

U.S. Banking Conditions and Risks

CEMLA/Dallas Fed Financial Stability Workshop
November 30, 2023



Federal Reserve
Bank of Dallas

Lorenzo Garza

Vice President
Banking Supervision & Regulation

Agenda



U.S. Banking Performance and Trends



Lessons Learned from 2023 Banking Volatility



Financial Stability Risks

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.



Federal Reserve
Bank of Dallas

U.S. Banking Performance and Trends

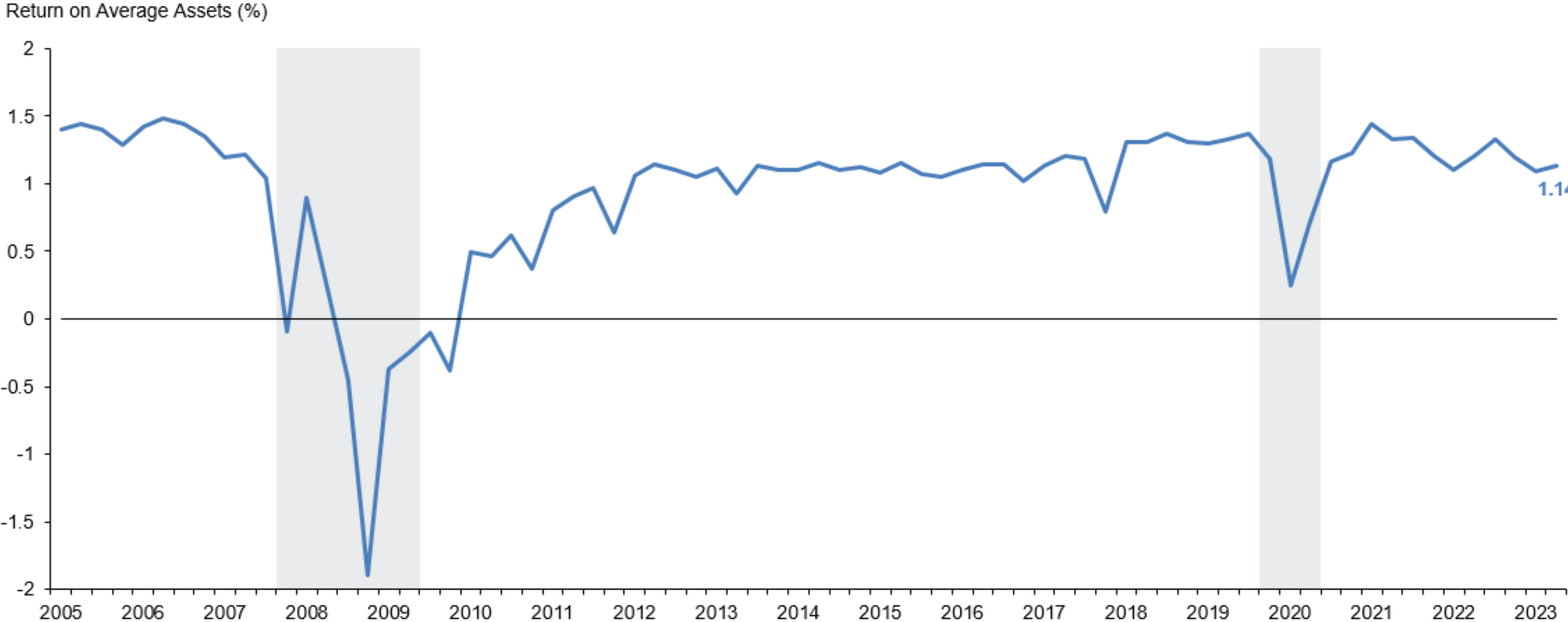


Summary of U.S. Banking Conditions

- Banking conditions remained satisfactory, and profitability improved as higher noninterest income and lower noninterest expense offset falling net interest income.
- Asset quality metrics remained benign, despite modest weakening for banks.
- Loan growth continued but slowed for most major loan categories.
- Equity capital ratios increased slightly.
- Deposit outflows moderated, as did reliance on noncore funding advances.
- Banks' deposit mix continues to shift toward interest bearing deposits, a trend that is likely to continue for the next few quarters as customers rate shop.

Note: Analysis excludes banks with assets greater than \$100 billion.

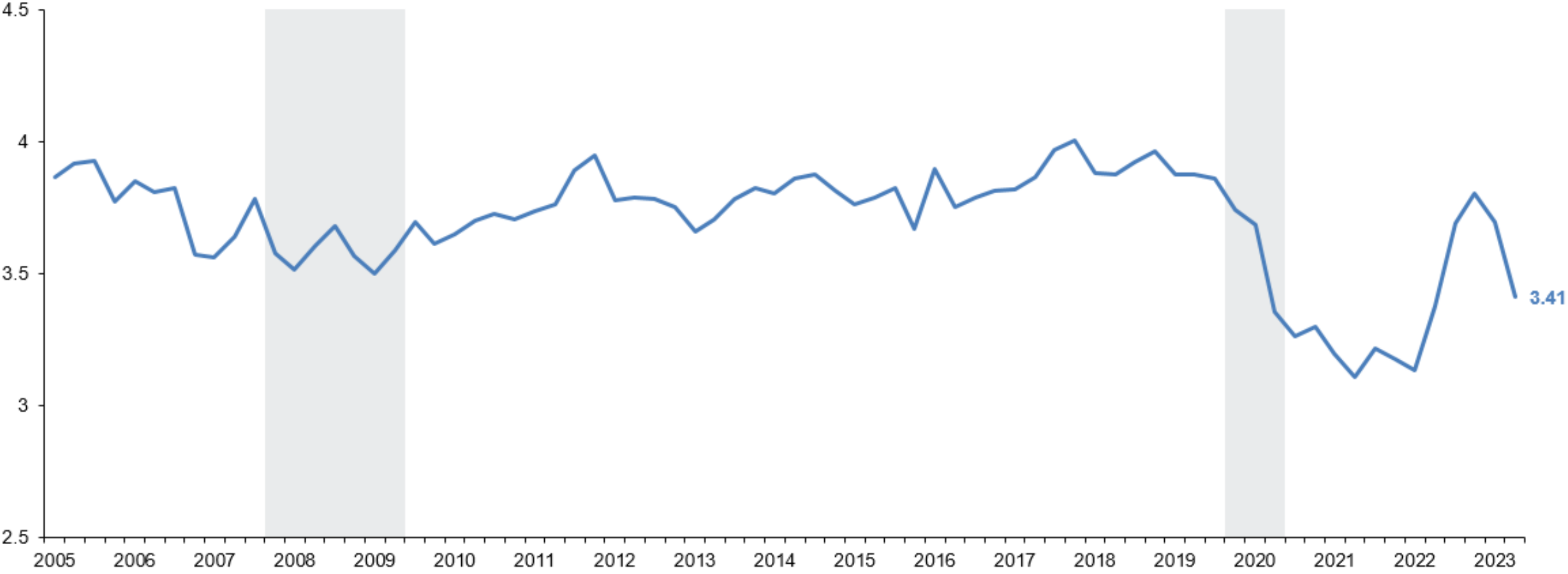
Profitability Up Slightly in Q2 2023; Mixed Performance Across Sector



NOTE: Excludes banks with assets > \$100B. Shaded areas indicate recession.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

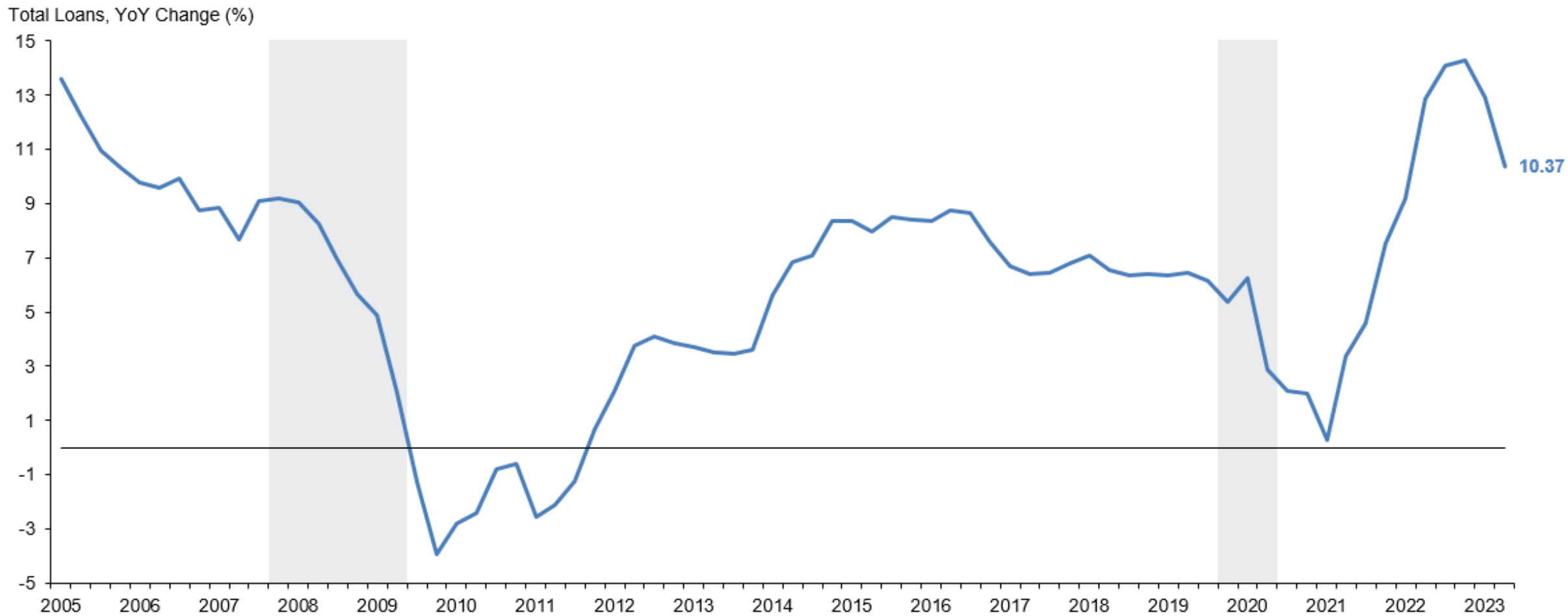
Bank NIMs Decline for Third Consecutive Quarter in Q2 2023

Net Interest Income, Percent of Average Earning Assets



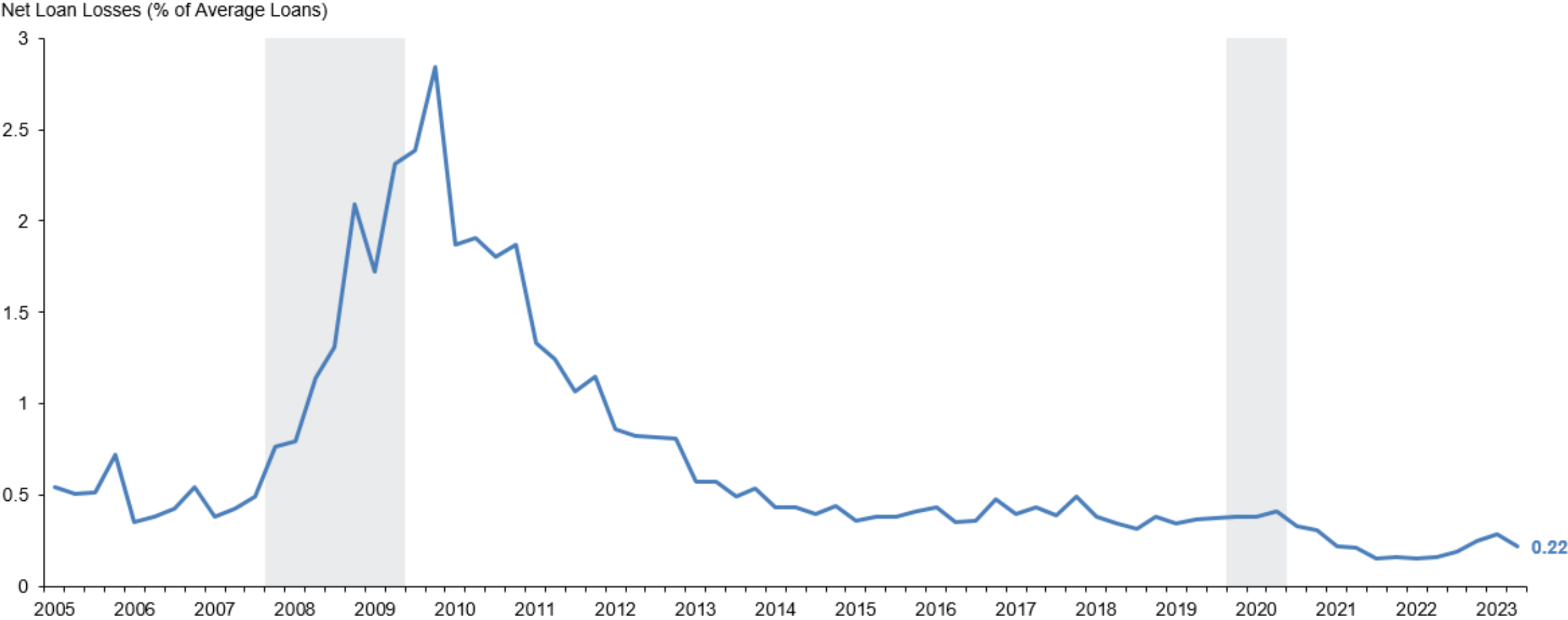
NOTE: Excludes banks with assets > \$100B. Shaded areas indicate recession.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

Loan Growth Slows in Q2 2023



NOTE: Based on a panel of banks with assets < \$100 billion, adjusted for merger activity. Excludes PPP loan balances. Shaded areas indicate recession.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

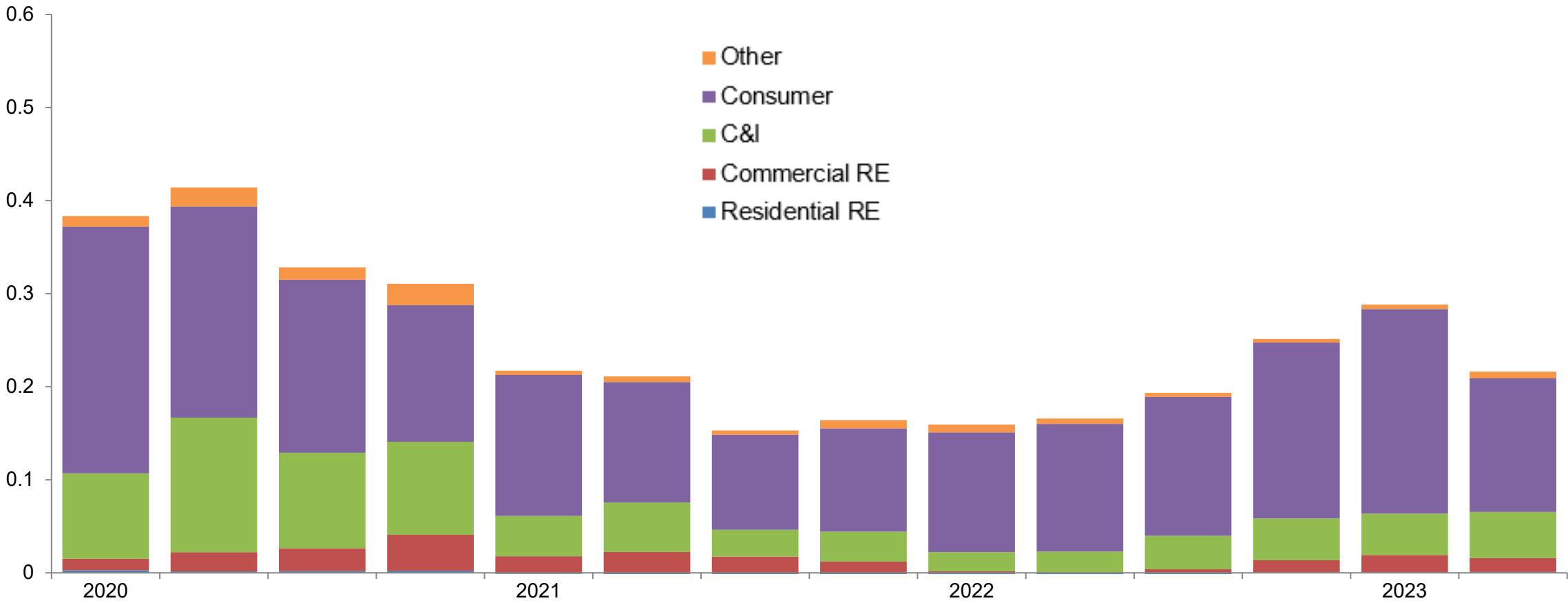
Net Charge-Off Rate Near Historical Lows; Watching CC, Auto, CRE



NOTE: Excludes banks with assets > \$100B. Shaded areas indicate recession.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

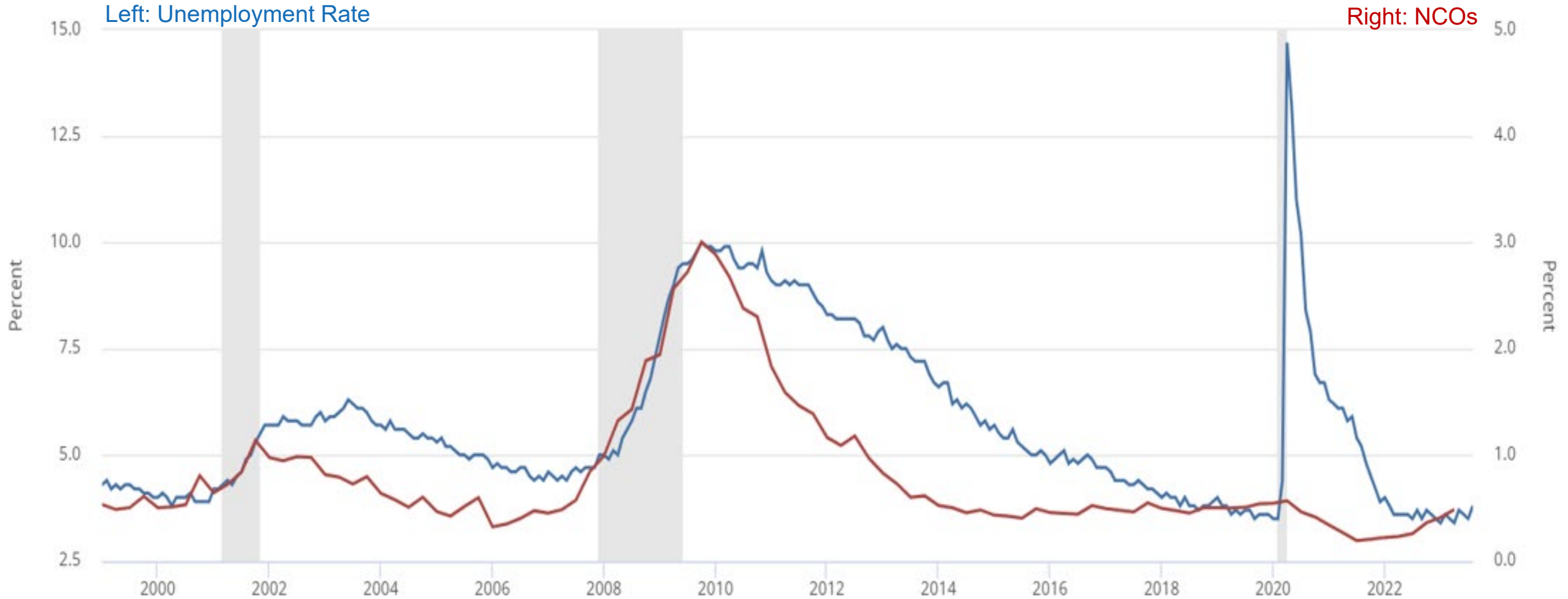
CRE Net Loan Charge-Off Rate Up From Last Year

Net Loan Charge-offs by Major Loan Type (% of Average Loans)



NOTE: Excludes banks with assets > \$100B.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

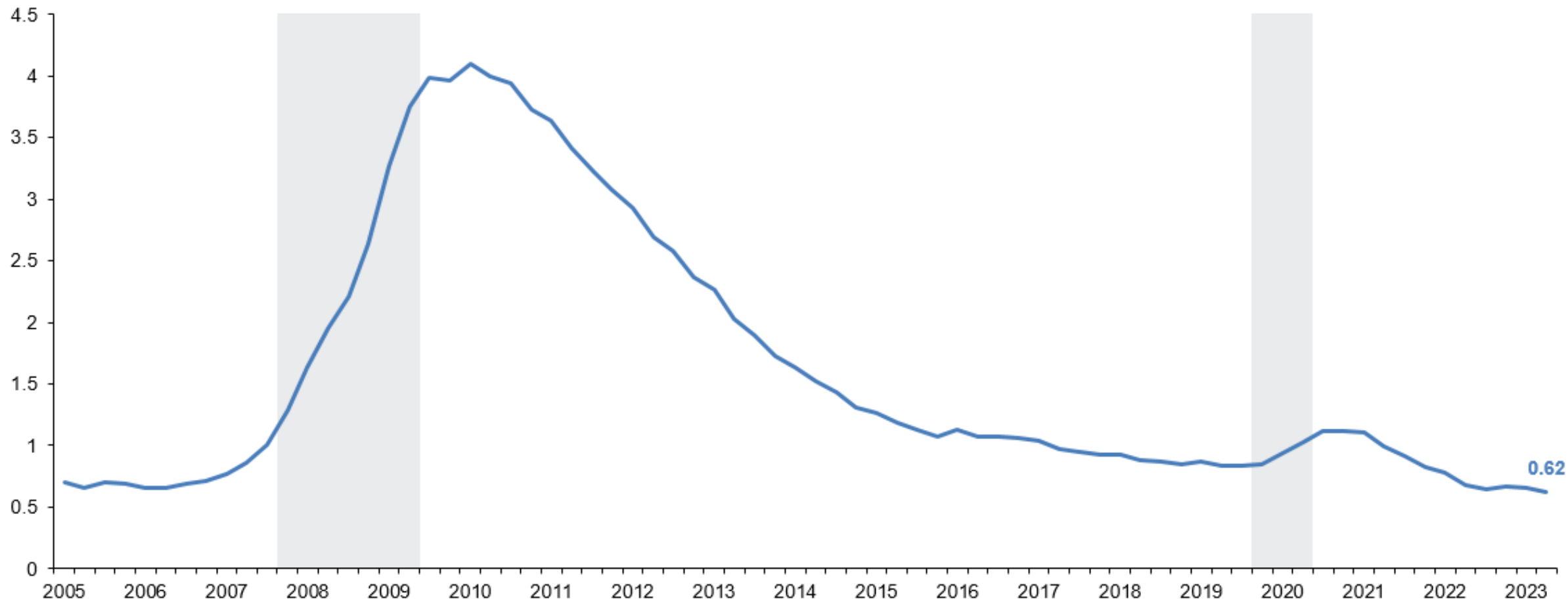
Loan Charge-off Rate Moves in Line with Unemployment Rate



SOURCES: BLS; FDIC

Noncurrent Loan Rate Also Holding Steady

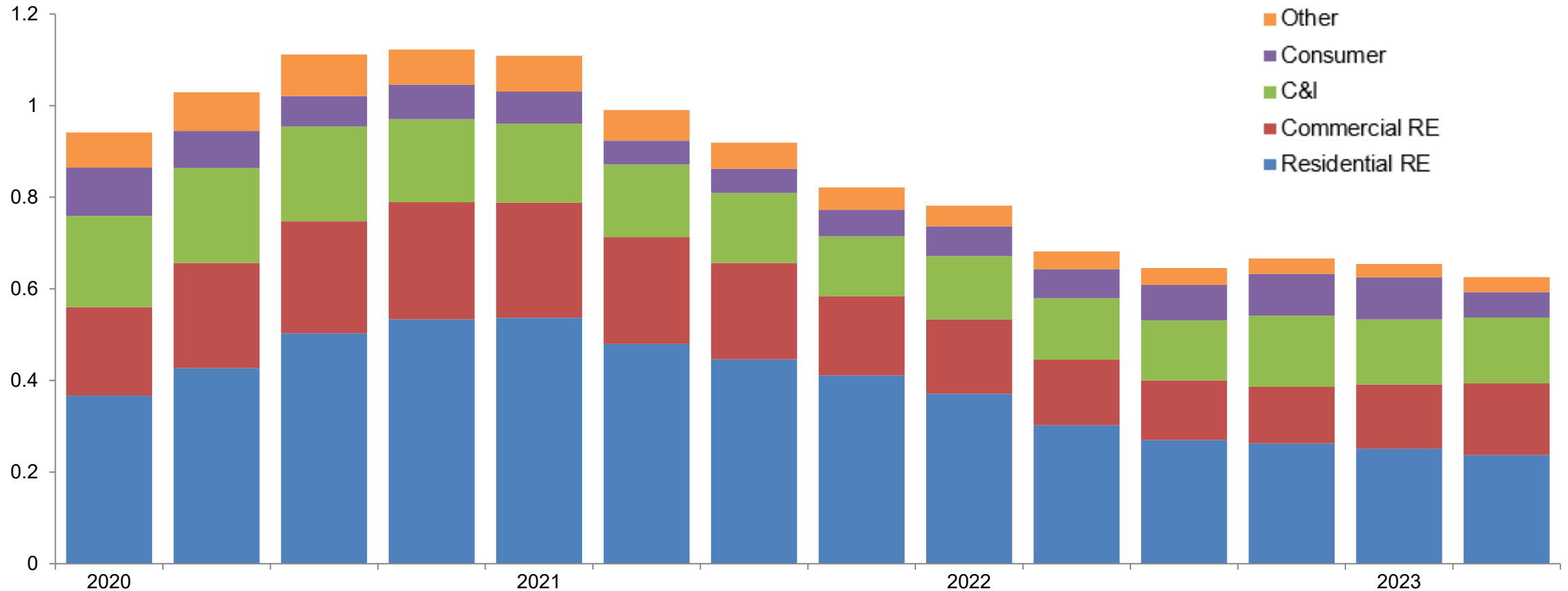
Noncurrent Loans (% of Total Loans)



NOTE: Excludes banks with assets > \$100B. Noncurrent loans are those past due 90+ days or on nonaccrual status. Total loans exclude PPP loans. Shaded areas indicate recession. SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

Increase in Noncurrent Loan Rate Driven by CRE, Consumer Loans

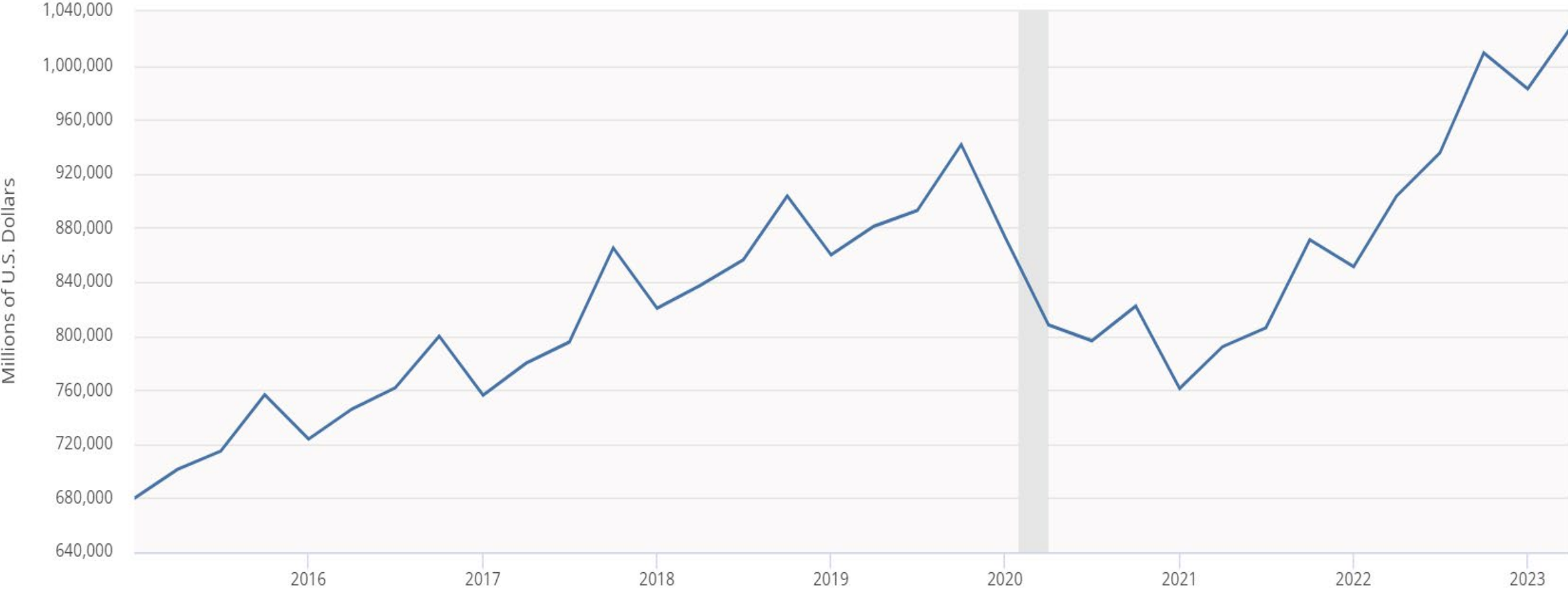
Noncurrent Loans by Major Loan Type (% of Total Loans)



NOTE: Excludes banks with assets > \$100B.

SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

Credit Card Outstanding Balances Are Up



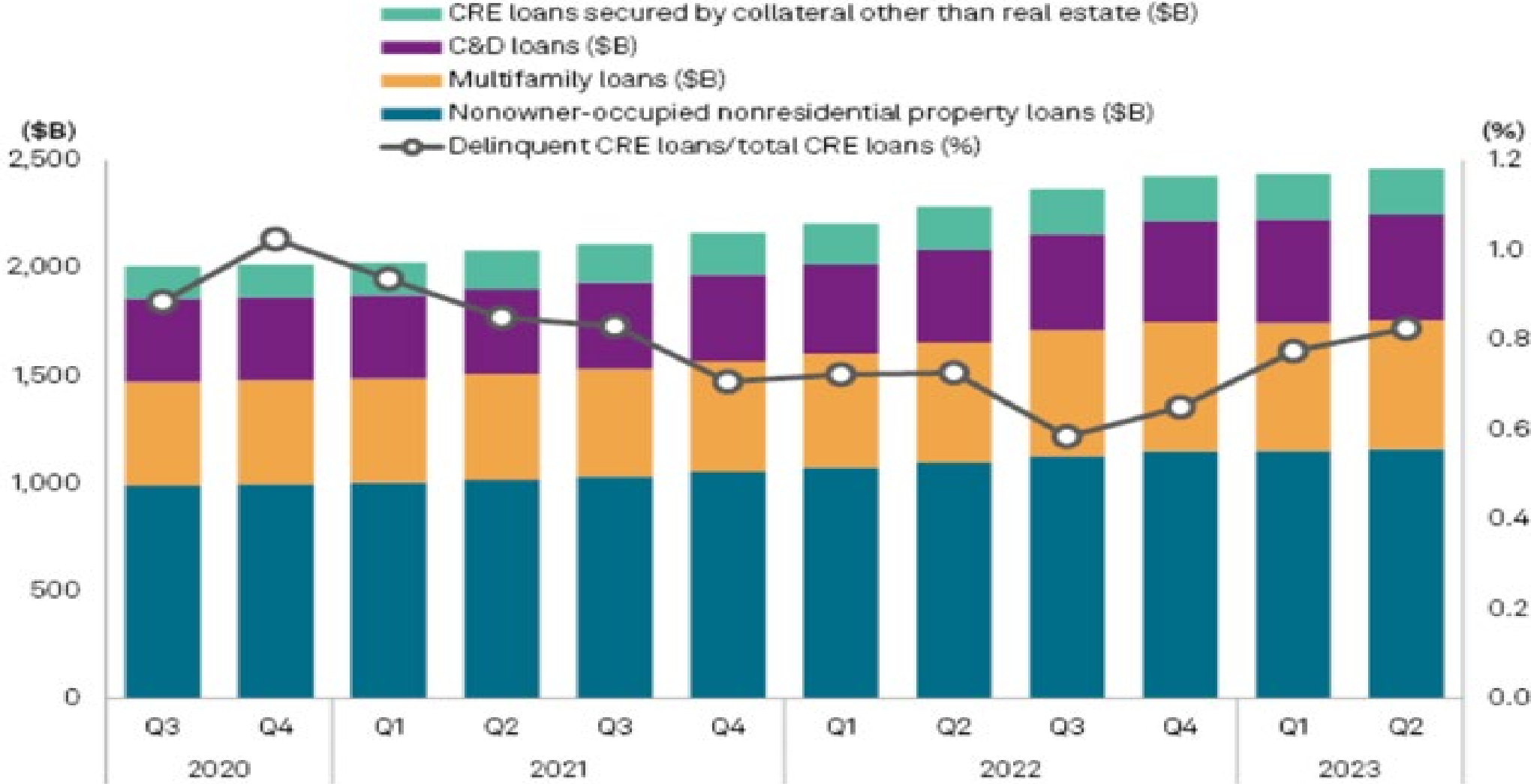
Source: Federal Deposit Insurance Corporation

Personal Savings Down Sharply as Fiscal Stimulus Dries Up



Source: U.S. Bureau of Economic Analysis

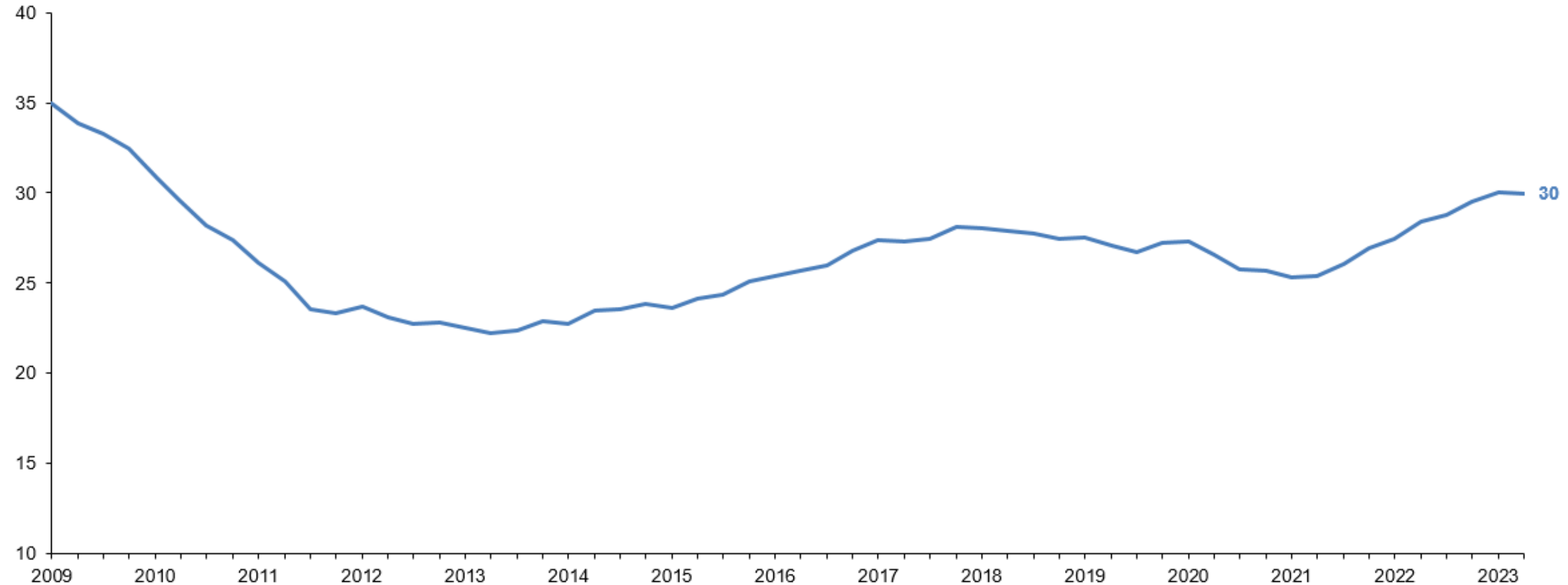
CRE Volumes Continue to Grow; Delinquencies are Increasing



SOURCE: S&P Global

Commercial Real Estate (CRE) Concentrated Banks Has Been Increasing

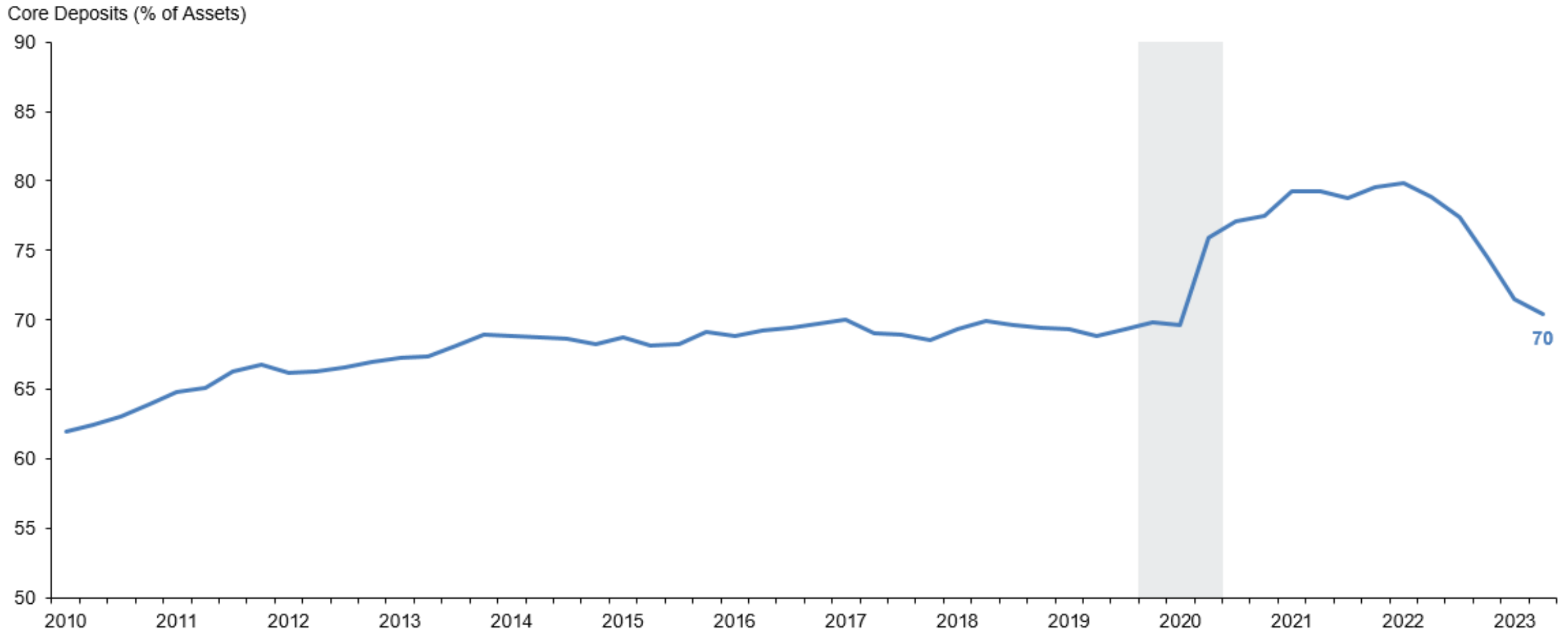
Percent of Banks with CRE Loans > 300% Tier 1 + ALLL or CLD Loans > 100% Tier 1 + ALLL



NOTE: Excludes banks with assets > \$100B. CRE loans include owner-occupied amounts.

SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

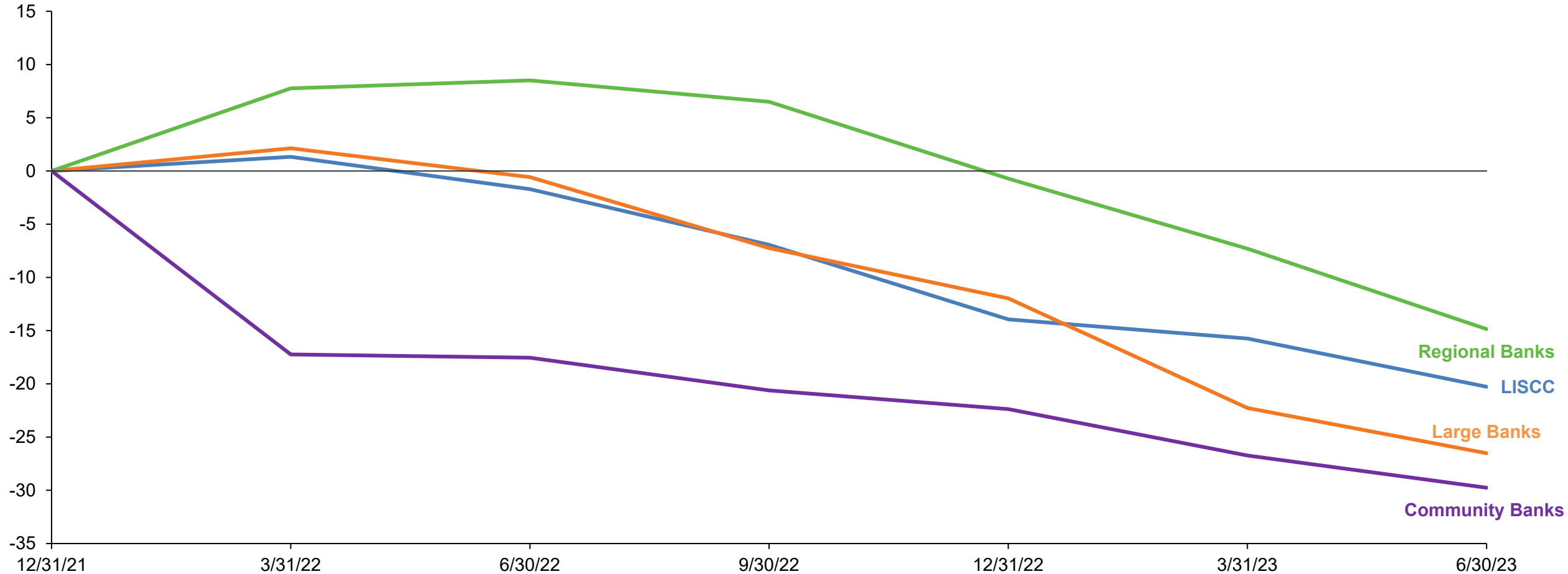
Core Deposits Return to Pre-Pandemic Levels



NOTE: Excludes banks with assets > \$100 billion. Shaded areas indicate recession.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

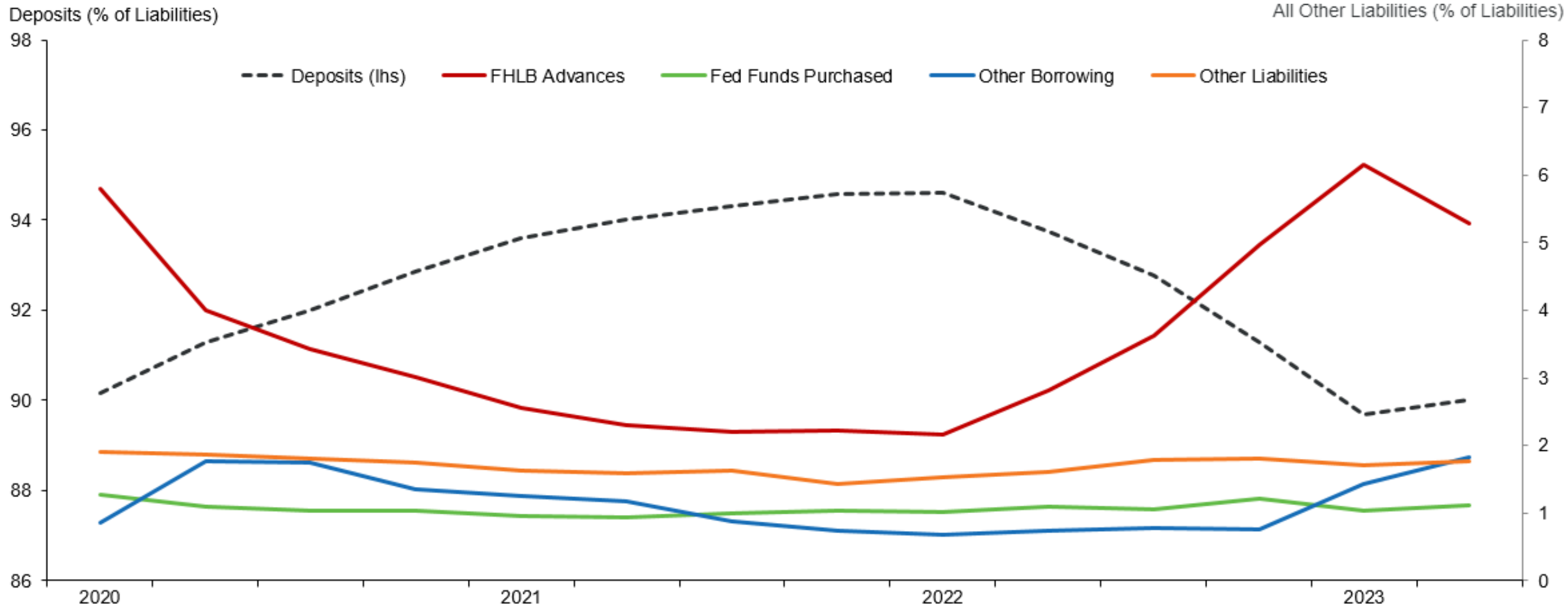
FR Y-9C Reported Deposit Trends by Portfolio

Noninterest Bearing Deposits (% change since 12/31/21)



SOURCES: Federal Reserve, FR Y-9C.

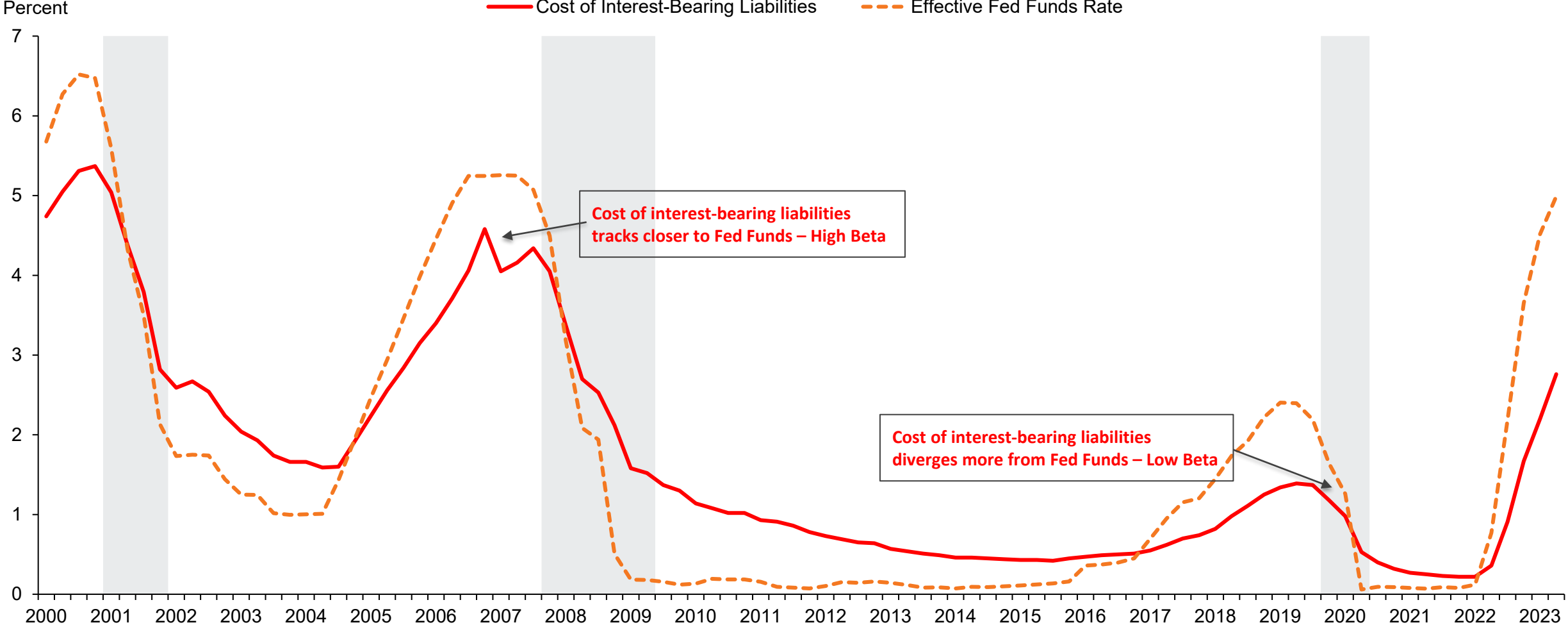
Banks Used FHLB Advances, Other Borrowing to Offset Deposit Outflows



NOTE: Excludes banks with assets > \$100B.

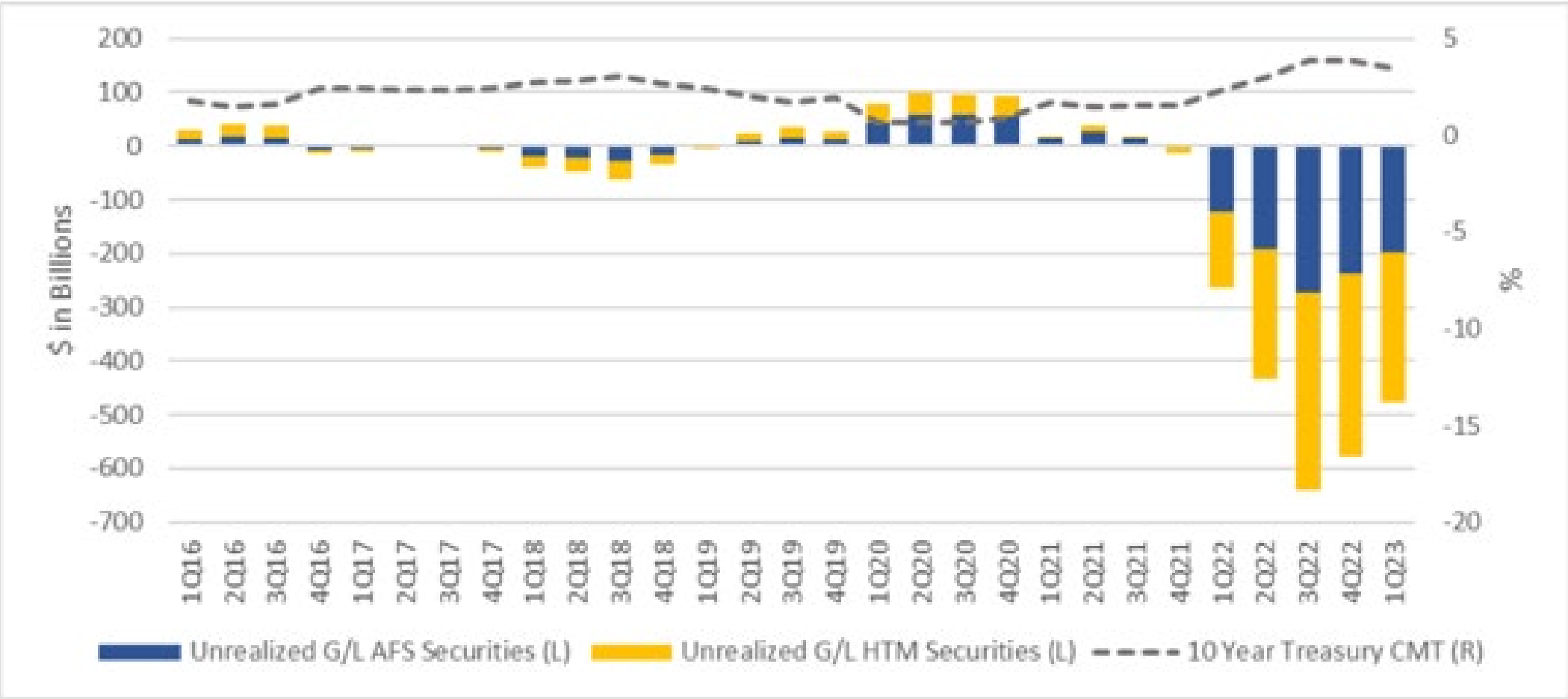
Source: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

Funding Costs Rising with Fed Funds Rate; Beta is Higher in Current Cycle



NOTE: Shaded areas indicate recession.
SOURCES: Federal Reserve; S&P Global Market Intelligence.

Unrealized Losses on Fixed Rate Debt Securities Rose, as Rates Rose

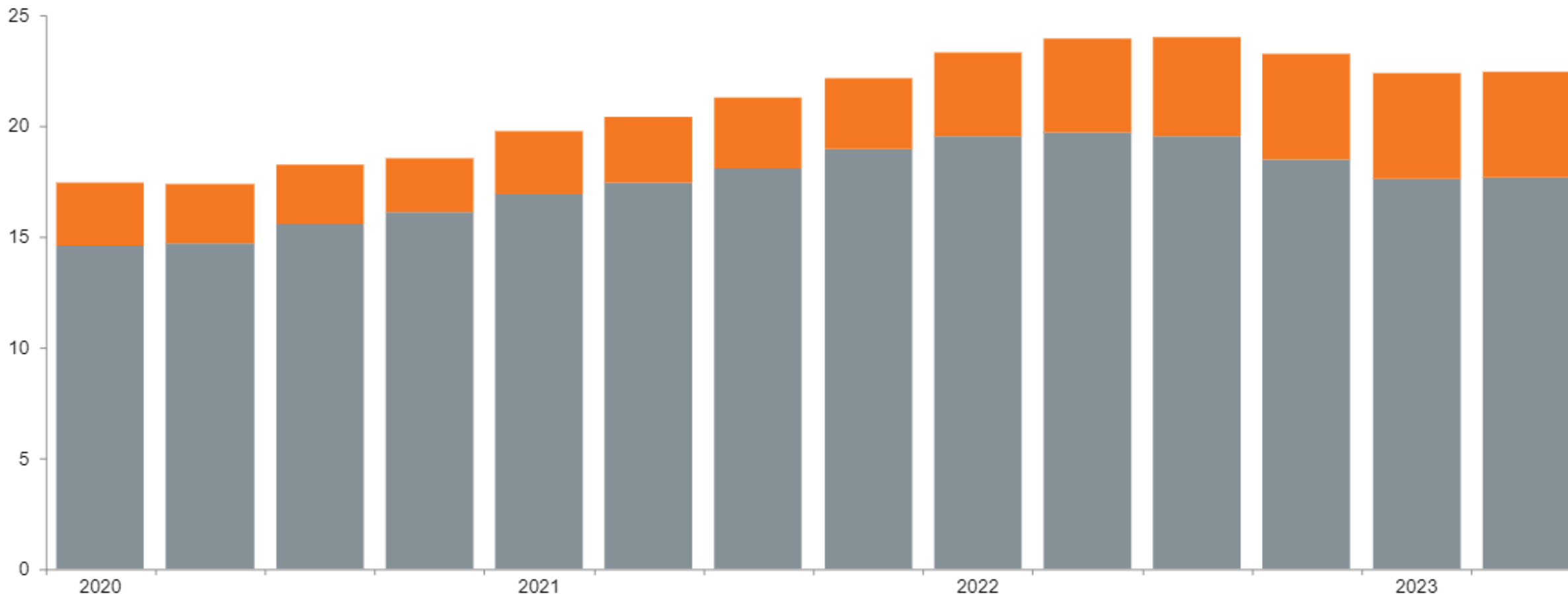


SOURCE: Call Report Data

Banks Shifting Securities from Available-for-Sale to Held-to-Maturity

Securities at Amortized Cost (% of Assets)

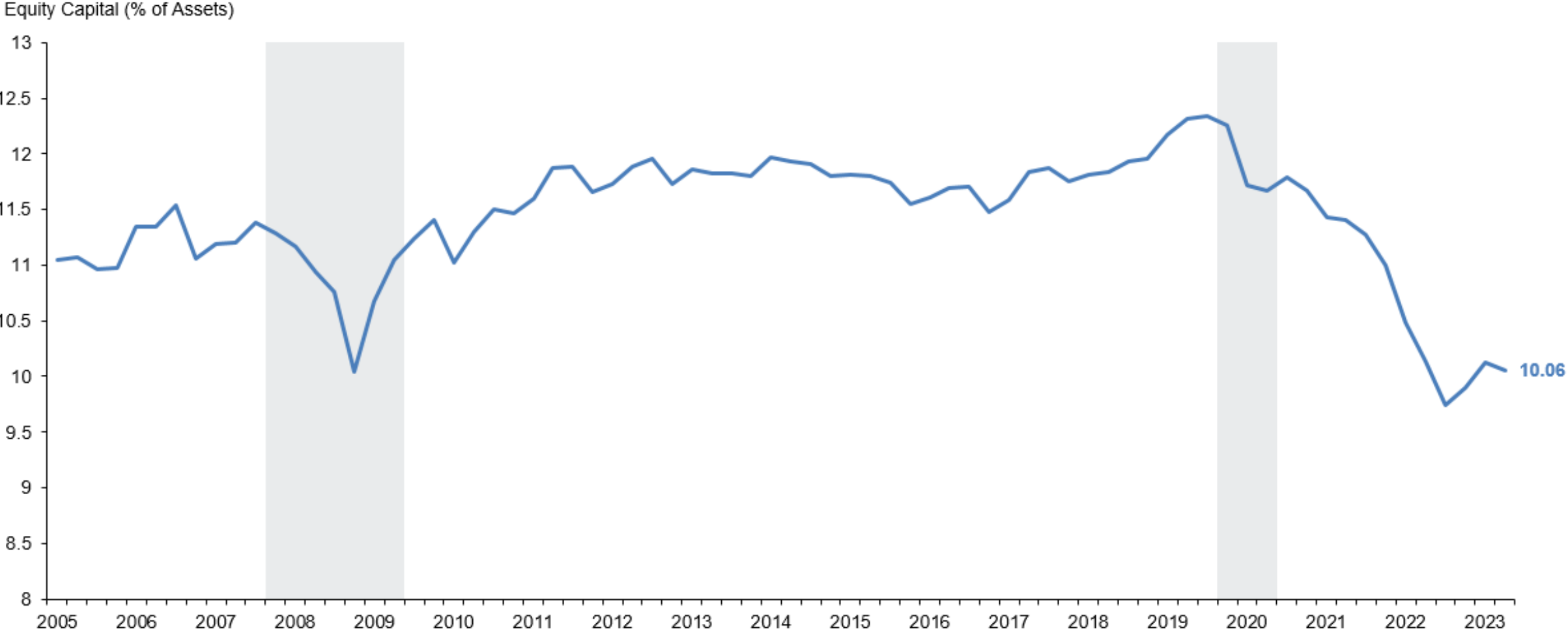
Securities at Amortized Cost (% of Assets)



NOTE: Excludes banks with assets > \$100B.

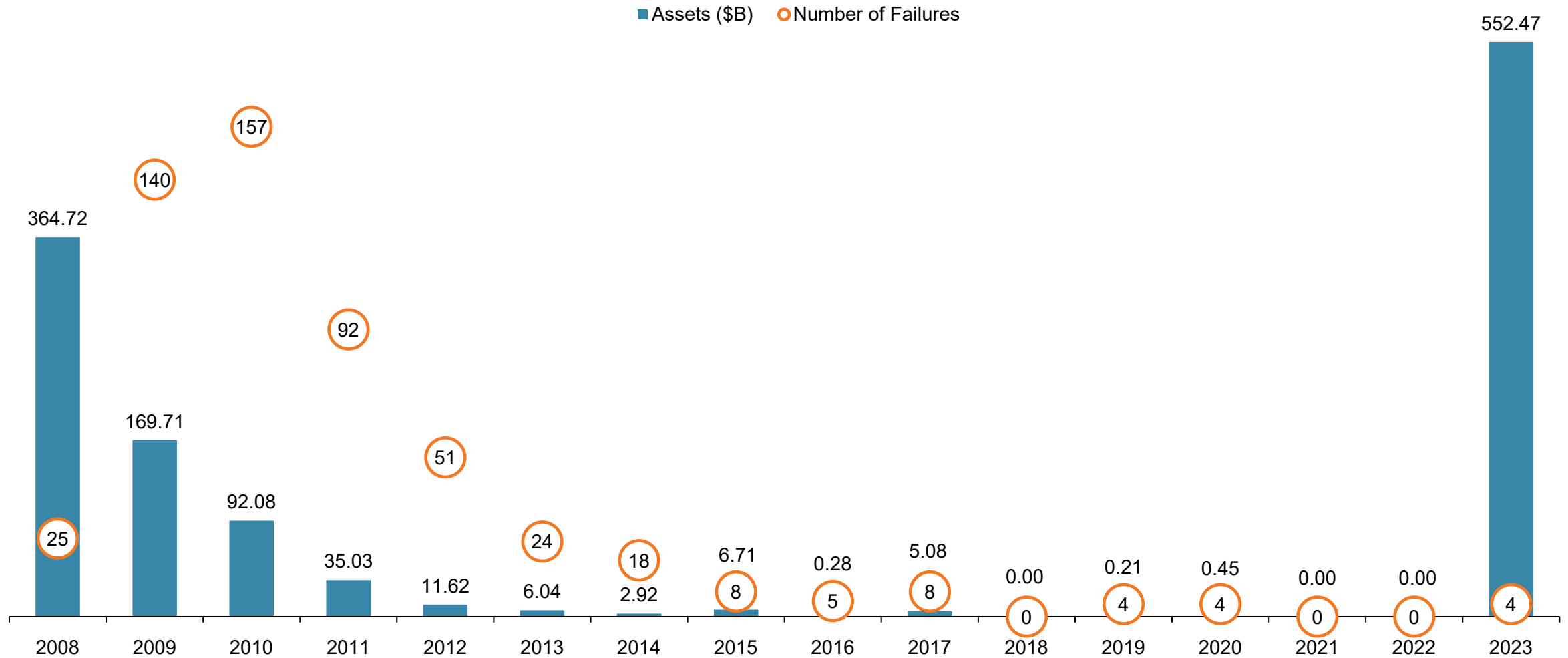
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

Capital Ratios Hold Steady in Q2 2023



NOTE: Excludes banks with > \$100 billion. Shaded areas indicate recession.
SOURCES: FFIEC, Reports of Condition and Income; FRB Dallas calculations.

Failed Bank Assets Reach Record High



NOTE: Total assets based on most recent regulatory filing before failure. 2023 data are year-to-date through August 15, 2023.

SOURCE: S&P Global Market Intelligence



Houston, Texas



Federal Reserve
Bank of Dallas



Federal Reserve
Bank of Dallas

Lessons Learned from 2023 Banking Volatility



Problem: Concentrations in Assets and Funding

- Between 2019 and 2021, SVB tripled in size as it benefited from rapid deposit inflows during rapid venture capital (VC) and technology sector growth in a period of exceptionally low interest rates.
- VC-backed companies accounted for more than half of SVB's deposits at year-end 2022, and client funds that SVB placed off-balance-sheet were even more concentrated in the same client group.
- Management assumed that the highly concentrated deposit base was more stable than it proved to be.
- These deposits were largely uninsured, and SVB invested them primarily in securities with longer-term maturities.

Problem: Inadequate Risk Management

- SVB failed its own internal liquidity stress tests and did not have workable plans to access liquidity in times of stress.
- Managed interest rate risks with a focus on short-run profits and protection from potential rate decreases, and removed interest rate hedges, rather than managing long-run risks and the risk of rising rates.
- SVB made counterintuitive modeling assumptions.
- The bank changed its own risk-management assumptions (about the duration of deposits to address the limit breach rather than managing the actual risk) to reduce how these risks were measured rather than fully addressing the underlying risks.

Problem: Inadequate Review and Challenge

- The full board of directors of Silicon Valley Bank did not receive adequate information from management about risks at SVB and did not hold management accountable for effectively managing the firm's risks.
- SVB did not take sufficient steps in a timely fashion to build a governance and risk-management framework that kept up with its rapid growth and business model risks.
- An SVB director, for example, told supervisors in 2022 that controls always lag growth.
- The Risk and Audit functions were inadequate relative to the size, risk, and complexity of the firm:
 - The CRO, who did not have the experience necessary for a large financial institution, left the organization and the position went unfilled for months.
 - Internal Audit had material weaknesses in the risk-assessment process, the process to define the IA audit universe, IA's continuous monitoring, and audit execution.

Stakeholders Break Ties with the Firm

- Silicon Valley Bank announced a balance sheet restructuring that was ill-timed. This occurred during a period of heightened uncertainty for the technology sector, and the bank face.
- SVB had:
 - Sold \$21 billion in available-for-sale (AFS) securities
 - Was booking a \$1.8 billion after-tax loss
 - Was planning to increase term borrowings by \$15 billion to \$30 billion
 - Was seeking to raise \$2.25 billion in capital.
- Deposit outflows were over \$40 billion on March 9, and management expected \$100 billion more the next day.
- **Technology and social media amplify the risks/challenges today!**

Lessons Learned from SVB, other reports

- Understand the intersect of interest rate risk, liquidity, earnings, and capital
- Update deposit attrition assumptions based on the recent learning from contagion events
 - Deposit attrition assumptions for online deposits will likely be a point of challenge as many of these firms experienced growth during the March contagion event as they were paying high rates.
 - Should evaluate how these deposits could behave during an idiosyncratic event when the firm is experiencing reputation risk.
- Ensure adequate back-testing and transparency on the key drivers
 - How accurate are prior assumptions?
- Ensure effective review and challenge by independent risk officer(s)
- Conduct scenario/sensitivity analysis and report results to ALCO, board risk committee, and boards of directors



San Antonio, Texas



Federal Reserve
Bank of Dallas



Federal Reserve
Bank of Dallas

Financial Stability Risks



Fed's October 2023 Financial Stability Report

- Asset valuations
- Borrowing by businesses and households
- Leverage in the financial sector
- Funding risks

Asset valuations

- Equity price-to-earnings ratios reached elevated levels.
- Risk premiums in corporate bond markets remained near the middle of their historical distributions.
- Prices of residential and commercial properties remained high relative to fundamentals.

Borrowing by Businesses and Households

- The ratio of total private debt to gross domestic product (GDP) continued to edge down and remained close to its historical average.
- The business debt-to-GDP ratio remained high, but debt issuance by the riskiest companies continued to be subdued. Firms' ability to service their debt remained solid despite declining interest coverage ratios.
- Household debt was at modest levels relative to GDP and concentrated among prime-rated borrowers.

Leverage in the Financial Sector

- The banking system remained sound and resilient, as risk-based capital ratios remained close to average levels over the past decade.
- Nonetheless, high interest rates continued to depress the fair value of longer-maturity, fixed-rate assets that, for some banks, were sizable.
- Leverage remained high at the largest hedge funds.
- Broker-dealer leverage remained near historically low levels.

Funding Risks

- Most domestic banks maintained high levels of liquid assets and stable funding.
- However, a subset of banks continued to face funding pressures, reflecting concerns over uninsured deposits and other factors.
- Structural vulnerabilities persisted at money market funds, some other mutual funds, and stablecoins.
- Liquidity risks for life insurers remained elevated as the share of illiquid and risky assets continued to edge up.



Federal Reserve
Bank of Dallas

Building a strong economy together