Conditions

Third Quarter 2022 Banking Conditions

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November 21, 2022

Rising rates benefit margins, hinder fair value of securities

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Net interest margins (NIMs) at District banks continued to rebound in the third quarter, increasing 30 basis points (bps) from last quarter to 3.58 percent (see Chart A11). Bank margins benefitted from increasing interest rates (150 bps quarter-over-quarter, 300 bps year-to-date) and changing balance sheet mix, as strong loan growth was funded by lower-yielding liquid assets. Rising interest income (see Charts A12-A13) offset only moderate increases in interest expense. As a result, net income increased to 1.33 percent of average assets, despite an increase in provision expense and continued declines in noninterest income (see Charts A4-A6).

The size of balance sheets across District banks remained stable in the third quarter, though the structure of assets and liabilities continued to shift (see Chart C3). Loan growth, when adjusted for Paycheck Protection Program (PPP) loans, totaled 3.5 percent quarter-over-quarter and almost 14 percent year-over-year. In contrast, cash and due from balances decreased 15 percent over the quarter and almost 48 percent since third quarter 2021, now approximating pre-pandemic levels (see Charts C15-C16). Additionally, deposits continued to decline in the third quarter, following the build-up throughout 2020 and 2021. Banks instead took on more borrowings and noncore deposits to fund loan growth, primarily short-term FHLB borrowings, as well as brokered deposits and federal funds purchased (see Charts D11-D12). Overall slowed growth in balance sheets has benefitted capital positions, with the District Leverage ratio increasing to 9.63 percent (see Chart A2), though risk-based ratios continued a slow declining trend.

Loans grew across all major loan types during the quarter, with the largest gains in commercial real estate (CRE), construction & land development (CLD), and 1-4 family lending (see Chart C4). As a result, District CRE and CLD concentrations levels increased to 172 percent and 54 percent of Tier 1 capital and the allowance, respectively. Asset quality metrics remain stable, with a continued low level of past due, nonaccrual, and restructured loans (see Charts B4-B5). Allowance levels are steady at 1.29 percent of loans, as banks have increased provisions (see Charts B1-B2) in response to elevated levels of loan growth.

Investment portfolio balances remained relatively stable during the quarter. However, banks continue to hold large unrealized losses within available-for-sale (AFS) securities (see Supplemental Chart 1). Unrealized losses totaled $11B, or 22 percent of Tier 1 capital, as of the third quarter. In response, banks have shifted more heavily into held-to-maturity (HTM) holdings (see Chart C12) and continue to shorten maturities of holdings (see Charts D3-D4). Additionally, given unrealized losses, banks looked to liquidity sources outside of securities, primarily interest-bearing bank balances (IBBB), to fund loan growth and deposit runoff. While total liquid assets approximate 19 percent of the balance sheet, liquid assets outside of securities represent only 5 percent (see Chart D7). Further, unrealized losses have placed downward pressure on the tangible common equity (TCE) ratio, which has declined to 7 percent across District banks (see Supplemental Chart 2).

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