As interest rates have now plummeted back to zero again and the U.S. economy is heading into a recession, the operating environment for U.S. banks has changed dramatically since 2019. With these headwinds facing community banks, why should bank managements be excited about what lies ahead?

As long as this economic shutdown does not linger into the fall, and as long as COVID-19 does not return with a vengeance and force us all back into our homes, the forthcoming recession could be a good opportunity for U.S. banks to prove how much improvement in liquidity and capital they have accomplished over the past decade, and, most importantly, how this added strength should allow U.S. banks to lean into these headwinds and add value for customers, employees and shareholders.

In the Great Recession, U.S. banks were exposed for deteriorating credit standards, not having enough capital and poor liquidity positions. As a result, bank managements were faced with dire consequences and choices and—out of desperation—left their customers, employees and shareholders exposed to the ills of a weakening economy. Government bailouts, tightening credit standards, employee layoffs, costly capital raises and a financial crisis were created from the weak position U.S. banks were in, and their constituencies paid for it.
The good news is that the bank management teams that survived the Great Recession came out the other end smarter and more determined than ever. Over the past dozen years, U.S. banks have increased their Tier 1 Common Regulatory Ratio from around 9% in 2008 to more than 13% today. They did so while improving Liquidity Coverage Ratios from under 100% in all three stress scenarios, which forecasted significant bank failures without government intervention, to currently comfortably above this critical threshold.

Underwriting standards and credit discipline have not been sacrificed, as we have seen several products, such as auto and agricultural lending, show signs of credit deterioration over the past several years, and growth in these products slowed rapidly. Moreover, back office and processing controls have been enhanced to limit operational risk and losses. The only thing it seems that U.S. bank managements did not learn from the last downturn was that being too asset-sensitive can hurt potential profitability when interest rates approach zero. There is no fixing this issue until interest rates begin to move higher again.

**Reaction to the recession**

Due to these improvements in safety and soundness, U.S. banks have reacted to this downturn differently. Instead of calling for customers to pay off their loans faster to limit out-sized exposures, most banks have been able to implement payment deferral programs to help their customers make it through the downturn and get back on their feet.

The new Paycheck Protection Program (PPP) loans were issued to support small businesses instead of supporting banks that needed the government assistance. Using these tools, bank employees rolled up their sleeves and went to work creating solutions for panicked customers versus spreading panic due to the prior uncertainty if their bank was just going to survive the downturn.

Community banks outshined their larger brethren in this area, assisting many local customers in a difficult time. Community banks with less than $10 billion in assets have processed 43% of PPP loans, though they represent less than 20% of the industry’s assets, according to S&P Global Market Intelligence data.

Lastly, U.S. bank stock prices have fluctuated wildly since the last economic downturn. Investors lost around 80% of their investment value in U.S. banks during the Great Recession and it took 2,641 days to recoup that lost value. In comparison, the overall U.S. stock market lost 50% and recovered in half the time. The elimination of dividends and, eventually, the recapitalization at severely depressed prices convinced investors that U.S. banks should be avoided at all costs whenever there was any sign of economic weakness. Due to this ingrained fear factor, U.S. bank stock price volatility has embedded around a 20% discount in relative valuations of U.S. banks compared with before the Great Recession.

**Soothing economic pain**

As the U.S. economy is on the brink of its next downturn, it is reassuring that the country’s community banks are better positioned to avoid another financial crisis and can help soothe the pain from this economic disruption.

As the U.S. economy is on the brink of its next downturn, it is reassuring that the country’s community banks are better positioned to avoid another financial crisis and can help soothe the pain from this economic disruption rather than add to the chaos. On the other side of this downturn, we believe that U.S. bank customers, employees and shareholders could change their perspective about their bankers and might even return to a period of trust and appreciation for the jobs that we all do to support the financial well-being of those we serve.

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I will present thoughts and ideas regarding bank and equity strategies in a quarterly webinar series produced by Vining Sparks. My next event is scheduled for Sept. 24 at 10 a.m. CDT. For more information, visit viningsparks.com or contact your Vining Sparks sales rep.