Credit Risk Trends

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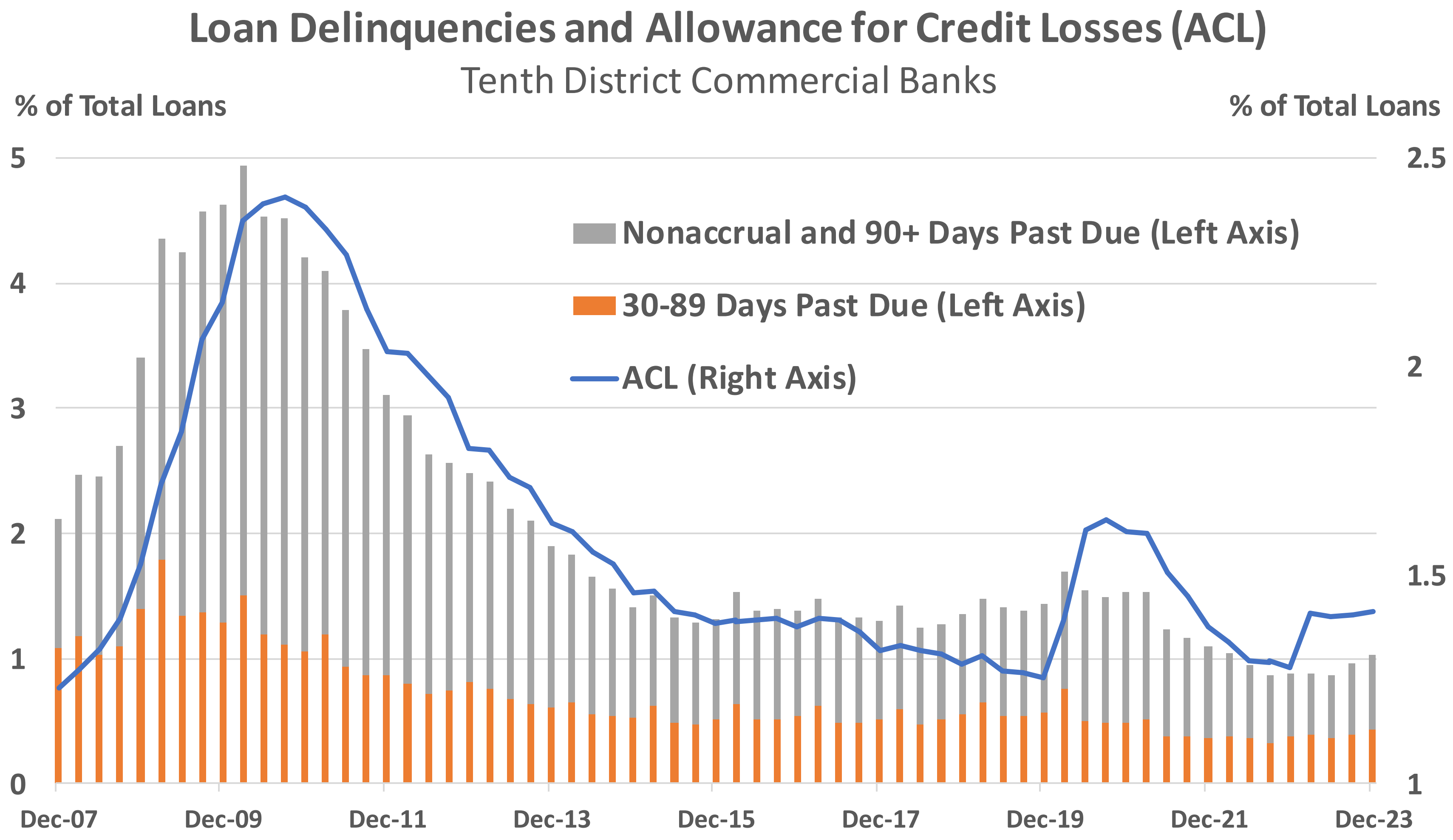
Key Themes

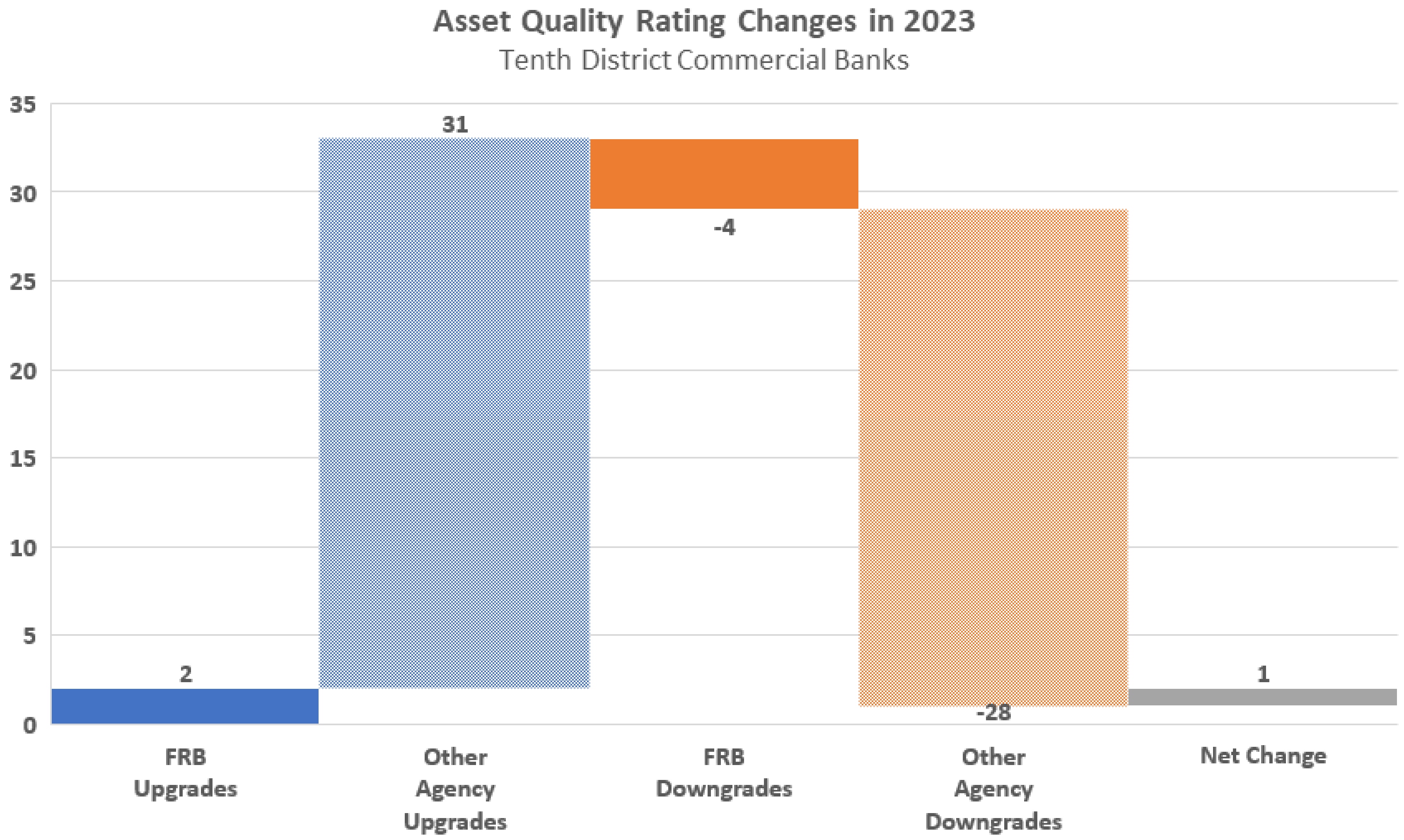
- Credit conditions have been resilient despite a number of challenges.
- Tenth District banks have experienced robust growth in commercial real estate (CRE) loans over the past two years, and CRE lending is showing rising risks with repricing at higher interest rates and deterioration in overall market fundamentals.
- The outlook for agricultural (Ag) credit conditions has dampened with commodity prices declining substantially.
- Adversely classified assets and credit losses are relatively low and stable at CRE- and Ag-concentrated banks, but risks remain.
- Supervisory events will focus on ensuring alignment to key risk management practices and adaptation of risk management practices to changing conditions.

Delinquency rates are near their lowest in a decade.



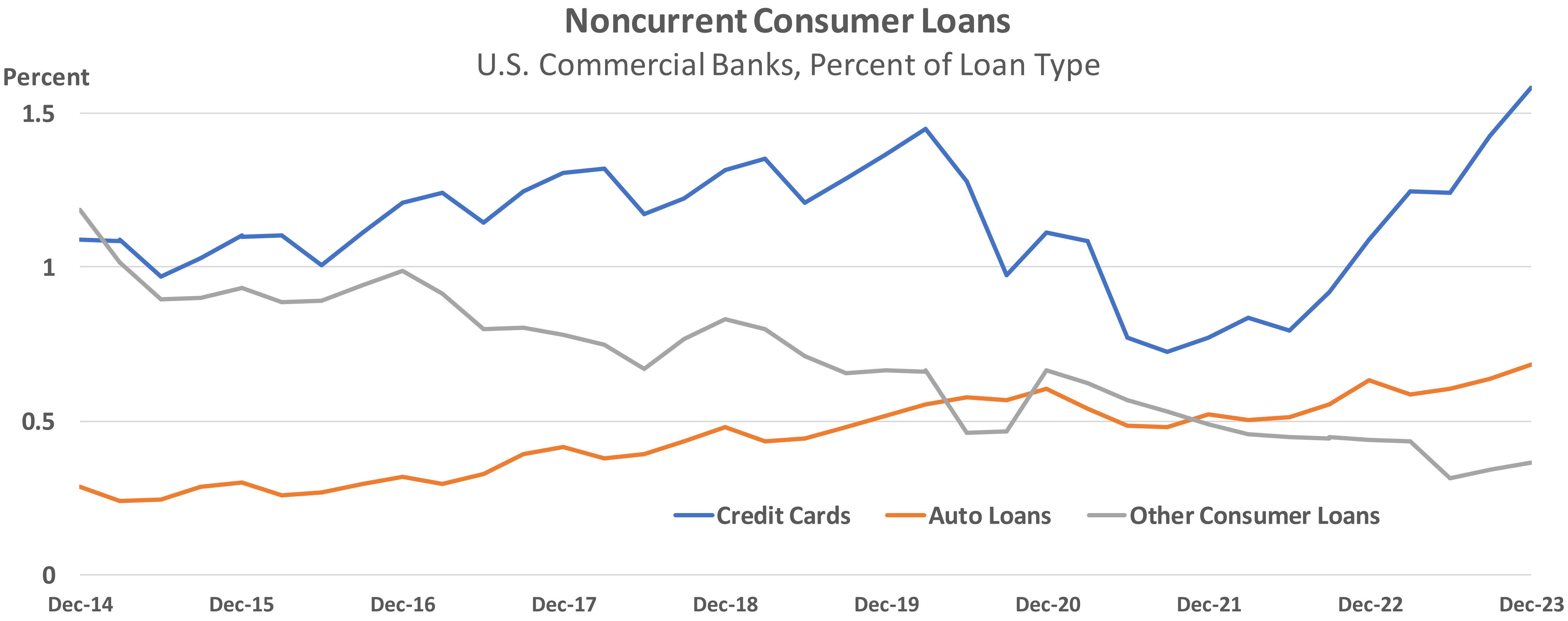
Source: *Reports of Condition and Income*

Asset Quality ratings have remained stable.



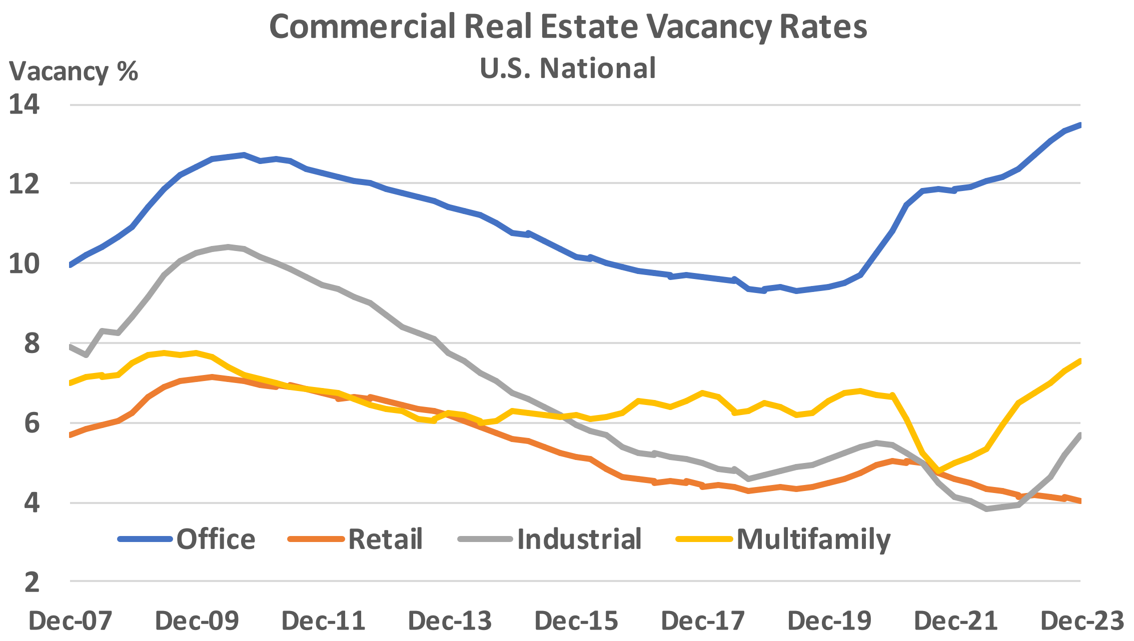
Source: *National Examination Data.*

However, credit card and auto delinquencies have moved up, indicating stress for some consumers.

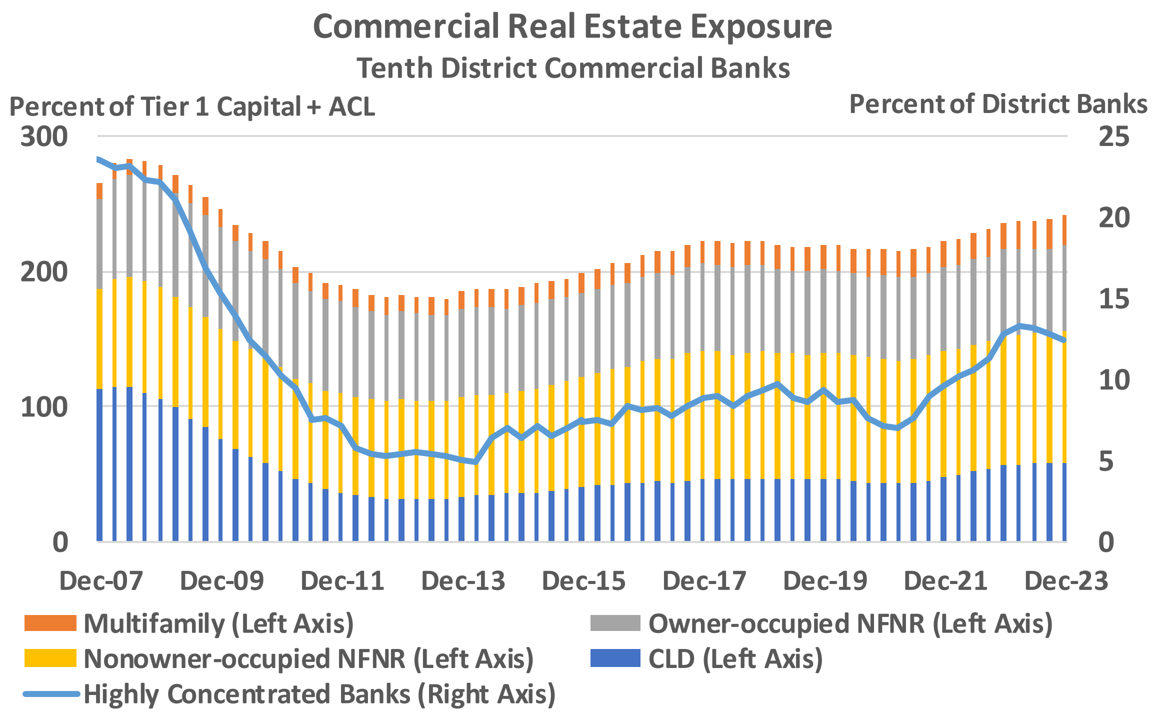


Note: *Noncurrent loans defined as loans 90+ days past due or nonaccrual.*
Source: *Reports of Condition and Income.*

CRE is facing a number of challenges, including rising vacancies and declining prices, increasing the focus on banks with large exposures to CRE.



Source: *CoStar.*



Note: **Highly concentrated CRE banks defined as those with construction and land development (CLD) loans > 100 percent of Tier 1 capital plus the ACL or nonowner occupied nonfarm nonresidential (NFNR) > 300 percent.*

Source: *Reports of Condition and Income.*

CRE banks operate with a higher risk profile than other banks.

	Tenth District CRE Banks*	Tenth District Banks with assets < $10B	All U.S. Commercial Banks
CRE loans to tier 1 capital + ACL	395%	141%	205%
Leverage ratio	10.02%	10.61%	10.45%
Return on average assets	0.98%	1.06%	1.02%
Net Interest Margin	3.71%	3.48%	3.42%
Allowance / Total Loans	1.17%	1.32%	1.24%
Liquid assets to total	11.17%	15.22%	16.30%
Problem banks (Composite 3+)	9.41%	4.75%	5.57%

Notes: *Median values as of December 31, 2023. *CRE banks are defined as commercial banks with CLD loans > 100 percent of Tier 1 capital plus the ACL or nonowner occupied NFNR > 300 percent. **Problem banks are defined as commercial banks with CAMELS composite ratings of 3 or worse.*
Source: *Reports of Condition and Income.*

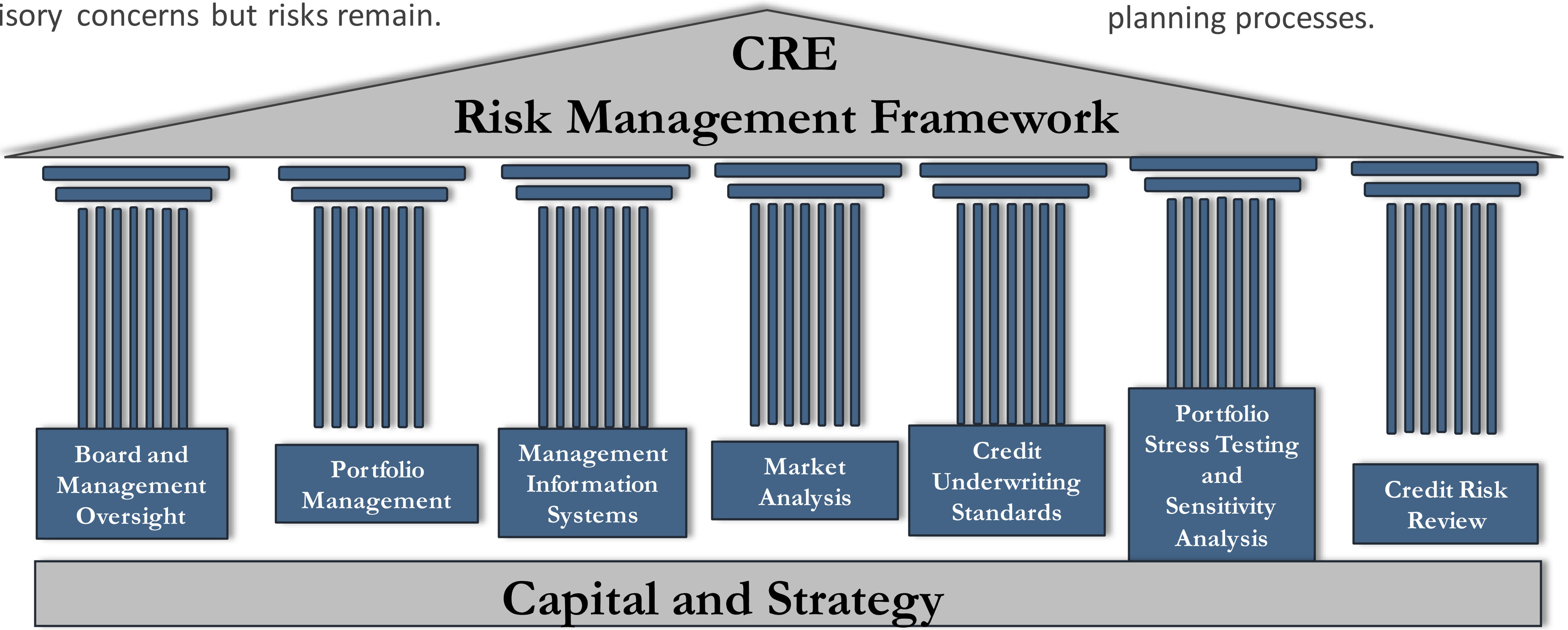
Establishing a robust risk management framework around CRE concentrations remains critically important.

Exam Observations

- Most supervisory findings at CRE-concentrated banks have been related to better aligning concentration risk management practices to SR 07-1.
- The relatively conservative underwriting and risk selection at CRE-concentrated banks help mitigate some supervisory concerns but risks remain.

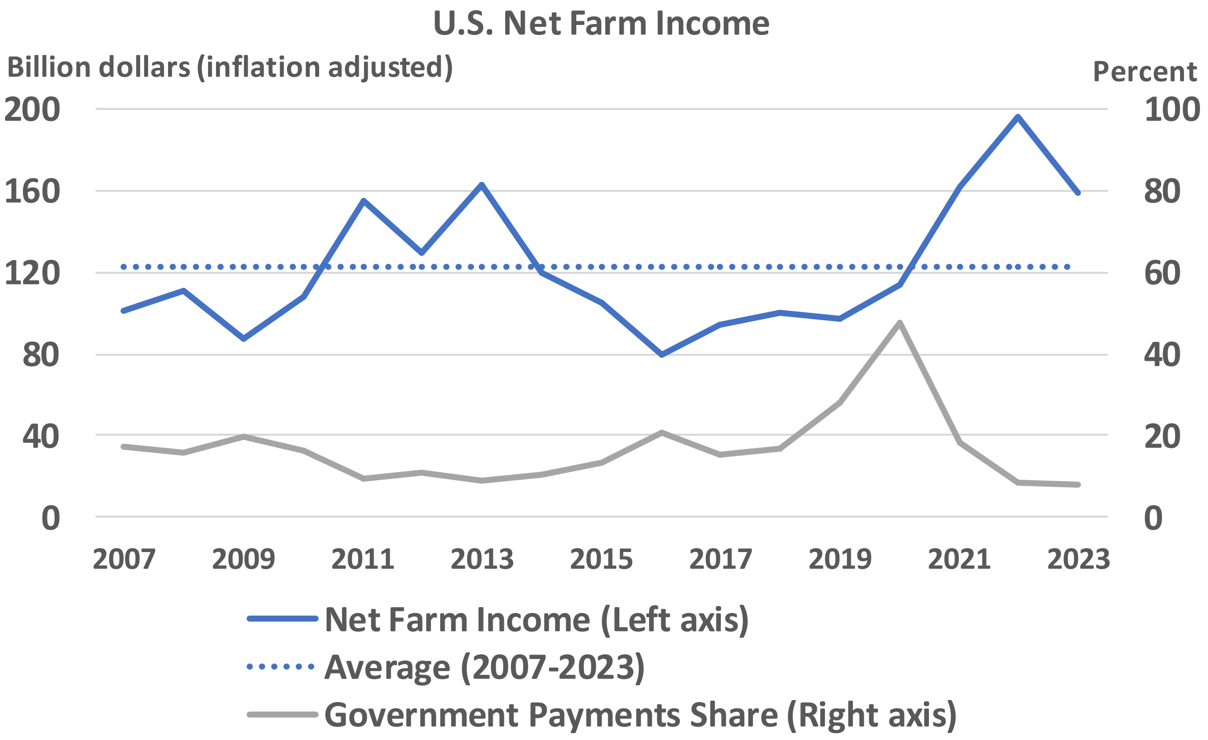
Common Supervisory Findings

- Clearly defining board's risk tolerance by formally establishing risk limits and sub-limits for different CRE loan types.
- Fine-tuning stress testing and better incorporating results into capital and strategic planning processes.

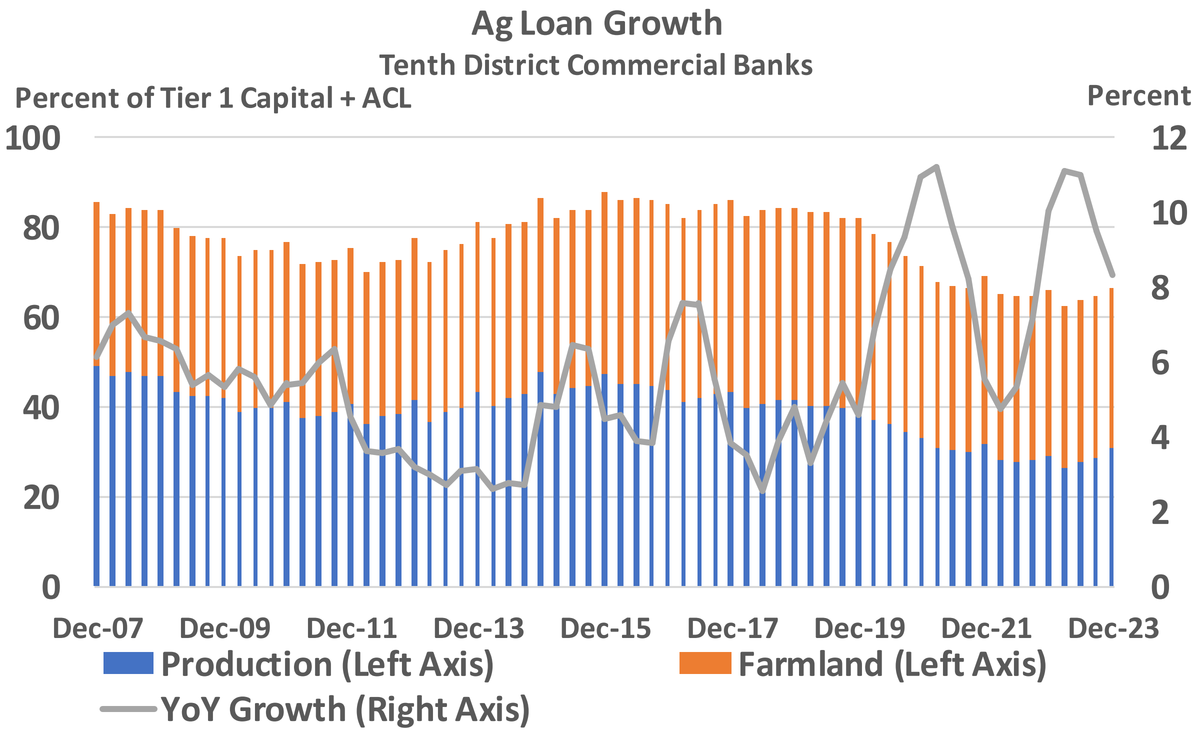


Source: *SR 07-01.*

Farm income declined in 2023 as Ag commodity prices fell substantially, while growth in Ag production loans continued to strengthen.



Source: *USDA.*



Source: *Reports of Condition and Income.*

Capital and liquidity levels of highly concentrated Ag banks lag those of peers.

	Tenth District Ag Banks*	Tenth District highly concentrated Ag banks**	All U.S. banks with assets < $10B
Ag loans to tier 1 capital + ACL	229%	371%	36%
Leverage ratio	11.18%	10.42%	10.49%
Return on average assets	1.06%	1.18%	1.02%
Net Interest Margin	3.39%	3.58%	3.43%
Allowance / Total Loans	1.36%	1.17%	1.24%
Liquid assets to total assets	16.63%	11.57%	16.56%
Problem banks (Composite 3+)***	3.72%	4.55%	5.23%

Notes: *Median values as of December 31, 2023. *Ag banks are defined as commercial banks whose combined ag production loans and loans secured by farmland equal or exceed 25 percent of total loans. **Highly concentrated ag banks are defined as commercial banks whose combined ag production loans and loans secured by farmland are equal to or exceed 300 percent of Tier 1 capital plus allowance. These definitions are for surveillance purposes only and are not considered regulatory definitions. ***Problem banks are defined as commercial banks with CAMELS composite ratings of 3 or worse.*
Source: *Reports of Condition and Income.*

Ag credit risk management basics remain relevant.

Exam Observations

- Examiner loan review has noted thinner profit margins on Ag loans due to higher financing costs which is tighter from very strong margins over the past two years.

Common Supervisory Findings

- Some supervisory findings at Ag concentrated banks have been related to better consistency on using sensitivity analysis.

Borrower Creditworthiness

- Management ability
- Projections
- Working capital
- Income sources

Borrower Cash Flow

- Financial strength
- Equity trend
- Capital expenditures
- Family living expenses
- Sensitivity analysis

Underwriting Standards

- Periodically reviewed and updated
- Matches bank objectives and risk selection/appetite

Credit Administration and Controls

- Cyclical factors
- Subsidies and loan guaranty programs
- Carryover debt

Loan Structure

- Match repayment to cash flows
- Match terms to collateral
- Amortization
- Loan covenants

Collateral Margins and Evaluations

- Formalized periodic monitoring
- Lien perfection

Source: *SR Letter 11-14.*

Concluding Thoughts

- Credit risk at Tenth District banks appears to have moderated from low levels. In the near-term, financial stress in credit risk is likely to remain limited but conditions are less favorable, particularly for CRE and Ag related borrowers.
- The strength of regional economic activity and looming maturity wall in CRE and Ag lending will be key risks to monitor in the year ahead.
- Although credit quality metrics are favorable and stable, supervisors continue to remind banks of the importance of proactive and sound risk management practices and capital planning to monitor any unforeseen changes and financial stresses.

Resources

Kansas City Federal Reserve Commercial Real Estate Index

Economic Bulletin "Banks' Commercial Real Estate Risks Are Uneven"

SR Letter 07-1 "Interagency Guidance on Concentrations in Commercial Real Estate"

Community Banking Connections article "Commercial Real Estate: Key Trends and Risk Management in a New Era"

Community Banking Bulletin Highlight "Risk premium for CRE lending has declined"

SR Letter 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk"

Community Banking Bulletin Feature "Agricultural loan growth has returned to pre-pandemic levels"

Community Banking Connections, "Slowing Agricultural Markets Highlight the Importance of Sound Risk Management Principles"

Kansas City Fed's quarterly Survey of Agricultural Credit Conditions

Community Banking Bulletin Highlight "CECL adoption's impact on community bank allowance levels"