FINANCIAL INTELLIGENCE *from* FHLBank Topeka

FHLBank Tenth District Community Bank Trends

Quarterly Analysis / Q1 2022

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The purpose of this analysis is to provide financial and performance trend data for member institutions headquartered in FHLBank's Tenth District comprised of Colorado, Kansas, Nebraska and Oklahoma.

Executive Summary: Where are we today?

The terms "unprecedented times," "uncertainty" and "unchartered waters" continue to dominate the rhetoric of today's economic environment. Chatter about a looming recession, or at a least a slowdown, continue to creep into conversations.

Covid cases are on the rise (again) and the reinstatement of earlier protocols are being considered in some parts of the country. Lockdown measures remain in place abroad in China but the outlook to reopen has improved. Geopolitical risks have provided yet another market disruption and international conflict has added to ongoing price pressures. Supply-side constraints are pushing input costs higher.

Households are feeling the pain as inflation continues to erode purchasing power. Income growth has not kept pace with spending. Consumers have turned to savings to help support spending habits as fiscal stimulus support has faded and preference for spending on discretionary items – furniture, entertainment, hospitality, etc. – has started to wane. Personal savings rates diminished quickly over the past five months, returning to levels not seen since 2008-2010.

The domestic labor market has remained a source of strength for the economy as Americans go back to work. Although, much of the job growth has been replacing those lost during the pandemic and less on new job creation. The pace of new jobs is moderating as the Federal Reserve (Fed) continues to raise rates and consumers are starting to pull back. The ability for businesses to pass increased costs on to the consumers is waning, presenting a challenge for plans to hire and invest.

The Fed is faced with an economy that needs cooling. The Fed has embarked on a daunting mission of trying to navigate a soft landing for the economy through an aggressive tightening of monetary policy. The Fed remains committed to reigning in inflation and has asserted it will continue to raise rates until inflation noticeably slows, even as equity markets remain volatile and signals of economic weakness have started to emerge.

Equity market momentum has declined in 2022. Bank stocks have lagged the broader market year-to-date after a strong 2021 performance. Soaring inflation, Fed action and talk of a possible recession has challenged markets. However, in May, bank stocks reversed course with positive returns, recouping losses seen during the first few months of the year. The market value of many bank bond portfolios has been pummeled this year. Some banks may use the pullback and current environment to utilize share buybacks as a capital management tool.

Source: S&P Global Market Intelligence

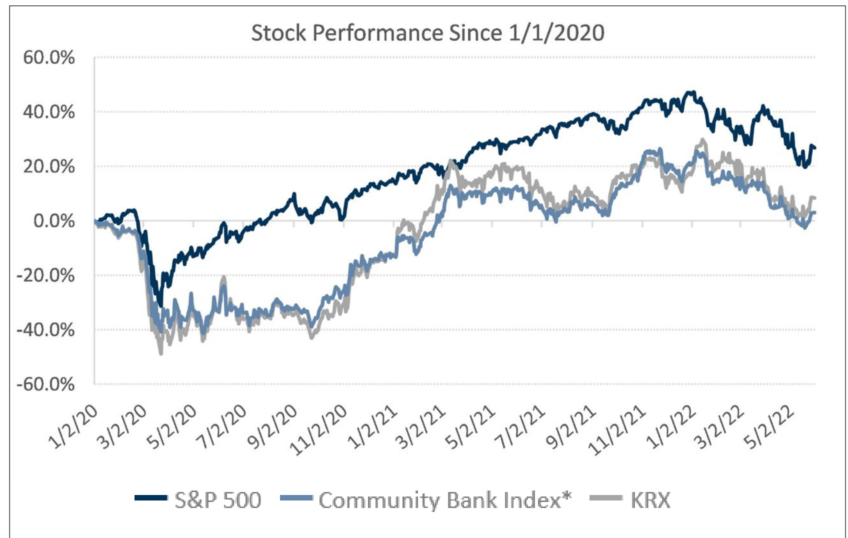
Merger and acquisition (M&A) activity has slowed as bank valuations move lower. To date, the number and value of announced M&A transactions have not kept pace with 2021 activity. Lower stock prices mean sellers' expectations will not be met, impacting buyer appetite for M&A deals. Industry analysts also noted that the uncertain economic outlook may cause a pause in deal activity until the environment becomes clearer.

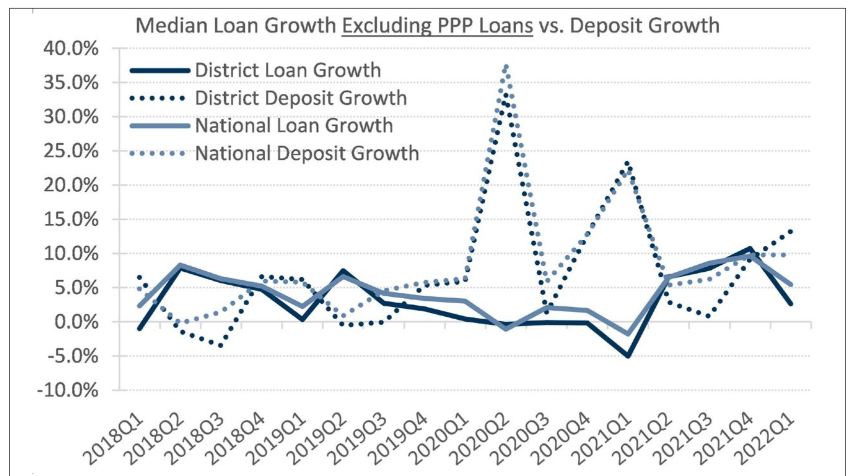
Competition has widened in the bank space, challenging the traditional operating environment for community banks. In addition to investing in technology and digital channels, building partnerships with fintech firms provides an opportunity to drive growth and profitability by reaching new customers and increasing product offerings. A community bank CEO focused on growing fintech relationships was recently quoted in an S&P Global Market Intelligence article saying, "We're 106 years old, but I don't want to act 106 years old. I can't afford to do that."

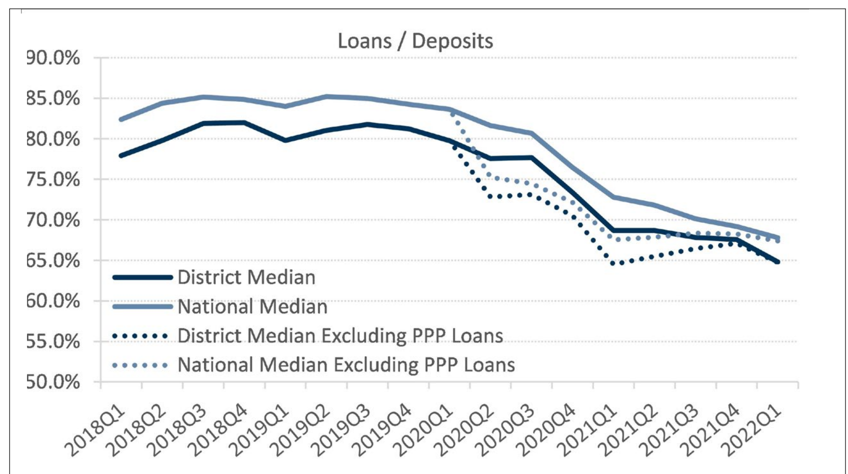
Banking Themes

Liquidity positions pushed higher for bank members during the first quarter of 2022. Loan demand slowed, while deposit balances surged. Margins remain under pressure, despite the rise in interest rates. Asset quality concerns remain muted and capital positions remain above prior cycle lows.

On a median basis, total loan growth followed past seasonal trends, declining during first quarter 2022. First quarter loan growth has







Source: S&P Global Market Intelligence. Stock performance through May 31, 2022.
**Community Bank Index created by FHLBank Topeka and consists of 74 select publicly traded community banking institutions (assets < $10 billion).*

historically been the slowest over the course of the year, but this year is also marked with red-hot inflation and rising interest rates. Loan growth excluding Paycheck Protection Program (PPP) lending was positive for the fourth consecutive quarter. Tenth District (District) outstanding PPP loan balances dropped 92% year-over-year and totaled $1.3 billion as of March 31, 2022.

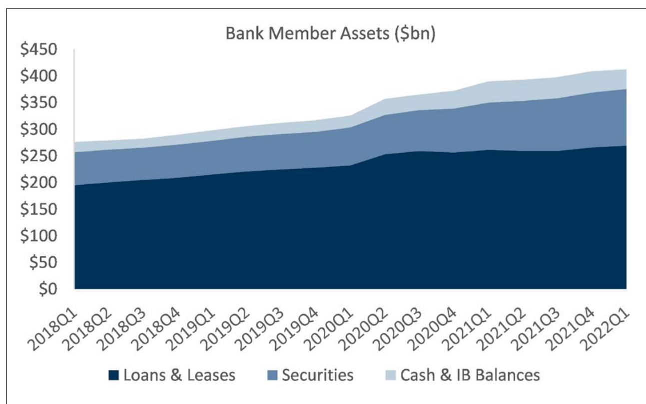
Loan growth was primarily attributed to commercial real estate and construction lending, along with commercial and industrial lending. During first quarter 2022, 1-4 family residential lending activity contributed to loan growth, but at a slower pace than prior periods. Strong home construction lending within the District continued through and has averaged 7.8% growth over the past four quarters – a multi-decade high. Growth in the loan portfolio was offset by a sharp decline in agricultural production loans, erasing the robust growth seen in the fourth quarter of 2021. Borrower loan utilization remains at multi-decade lows with unused loan commitments hovering around 20% of total loans.

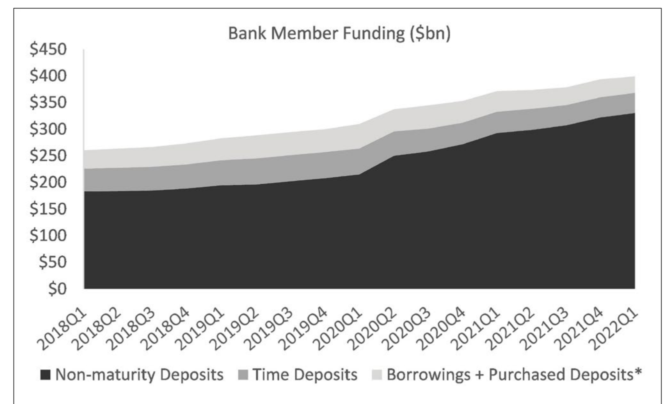
A slowdown in mortgage banking activity is on the horizon as interest rates rapidly rise, refinance opportunities dissipate and mortgage originations decline. Lowering mortgage banking revenue guidance has become a common theme across the industry for the foreseeable future. Expenses related to mortgage operations have also come in to focus as institutions prepare to combat segment headwinds.

Lower-yielding assets continue to represent a growing portion of balance sheet composition on the asset side. Institutions continued to move cash into securities to take advantage of the yield curve shift as deployment into loans was limited in the first quarter. Treasury security portfolios ballooned during those three months, growing $3.3 billion in the aggregate – almost double Treasury security balances at March 31, 2021. The security portfolio maturity and repricing profile shifted during first quarter 2022 with the 1-to-3-year and 3-to-5-year debt securities buckets growing considerably.

The swift rise in interest rates has had a significant negative impact on the market value of bonds in bank portfolios, hitting accumulated other comprehensive income with unrealized losses in the available-for-sale portfolio. Held-to-maturity (HTM) portfolio balances jumped during the first quarter as some institutions looked to avoid the impact of volatility. However, classifying securities as HTM restricts the flexibility management has in managing the portfolio.

On the deposit front, noninterest-bearing deposits continue to represent a greater portion of financial institutions' funding. Total deposits in the District grew nearly $100 billion in the past eight quarters, all in non-maturity deposit accounts. The stability of these deposits is unknown and could be vulnerable as the Fed ratchets up interest rates and continues to shrink its balance sheet. Loan-to-deposit ratios fell to a new multi-decade low as deposit balances continue to build. Wholesale funding needs are limited as financial institutions await opportunities to deploy surplus liquidity.





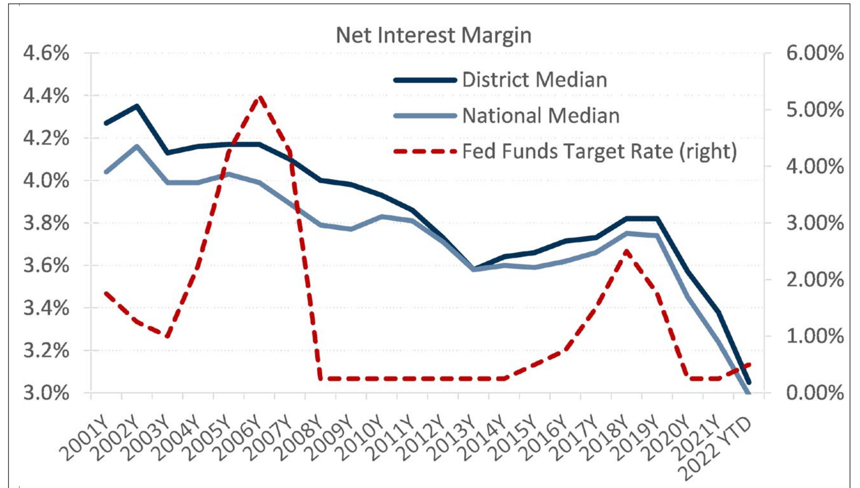
Source: S&P Global Market Intelligence.

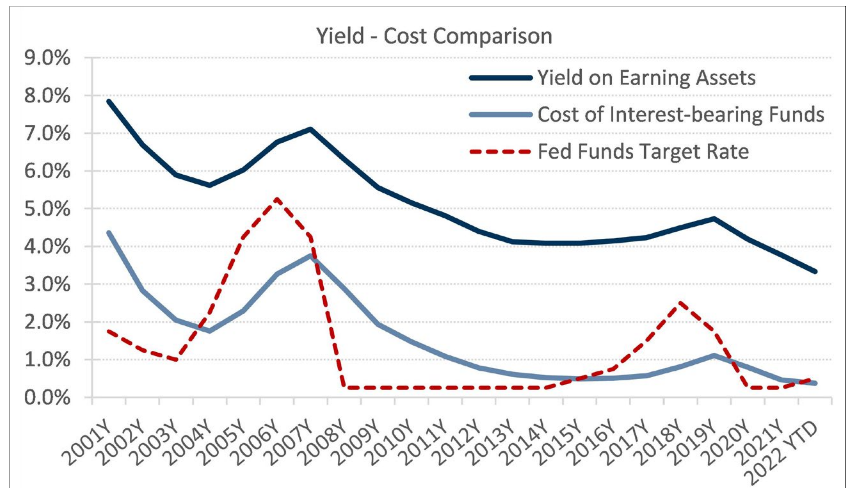
Net interest margins plunged lower during first quarter 2022, even as rate liftoff commenced. Rate hikes will be especially favorable for asset sensitive banks. As loan growth returns, net interest income will get a boost as new loans are originated at higher rates and interest rates move above loan floors. Higher yields in the bond market should also offer further support to margin growth later in 2022.

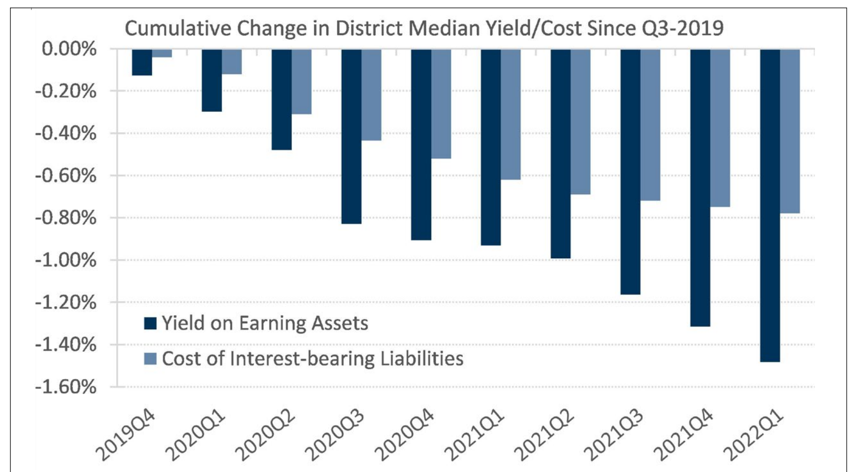
Fierce loan competition has kept pressure on loan yields and remains a headwind to margin expansion. All institutions — banks, credit unions, insurance companies, nonbank lenders — are seeking quality higher-earning assets to put on their balance sheet. Institutions are not only competing on rate, but on loan structure such as longer amortization and interest-only periods.

Cost of funds remain historically low, and creeped lower during first quarter 2022 despite an increase in rates. An inflection point for deposit costs is nearing. Deposit betas are now a recurring topic of discussion. Some expect deposit betas will be lower than in past tightening cycles due to excess liquidity sitting in the banking system. However, competition with non-traditional bank entities may challenge that expectation. The rapid pace of rate hikes may also alter deposit pricing decisions compared to the last hiking cycle.

Efficiency ratios improved in first quarter 2022 due primarily to a decline in noninterest expense. After two quarters of falling head counts at District banks, the number of full-time employees increased. Noninterest



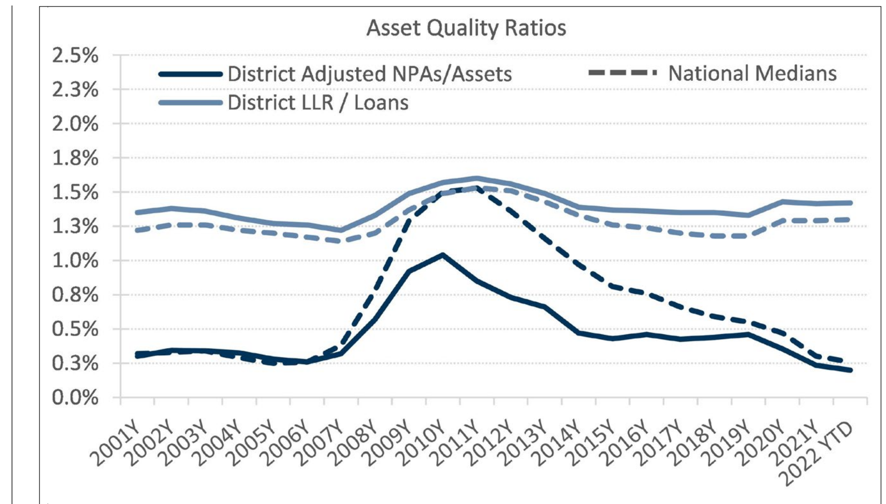


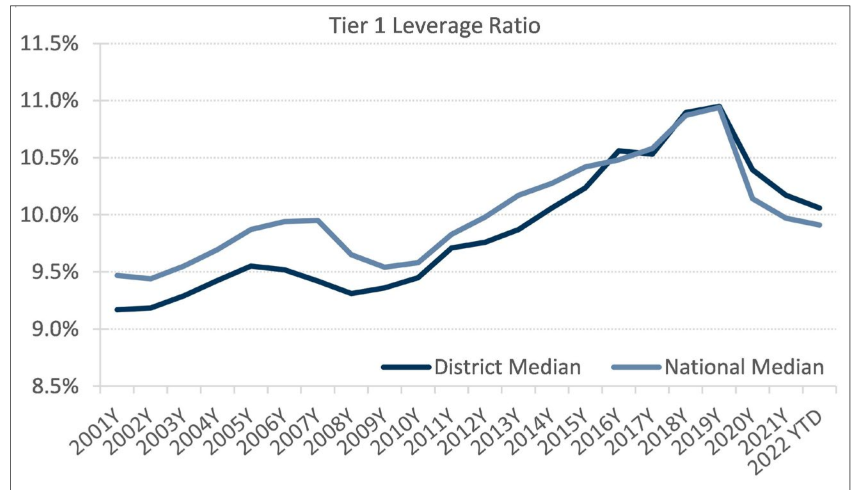


Source: S&P Global Market Intelligence.

income ticked lower for the fourth consecutive quarter and is expected to be strained from fee-income generating lines of business-like mortgage banking. Many institutions are facing regulatory and competitive pressures to revisit their overdraft and nonsufficient fund fees — placing additional stress on operating revenue.

Aggregate provisions across the District moved slightly higher during March 2022. Most banks did not have a provision during the first quarter, some boosted reserves and a handful reported negative provisions. Continued strong credit quality, waning uncertainty around the economic impact of COVID and the economic recovery to date support current loan loss reserve positions. However, persistent elevated inflation concerns, emerging geopolitical risk and ongoing supply chain challenges could spark a return to position provisioning in upcoming quarters. Although capital positions have declined through the pandemic as asset growth soared, banks remain well-capitalized compared to the prior cycle.





Looking Ahead

A cautious sentiment towards the economic environment is growing and many say a slowdown, or recession, is inevitable. The timing and severity, however, remains unknown. The banking industry is on solid footing with strong fundamentals and are well-positioned to weather looming macroeconomic and geopolitical risks.

In FHLBank Topeka's April Financial Intelligence article **Smart Moves for Every Scenario**, Oklahoma Regional Manager Drew Simmons says, "The question financial institutions need to ask right now is how their balance sheet and liquidity will respond to the volatile scenarios that could play out over the next 18 to 24 months. If history is any indication, the inversion of the treasury curve will result in some form of a recession."

The time is here to prepare, not predict, for an evolving rate environment. Drew explains how in **an additional FI article**.

Source: S&P Global Market Intelligence.