Conditions

First Quarter 2022 Banking Conditions

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Margins remain compressed while slowed growth provides some relief to capital ratios.

By Mary Bongers

Current banking conditions are heavily influenced by recent economic trends, most notably changes in the interest rate environment. The two recent rate hikes by the Federal Open Market Committee (FOMC), as well as the signaling of further increases, have impacted bank financials and will continue to play a large role in shaping banking conditions throughout the year. Bank net interest margins (NIMs) remain compressed (see Charts A10-A11), with yields on earning assets continuing to decline through the first quarter, as rate hikes have yet to fully flow through balance sheets. Recent increases in the federal funds rate have not been large enough to raise all variable rate loans above floors, and competition for loans is aggressive[1] limiting loan yield increases. Additionally, balance sheets remain flush with liquid, yet low-yielding assets, placing continued pressure on margins. Although interest income remains depressed, interest expense across the Tenth District (District) is also low, totaling 0.17 percent of average assets, a record low. Most banks have not begun raising interest paid on deposits due to the abundance of funds, resulting in low deposit betas.[2]

Interest rate movements have also impacted unrealized positions in available-for-sale (AFS) securities portfolios. As a result of interest rate increases, unrealized losses at District banks totaled 10.5 percent of tier 1 capital in the first quarter, marking a record level (see Supplemental Chart 1, below). Balance sheet management during the pandemic contributed to current unrealized positions, as many banks extended securities portfolio duration (see Charts D3-D4) in pursuit of higher yields as a response to compressing NIMs from tepid loan demand and increasing liquid assets throughout the health crisis. However, banks have since begun shortening securities portfolios, and investments with maturities under 5 years now constitute more than 50 percent of total securities for the first time since the third quarter of 2020.

Unrealized losses impact bank liquidity positions, though balance sheets remain flush with liquid assets, totaling 25 percent of assets, (see Charts D8-D9) and the loan-to-deposit ratio remains low at 64 percent (see Charts D5-D6). Quarterly deposit growth has slowed to 1.3 percent, while total loan growth remains modest at 2 percent and has been funded in part by sizeable decreases in cash and due from balances (see Chart C3). Increases in loans during the quarter have been largely driven by growth in commercial real estate (CRE) and commercial and industrial (C&I) lending, offsetting the decrease in agricultural loans (see Chart C4).

Asset quality remains stable as past due, nonaccrual, and charge-off levels are low and decreasing (see Charts B4-B5). Loans modified under section 4013 of the CARES Act also declined further, totaling just over 1 percent (see Supplemental Chart 2, below).[3] Allowance for Loan and Lease Loss (ALLL) levels are directionally consistent with problem assets and decreased to 1.3 percent of total loans, while the coverage ratio continues to increase (see Charts B12-B13). Despite the decline in ALLL to total loans, provisions have increased in support of aggregate allowance levels, following low or reverse provisioning throughout 2021. However, provisions remain historically low at 0.05 percent of average assets in the District (see Charts B1-B2).

Increased provision expenses, as well as depressed NIMs, have impacted earnings performance through the first quarter. Return on average assets (ROAA) decreased to 1.10 percent across District banks (see Charts A4-A6). Declines in noninterest income also hindered earnings, though are offset by continued cost efficiencies gained in overhead expenses (see Charts A14-A17).

Capital levels continue to be pressured by bloated balance sheets. The Leverage Ratio remained mostly balanced from the prior quarter, totaling 9.11 percent across District banks (see Charts A1-A2). While capital ratios are hindered by the increasing size of balance sheets, growth has slowed, and capital injections into District banks increased in the first quarter.

To view the full article, including key charts, click here.

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Endnotes

[1] The Fed - The April 2022 Senior Loan Officer Opinion Survey on Bank Lending Practices (federalreserve.gov)

[2] Deposit beta measures how responsive management's deposit repricing is to the change in market rates.

[3] COVID loan modifications may be reported for loans with modifications occurring through January 1, 2022. Accordingly, any newly modified loan going forward can no longer qualify under Section 4013 of the CARES Act.