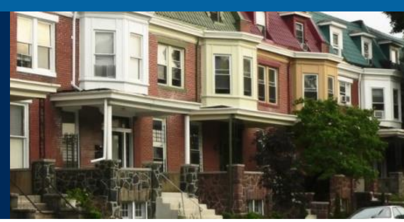
5th District Economic and Banking Conditions Update

September 2022 Edition

Financial Data as of Q2 2022



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This report is based upon preliminary data from Q2 2022 and prior Condition & Income Reports as well as other examination and economic sources. Data has been prepared primarily for bank supervisors and bankers. The opinions expressed in this publication are those of the authors. Opinions are intended only for informational purposes, and are not formal opinions of, nor binding on, the Federal Reserve Bank of Richmond or the Board of Governors of the Federal Reserve System.

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- Knowledgeable and responsive staff and risk specialists

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- Committed outreach and education programs

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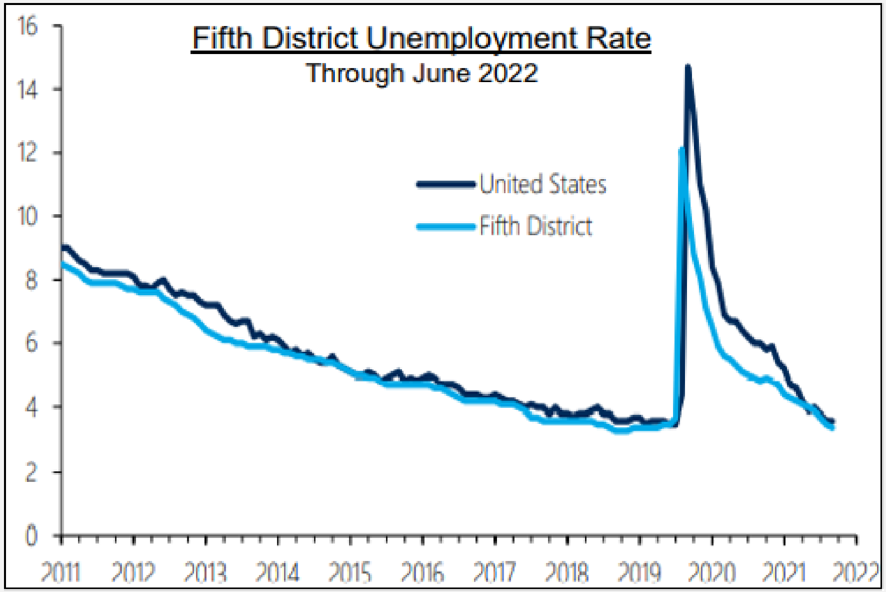
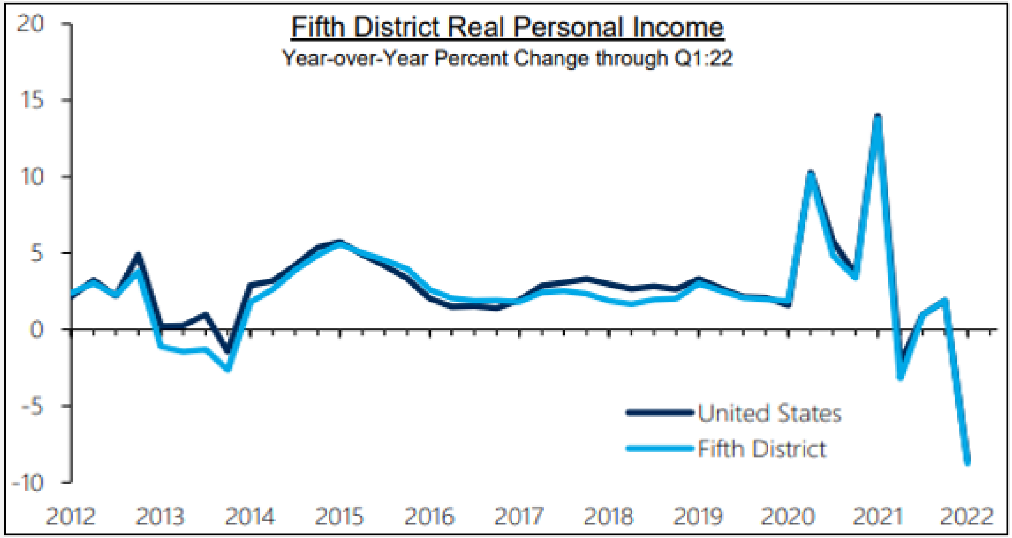
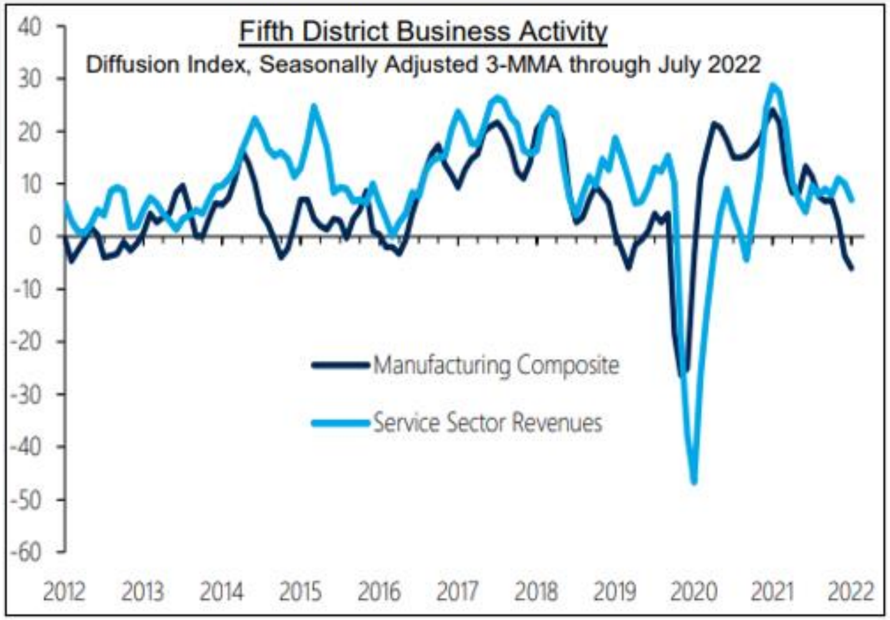
Economic Conditions

August Summary[1]**:** The regional economy continued to expand modestly, although there were emerging signs of softening demand. Manufacturers reported declines in shipments and new orders; at the same time, they continued to struggle with supply chain disruptions, labor shortages, and rising costs. Fifth District ports continued to report that imports outpaced exports. Meanwhile, trucking firms reported some easing of freight conditions and a modest increase in labor availability. Retailers reported some reduced demand for their goods, although sourcing remained difficult and inventories stayed low. Leisure travel, on the other hand, held strong and business travel started to come back. Real estate markets—residential and commercial—were tight, although in some residential markets, inventories of homes for sale and days on market increased from low levels. Financial institutions reported slowing in commercial loan demand after a strong Q2, which they attributed to rising interest rates. Residential mortgage lending also slowed in August, but auto lending remained strong. Nonfinancial services firms generally reported moderate growth and solid demand but some expressed uncertainty about the future. Labor markets remained tight, although there was some emerging signs of improved labor availability. Price growth remained robust although, again, there were some incipient signs of slowing growth in recent weeks.







1 Source: For an Update of the Fifth District Economy – view the full report here: [Snapshot - Federal Reserve Bank of Richmond](#) or here: [Beige Book](#)

Top Banking Risks

Macroeconomic Risk

The sustained presence of inflation in many sectors of the economy and the Federal Reserve's commitment to addressing it- in monetary policy actions and accompanying statements- have raised concerns about the future path of economic activity. Labor markets remain tight, creating upward pressure on prices in addition to pressure caused by continued supply chain disruptions. Commodity price increases and weakened supply chains, in part driven by the war in Ukraine, are creating broader disruptions in economic activity. The current environment of inflationary pressures and rising interest rates presents challenges for both consumers and businesses, with possible impacts to compliance risk, credit risk, and liquidity. With rising rates increasing borrowing costs, there may be implications for credit product selection and the risks associated with different products (i.e. adjustable rate mortgages or home equity lines of credit). Additionally, the combined effect of higher borrowing costs and increases in other expenses could negatively impact borrowers' repayment capacity. The numerous economic headwinds are creating an environment of uncertainty in the markets making it difficult for banks to forecast their balance sheets and model relevant risk factors.

Labor Market Dynamics

Labor market dynamics, digitization and evolving business needs have led to significant competitive pressures for banks. The implementation of a hybrid work environment is another complicating factor as it necessitates a dual control structure and increases operational complexity in many cases. Labor market dynamics are also having an impact on profitability as banks have already incurred increased labor costs. Additionally, several bankers in the 5th District have specifically highlighted the challenges they are experiencing with labor market dynamics. These market challenges could increase the likelihood of mergers & acquisitions (M&A) activity long-term.

Balance Sheet Management

Balance sheet management represents the process of selecting assets and liabilities to achieve a balance between profitability and acceptable levels of both liquidity and interest rate risk (IRR), while also maintaining an appropriate level of capital. The economic situation remains clouded due to several factors, including high inflation, geopolitical risk, and rising interest rates. Rising rates have already exerted a negative effect on some banks who have had the associated unrealized losses on available-for-sale (AFS) securities flow through to regulatory capital. While the regulatory capital of most banks is shielded from this effect, banks' tangible common equity is still broadly exposed to it, potentially hurting bank stock prices and credit ratings. Management teams also must navigate the various earnings implications of the current economic environment such as: contending with surging labor costs and other non-interest expenses combined with the loss of fee revenue due to the recent trend focused on reducing deposit service charge fees, and the potential impact of rising rates on mortgage activity and originations. Additionally, deposit dynamics remain a key watchpoint as deposit growth is slowing and there is uncertainty around the stability of deposits going forward. Banks are still holding onto excess liquidity, which has allowed deposit rates to lag interest rate hikes, even as monetary policy is tightening at a far quicker pace than witnessed during the last cycle. Though, if deposit pricing pressure increases and low-cost deposits run-off as rates rise, banks may need to replace them with higher-cost funding sources, thereby hurting bank margins.

Top Banking Risks Cont.

Commercial Real Estate (CRE)

While CRE fundamentals have held up well, the longer-term outlook for CRE is cooling amidst slowing economic growth, rising interest rates, inflation, and geopolitical uncertainty. CRE values could decline if cap rates rise alongside interest rates and stress of debt service could build, especially for floating rate borrowers. Sectors and geographies that have not fully recovered from the pandemic are most at risk. For example, office, retail and hotel remain stressed and are subject to continued uncertainty as banks are lending more cautiously to these sectors. The inflation and supply chain issues, previously fueled by the pandemic are now attributed to the war in Ukraine and could negatively impact construction project costs and schedules as well as other segments of CRE. Additionally, challenging labor market dynamics are contributing to production and service issues and preventing some sectors from operating at full capacity. Furthermore, competition amongst banks and even non-banks is intensifying, particularly for CRE deals, which could create downward pressure on loan yields and have negative implications for bank margins. While there is uneven loan performance across property types, the CRE sector continues to experience incremental declines in loan delinquencies.

Cybersecurity

Cybersecurity remains an ongoing and significant threat to the banking industry. Ransomware is the most impactful of the cyber threats as attacks have increased in frequency and scale in recent years and cyber criminals are increasingly targeting smaller financial institutions and third-party service providers with less robust data security systems than larger banks. This involves not only taking control of sensitive information but also disabling bank operations, in some cases, by taking control of networks, systems, etc. The ongoing war in Ukraine remains a top geopolitical concern impacting cyber risk and recent guidance was issued to financial institutions about the threat posed by Russian/Russian-affiliated bad actors. Banks are readying themselves for cyberattacks and the threat of such attacks will likely drive further investments in the security landscape. To date, financial institutions have not experienced an uptick in nation-state incidents but should remain hypervigilant. Further, as companies proceed with hybrid business models, the possibility of a breach via remote access systems remains elevated. Cyber-criminals continue to exploit known social engineering vulnerabilities amid pandemic confusion while looking for weaknesses in critical infrastructure. Additionally, attackers are using targeted phishing schemes that give the appearance of legitimate emails.

Fraud

Fraud threat remains an area of elevated concern, especially as the digital banking industry grows. The pandemic accelerated the shift to digital banking and with it came increased cyber fraud, particularly aimed at fintechs, and banking partners are, by extension, feeling the pain. This increases the importance of implementing strong controls and leveraging new technology to identify fraud. Fraud activity also continues to be identified in government-related assistance programs, as well as other Covid-driven schemes, which are still being investigated.

State of the District

District banking conditions remained stable from a capital, liquidity, and supervisory ratings perspective but are heavily influenced by macroeconomic headwinds, most notably high inflation and rising interest rates. On a positive note, Q2 was marked by strong loan growth across the board and margin expansion for District Banks. Liquidity positions across the District remained strong; however, deposit growth has slowed, and additional deposit volatility is expected as more rate sensitive customers react to the higher rate environment, underscoring the importance of evaluating deposit stability. While District Banks have proved resilient during the pandemic, significant uncertainty prevails as banks navigate this rising rate cycle and market volatility. This uncertainty in the market makes forecasting and balance sheet management even more challenging. In addition to these factors, the banking industry continues to grapple with hiring struggles and heightened cyber risk.

- Profitability metrics turned a corner in Q2 as the benefit of rising rates finally began to flow through bank balance sheets and margins rebounded from historic lows due to strong loan growth. While deposit growth is reverting to normal, the deposit glut brought on by the pandemic has resulted in some of the highest noninterest -bearing deposit concentrations on record, giving banks a cost-efficient funding base if they can manage to limit runoff. While many banks can afford some deposit runoff given the historic influx, retaining deposits as pricing pressures mount could be challenging and cause some banks to turn to higher cost and potentially volatile funding sources. As firms continue to manage a volatile global economy and experience balance sheet changes, management teams may benefit from enhancing liquidity and interest rate risk (IRR) modeling practices, including but not limited to, modeling deposit behavior and alternative yield curve scenarios given the uncertain path of future rates.

- Loan growth was strong in Q2 and District Banks outpaced the nation in all categories even as rates continued to increase. However, there is a high degree of uncertainty on how inflation, rising rates, and recessionary concerns will impact lending in the second half of the year as there are already reports of slowing demand in August.

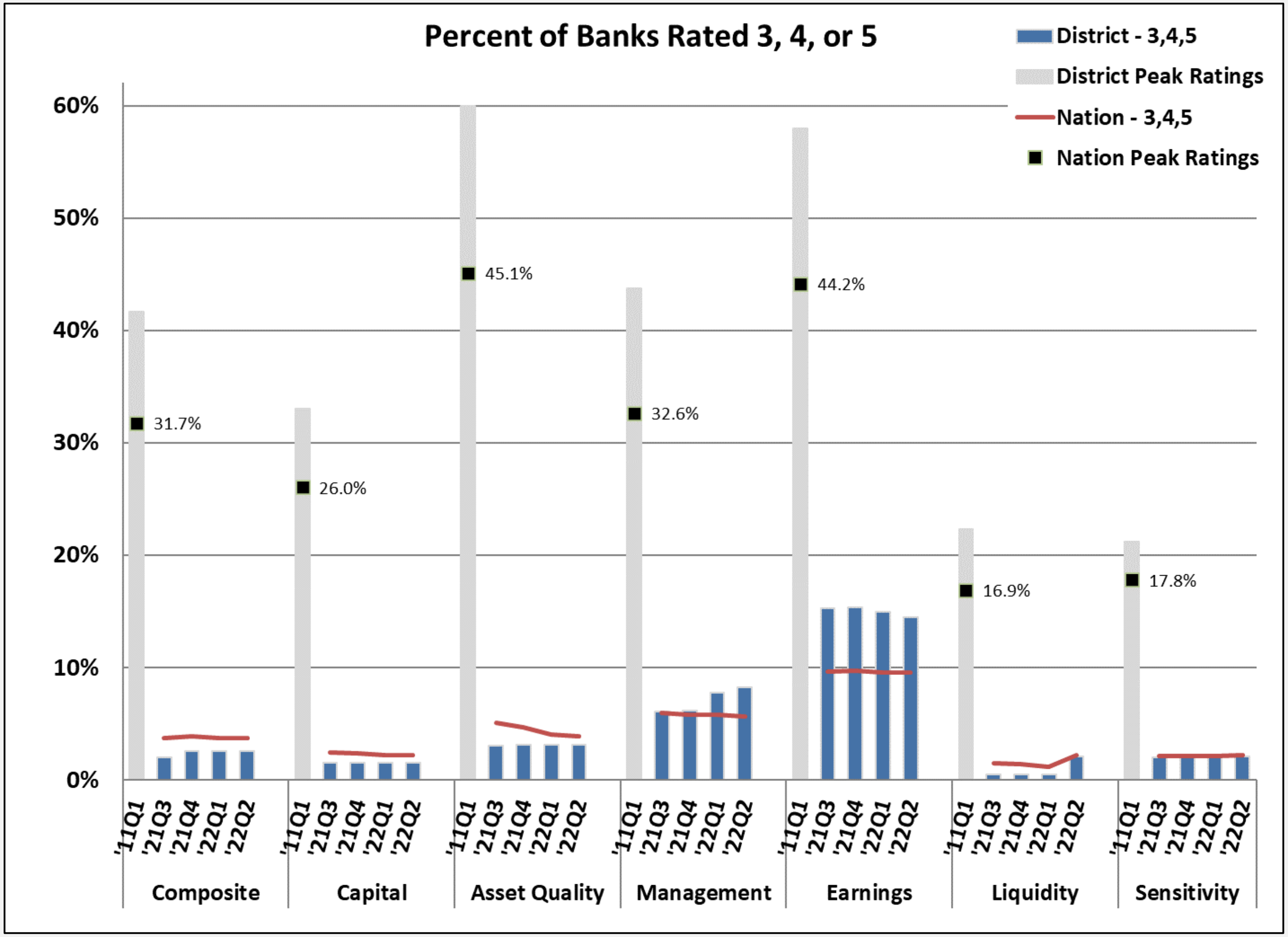
- Credit quality remained strong as nonperforming loans and loan losses continued decreasing to historic lows. The Allowance for Loan Loss and Leases (ALLL) remained flat in Q2 as the number of District Banks taking negative provisions decreased from Q1. Two thirds of District Banks increased provisioning levels and most of these increases were commensurate with loan growth. While credit metrics are at historic lows, many firms expressed concern over the impact the economic climate could have on borrower performance.

- Liquid assets decreased in Q2 for the first time since the start of the pandemic, as banks began to right-size their balance sheets by deploying some excess liquidity into loans. Slowing deposit growth paired with rapid loan acceleration in Q2 resulted in loans-to-deposit ratios increasing for the first time since the beginning of the pandemic.

- The majority of District Banks have asset-sensitive balance sheets, which should improve margins as interest rates rise. However, many banks are experiencing a growing level of unrealized losses in their securities portfolios given the rapid increase in rates. While these unrealized losses are unlikely to impact most banks from a capital or liquidity perspective, they do present a challenge to managing and optimizing the balance sheet.

- Capital continues to be a source of strength for District Banks despite the decreasing trend in tier 1 capital driven by asset growth outpacing capital formation.

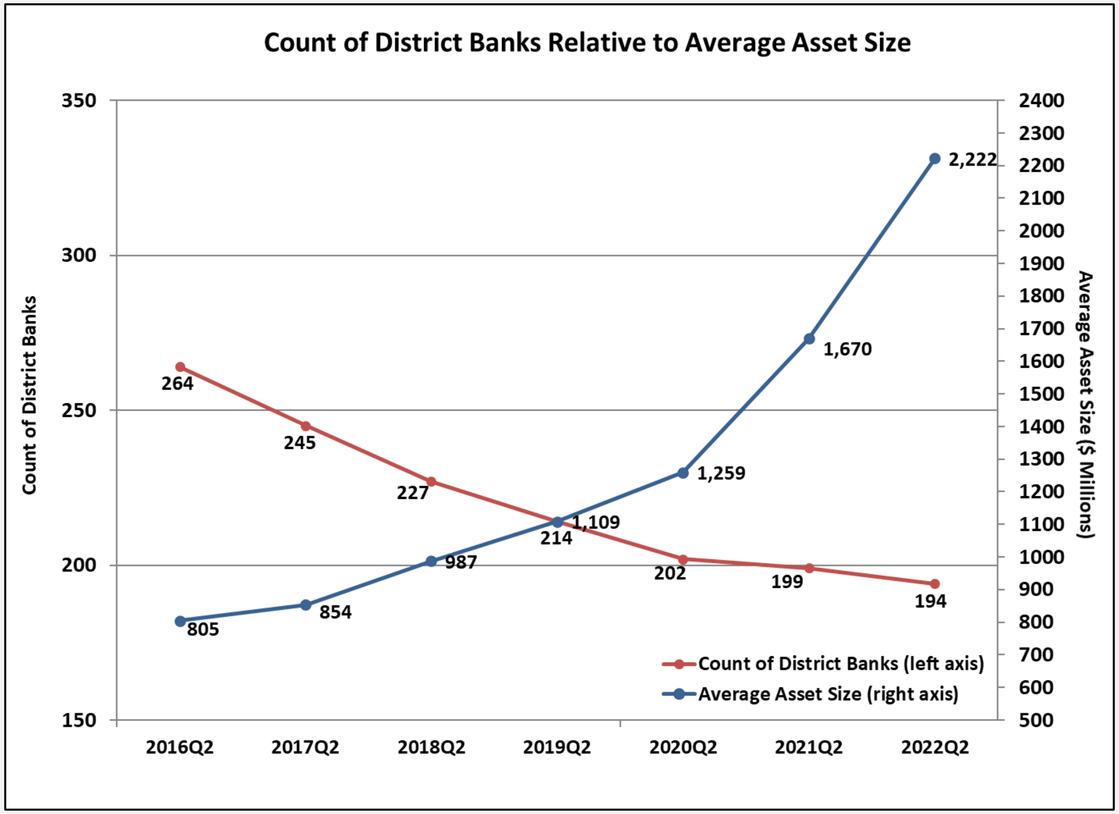
<u>Supervisory Ratings:</u> From a safety and soundness standpoint, the majority of District Banks remain in satisfactory condition.



Gray bar represents the District peak in % of banks rated 3, 4, or 5 **from the previous recession**.

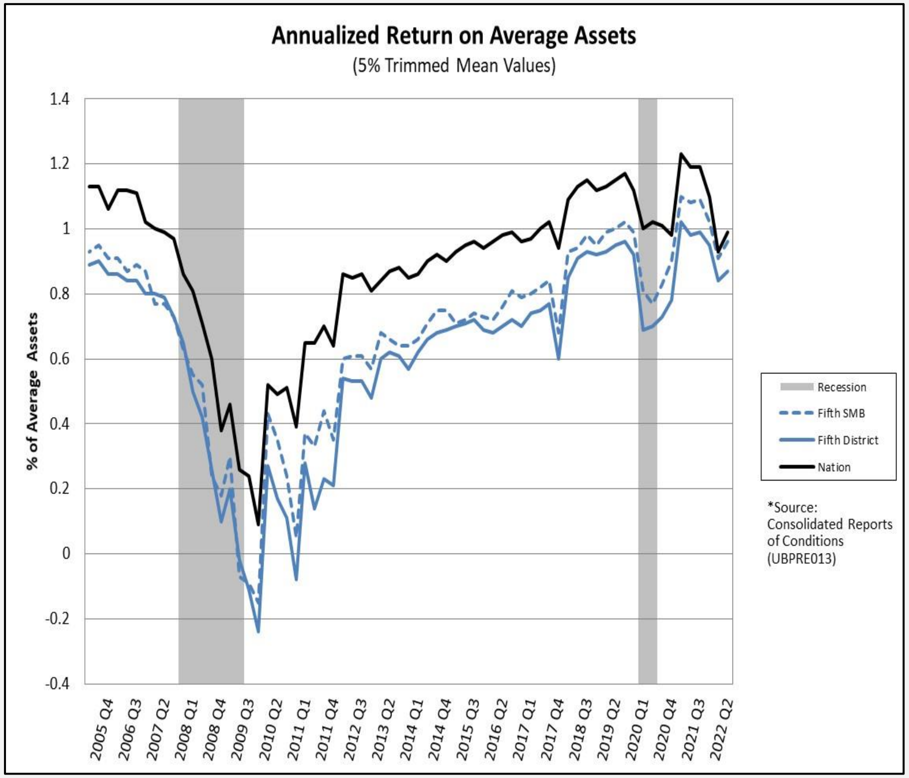
- There has been little movement in ratings in recent years, as banks have weathered the pandemic well. While earnings remain the most challenging rating category, profitability improved in Q2, and bankers are looking to continued rate hikes for margin expansion in the near term.
- Liquidity risk remains at historically low levels but edged up in Q2 as rising interest rates and slowing deposit growth may impact liquidity levels going forward.

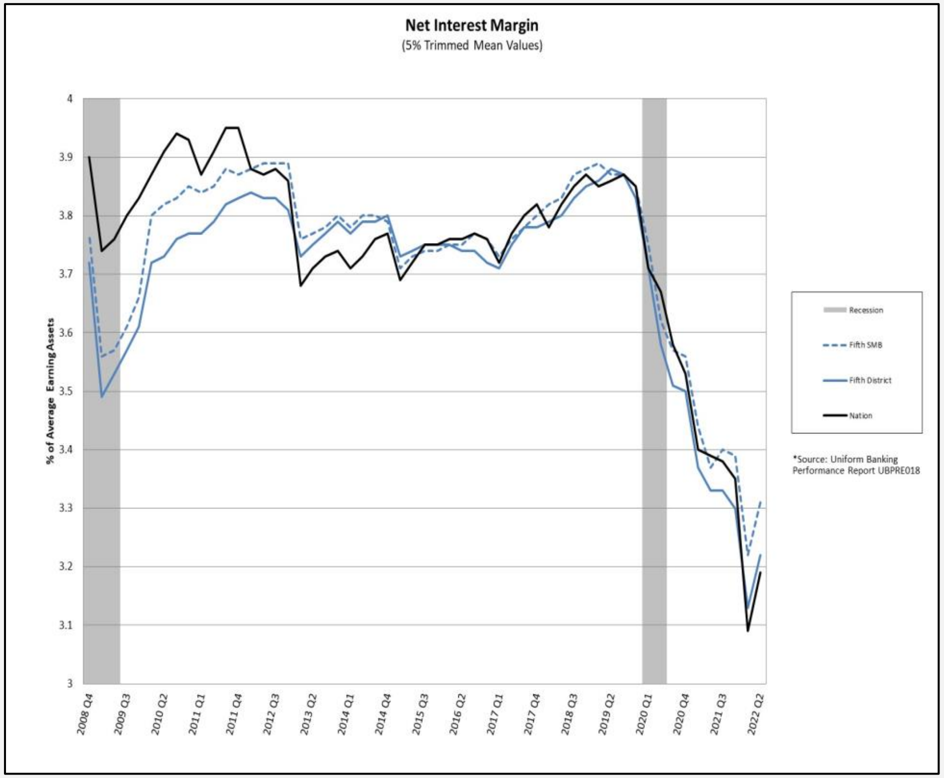
<u>M&A</u>: The rising interest rate environment weighs on bank M&A.



- M&A activity faces significant headwinds as the aggressive tightening of monetary policy is causing some would-be buyers to reconsider deals. Additionally, the impact of rising rates, while advantageous from an earnings standpoint, is not all positive. Given the inverse relationship between interest rates and bond prices, banks are experiencing massive unrealized losses in their available-for-sale portfolios, which have consequently reduced accumulated other comprehensive income (AOCI) and driven down tangible book values. At the same time, the rate environment is altering merger math as rate marks drive up buyers’ tangible book value dilution and earnback periods. For banks that do strike deals in the current environment, detailing the impact of rising rates to investors can be complicated.

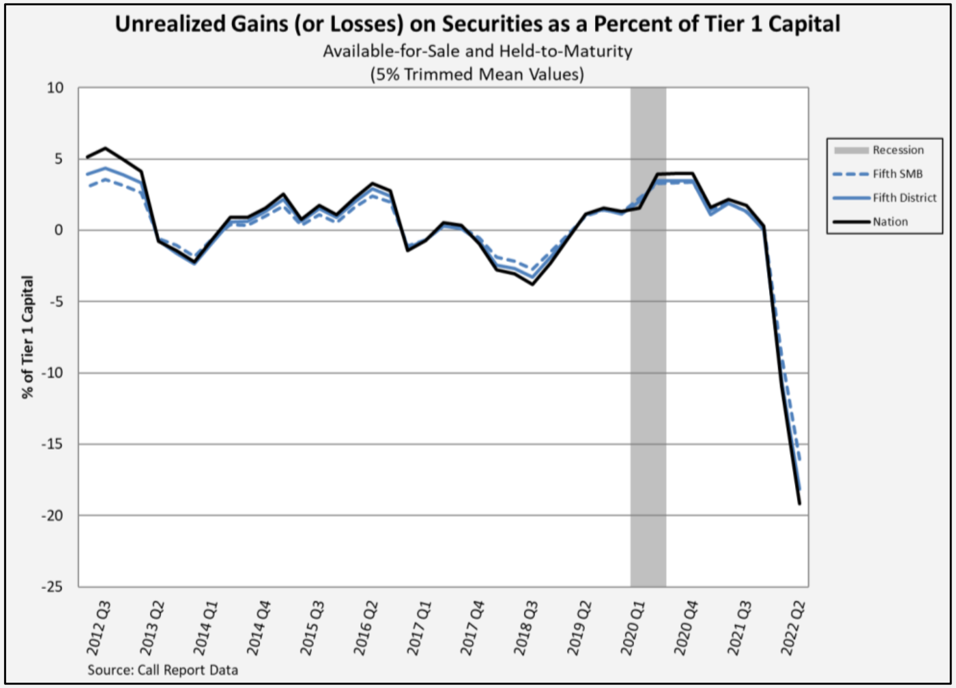
Earnings: Margins rebounded from historic lows as interest income improvements came to fruition in the rising rate environment.

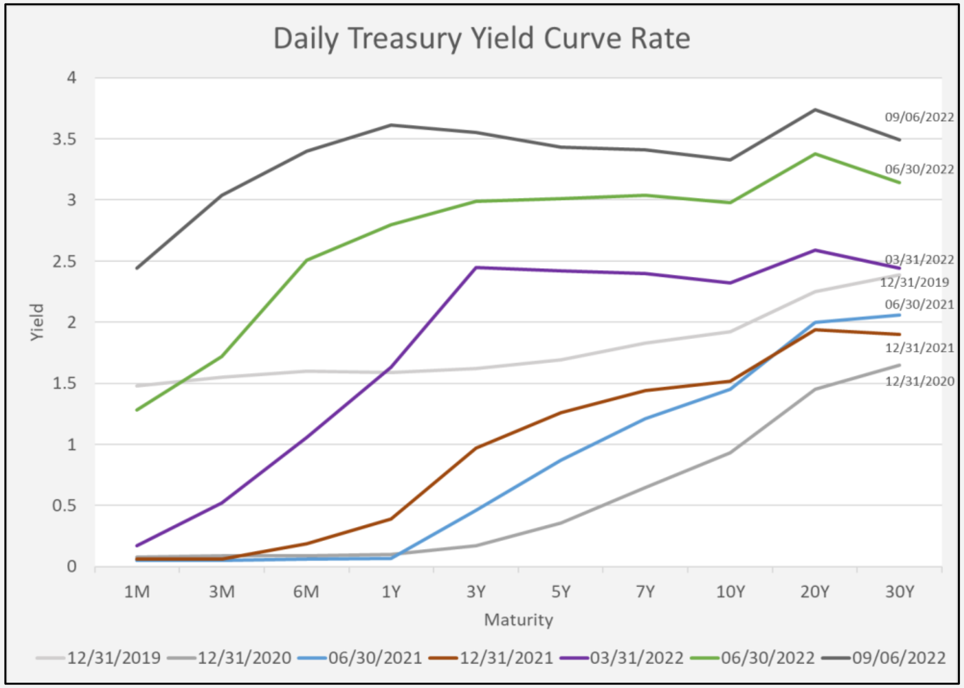




- Strong loan growth provided a boost to profitability in Q2 as banks finally began to see the benefit of increasing rates.
- 69% of District banks witnessed a quarterly increase in ROAA and 84% observed a quarterly increases in NIM.
- District efficiency ratios fell in 77% of District banks from last quarter, as net interest income rose at a higher rate than non-interest expenses.

<u>Sensitivity:</u> Facing inflationary pressures, District Banks are well-positioned for rising rates.





- As interest rates rise, District banks continue to hold high levels of liquidity and asset-sensitive balance sheets, positioning themselves to benefit from increasing rates. However, the flattening and inversion of the yield curve depicted above may present challenges over the longer term in managing interest rate risk and maximizing earnings.
- Interest rate risk modeling assumptions take on increased significance in the current rate environment. This includes deposit assumptions for both surge and core deposit account types, loan repricing assumptions which may be muted by significant market competition, and different yield curve scenarios given the uncertainty regarding future rate movements.
- Banks are managing a larger than usual investment portfolio and have experienced a growing level of unrealized losses given the rapid increase in rates. In Q2, unrealized losses on AFS and HTM securities at District Banks comprised an average of 18% of tier 1 capital, up from 10% in Q1. Banks may be reluctant to sell securities at a loss to meet liquidity needs, but should they elect to do so, impacts to capital would be limited.

Loan Growth: Loan growth boomed in Q2, but economic conditions may dampen the trend going forward.

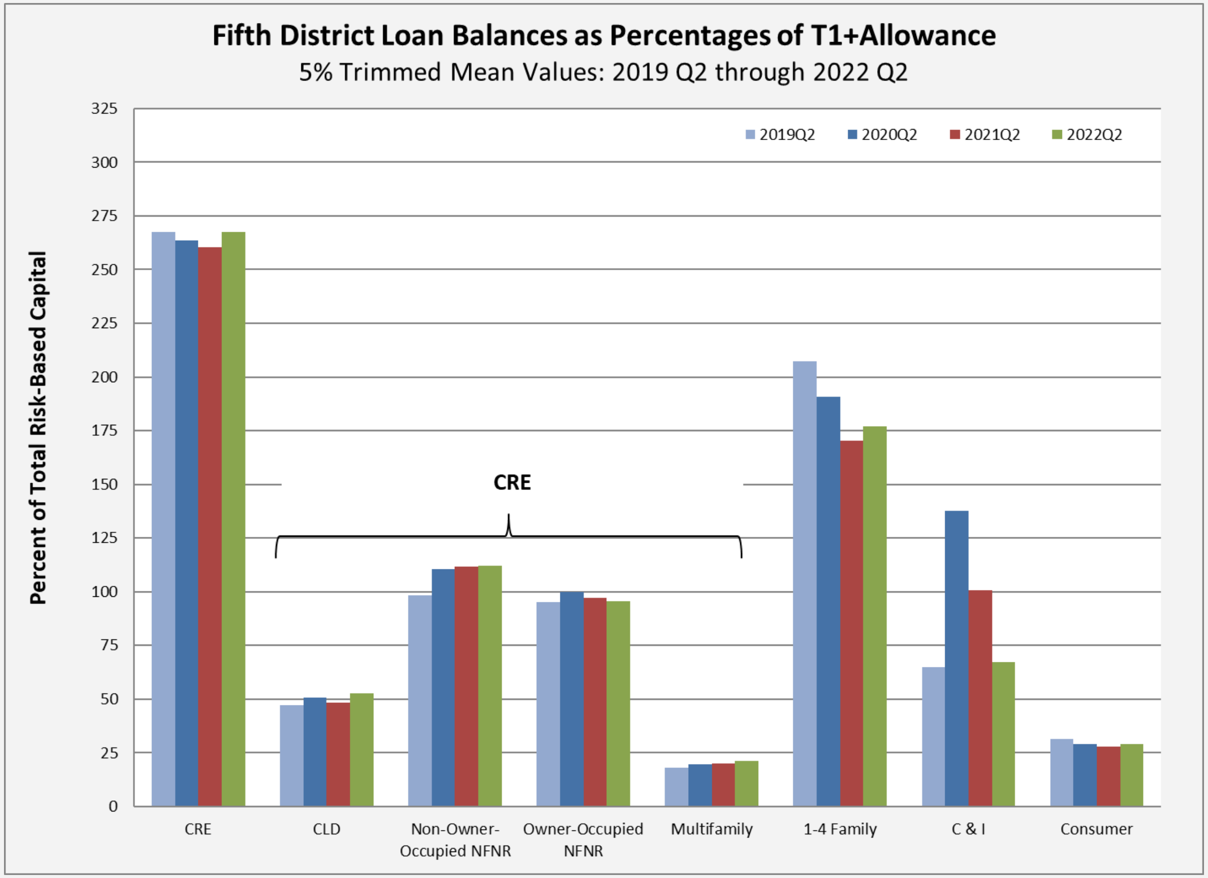
Average Annual Loan Growth By Category* 2Q 2022			
	Nation	Fifth	Fifth SMB
Total Loan Growth	6.4	9.4	7.3
Total Loans Less PPP	12.2	16.1	13.6
Total CRE	15.4	17.5	14.3
Residential Real Estate**	9.9	9.9	6.4
Consumer	8.9	14.3	20.0
Agricultural/Farm	4.3	5.3	(0.3)
Other Loans	26.4	5.4	(0.0)

**5% trimmed means.*

*** Includes 1-4 Family and HELOC loans.*

- Total loan growth was strong in every segment during Q2, even as interest rates began to rise.
- However, there is a high degree of uncertainty on how inflation, rising rates, and recessionary concerns will impact lending in the second half of the year. On the demand side, inflation and rate hikes may cool loan demand by driving up prices and reducing affordability. On the loan supply side, concerns regarding recession may prompt some banks to tighten their underwriting standards.

Concentrations: Average CRE concentrations trend upwards for District and National Banks.



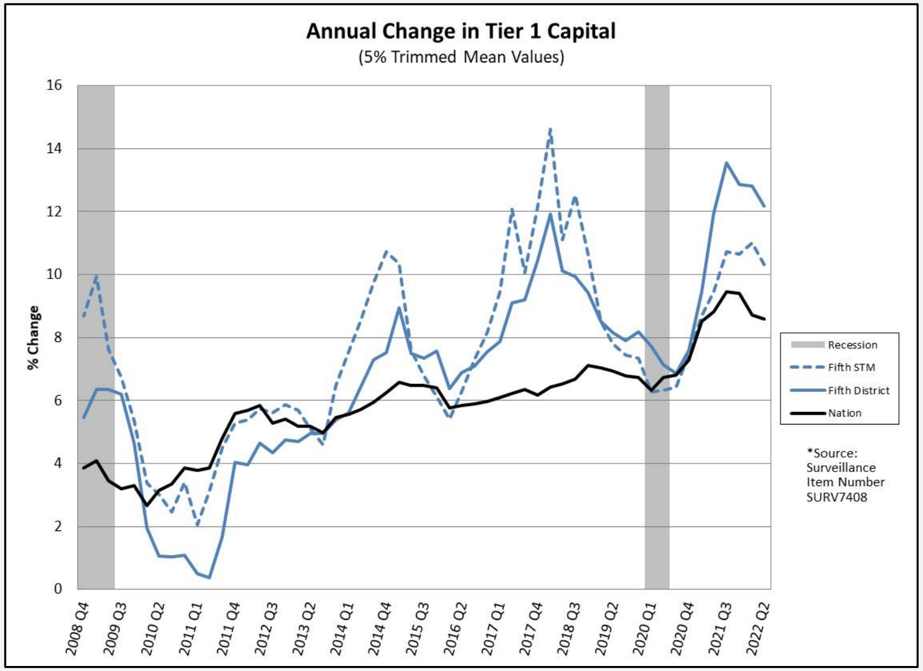
Average CRE / T1+Allowance*	2013-22**	2022Q2
MD		338.0
NC		317.1
SC		275.6
VA		264.8
WV		189.3
District		267.4
Nation		205.7

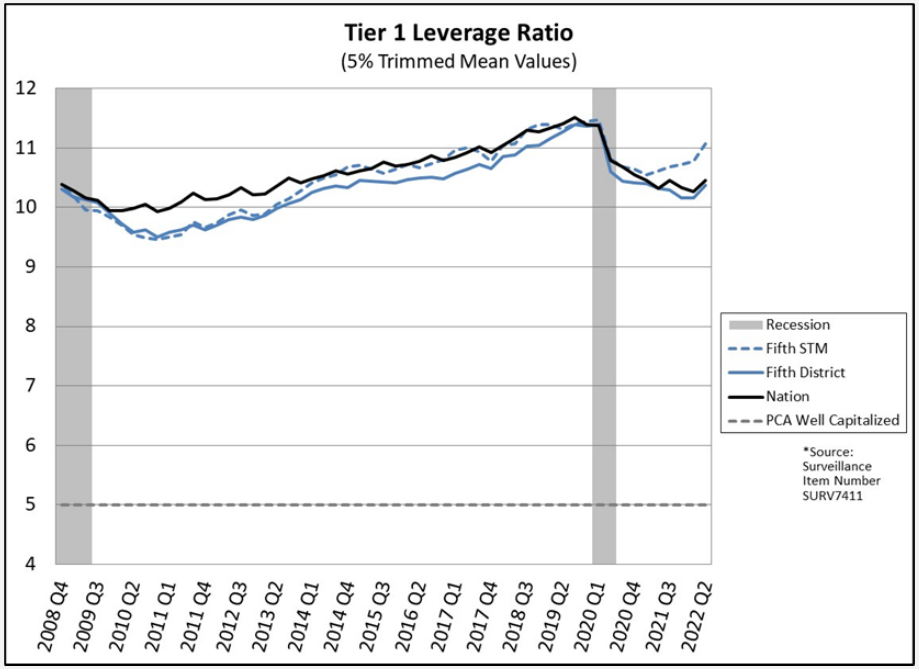
**5% Trimmed mean; includes owner-occupied CRE*
*** Data as of Q2 each year*

- CRE loan growth was strong during the first half of 2022, and concentrations edged up from one year prior. Though CRE concentrations at District Banks grew slower compared to all banks in the nation, concentrations remain much higher in the 5th District. While CRE performance has held up well, rising rates may increase borrowing costs and cool demand in the second half of the year. Indeed, some reports indicate that CRE activity has softened since the end of Q2, particularly demand for office space[1].
- The overall decline in C&I concentrations continues to be driven by PPP runoff; however, C&I as a percentage of total risk-based capital appears to be stabilizing and returning to pre-pandemic levels.

1: September Beige Book

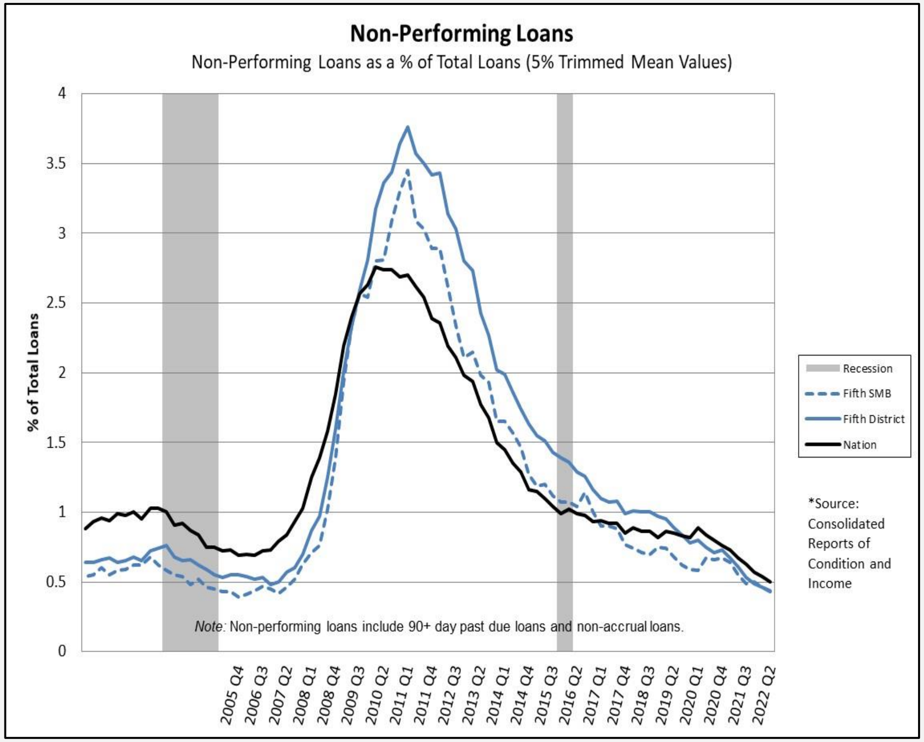
Capital: Capital continues to be a source of strength for District Banks.

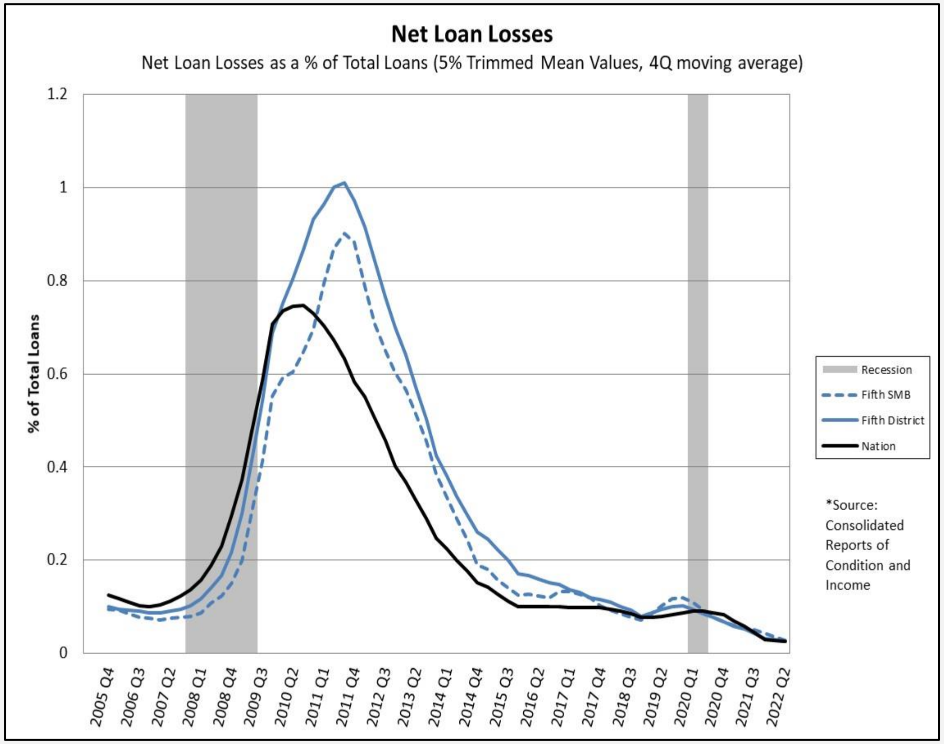




- Although risk-based capital ratios remained well above PCA thresholds, tier 1 capital annual growth levels decreased for the third straight quarter for District Banks as asset growth outpaced capital formation.
- Tier 1 leverage ratios increased in Q2 and remain strong. Negative AOCI from unrealized losses in banks' securities portfolios remains a watchpoint, though is unlikely to have a material impact on regulatory capital due to the AOCI opt-out election.
- If unrealized AFS Securities losses became realized, 5th District institutions would witness a 141 basis point decrease to its Tier 1 Leverage ratios, on average.

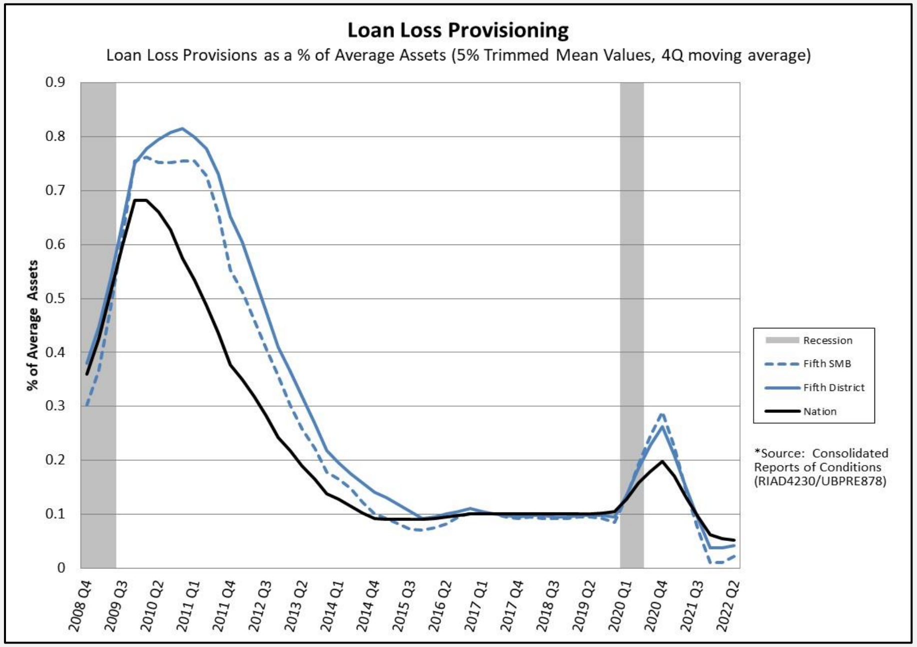
Asset Quality: Asset quality risk metrics remained at historic lows in Q2.

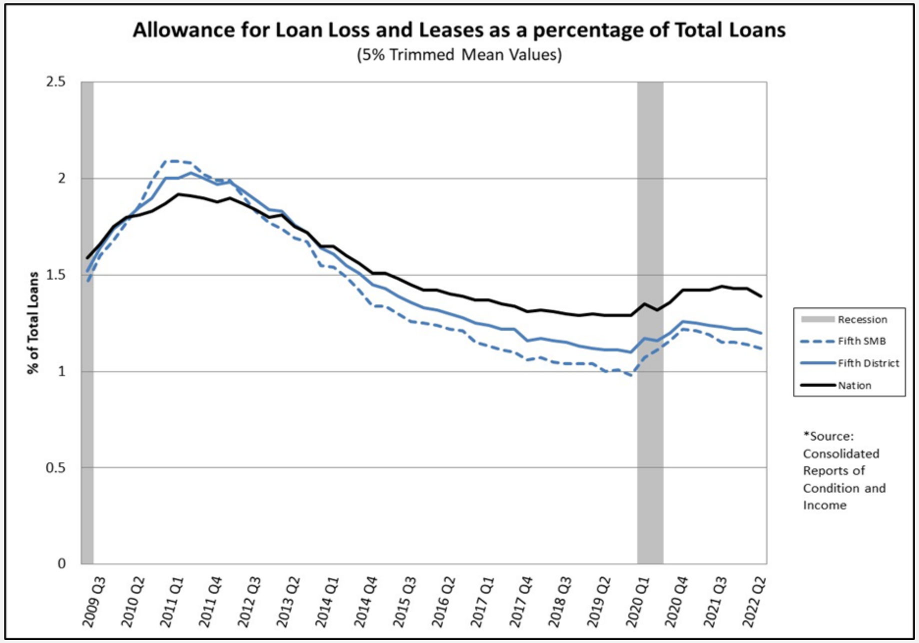




- Non-performing loans and net loans losses at District Banks continued decreasing to pre-Great Recession lows, which is consistent with national trends.
- Still, some banks have reported tightening loan standards and are closely monitoring areas like offices and health care properties.

<u>ALLL:</u> ALLL remained relatively flat in Q2 despite increases in provisioning for the first time since Q4 2020.

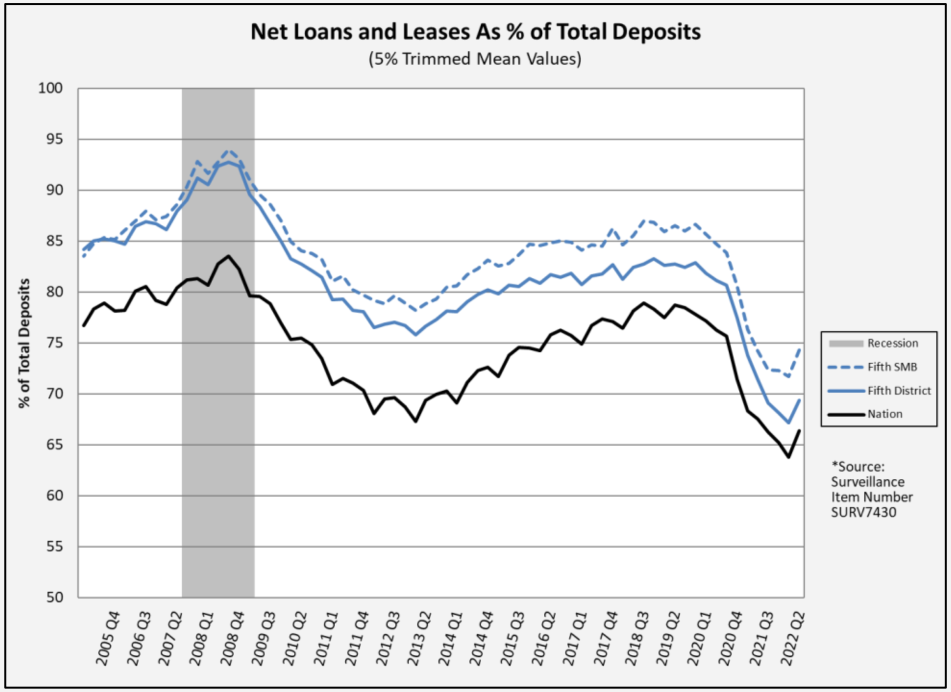


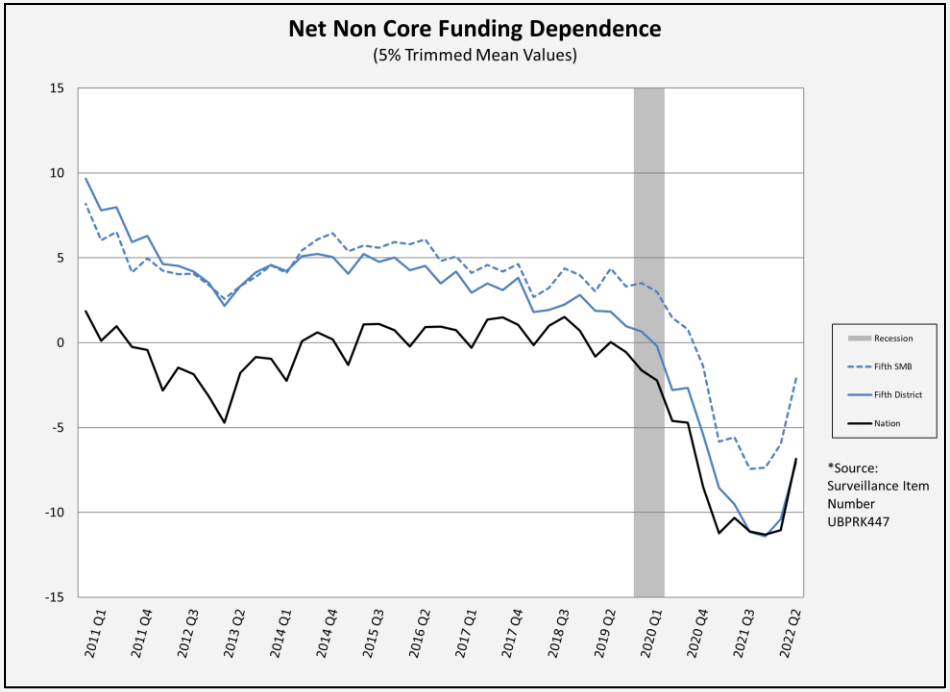


- Two-thirds of community banks in the District increased provisioning levels in Q2 from the prior quarter, which was largely commensurate with loan growth.

- Negative provisioning continued its decline in the District, with only 13% of District Banks (no large banks) booking negative provisions totaling $22 million in Q2 2022. As a comparison, in Q2 2021, 21% of District Banks booked negative provisions, with large banks comprising the majority of total negative provisioning ($5.8 billion).

<u>Liquidity:</u> Liquidity positions remained strong, but the deposit glut may be subsiding.





- Liquidity remained well above pre-pandemic levels at most District and National Banks despite the decrease in liquid assets relative to total assets for the first time since the pandemic began.

- The influx of deposits observed during the pandemic is slowing and as inflation and rate hikes persist, banks are contemplating the stability of deposits. 40% of District Banks reported negative quarter-over-quarter deposit growth in Q2 – a significantly higher proportion than the 2 to 23% reporting negative deposit growth during any other post-pandemic quarter.

- Slowing deposit growth paired with rapid loan growth in Q2 resulted in loans-to-deposit ratios increasing for the first time since the beginning of the pandemic. Accordingly, net non-core funding dependence spiked in every cohort, as banks looked to sources outside of core deposits to accommodate the hot loan market. The uptick was driven in large part by a jump in Federal Home Loan Bank (FHLB) funding, particularly at District Banks.

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- The **Richmond Fed's website** includes a banker education section with links to fraud awareness, speakers' bureau, resources for financial institution directors, introduction to regulatory reporting. Look under Education for Bankers.

Federal Reserve Resources

- **Community Banking Connections** covers issues that community banks face, providing resources on key supervisory guidance, highlighting new regulations and offering perspectives from bank examiners and other Federal Reserve staff **communitybankingconnections.org**

- **FedLinks** articles highlight key elements of a supervisory topic to improve clarity and understanding about the topic and examiner expectations for applying related supervisory guidance. FedLinks articles are **most helpful for bank holding companies and banks with assets of $10 billion or less**. **communitybankingconnections.org/fedlinks.cfm**

- **The BSA Coalition** is a forum in which experts at financial institutions, regulatory and law enforcement agencies and other organizations can discuss and debate questions, guidance and day-to-day issues affecting the development and implementation of **effective Bank Secrecy Act/Anti-Money Laundering programs**. **bsacoalition.org**

- **Outlook Live** is The Federal Reserve System's **audio conference series on consumer compliance issues and hot topics** such as CRA, HMDA and fair lending compliance; service member financial protection and compliance consideration for vendor risk management. Live sessions are scheduled throughout the year, and archives of past presentations are available on the website. **consumercomplianceoutlook.org/outlook-live**

- **Consumer Compliance Outlook** is a Federal Reserve System publication dedicated to consumer compliance issues. **consumercomplianceoutlook.org**