FHLBank Tenth District Financial Institution Trends

Quarterly Analysis for Member Banks and Credit Unions

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Issues in Focus for Members

- EARNINGS!/Margin management → Challenging conditions, top of mind
- Tangible capital positions → On watch
- Deposit funding environment → Persistent headwinds
- Uncertain economic outlook → More questions than answers
- Credit containment → Remains on solid footing (for now?)
- LIQUIDITY! → Access/contingency plans in focus

2nd Quarter Balance Sheet Key Takeaways

- Shift in share/deposit composition as customers seek higher rates
- Funding mix evolving as banks look to fill the liquidity gap with alternative funding sources … more so at banks than credit unions
- On-balance sheet liquidity positions decline
- Loan growth was offset by declines in cash and security balances at most institutions
- For some institutions, reserve build mode underway
- Equity positions intact but security portfolios remain underwater

Looking Ahead

- Attractive investment alternatives and the ability for consumers to move money quickly could lead to continued deposit disintermediation.
- Uninsured deposit exposure will continue to gain attention from regulators, along with liquidity stress testing and cash flow monitoring.
- Caution for an economic downturn and tightening credit conditions could slow lending activity.
- Access to liquidity and collateral capacity imperative going forward as the ability to sell securities to generate liquidity remains restricted due to underwater position of security portfolios.
- Margins have peaked, significant pressure on horizon.
- Continue to monitor for tangible signs of credit quality deterioration.
- Market volatility is likely to remain heightened with both domestic and global uncertainties.

Q2 2023 Bank Member Trends

Graphs and Charts

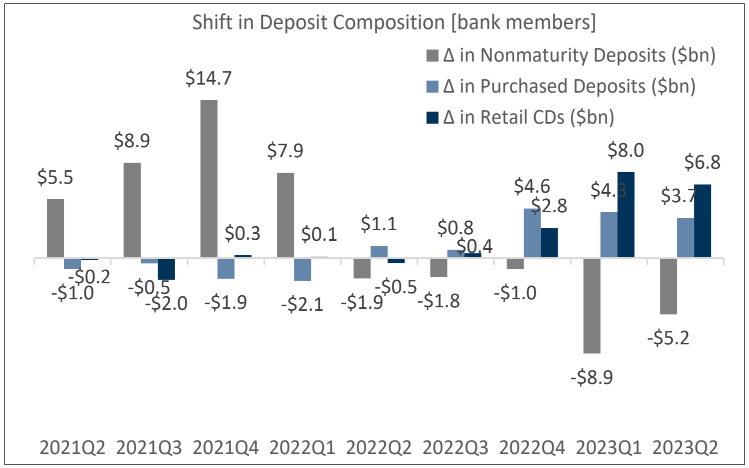
Migration of Deposits in Pursuit of Higher Rates

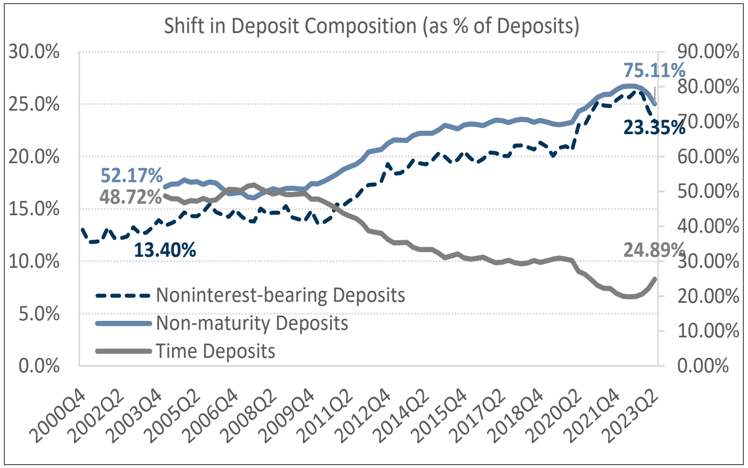
Deposit mix is evolving at member banks with retail CDs growing over 60% since the Fed began raising rates in 1Q22.

Noninterest-bearing deposits as a % of total deposits are shifting lower after reaching historically high levels with the massive influx of liquidity experienced during the pandemic.

Many institutions are focused on retaining existing deposits – playing defense against attractive yields in money market funds and other investment alternatives, such as the Treasury market.

Although purchased deposits may not be the most cost-effective funding source, use has increased to help supplement deposit outflows and support loan-to-deposit ratios.





Note: Purchased deposits = net brokered deposits (excludes reciprocal brokered deposits) + listing service deposits.

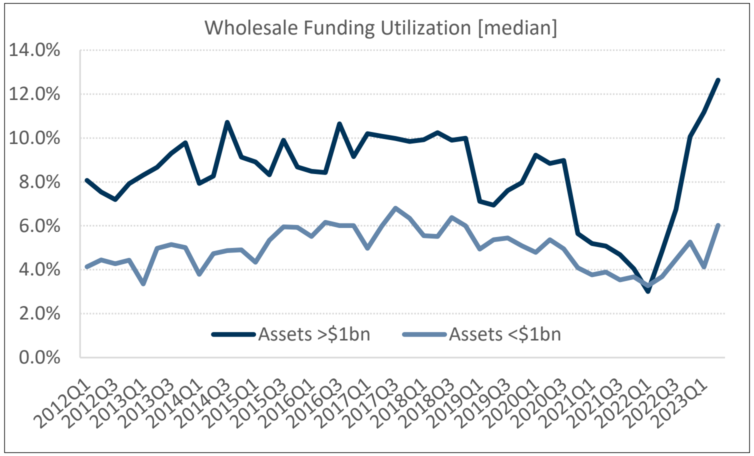
Advance Utilization Returns to Pre-Pandemic Levels

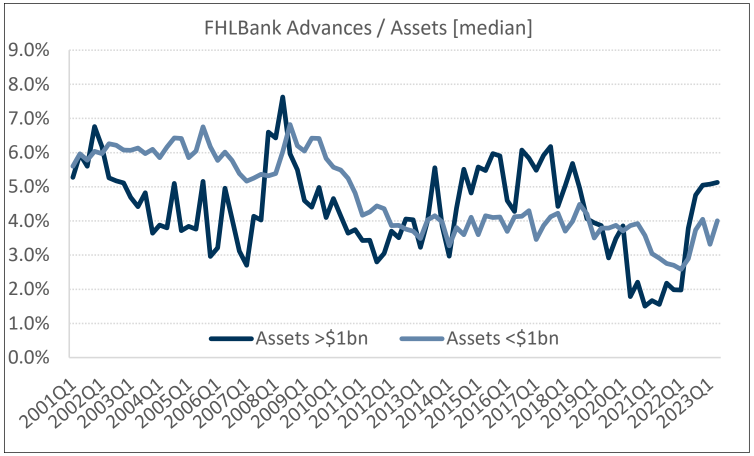
Just as the deposit mix is evolving at member banks, the overall funding mix is shifting with a greater reliance on wholesale funding sources.

A growing funding gap* has led to increased reliance on alternative funding sources as core deposits (excludes jumbo CDs, brokered deposits and listing service deposits) have declined for five consecutive quarters.

Growth in wholesale funding is attributed to further utilization of FHLBank advances, purchased deposits and the temporary Bank Term Funding Program (BTFP).

In 2Q23, the number of members <u>not</u> utilizing wholesale funding sources reached a near record low amid a challenging deposit environment.





*Change in funding sources (loans, securities, cash) less change in core deposits.
Note: Wholesale funding utilization = (total borrowings + net brokered deposits + listing service deposits) / (total borrowings + total deposits)

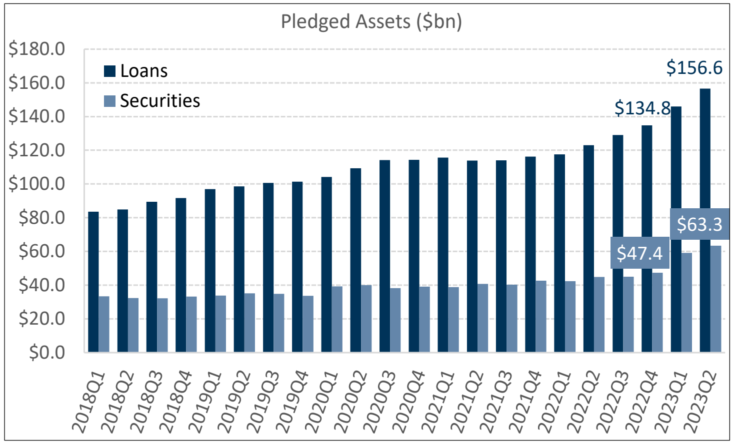
Liquidity Continues Downward Trend

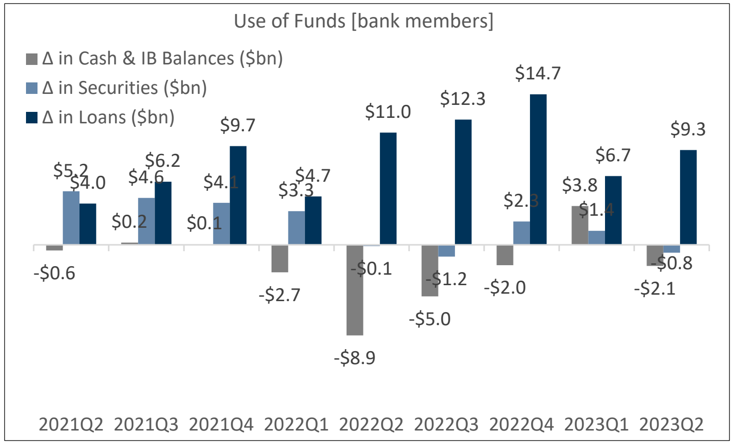
Loan growth picked up quarter-over-quarter, led by commercial real estate and C&I lending.

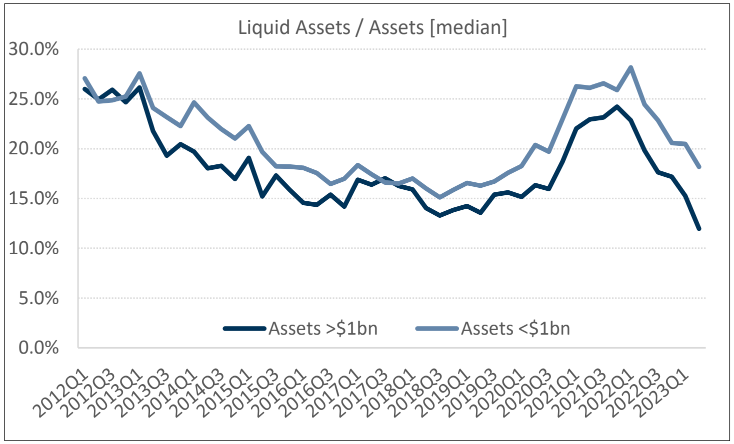
Ag lending posted strong quarterly growth and aggregate balances reached a new high of $31.4bn.

Loan and security pledging activity notably jumped following the Q1 bank failures as members looked to shore up access to alternative funding sources should an unexpected liquidity need arise.

A decline in cash and securities, coupled with an increase in pledged assets contributed to waning liquidity positions.







Bank Margins Face Significant Headwinds

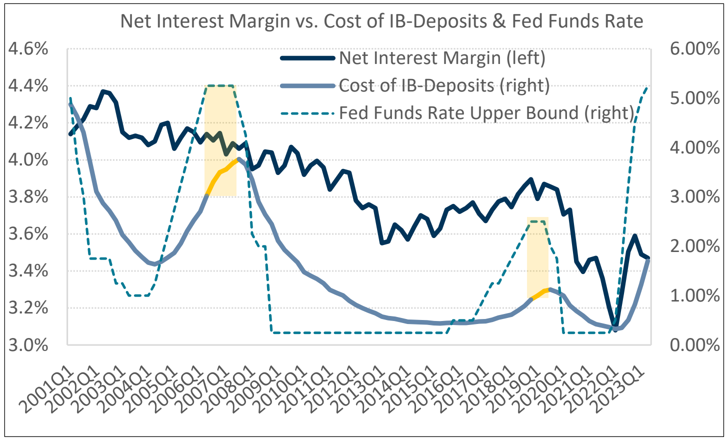
Although margins expanded at a rapid pace early in the rate cycle – primarily due to strong loan growth – margins (dark blue line) have not returned to pre-pandemic levels.

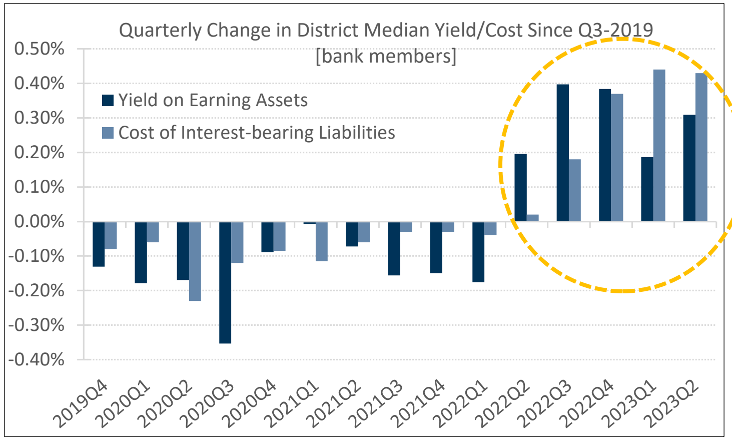
Deposit pricing pressure amplified by competition, both among financial institutions and with investment alternatives outside the banking system, has driven funding costs higher (light blue line).

The yellow shading below, illustrates the continued rise in deposit costs after the Fed funds rate has peaked over the past two rate cycles.

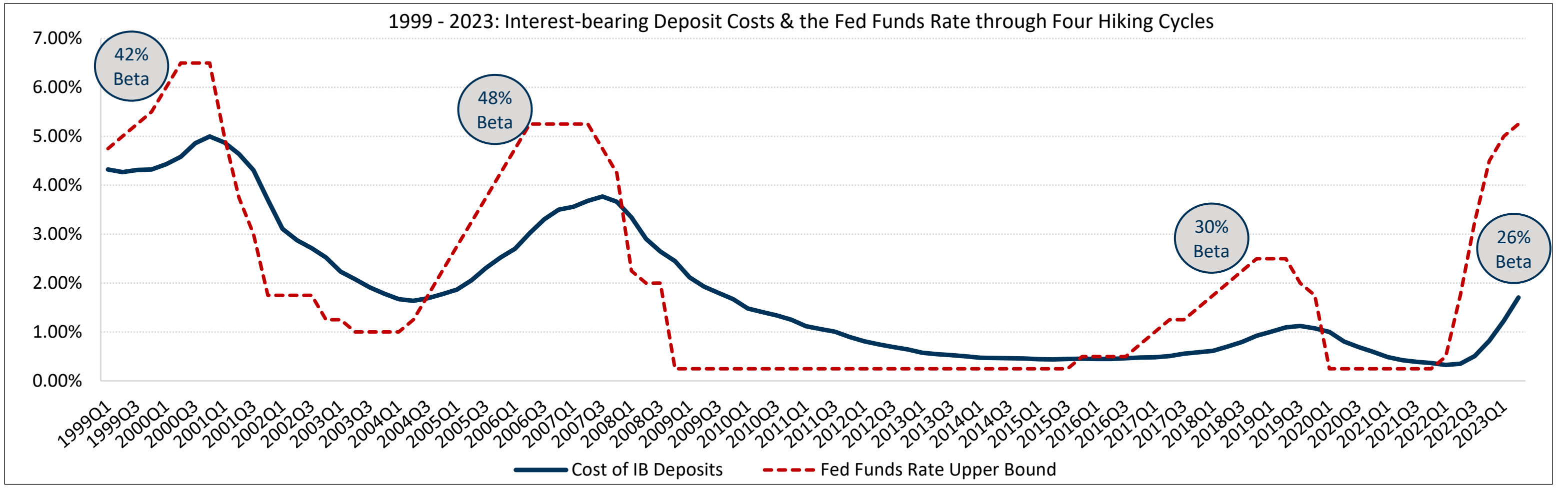
The shift into higher-yielding maturity deposit accounts and increased use of wholesale funds are contributing to margin compression.

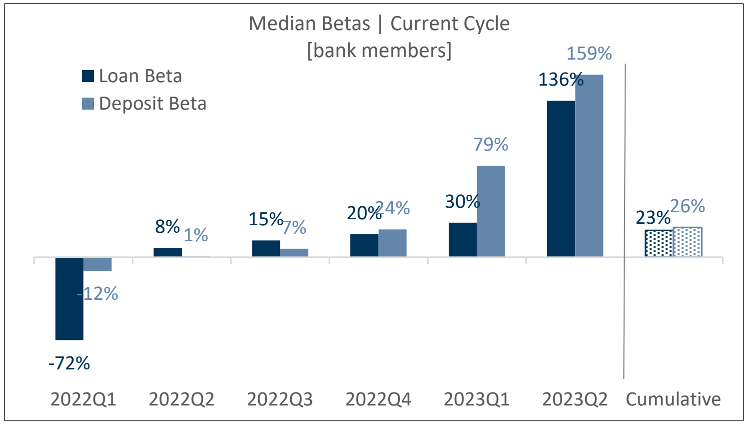
To date, asset yields have failed to keep pace with the growth in funding costs, adding yet another layer to a challenging margin and earnings outlook.





Bank Deposit Betas Accelerate … With Room to Run





Higher rate offerings on both standard accounts and special promos has led to a rapid increase in the median deposit beta for members over the past two quarters.

The shift in deposit composition is reflected in higher deposit costs.

If the historical lagging effect in deposit costs in a rising rate environment holds true through the current cycle, expect costs to move upward, even after the Fed stops tightening.

Note: Bank members only.

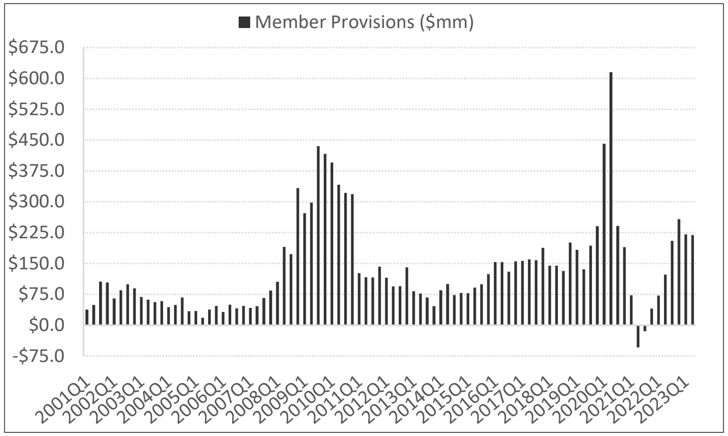
In Reserve Build Mode Even as Strong Asset Quality Persists

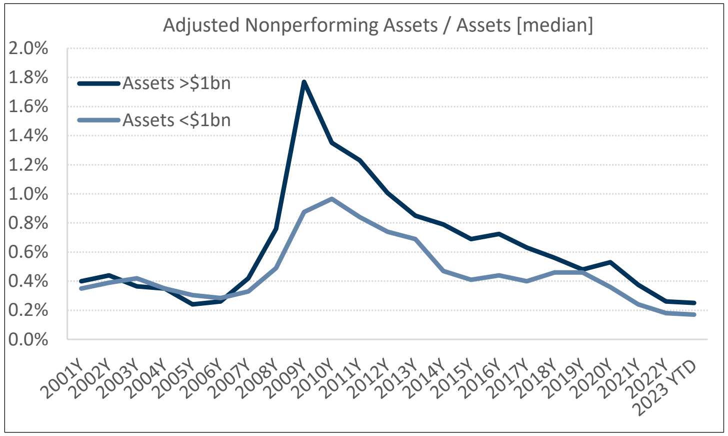
About half of our District members recorded provision expense in the second quarter, while the other half recorded no provision.

Some continued to build reserves as credit containment concerns linger, despite resilient asset quality positions.

After ten consecutive quarters of declining aggregate adjusted nonperforming assets, the District balance of adjusted nonperforming assets reversed course during the second quarter.

Nonaccruals ticked up in 1-4 family residential and ag production loans. Net charge-offs are on the rise – mostly within C&I, credit card and other consumer (e.g., cars) loan portfolios.





Note: Adjusted nonperforming assets excludes U.S. government guaranteed portion of nonaccrual loans.

Q2 2023 Credit Union Trends

Graphs and Charts

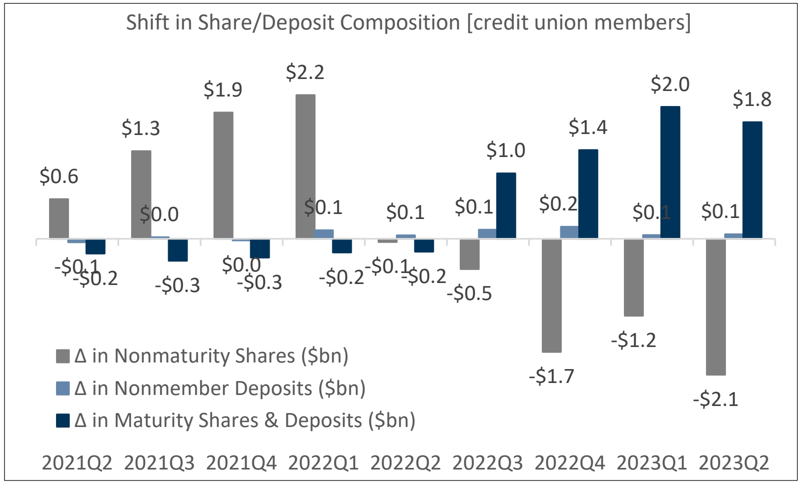
Migration of Shares/Deposits in Pursuit of Higher Rates

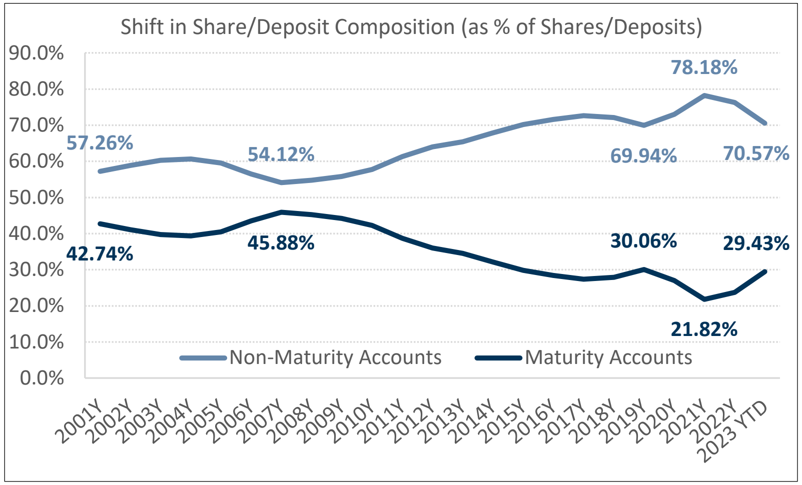
Share/deposit mix is evolving at member credit unions with share certificate balances growing over 70% since the Fed began raising rates in 1Q22.

Share/deposit growth has been stagnant over the past several quarters. In fact, the overwhelming majority of credit union members saw an outflow of shares/deposits in the second quarter.

Many institutions are focused on retaining existing shares/deposits – playing defense against attractive yields in money market funds and other investment alternatives, such as the Treasury market.

Consumers are shifting their allocation of money and/or spending cash reserves built up throughout the pandemic.



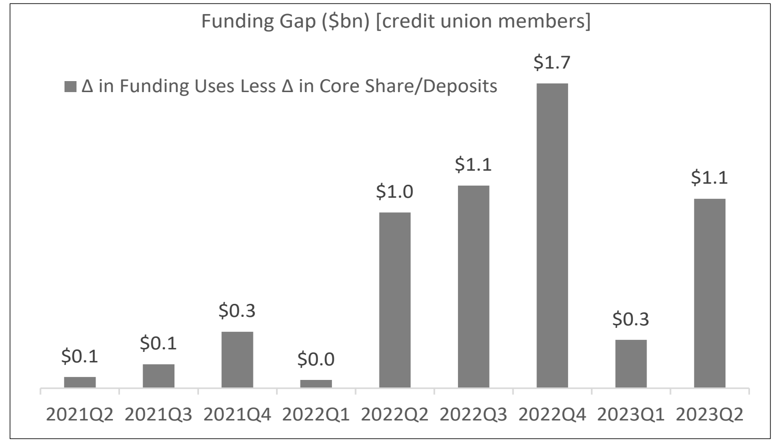


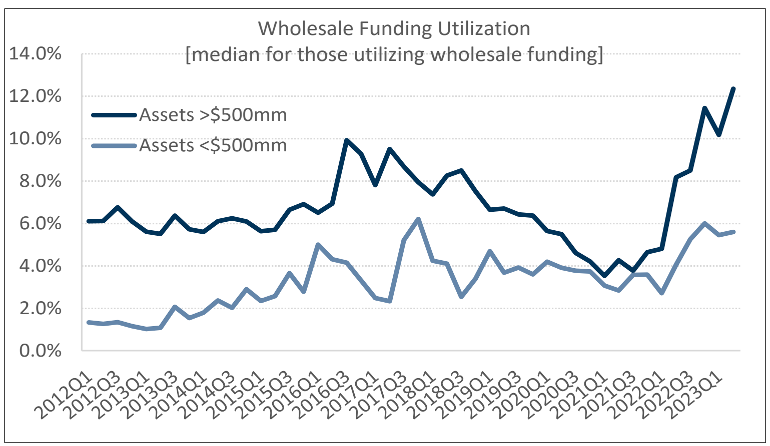
Advance Utilization Remains Elevated

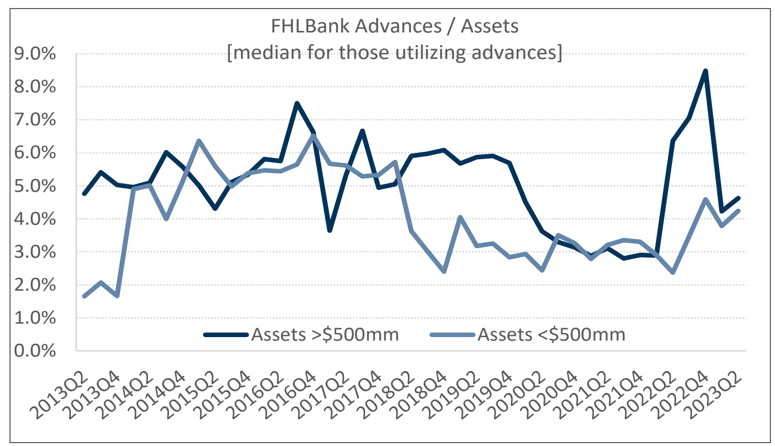
An elevated funding gap has led to increased reliance on wholesale funding sources to help supplement asset growth over the past several quarters.

FHLBank advances continue to be the primary source of wholesale funding for member credit unions, although the BTFP has emerged as temporary alternative source.

Nearly 60% of credit union members are utilizing advance funding, a record high.







Note: Core shares = total shares/deposits less nonmember deposits

Note: Wholesale funding utilization = (total borrowings + nonmember deposits) / (total borrowings + total shares/deposits)

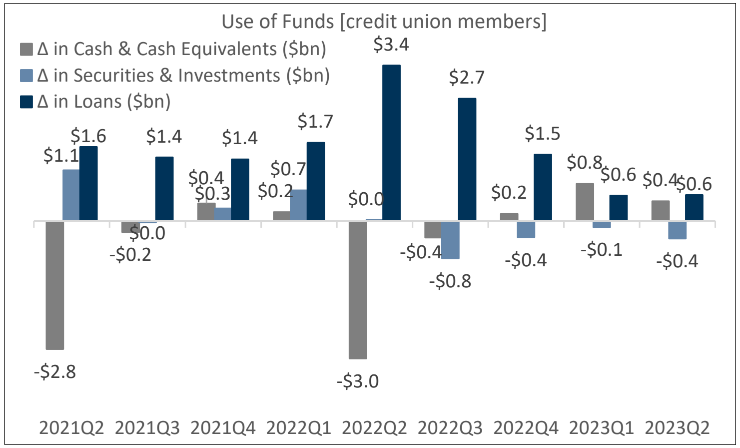
Liquidity Continues Downward Trend

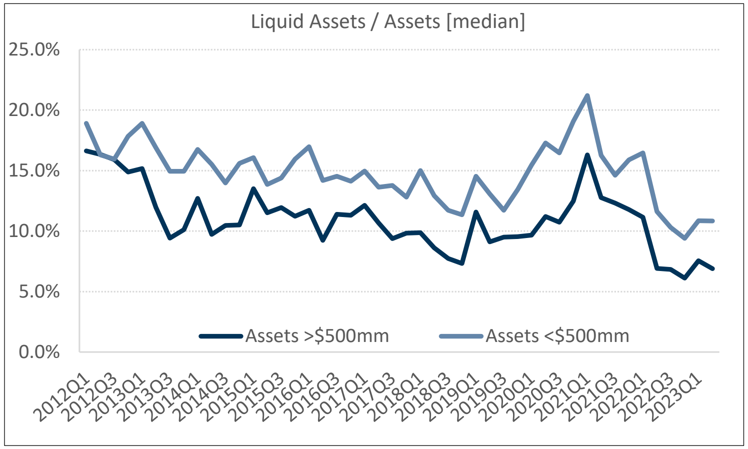
Loan growth ticked up quarter-over-quarter, led by commercial lending and junior lien/HELOC lending.

Commercial lending continues to be a strong lending space, growing over 20% year-over-year.

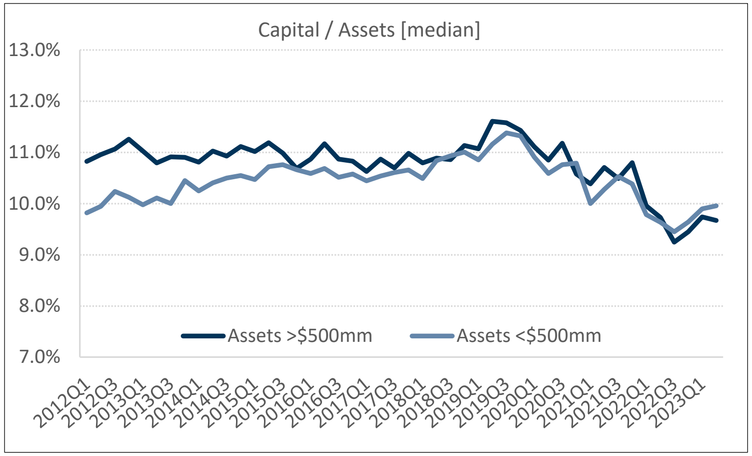
Loan and security pledging activity jumped following the Q1 bank failures as members looked to shore up access to alternative funding sources should an unexpected liquidity need arise.

A slight increase in cash was offset by a decline in securities and growth in pledged assets, resulting in falling liquidity positions for most members.





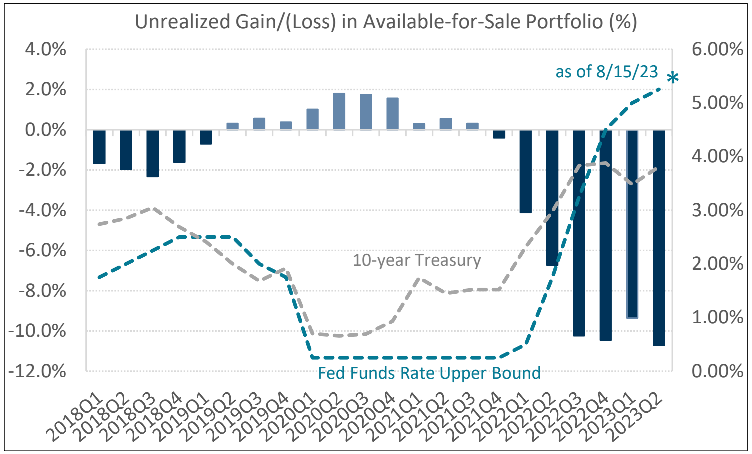
Capital Positions Stable But Remain Under Pressure

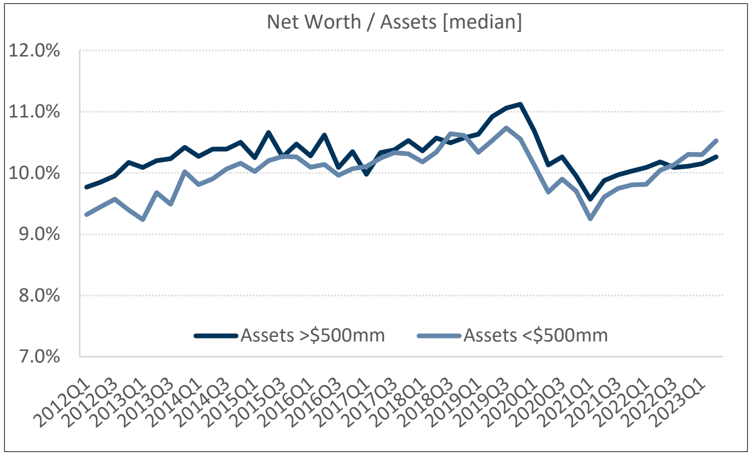


The rate outlook of "higher for longer" to keep pressure on capital with underwater security portfolios.

Volatility late in the second quarter pushed market rates higher, erasing some of the improvement seen in member unrealized loss positions.

Net worth and risk-based capital positions remain healthy and well-capitalized.





Margins Rebound as Funding Costs Lag

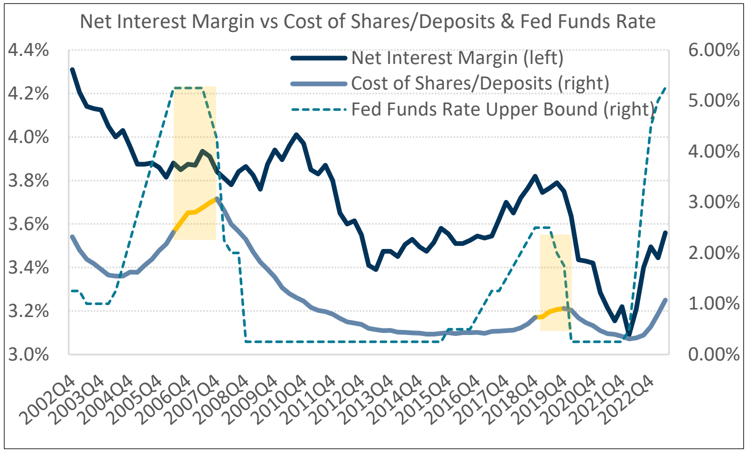
Margins expanded at a rapid pace early in the rate cycle – primarily due to strong loan growth – but have not yet returned to pre-pandemic levels (dark blue line).

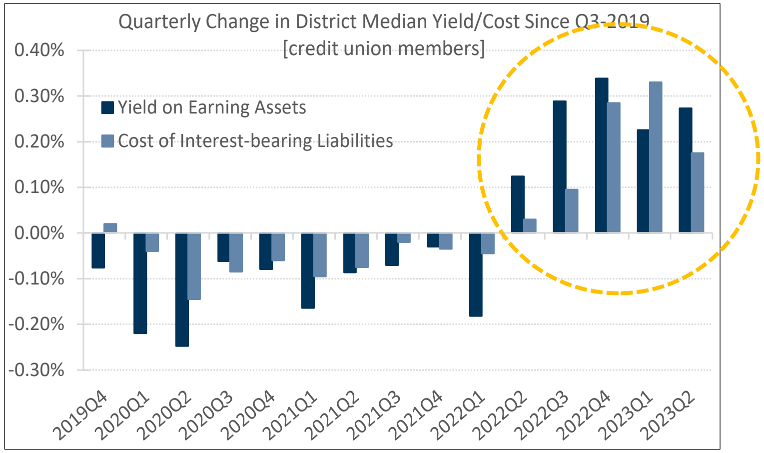
Credit unions are benefiting from asset yields repricing up.

Share/deposit pricing pressure amplified by competition, both among financial institutions and with investment alternatives outside the banking system, has driven funding costs higher (light blue line).

The yellow shading below, illustrates the historic lagging effect seen over the past two rate cycles when share/deposit costs continue to rise even after the Fed funds rate has peaked.

The shift into higher-yielding maturity share/deposit accounts, increase in rate offerings and growth in wholesale funding use will keep upward pressure on funding costs.





In Reserve Build Mode Even as Strong Asset Quality Persists

Nearly all District members recorded provision expense in the second quarter.

Reserves on the rise as credit containment concerns linger, despite resilient asset quality positions.

Although nonperforming assets as a percent of assets remains historically low, aggregate balances pushed to new multi-decade high.

The rise in delinquencies are mostly attributed to used vehicle loans, and to a lesser extent, first lien 1-4 family and new vehicle loans.