Conditions

Third Quarter 2023 Banking Conditions

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November 28, 2023

Funding challenges impact earnings performance and liquidity positions.

The composition of Tenth District (District) bank balance sheets continues to change though overall asset size remains flat (see Chart C3). During the third quarter, loan growth continued, albeit at a slower rate (see Chart C9), totaling 1.7 percent quarter-over-quarter. Commercial real estate (CRE) lending has seen the most growth (see Chart C4), resulting in increasing concentrations across the District (see Supplemental Chart 1). At September 30, 2023, total CRE loans as a percent of Tier 1 capital and allowances totaled 241 percent, the highest level since the 2009 concentration of 248 percent. As the size of loan portfolios in relation to total assets is recovering from pandemic-era lows (see Chart C6), liquid assets continue to decline (see Chart D7). The liquid asset ratio totals 13.5 percent (see Chart D9), its lowest level since 2008 when the ratio totaled 12.2 percent. Much of the decline during the year is attributable to an increase in pledging of securities to boost borrowing capacity, though that trend stabilized in the third quarter. Further, securities continue to be impacted by large levels of unrealized losses on securities, which increased during the quarter, totaling an aggregate 31.5 percent of Tier 1 capital (see Supplemental Chart 2).

Funding profiles also continue to shift, characterized by declining core deposits that have been replaced by more costly borrowing options. The majority of District banks (73 percent) have seen core deposit runoff year-over-year, while wholesale and noncore funding have increased rapidly (see Charts D10 and D12). In the third quarter, time deposits saw the largest increase, followed by Federal Home Loan Bank (FHLB) and other borrowings. Additionally, capital levels continue to increase. Capital growth outpaced nominal asset growth during the quarter, benefitting the Tier 1 Leverage ratio (see Chart A2). Risk-based capital ratios also increased despite rising risk-weighted asset levels. However, the tangible common equity ratio declined to 7.1 percent, hindered by unrealized losses.

Earnings metrics have weakened across banks, primarily impacted by compressing net interest margins (NIM). The District ROAA totaled 1.1 percent during the quarter, down from 1.3 percent at the same period last year (see Chart A3). The majority of District banks experienced declining margins in the third quarter, with the exception of the smallest banks (see Chart A11).

NIM compression is attributable to a rapidly rising cost of funds, which is at a 15-year high and has increased at the fastest pace in modern banking history. Funding costs are impacted by intensified deposit pricing pressure, as well as changing funding mix, and are especially elevated among the largest District banks. However, strong interest income has prevented further declines in the NIM (see Chart A13). Yields on earning assets have increased to the highest level since 2008, benefitting from loan growth and rising interest rates. Other earnings metrics—namely, noninterest items—remain steady, though provision expenses and charge-offs have increased among the larger District banks (see Charts B2-B3). Additionally, some banks are beginning to realize losses on underwater bonds, with 22 percent of District banks recognizing some amount of losses year-to-date.

Asset quality metrics remain sound in the District, though there are few signs of deterioration. Noncurrent and nonaccrual loans have increased slightly, though remain well below historical norms (see Chart B5). Most notably, consumer past due levels continue to increase, and C&I past due loans have begun to rise (see Chart B8). At larger District banks, allowance for credit loss levels have correspondingly increased in anticipation of credit deterioration and now total 1.4 percent of loans.

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