US Daily: A Status Check on Bank Lending and Bank Balance Sheets (Abecasis)

- Since the turmoil in the banking system subsided earlier this year, deposit outflows have stabilized and bank lending growth has stopped declining. Nevertheless, lending growth remains slower than at the start of the year, and the renewed rise in long-term interest rates could reignite concerns about banks' balance sheets. In this *US Daily*, we leverage the latest bank-level data from regulatory call reports to investigate the drivers behind the recent slowdown in bank lending and assess banks' balance sheet health.
- Nominal bank lending growth has slowed from 10% to 2% since the start of this year on a 3-month annualized basis, for two main reasons. First, deposit outflows and higher deposit rates have led banks to reduce lending to a degree roughly in line with the usual historical relationships. Second, recession fears have likely led banks to reduce lending, and we find that banks that built up more provisions for loan losses over the last year have slowed lending by more.
- The recent rise in long-term interest rates could bring back the concerns from this spring about mark-to-market losses on banks' asset portfolios. Historically, banks have hedged their interest rate risk by matching the interest rate sensitivity of their interest income and interest expense (the deposit beta). Reassuringly, we find that this has remained the case this cycle and that deposit betas are only modestly higher now than at similar points in past hiking cycles for most banks.
- Going forward, we expect the drag on growth from tighter bank lending standards to fade because we expect bank lending standards to remain roughly unchanged in Q3—as fading recession fears and modestly higher bank stock prices roughly offset higher interest rates—and to start to normalize gradually next year. We expect the tightening in financial conditions and lending standards to generate a roughly 0.2pp drag on GDP growth next year, down from around 1pp in 2023 and 1.2pp in 2022.

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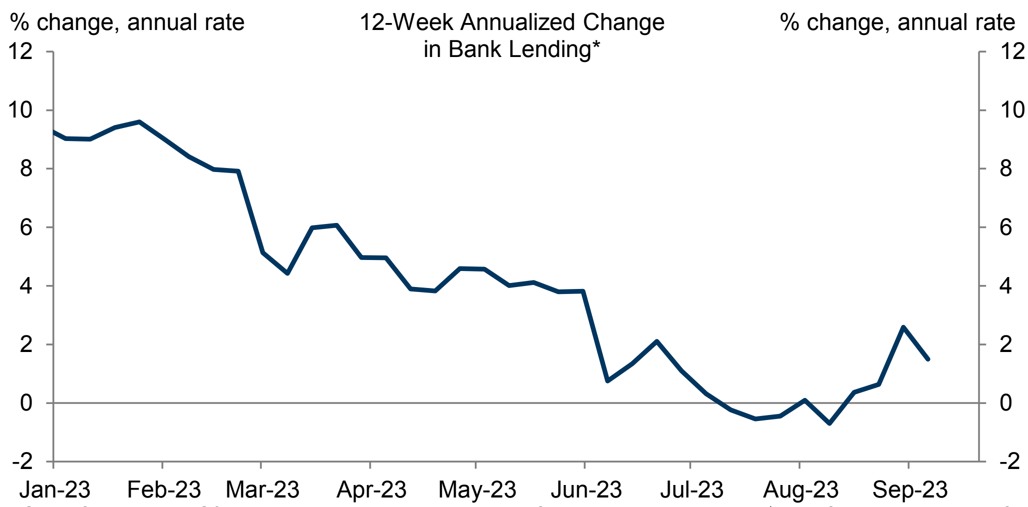
A Status Check on Bank Lending and Bank Balance Sheets

After the turmoil in the banking system subsided earlier this year, deposit outflows have stabilized and bank lending growth has stopped declining. Nevertheless, lending growth remains slower than at the start of the year, and the renewed rise in long-term interest rates could pose risks to banks' balance sheets. In this *US Daily*, we leverage the latest bank-level data from regulatory call reports to investigate the drivers behind the recent slowdown in bank lending and assess banks' balance sheet health.

Exhibit 1: Nominal Bank Lending Growth Slowed From 10% to 2% Annualized Since the Start of the Year



* Sum of real estate, C&I, and consumer loans. The week of March 22 is adjusted by $60bn for the divestment of loans from a bank in receivership to nonbank institutions that are not included in the H.8. Mergers and acquisitions occasionally cause jumps.

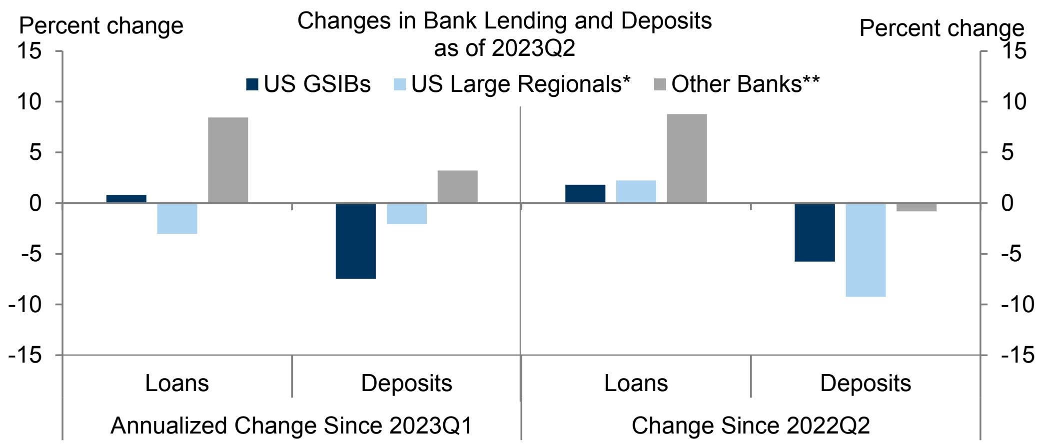
Source: Federal Reserve, Goldman Sachs Global Investment Research

What is driving the slowdown in bank lending?

Bank lending growth has slowed for two main reasons, higher interest rates and fears of recession. We discuss each in turn.

Higher interest rates and deposit outflows have led banks to reduce lending. Indeed, regional banks—who saw substantial deposit outflows in 2023Q1—pulled back on lending the most in 2023Q2, although deposit outflows at these banks have moderated in the second quarter (Exhibit 2).

Exhibit 2: Regional Banks Pulled Back on Lending the Most in 2023Q2, Although Deposit Outflows From Regional Banks Moderated As the Turmoil of 2023Q1 Subsided

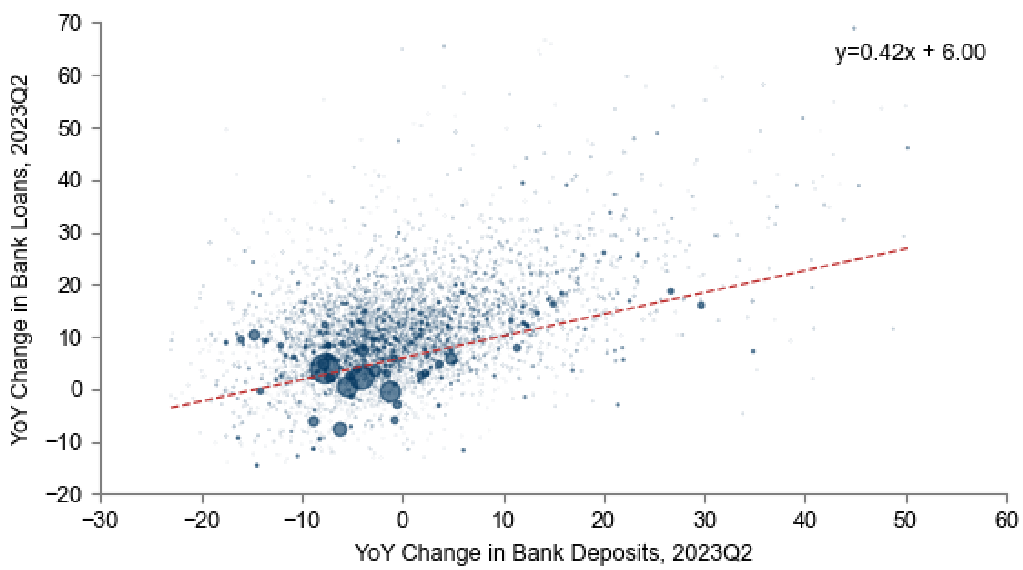


Note: We adjust for the effects of mergers and acquisitions throughout the periods shown.
* PNC, Zions, PacWest, Truist, M&T, Fifth Third, Huntington National, Regions, Citizens, Keybank, Comerica, BMO Harris, First Citizens, US Bank, Ally Bank, Capital One, and Schwab.

Source: Federal Financial Institutions Examination Council, Goldman Sachs Global Investment Research

We also find that the relationship between deposit flows and lending has held more broadly across the banking system (Exhibit 3), although this could be the result of banks choosing to hold fewer deposits and restrict lending in the face of higher rates and rising funding costs rather than a forced slowdown in lending as a result of deposit outflows. Taken at face value, this relationship suggests that bank lending does not respond dollar-for-dollar to reduced deposits (as we have previously noted), but that each dollar of reduced deposits has lowered lending by about $0.30.[1]

Exhibit 3: Lower Deposit Growth Can Only Partly Explain Slower Bank Lending Since Last Year…



Source: Federal Financial Institutions Examination Council, Goldman Sachs Global Investment Research

[1] Loans in the banking system amount to around 70% of deposits.

To gauge how the relationship between lending, deposits, and interest rates compares with the historical norm, we leverage bank-level data since 1985. In the first row, we estimate the impact of changes in a bank's deposit levels on changes in its lending. In order to focus on the effect of changes in deposit levels caused by deposit outflows, we restrict the sample to instances in which the spread between the funds rate and deposit rates moves in the same direction as the quantity of deposits—that is, instances in which deposits decline even though banks lower the spread they earn on them and instances in which deposits increase even though banks raise the spread they earn on them. We find that the impact of demand-driven deposit outflows on lending has been in line with the average historical relationship so far this cycle. The second row shows that the relationship between changes in banks' interest expenses and bank lending growth is weaker than the historical norm.

Taken together, these results suggest that interest rates and deposit flows have not led to an unusual slowdown in bank lending so far.

Exhibit 4: … And the Bank-Level Relationship Between Bank Deposits, Interest Costs, and Lending This Year Has Been Broadly in Line With the Historical Pattern

	Dependent Variable: YoY Bank Lending Growth	
	Panel Regression, 1985-2023	Cross-Section, 2023Q2
Independent variable:		
YoY Deposit Growth (Shock to Deposit Demand)	0.61 [0.00]	0.69
Bank Interest Expenses*	-0.70 [0.00]	-0.22

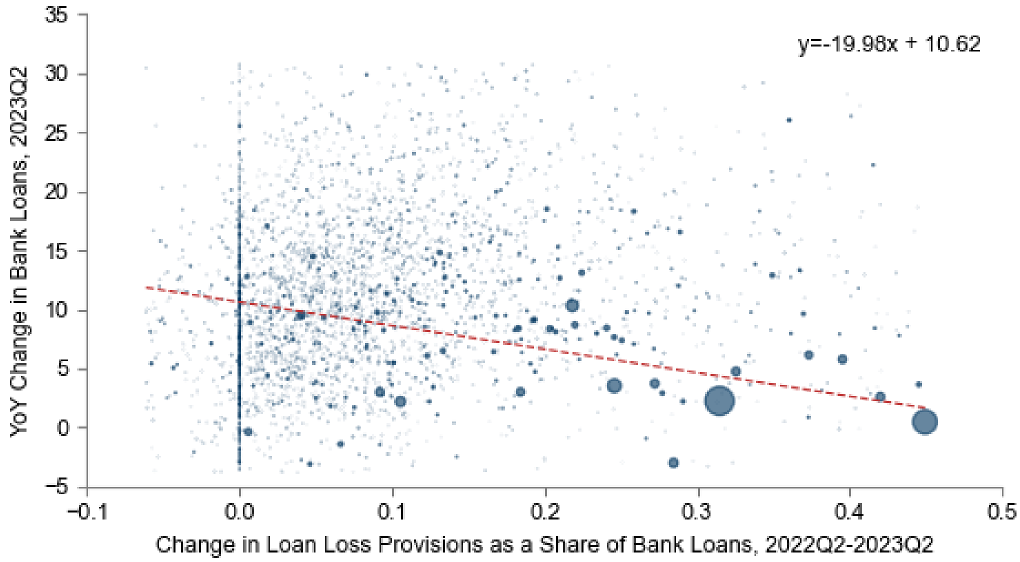
* We estimate the coefficient in two stages in the panel regression to capture changes in interest expenses that follow changes in the federal funds rate. This allows us to isolate changes in interest expenses that can be attributed to rate hikes.

Note: P-values are shown in parentheses. Variables are trimmed at the 5% level. We include entity fixed effects in all specifications and time fixed effects in the first two specifications.

Source: Goldman Sachs Global Investment Research

The second reason why banks have reduced lending is fear of recession. Consistent with this, we find that banks that built up more provisions for loan losses have slowed lending by more over the last year (Exhibit 5). Assuming that recession fears abate, these banks will likely increase lending growth going forward.

Exhibit 5: Banks That Built Up More Provisions for Loan Losses Have Slowed Down Lending by More, Suggesting That Recession Fears Could Underpin Some of the Lending Slowdown This Cycle



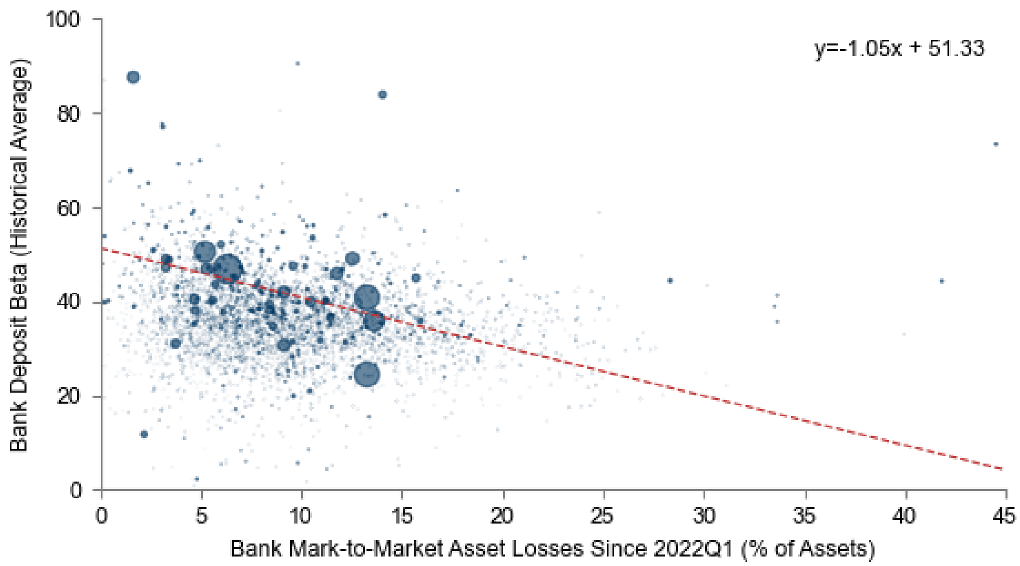
Source: Federal Financial Institutions Examination Council, Goldman Sachs Global Investment Research

The widely-anticipated increase in capital and other regulatory requirements announced in late July also likely made banks reluctant to lend in order to preserve capital (see our banks analysts' reports here, here, and here), and the share of banks reporting that regulatory constraints were an important reason for tightening lending standards in the Fed's Senior Loan Officer Opinion Survey is at its highest level since 2018.

Will higher rates bring back concerns about bank balance sheets?

Higher long-term rates can expose banks to asset losses if they hold large amounts of securities purchased before yields started rising in early 2022. But historically, banks have hedged their interest rate risk by matching the interest rate sensitivity of their interest income and interest expense (the deposit beta), and we find that this has remained the case this cycle (Exhibit 6).

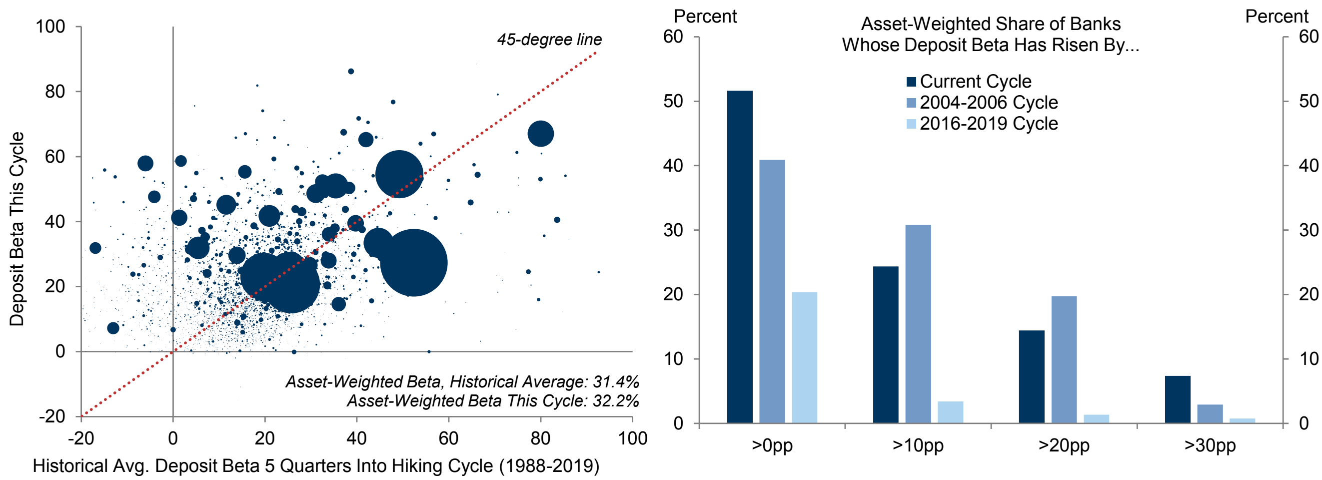
Exhibit 6: Banks Whose Asset Portfolios Are Most Sensitive to Higher Interest Rates Also Have the Most Sluggish Depositors, Allowing Them to Benefit from Low Funding Costs Relative to Market Interest Rates



Source: Federal Financial Institutions Examination Council, Goldman Sachs Global Investment Research

One risk that we have previously highlighted even to banks that manage their interest rate risk well is that deposit betas could be higher this cycle because of innovations like online banking. We have previously shown that miscalculating the deposit beta can be very costly for banks, so a meaningfully different beta this cycle could erode the value of banks' deposit franchise and leave them vulnerable to large losses. But Exhibit 7 shows that, while deposit betas are modestly higher for many banks this cycle (especially compared to last cycle, when deposit betas remained unusually low), they are not unusually high compared to the historical norm. And while elevated uncertainty after the bank failures of earlier this year is likely to keep banks cautious, the fact that deposit betas are roughly in line with their historical average at this point in the cycle should reduce the scope for miscalculation.

Exhibit 7: Deposit Betas Are Higher for Some Mid-Sized Banks But Are Not Much Higher Than the Historical Average for Most Banks at This Point in the Hiking Cycle

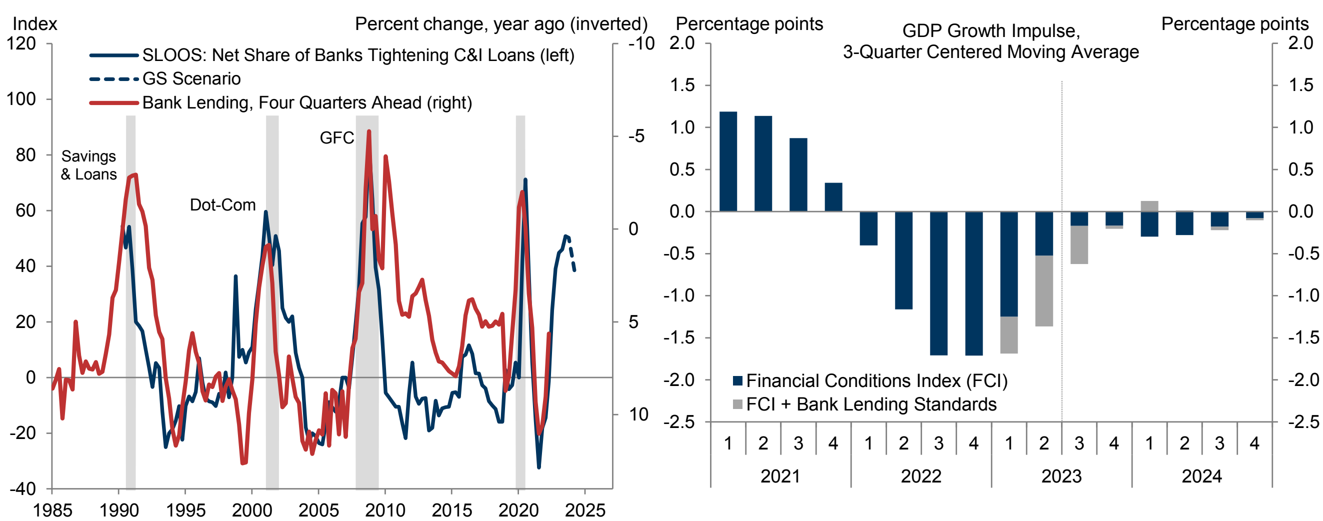


Note: Bubbles proportional to banks' current assets.

Source: Federal Financial Institutions Examination Council, Goldman Sachs Global Investment Research

To gauge the impact of tighter bank credit on growth, we use our extended financial conditions impulse framework augmented with the Senior Loan Officer Opinion Survey's (SLOOS) measure of bank lending standards, which has tracked subsequent changes in actual bank lending well (left-hand side of Exhibit 8). Our model of bank lending standards suggests that subdued recession fears and modestly higher bank stock prices should offset higher interest rates and leave lending standards roughly unchanged this quarter, and we assume that lending standards will normalize gradually over the next year. Taken together, we estimate that financial conditions and lending standards will generate a roughly 0.2pp drag on GDP growth in 2024, down from around 1.0pp in 2023 and 1.2pp in 2022.

Exhibit 8: We Continue to Expect Tighter Bank Lending to Weigh on Growth, But Expect That Most of the Drag Is Now Behind Us



Source: Federal Reserve, Goldman Sachs Global Investment Research

Manuel Abecasis

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