# US Banks: Reading the Tea Leaves

# Implication of higher rates

Industry Overview

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Equity
United States
Banks

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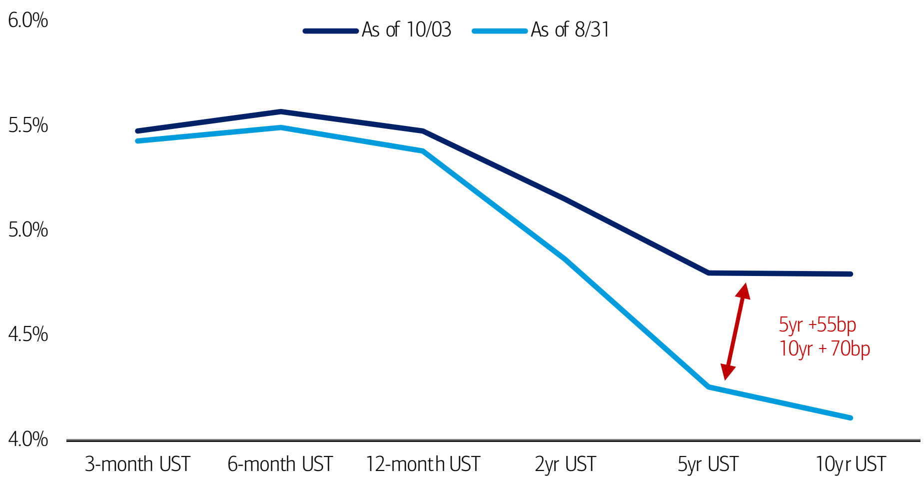
## Spike in rates catches Street off-guard, investors react

The spike in UST yields "bear steepening" has surprised the Street, with the 10yr yield near 4.8% vs. Bloomberg consensus and BofA Economics team forecast for ~4% by YE23 and ~3.5% by YE24. There are four ways in which the yield curve steepening is likely to impact fundamentals and outlook for bank stocks: 1) pressure on capital levels due to rising MTM losses on bond books (-ve) 2) deposit repricing risk (-ve) 3) credit quality implications (-ve/+ve) and 4) higher asset yields (+ve). We discuss each of these below.

## It will be hard to break up (with rates)

We see it as almost impossible in the near term for bank stocks to disconnect with the price action in UST yields. However, we believe the sell-off has created an attractive risk/reward for longer-term investors in certain stocks that are trading near TBV, while also operating with healthy capital cushions. These include Wells Fargo, Goldman Sachs, First Horizon, East West, New York Community and Western Alliance. Higher rates that lead to a worse than expected credit cycle and/or create a market shock are a key risk. Relevant research: US Banks: Higher = Harder

**Exhibit 1: The 10yr treasury yield has reached levels not seen since pre-GFC**
Yield curve as of 10/3 vs. yield curve as of 8/31




**Source:** BofA Global Research, Bloomberg

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## #1 Focus: Impact from bond losses on capital

For bank investors, the immediate concern is tied to increasing unrealized losses on AFS (available for sale) bonds that are seen as thinning the capital cushion. Investors were already laser focused on this factor going into 3Q EPS season and the move in yields over the past few days is only likely to add to these concerns. See **Exhibits 2-9** for CET1 (common equity tier 1), TCE/TA (tangible common equity to tangible assets) capital ratios, bond book duration. **Continued page 2...**

## #2 Focus: Deposit repricing risk

We believe depositor rate sensitivity is more likely to be influenced by the Fed Funds rate (for example, breaching 6% could create another wave of repricing) vs. longer term yields. However, higher for longer rates (combined with $100bn/month in QT) do have the potential to challenge the Street's 2024 net interest income (NII) outlooks due to worse than expected funding costs. In particular, consumer shift towards time deposits could lead to higher terminal deposit betas even if the Fed is done after one more hike. See **Exhibits 10-17** for deposit costs, cycle to date deposit betas, time deposits as a % of total.

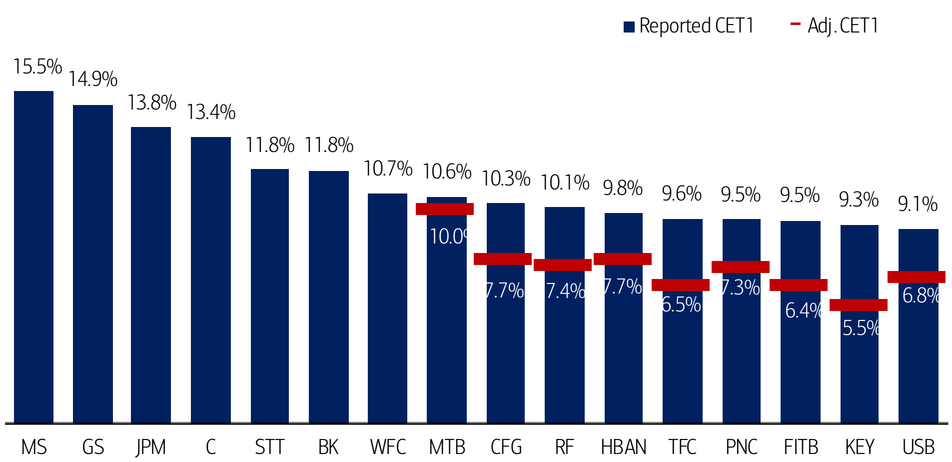
## #3 Focus: Credit, the good and the bad

Lagged effects of Fed rate hikes and the impact from the ongoing pullback in bank lending are already expected to lead to a worsening in credit quality. While investors have been bracing for credit normalization (and then some), a higher for longer rate backdrop has the potential to lead to a worse than expected credit outcome. Stagflation scenario being the worst of all scenarios if the rates do not move lower despite economic weakness. Positively, if the recent re-steepening in the yield curve (2yr/10yr spread) is indicating a reduced likelihood of an economic downturn (= economy/job market resilient), then that could increase investor confidence that credit losses should remain at manageable levels. Relevant research: High Yield Strategy: You Ain't Seen Nothing Yet . See **Exhibits 18-19** for loan loss reserves as of 2Q23 vs. pandemic peak.

## #4 Focus: Repricing asset yields

This gets less attention given the outsized focus on the headwinds facing the industry, but the one upside from higher for longer rates is the upside to asset yields. Banks with fixed rate assets or roll-off in prior fixed rate hedges (that had synthetically depressed asset sensitivity) could be better positioned to mitigate some of the funding cost squeeze over the next 12-24 months. KeyCorp is a prime example of this phenomenon, although the recent spike in yields has refocused investor attention on AOCI headwind. We expect asset repricing to garner more attention during 3Q EPS season and into 2024 as the Street tries to assess NII defensibility next year. See **Exhibits 20-23** for fixed rate loans to AEA, securities to AEA

**Exhibit 2: Median large cap reported CET1: 10.4%**
2Q23 reported and adjusted (for AOCI) CET1 ratios for large cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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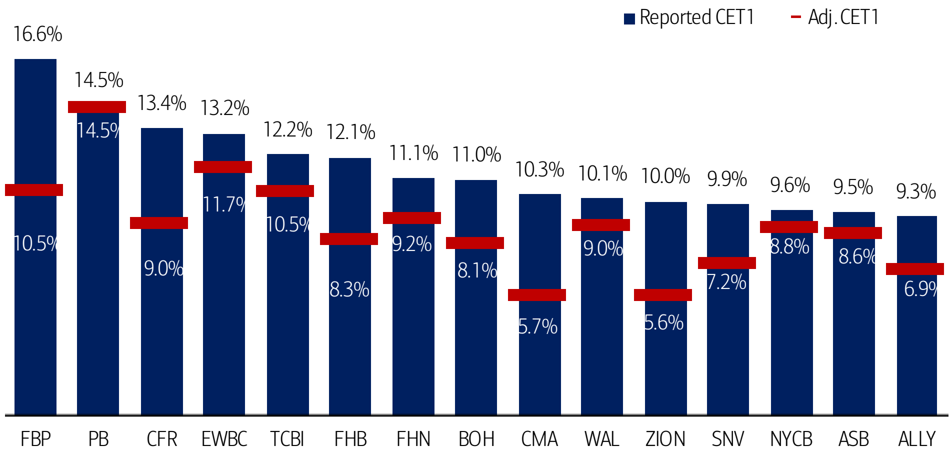
**Exhibit 3: Median mid cap reported CET1: 11%**
2Q23 reported and adjusted (for AOCI) CET1 ratios for mid cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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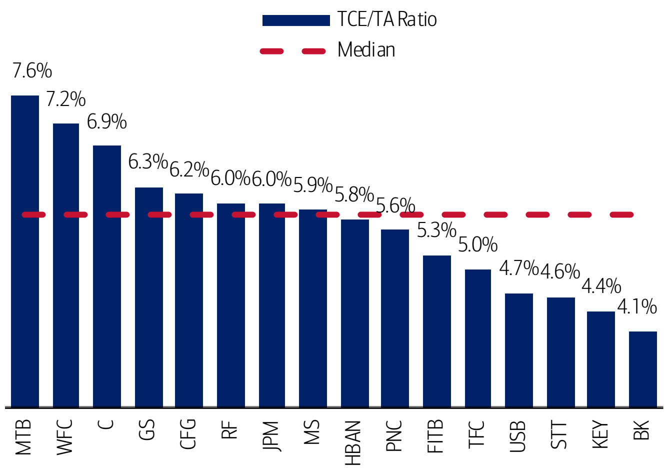
**Exhibit 4: Large cap banks: Median TCE/TA ratio: 5.9%**
2Q23 TCE/TA ratios for large cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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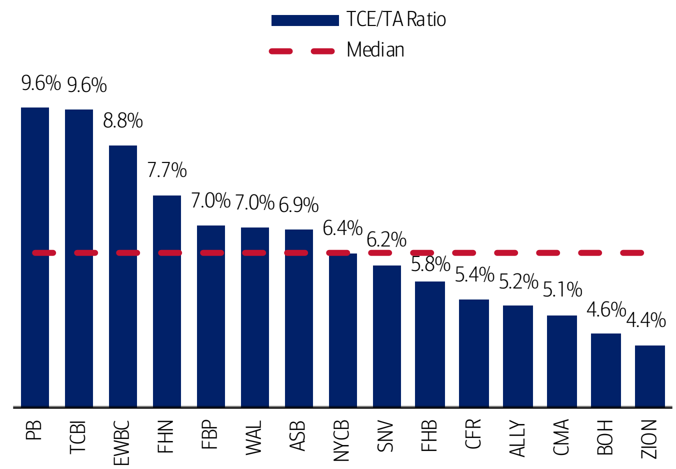
**Exhibit 5: Mid cap banks: Median TCE/TA ratio: 6.4%**
2Q23 TCE/TA ratios for mid cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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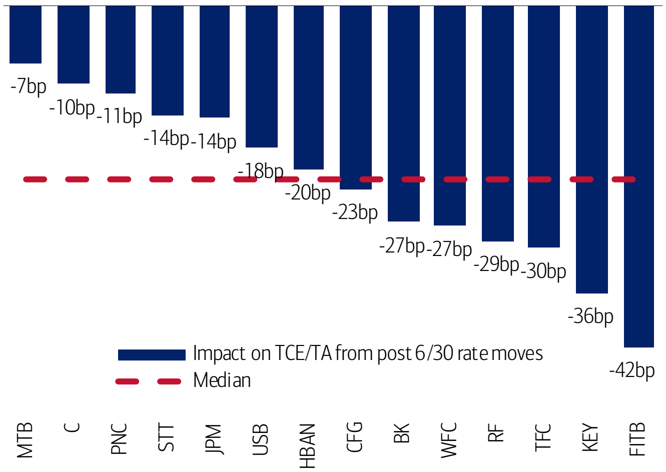
**Exhibit 6: Large cap banks: Est. median impact to TCE/TA ratio; -22bp**
Estimated impact on 2Q23 TCE/TA ratio from incremental AOCI




**Source:** BofA Global Research, company filings, Bloomberg, SNL Financial
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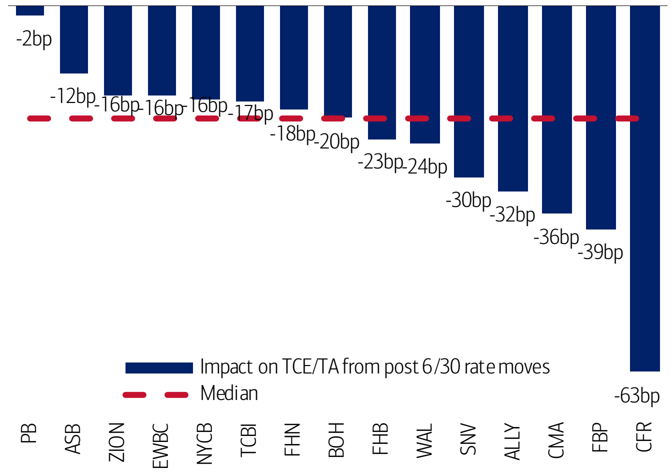
**Exhibit 7: Mid cap banks: Est. median impact to TCE/TA ratio; -20bp**
Estimated impact on 2Q23 TCE/TA ratio from incremental AOCI




**Source:** BofA Global Research, company filings, Bloomberg, SNL Financial
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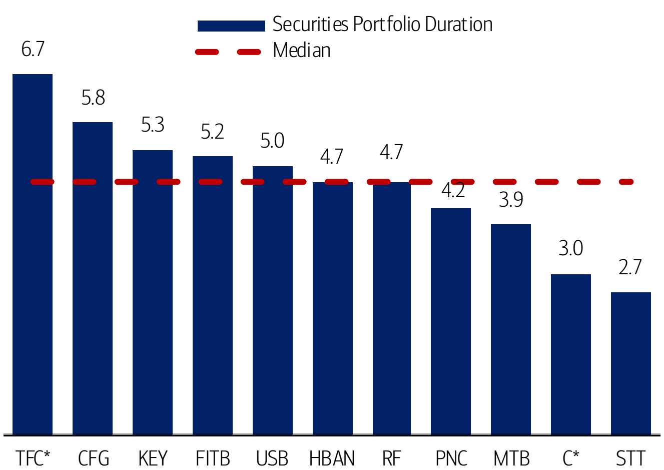
**Exhibit 8: Large-cap banks: Median securities duration: 4.7 years**
Large cap securities portfolio durations in years




**Source:** BofA Global Research, company filings
*TFC as of 4Q22, C as of 1Q23
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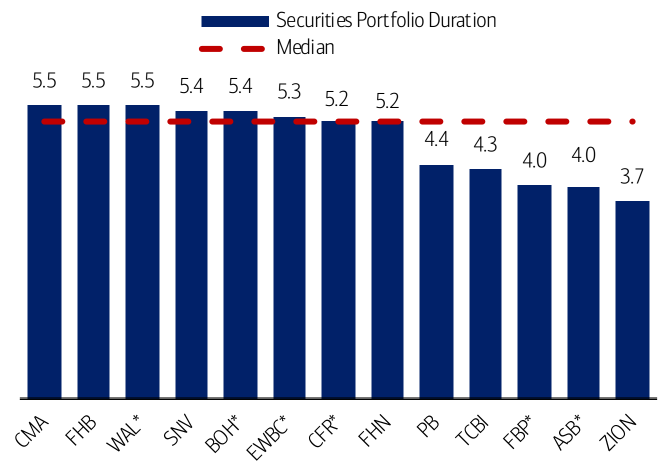
**Exhibit 9: Mid-cap banks: Median securities duration: 5.2 years**
Mid cap securities portfolio durations in years




**Source:** BofA Global Research, company filings
*WAL as of 4Q22, BOH/EWBC/CFR/FBP/ASB as of 1Q23
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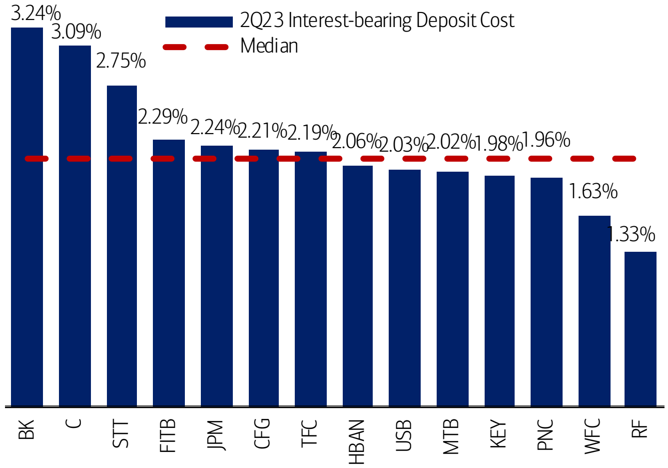
**Exhibit 10: Median large cap interest-bearing deposit cost - 2.13%**
2Q23 average interest-bearing deposit cost for large cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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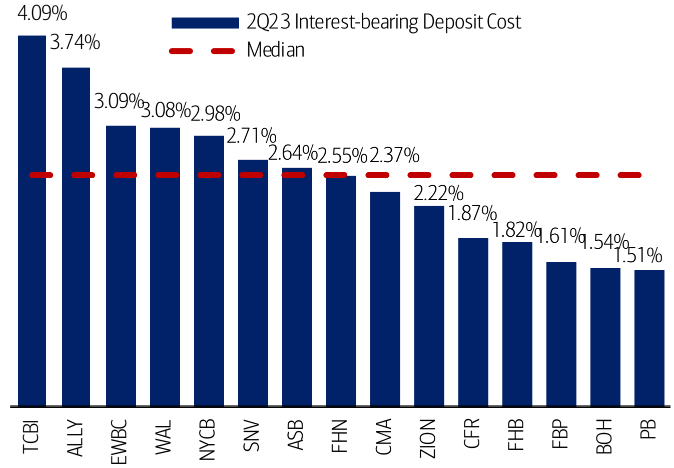
**Exhibit 11: Median mid cap interest-bearing deposit cost - 2.55%**
2Q23 average interest-bearing deposit cost for mid cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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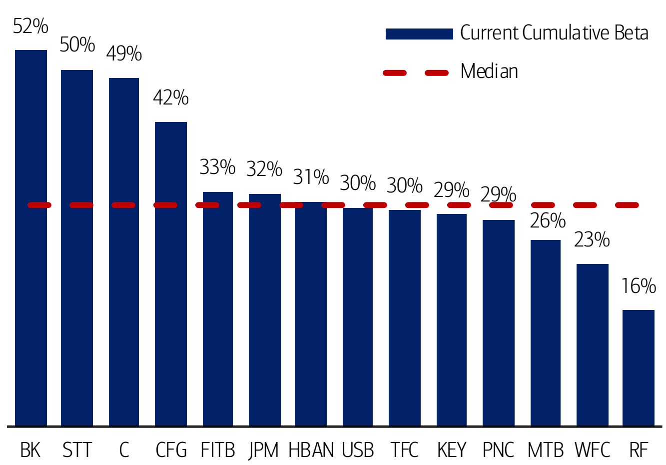
**Exhibit 12: Large-cap banks: Median cumulative beta: 31%**
Cumulative total deposit beta 2Q23 vs. 4Q21




**Source:** BofA Global Research, company filings, SNL Financial

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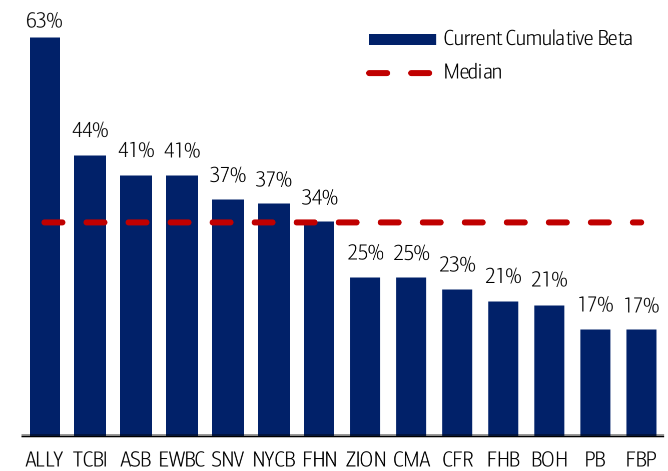
**Exhibit 13: Mid-cap banks: Median cumulative beta: 34%**
Cumulative total deposit beta 2Q23 vs. 4Q21




**Source:** BofA Global Research, company filings, SNL Financial

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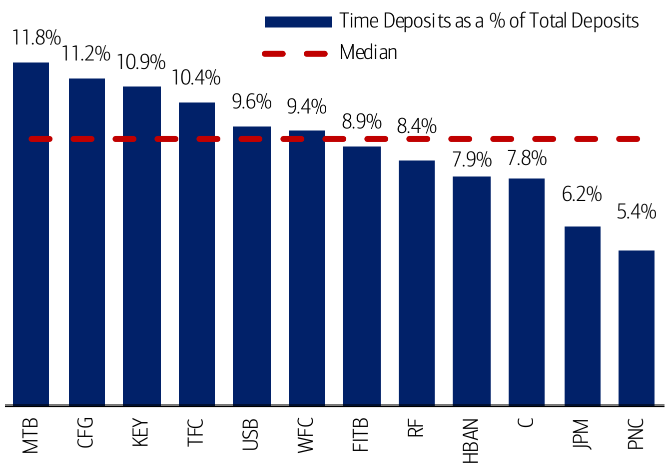
**Exhibit 14: Time deposits are 9.2% of total deposits at large caps**
Time deposits as a % of total deposits for large cap coverage, as of 2Q23




**Source:** BofA Global Research, FR Y-9C, SNL Financial

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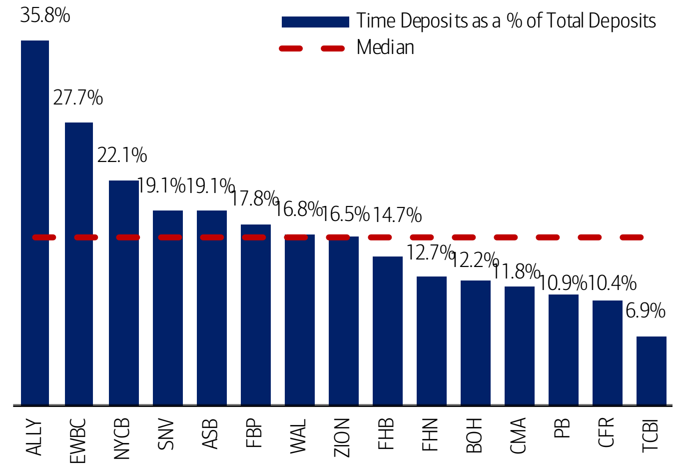
**Exhibit 15: Time deposits are 16.5% of total deposits at mid caps**
Time deposits as a % of total deposits for mid cap coverage, as of 2Q23




**Source:** BofA Global Research, FR Y-9C, SNL Financial

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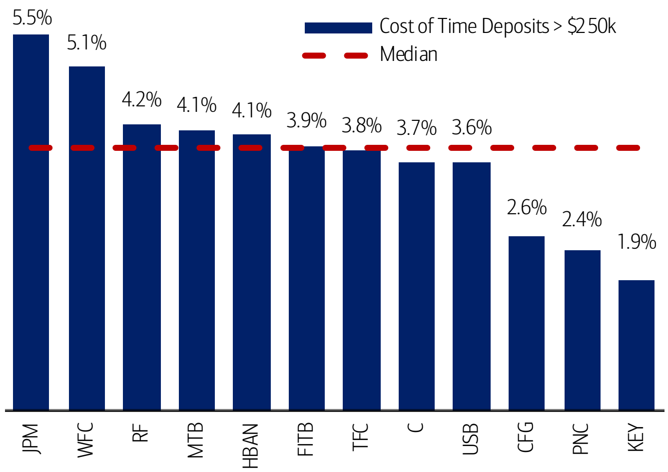
**Exhibit 16: Median large cap cost of time deposits > $250k: 3.9%**
Cost of time deposits > $250k for large cap coverage, as of 2Q23




**Source:** BofA Global Research, FR Y-9C, SNL Financial

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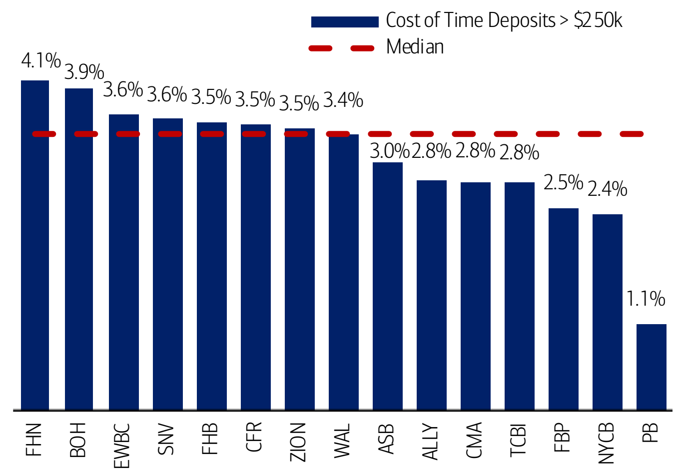
**Exhibit 17: Median mid cap cost of time deposits > $250k: 3.4%**
Cost of time deposits > $250k for mid cap coverage, as of 2Q23




**Source:** BofA Global Research, FR Y-9C, SNL Financial

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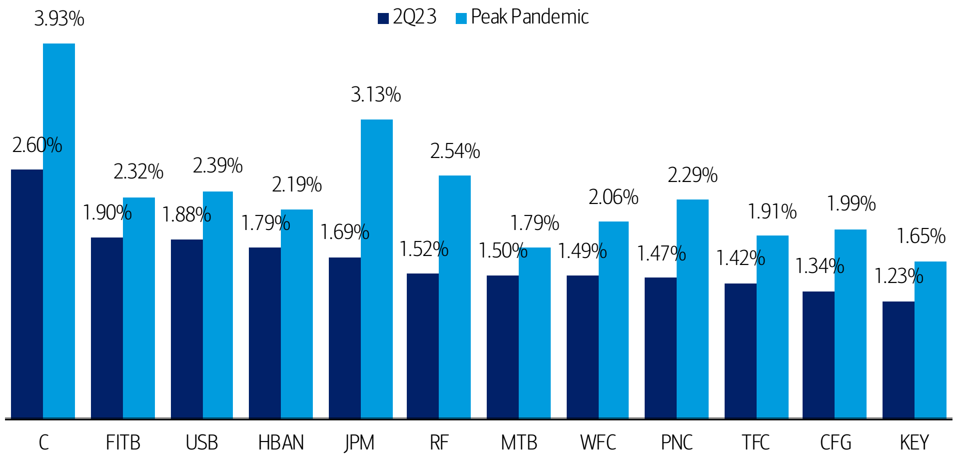
**Exhibit 18: Large-cap banks on median are still 73bp below peak pandemic reserve levels...**
2Q23 loan loss reserves vs. peak pandemic reserves for large cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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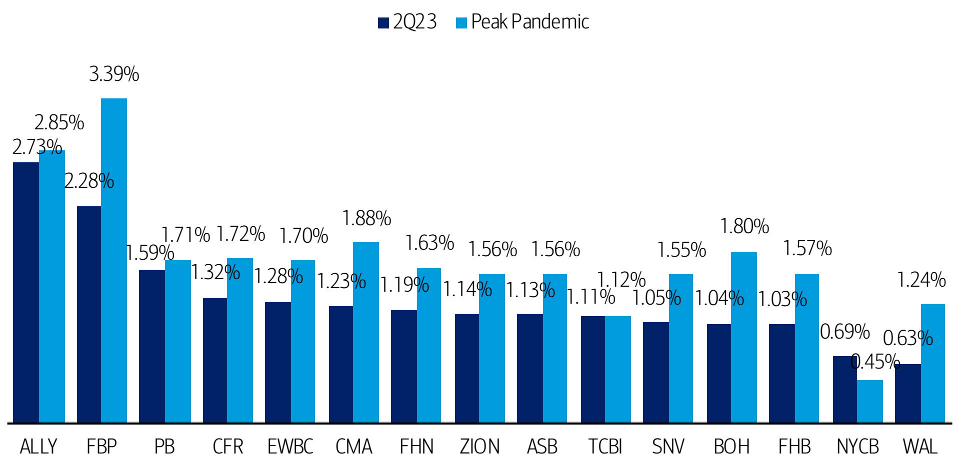
**Exhibit 19: ...while mid cap banks are only 48bp below peak pandemic reserve levels on median**
2Q23 loan loss reserves vs. peak pandemic reserves for mid cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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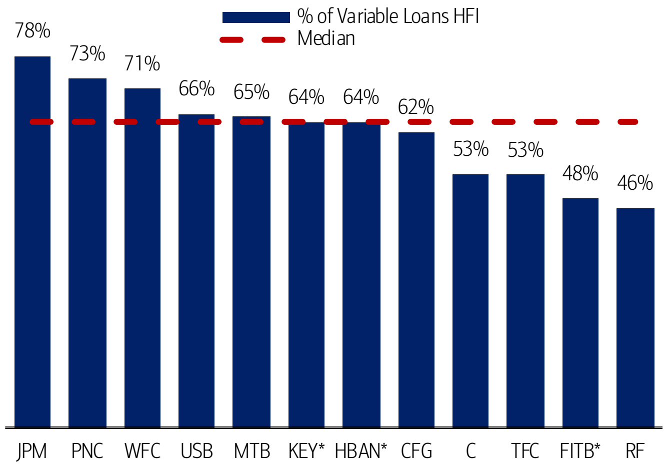
**Exhibit 20: Large-cap banks: Median variable loan HFI %: 64%**
Large cap variable loan HFI %




**Source:** BofA Global Research, company filings
*KEY, HBAN, FITB as of 2Q23

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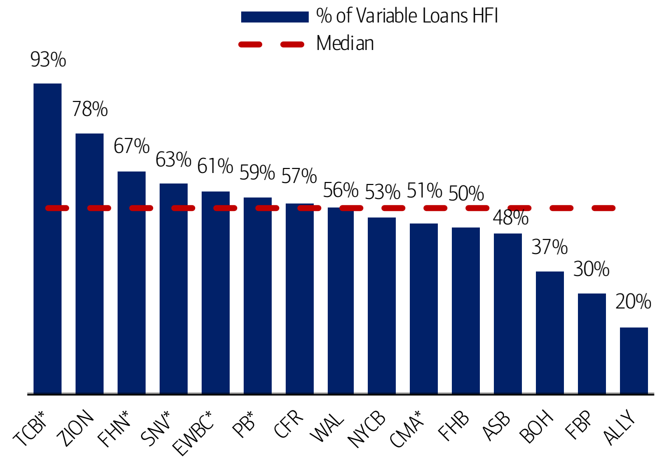
**Exhibit 21: Mid-cap banks: Median variable loan HFI %: 56%**
Mid cap variable loan HFI %




**Source:** BofA Global Research, company filings
*TCBI, SNV, EWBC, PB, CMA, FHN as of 2Q23

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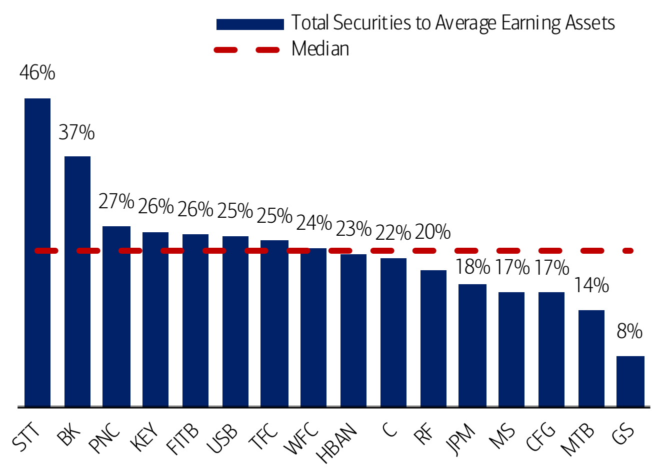
**Exhibit 22: Securities make up 23% of median large cap AEA**
2Q23 total securities as a percentage of AEA for large cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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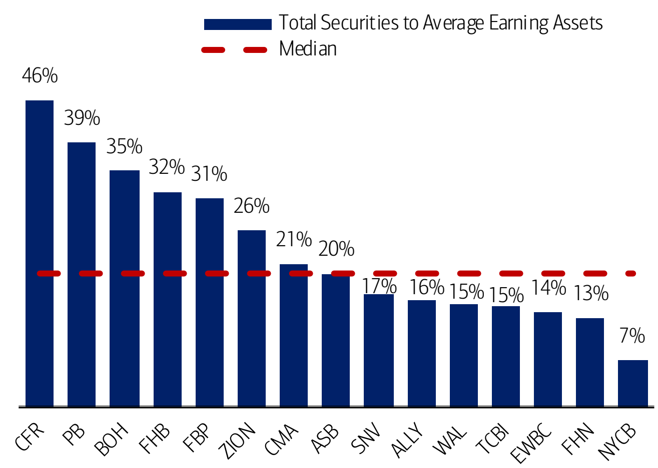
**Exhibit 23: Securities make up 20% of median mid cap AEA**
2Q23 total securities as a percentage of AEA for mid cap coverage




**Source:** BofA Global Research, company filings, SNL Financial

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**Exhibit 24: Companies mentioned**
Companies mentioned in this report

| BofA Ticker | Bloomberg ticker | Company name | Price | Rating |
|---|---|---|---|---|
| EWBC | EWBC US | East-West | US$ 50.09 | B-1-7 |
| FHN | FHN US | First Horizon Corp. | US$ 10.37 | C-1-7 |
| GS | GS US | Goldman Sachs | US$ 306.12 | B-1-7 |
| NYCB | NYCB US | New York Community | US$ 10.75 | B-1-7 |
| WFC | WFC US | Wells Fargo | US$ 38.67 | B-1-7 |
| WAL | WAL US | Western Alliance | US$ 41.9 | C-1-7 |

**Source:** BofA Global Research

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## Price objective basis & risk

### East West Bancorp, Incorporated (EWBC)

Our $75 PO incorporates recession risk (via applying a trough P/TBV multiple). We apply a 50% weighting to our 2023 P/E multiple, with the remaining 50% evenly split between 2024 P/E and 2023 P/TBV multiples. We assign 9.0x/8.0x/1.8x multiples respectively, versus peer multiples (9.5x/9.3x/1.2x) due to risk of outsized EPS pressure in the current rate environment.

Upside risks to our PO are a faster-than-expected economic rebound, higher interest rates. Downside risks to our PO are a worsening in the macro-economic outlook, decline in interest rates.

### First Horizon Corporation (FHN)

Our $14 PO is based on apply a 50% weighting to our 2023 P/E, with the remaining 50% evenly split between 2024 P/E and 2023 P/TBV. We assign 9.5x/9.5x/1.2x multiples based on historical valuation for bank stocks, FHN and our expectations for a US economic recession over the next 6-12 months (we apply a trough P/TBV multiple). The assigned multiples are in-line with peer multiples (9.5x/9.0x/1.2x) given the persistent overhang on EPS outlook tied to deposit growth trends which offsets the superior growth potential and significant capital optionality.

Risks to the upside are stronger-than-expected loan/deposit growth and better-than-expected mgmt. execution post-TD acquisition termination. Risks to the downside are lack of clarity from mgmt. on strategic and operating outlooks, deposit outflows, regulatory overhang, slower revenue growth trends, and a worsening US economic outlook.

### Goldman Sachs (GS)

Our $388 PO incorporates recession risk (via applying a trough multiple). We apply a 50% weighting to our 2023 P/E multiple, with the remaining 50% evenly split between 2024 P/E and 2023 P/TBV multiples. We assign 12.6x/12.0x/1.5x multiples, respectively, above peers (9.3x/8.5x/1.5x) due to lower credit risk relative to peers into a potential recession.

Risks to the upside is stronger capital markets activity.
Risks to the downside are a weaker economy/capital markets, macro or geo-political issues, competition, structural pressures, tougher global regulation, and litigation.

### New York Community Bancorp (NYCB)

Our $15 PO is based on apply a 50% weighting to our 2023 P/E, with the remaining 50% evenly split between 2024 P/E and 2023 P/TBV. We assign 10.0x/9.5x/1.4x multiples based on historical valuation for bank stocks, NYCB and our expectations for a US economic recession over the next 6-12 months. The assigned multiples are broadly above peer multiples (9.5x/9.0x/1.2x).

Upside risks to our price objective are: better than expected growth 2) steepening in the yield curve and 3) better than expected deal synergies. Downside risks to our price objective are: worse than expected growth, significantly higher than (market) expected Fed Funds rate, severe downturn in the NYC economy and the NYC commercial real estate market.

**Wells Fargo & Company (WFC)**
Our $50 PO incorporates recession risk. We apply a 50% weighting to our 2023 P/E multiple, with the remaining 50% evenly split between 2024 P/E and 2023 P/TBV multiples. We assign 11.5x/11.2x/1.2x multiples respectively, compared with large-cap peers (9.3x/8.5x/1.5x).

Downside risks to our price objective are a worse-than-expected economic downturn that lead to significantly higher-than-expected credit losses, elevated expense trajectory, slower-than-expected resolution of its consent orders. Upside risks are better-than-expected credit quality (i.e., lower loan losses) and material expense management that improve visibility on future earnings.

**Western Alliance Bancorp (WAL)**
Our $60 PO is driven by assigning a 1.3x YE23 TBV vs. our return on tangible common equity forecast of around 16% for FY24. We believe the perceived risk to EPS/ROTCE from rising funding costs and/or credit risk if the economy hits a hard landing is likely to cause investors to assign a higher cost of equity. Given the uncertain EPS outlook, we believe the stock is more likely to trade on P/TBV relative to ROTCE expectations vs. on EPS outlook.

Risks to the upside are stronger-than-expected loan/deposit growth. Risks to the downside are deposit outflows, regulatory overhang, slower revenue growth trends, and a worsening US economic outlook.

## Analyst Certification

I, Ebrahim H. Poonawala, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

**North America - Banks Coverage Cluster**

| Investment rating | Company | BofA Ticker | Bloomberg symbol | Analyst |
|---|---|---|---|---|
| **BUY** | | | | |
| | Citigroup Inc. | C | C US | Ebrahim H. Poonawala |
| | Cullen/Frost Bankers Inc | CFR | CFR US | Ebrahim H. Poonawala |
| | East West Bancorp, Incorporated | EWBC | EWBC US | Ebrahim H. Poonawala |
| | Fifth Third Bank | FITB | FITB US | Ebrahim H. Poonawala |
| | First Bancorp Puerto Rico | FBP | FBP US | Brandon Berman |
| | First Horizon Corporation | FHN | FHN US | Ebrahim H. Poonawala |
| | Goldman Sachs | GS | GS US | Ebrahim H. Poonawala |
| | JPMorgan Chase & Co. | JPM | JPM US | Ebrahim H. Poonawala |
| | KeyCorp | KEY | KEY US | Ebrahim H. Poonawala |
| | M&T Bank | MTB | MTB US | Ebrahim H. Poonawala |
| | Morgan Stanley | MS | MS US | Ebrahim H. Poonawala |
| | New York Community Bancorp | NYCB | NYCB US | Ebrahim H. Poonawala |
| | Synovus Financial Corp. | SNV | SNV US | Ebrahim H. Poonawala |
| | The Bank of New York Mellon Corporation | BK | BK US | Ebrahim H. Poonawala |
| | Toronto-Dominion Bank | TD | TD US | Ebrahim H. Poonawala |
| | Toronto-Dominion Bank | YTD | TD CN | Ebrahim H. Poonawala |
| | U.S. Bancorp | USB | USB US | Ebrahim H. Poonawala |
| | Wells Fargo & Company | WFC | WFC US | Ebrahim H. Poonawala |
| | Western Alliance Bancorp | WAL | WAL US | Ebrahim H. Poonawala |
| **NEUTRAL** | | | | |
| | Ally Financial | ALLY | ALLY US | Brandon Berman |
| | Associated Banc-Corp | ASB | ASB US | Brandon Berman |
| | Bank of Montreal | BMO | BMO US | Ebrahim H. Poonawala |
| | Bank of Montreal | YBMO | BMO CN | Ebrahim H. Poonawala |
| | Bank of Nova Scotia | YBNS | BNS CN | Ebrahim H. Poonawala |
| | Bank of Nova Scotia | BNS | BNS US | Ebrahim H. Poonawala |
| | Citizens Financial Group | CFG | CFG US | Ebrahim H. Poonawala |
| | Comerica Incorporated | CMA | CMA US | Ebrahim H. Poonawala |
| | Huntington Bancshares Inc. | HBAN | HBAN US | Ebrahim H. Poonawala |
| | Regions Financial | RF | RF US | Ebrahim H. Poonawala |
| | Royal Bank of Canada | RY | RY US | Ebrahim H. Poonawala |
| | Royal Bank of Canada | YRY | RY CN | Ebrahim H. Poonawala |
| | State Street Corporation | STT | STT US | Ebrahim H. Poonawala |
| | Truist Financial | TFC | TFC US | Ebrahim H. Poonawala |
| **UNDERPERFORM** | | | | |
| | Bank of Hawaii Corp. | BOH | BOH US | Brandon Berman |
| | Canadian Imperial Bank of Commerce | CM | CM US | Ebrahim H. Poonawala |
| | Canadian Imperial Bank of Commerce | YCM | CM CN | Ebrahim H. Poonawala |
| | First Hawaiian Inc. | FHB | FHB US | Brandon Berman |
| | Prosperity Bancshares Inc | PB | PB US | Ebrahim H. Poonawala |
| | Texas Capital Bancshares Inc. | TCBI | TCBI US | Brandon Berman |
| | The PNC Financial Services Group, Inc. | PNC | PNC US | Ebrahim H. Poonawala |
| | Zions Bancorp | ZION | ZION US | Ebrahim H. Poonawala |

# Disclosures

## Important Disclosures

**Equity Investment Rating Distribution: Banks Group (as of 30 Sep 2023)**

| Coverage Universe | Count | Percent | Inv. Banking Relationships [R1] | Count | Percent |
|---|---|---|---|---|---|
| Buy | 98 | 50.78% | Buy | 81 | 82.65% |
| Hold | 47 | 24.35% | Hold | 35 | 74.47% |
| Sell | 48 | 24.87% | Sell | 36 | 75.00% |

**Equity Investment Rating Distribution: Financial Services Group (as of 30 Sep 2023)**

| Coverage Universe | Count | Percent | Inv. Banking Relationships R1 | Count | Percent |
|---|---|---|---|---|---|
| Buy | 156 | 53.24% | Buy | 94 | 60.26% |
| Hold | 79 | 26.96% | Hold | 52 | 65.82% |
| Sell | 58 | 19.80% | Sell | 32 | 55.17% |

**Equity Investment Rating Distribution: Global Group (as of 30 Sep 2023)**

| Coverage Universe | Count | Percent | Inv. Banking Relationships R1 | Count | Percent |
|---|---|---|---|---|---|
| Buy | 1869 | 53.48% | Buy | 1046 | 55.97% |
| Hold | 828 | 23.69% | Hold | 461 | 55.68% |
| Sell | 798 | 22.83% | Sell | 370 | 46.37% |

R1 Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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| Investment rating | Total return expectation (within 12-month period of date of initial rating) | Ratings dispersion guidelines for coverage cluster[R2] |
|---|---|---|
| Buy | ≥ 10% | ≤ 70% |
| Neutral | ≥ 0% | ≤ 30% |
| Underperform | N/A | ≥ 20% |

[R2] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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