than make up for that one-time hit in 2017, pushing community bank earnings $1.7 billion, or 5.4%, higher than results would have been without tax reform. The lower tax rate and the benefit of being compared to a lower earnings base in 2017 should allow earnings to grow by 19% in 2018.

U.S. banks plan to share some of the windfall created by tax reform with their employees and customers, but community banks stand to retain nearly 40% of the savings.



* Assumes a 21% corporate tax rate and potential changes to expenses that will come from reinvestment of tax reform windfall, beginning in 2018.
Sources: S&P Global Market Intelligence, proprietary estimates

A number of banks have announced plans to use some of the windfall to increase their hourly minimum wage to $15. Some of those institutions and others are paying one-time bonuses to certain employees and have unveiled plans to make sizable charitable donations.

S&P Global Market Intelligence estimates that the total cost of such plans will amount to just 1.75% of community banks' expenses in 2018. We believe expenses could remain elevated in the years after that as banks reinvest in their franchises.

Banks have struggled for years to lever their existing capital by making loans. Unless the economy grows at a significantly faster pace, banks likely will not be able to fully deploy the additional funds generated by tax reform. The windfall from tax reform will leave banks, which already believe they have excess capital, flush with even more funds.

Bankers expect the industry to use the newfound capital to go on the offensive and have warned investors not to expect all the savings from tax reform to fall to the bottom line.

Some investors have incorporated heightened competition into their thinking. They have noted that when banks receive an influx of capital, they tend to use the funds to take market share. Some investors do not expect the response to tax reform to be any different.

Banks can take market share through superior service, but they often do it by offering lower prices.

CECL looming on the horizon

Reserves are expected to rise even more beginning in 2020, when institutions must adopt a new methodology for calculating the allowance for loan and lease losses. The new provision is called the Current Expected Credit Loss model.

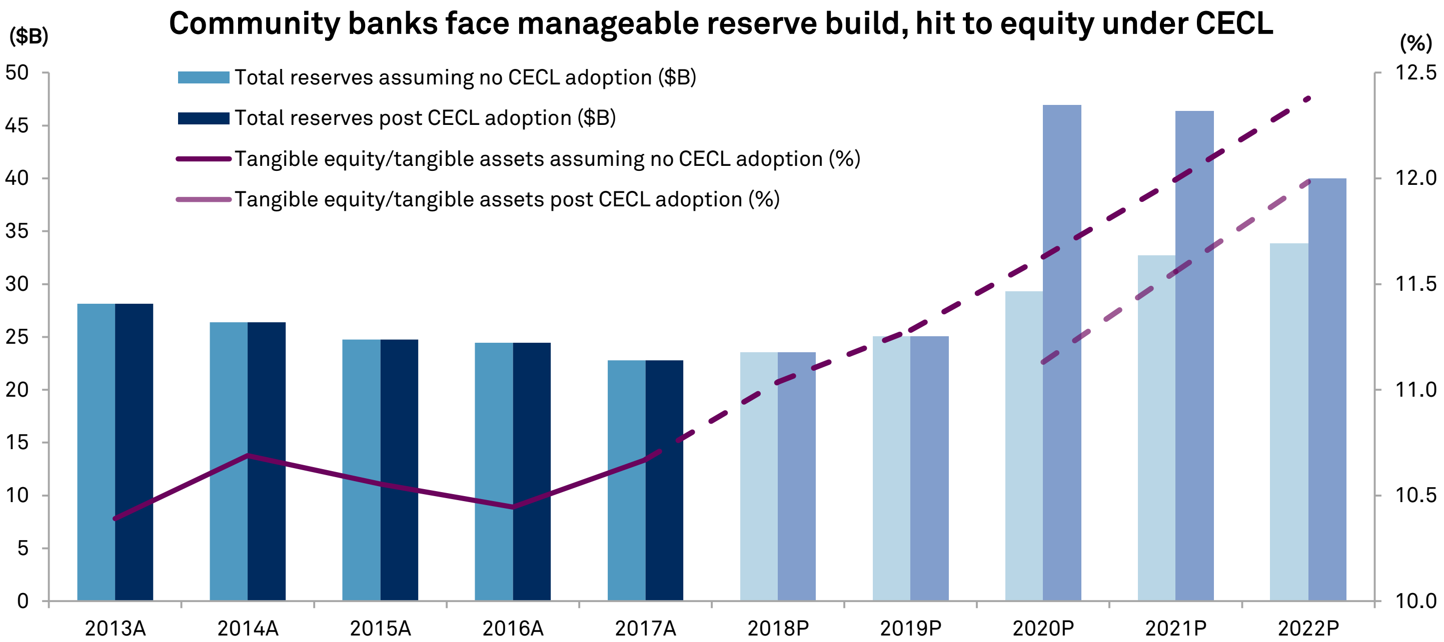
CECL will mark a considerable shift in how banks reserve for losses. Today, banks record losses when it becomes probable that a loan will be impaired, dispersing reserves over time. The process will change under CECL when banks significantly build their allowance for loan losses on the date of adoption.

S&P Global Market Intelligence has developed a scenario to estimate CECL's impact on community banks. In our analysis, we assumed loan portfolios at community banks had an average life of four and a half years, based on the institutions' current loan composition. We further assumed that reserves would equal cumulative net charge-offs in the four and a half years after adoption.

We assumed uniform CECL adoption by all banking subsidiaries at Jan. 1, 2020, and based the scenario on our longer-term outlook for credit quality. That outlook projects that loan portfolios will begin deteriorating more significantly in 2020, with net charge-offs eventually peaking at 0.79% of average loans in 2022.

Under that scenario, if CECL reserves match charge-offs over the period beginning in 2020, the required reserve build for community banks could reach $17.7 billion, or about 1.6x the level of reserves projected under our baseline scenario. The latter scenario assumes that banks continue operating under the incurred loss model.

The increase in reserves would result in a considerable capital hit to banks, reducing the industry's tangible equity-to-tangible assets ratio by 50 basis points in 2020.



Projections current as of March 22, 2018. Data compiled between March 2 and March 16, 2018.
CECL = Current Expected Credit Loss model, a new reserve methodology most banks must implement beginning in 2020.
CECL scenario assumes uniform adoption of the accounting standard by all banking subsidiaries at Jan. 1, 2020; that all loan portfolios have an average life of 4.5 years based on current portfolio composition across the banking industry; and that required reserves under CECL equal projected cumulative net charge-offs in the 4.5 years after adoption.
Net charge-off projection based on a longer-term outlook for credit quality, which assumes losses peak in 2022 and then decline.
Sources: Federal Reserve, Fannie Mae, Freddie Mac, S&P Global Market Intelligence, proprietary estimates

We expect community banks to react to the change and raise rates on newly originated loans, particularly longer-dated real estate credits that will require a larger reserve build under CECL. We have incorporated that change into our CECL scenario and assumed the community bank group's loan yield will be a few basis points higher after adoption.

We assumed that loan growth will be slower than it would have otherwise been as banks with thinner capital ratios hoard cash and work to rebuild their capital bases. We also assumed that deposit costs at community banks would not increase quite as quickly given that their funding needs would not be as great.

Assuming the credit cycle bottoms in 2022, CECL could leave community banks better prepared for a downturn. Since CECL requires banks to reserve for the full life of loans at the date of adoption, much of the required reserves in future years will have already been set aside in 2020. That means additional increases in the allowance for loan losses would be minimal in 2021 and 2022, resulting in lower provisions for loan losses than would have been recorded under the current reserve methodology.

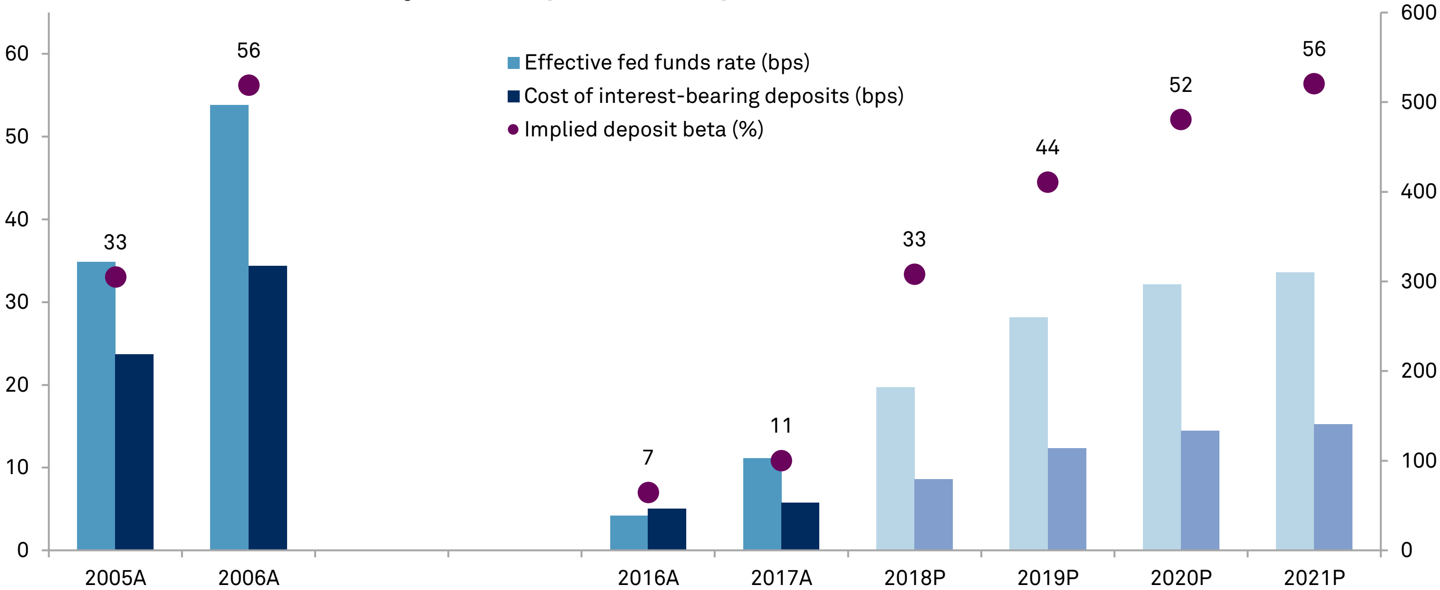
Given that change, earnings would hold steady in 2022 under our CECL scenario, causing capital ratios to rebound right as credit losses are peaking.

Deposit competition heating up

As community banks put more liquidity to work, their funding pressures and deposit costs will grow, albeit at a slower pace than their larger counterparts.

Community banks' cost of interest-bearing deposits only rose modestly to 0.53% in 2017 from 0.46% in 2016 despite a trio of rate hikes from the Federal Reserve. Community banks recorded a deposit beta, or the percentage of changes in rates they passed on to customers, of just 11% in 2017, well below the roughly 20% beta recorded by the banking industry as a whole.

Community bank deposit betas poised to rise off historical lows



Figures for the fed funds rate through 2019 are based on 3-point averages including estimates provided in *The Wall Street Journal*'s monthly survey of more than 60 economists. Figures for 2020 and 2021 are estimates from the Congressional Budget Office.
Actual reported figures used when available.
Sources: S&P Global Market Intelligence, proprietary estimates

Community banks have historically lagged increases in rates by greater amounts than their larger counterparts, and while that trend should continue, the gap is expected to narrow. Interest-bearing deposits should become larger portions of banks' funding bases and eventually revert back to the relative size on community bank balance sheets witnessed before the Fed lowered short-term rates to historical lows.

S&P Global Market Intelligence expects that deposit costs will rise at a faster pace in 2018. The projections assume a beta of 33% on interest-bearing deposits in 2018 and expect that beta to increase to 44% in 2019 after the impact of higher rates takes hold and funding pressures grow.

Community bank earnings should dip modestly in 2019 as funding costs rise and impede margin expansion. S&P Global Market Intelligence sees earnings falling again in 2020 as credit quality begins to deteriorate. The projections also assume that in 2020, GDP growth will slow and the unemployment rate will move modestly higher. The benefits of higher interest rates should also wane as funding costs catch up with the expansion in earning-asset yields.

The 2018 US Community Bank Market Report contains our full five-year outlook and historical data. It is available to S&P Global Market Intelligence subscribers, along with supplementary data exhibits and an industry projections template that allows for different growth assumptions in each year. Contact us for more information.

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