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Checking In on the Banking Industry

2020 was a year of challenges in many aspects of life, business, and the economy. The start of 2021 brought a close to a tumultuous year and opened the door to a year of economic recovery and a hope for more normal times. In March 2020, the banking industry was rocked when the Fed funds rate was cut down to zero at an unprecedented speed and Treasury yields tumbled to all-time lows. Additionally, the massive influx of stimulus related deposits that flowed into the banking system greatly changed the size and structure of balance sheets. As a former bank examiner, I am taking a chapter from my previous regulatory career by looking at the banking industry as it relates to the Uniform Financial Institutions Rating System and its six components, known as CAMELS.

Capital – A wise person once told me that capital cures a lot of ills. While this statement is very true, not properly leveraging your capital may leave some additional earnings and shareholder returns on the table. Before the pandemic hit, leverage ratios were very strong with only 14 banks on the "less than well capitalized" list. For the most part, leverage ratios haven't been stressed in the traditional sense with loan losses; however, many institutions have seen a reduction in their leverage ratios as asset growth has greatly outpaced capital growth. Additional pressure on leverage ratios could continue throughout 2021.

Asset Quality – This is likely the biggest unknown of all the components. When the COVID-19 pandemic forced many states to shut down to varying magnitudes, many businesses struggled and millions lost their jobs. As we continue the second half of 2021, the delta variant is pushing its way throughout the country, but in general, we haven't seen massive asset quality problems materialize. Asset quality is likely to vary greatly from bank to bank and region to region. Some institutions have more exposure to the most hard-hit industries while others have little to no exposure. We do know that extensions, deferrals, and government stimulus have propped up some businesses and kept loans from going bust. Time will tell which businesses and customers will be able to get back on their feet and which won't.

Management – Management is easily the most subjective component of all the CAMELS components. Bank management has been extra busy with the many challenges being thrown their way due to the pandemic. Community banks have continued to shine bright, providing us a friendly reminder of just how important they are to the communities of this country.

Earnings – The industry was riding high in 2018 and 2019 after record years of profitability through expanding net interest margins, low provision expenses, and lower tax rates. However, zero bound short-term interest rates, combined with high levels of low earning cash liquidity, have put margins back under pressure. The average community bank has seen significant margin compression in 2020 and 2021. In 2020, many institutions were aggressive in providing for their allowance for loan losses, given the uncertainty of the economy throughout the year. Going forward, many predict low interest rates are here to stay; therefore, some level of margin compression will likely continue. Many banks are likely well reserved against future loan losses, and the absence of more near-term provision expenses will be welcomed.

Liquidity – Higher loan-to-deposit ratios and less on-balance sheet liquidity was the consistent theme for many institutions over the last several years; however, the pandemic quickly changed

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that theme. A combination of massive government stimulus via direct payments and the PPP loan program, coupled with higher personal savings rates and a flight to quality, boosted the industry's deposit base and overall liquidity picture extremely fast. Institutions are now flush with more liquidity than they have been in years and this excess liquidity doesn't seem to be going away anytime soon. Having excess on balance sheet liquidity 18 months ago was generally a good thing as loan demand was consistently outpacing deposit growth. The pandemic has completely flipped that narrative. Excess liquidity is now the enemy with short term interest rates near zero and a lack loan demand (outside of PPP loans) plaguing the industry.

Sensitivity to Market Risk – Once the financial crisis sent short term rate to zero, most bank examiners tended to associate interest rate risk only if interest rates increased. However, the pandemic quickly reminded us that most banks perform better when interest rates rise. During a rising rate environment, the economy experiences growth and expansion and margins tend to expand due to stronger loan demand, higher loan and bond yields, as well as deposit costs that lag market rates. Institutions spent most of the last decade preparing their balance sheets for rising interest rates; therefore, they were not as well prepared for the pandemic-induced zero interest rate environment. Margins contracted hard and fast in 2020 and are currently at historic lows. Today, the vast majority of institutions are well positioned for rising interest rates as their stockpiles of short-term liquidity have pushed them even further asset-sensitive than before. As we find ourselves near historically low interest rates, we must remind ourselves that the risk of rates not rising is a risk not to ignore.

Bank balance sheets have been dealt a tough hand with all the deposits flowing into the banking system at historically low interest rates. Community banks have once again shown their resiliency during tough times and will continue to push forward.

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