PMA®

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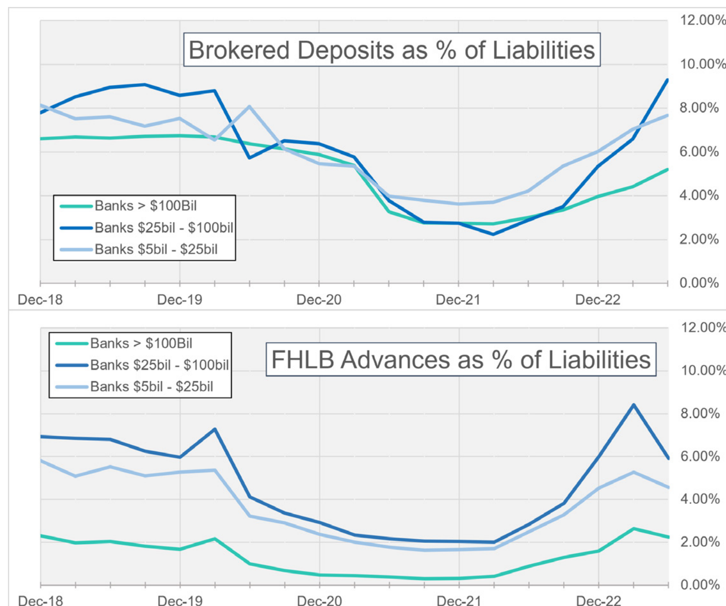
# Credit Update:
## Deposit Volatility Wanes but Funding Costs Still Pressuring Banks

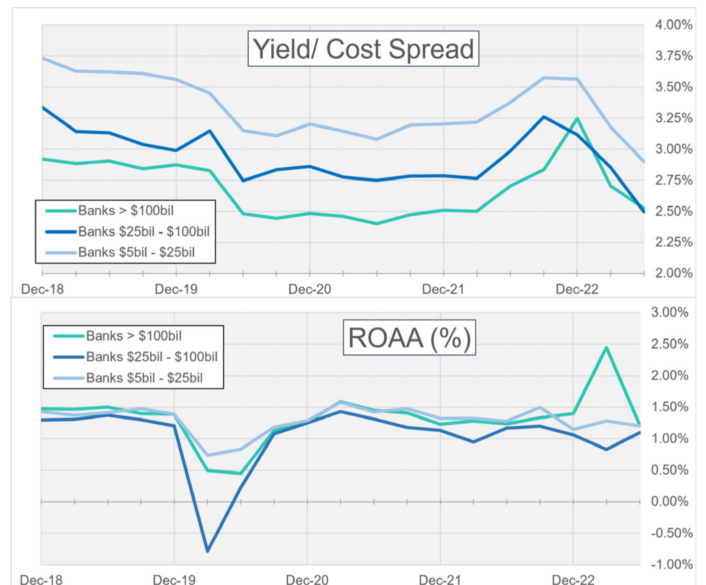
Over a decade of low short-term rates led to complacency for depositors and banks with respect to deposits. The deposit crisis of March 2023 alerted the broader market to the slow burn of core deposits – outflows that preceded the frenzy – either slowly getting reallocated to higher yielding money markets or customers spending down saved stimulus. Silicon Valley Bank's collapse reminded everyone that core deposits can experience outflows and become more costly for banks.

While solvency and liquidity concerns subsided in 2Q23, competition for deposits persisted. Regional banks continue to feel the brunt of the blow as they have raised large size deposits but lack the "too big to fail" status of the nation's largest banks. Compared to community banks, regional banks may not enjoy the degree of local commitment from depositors. In addition, the regionals have a greater reliance on loan growth and spreads than the largest money center banks who have scale and better revenue diversification into fee-based activity.

Core deposits continued to flow out from banks of all sizes into money market funds during 2Q23 ($220 billion asset increase in money market funds for the quarter), which has forced banks to increase reliance on costlier wholesale funding. Non-core funding ticked up again, this time 3.3% quarter-over-quarter to 15.7% of total deposits for the larger regionals (between $25 and $100 billion in assets), and the composition shows that these banks spent 2Q23 paying down advances from the Federal Home Loan Banks with brokered deposits. These FHLB advances can act as a reliable lifeline in a liquidity crunch, but they require collateral and tie up capital. While brokered deposits are costly, the shift frees up the FHLB lifeline, and helps the regionals report net deposit growth – at a time when deposit inflows and stability were viewed positively by markets and bank regulators.




The funding base trends we saw in 1Q and 2Q illustrate the sprint to secure liquidity followed by the desire to recalibrate balance sheets based on fresh deposit beta assumptions. The "bank-run" threat has tapered but banks continue to face compressing spreads due to the competitive wholesale funding environment, and decelerating loan growth. Most institutions cut noninterest expenses to help absorb the impact which buoyed return on average assets for 2Q23. Fortunately, there were areas to trim, and likely some additional room to scale back if funding pressures persisted, but this approach is more akin to surviving instead of thriving. The disproportionate impact on regional banks could limit their ability to grow capital and build a cushion against new and amended regulatory thresholds and hurdles.




While there was an initial push to enhance bank regulation, this has quickly faded. One proposal was to increase capital requirements for banks over $100 billion in assets. Such a proposal may be helpful if enacted but it leaves a large portion of the regional banking market with no new regulatory requirements.

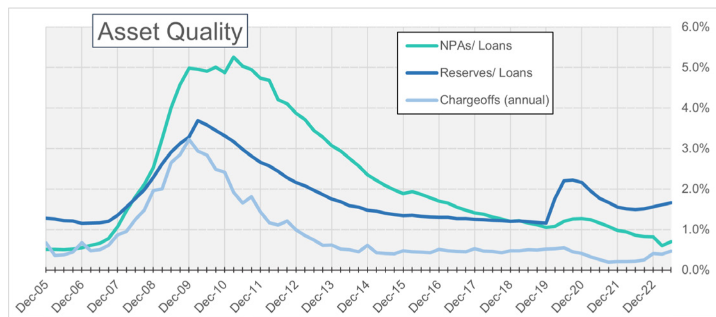
Despite some stakeholders' concerns around effectiveness of such proposals, from a credit investor's perspective, higher capital and reserve requirements are viewed positively.

### Asset Quality & Credit Trends:

Loan quality remains solid with non-performing loans and delinquencies well below historical standards. COVID caused a speed-bump in the decade long trend of improving loan quality, but fiscal and monetary stimulus ultimately provided more than enough capital to stabilize loan portfolios. Rapid monetary tightening, hybrid working environment, geopolitical pressures to name a few will clearly stress some industries and pockets within loan portfolios.

Fortunately, this stress is a product of a fairly routine credit cycle. Several of the previous economic slowdowns were a result of asset bubbles and exogenous factors that were greater shocks to the system. Additionally, the pandemic proved to be a good test run for banks to scrub their loan books and increase reserves where needed. Borrowers deserve some credit as well. Managing rising interest costs probably feels like a walk in the park after contending with supply chain constraints and labor shortages through the pandemic.

We would expect delinquencies to rise in the near term as higher rates start to shake loose less efficient borrowers and projects. While we haven't seen asset quality materially deteriorate yet, we do see banks preparing for a turning of the tide by increasing loan loss reserves (see below) and frequently using the phrase "asset quality normalization" during earnings calls which suggests increasing charge-offs are just reverting back to the mean after artificially low levels post-stimulus. "Normalization" is a fair description but it's also fair to imagine that dramatically higher rates and tighter lending standards will take a toll on bank asset quality. It is too early to assess the impact and trend with conviction but worthy of carefully monitoring in the coming quarters.




Commercial real estate (CRE), specifically office space, continues to receive a lot of attention given the stress caused by a hybrid working environment. It's worth noting that most banks historically have limited their exposure to this segment, opting to syndicate or securitize excess loan production. S&P took ratings action in August 2023 on several institutions – office CRE exposure was a significant factor in this evaluation along with funding cost pressures – and highlighted the fact that only a select few banks are potentially overexposed. Most larger regionals and money center banks have between 1 – 10% of their total loan portfolio allocated to office CRE limiting refinance and default risk over the coming years. Office exposure will be a headwind for some banks and remains a valid concern; however, the hype is likely overdone and doesn't appear to present a systemic risk to the banking industry.

## The PMA Credit Research Process

The PMA Credit Process includes four steps which begin with gathering data and analyzing a bank's credit quality and continues with ongoing risk management throughout the life of a holding. The process helps public funds investors avoid repayment, reinvestment and reputation risk that may be associated with a bank failure.

### Step 1: Gather Bank Data

The process begins with gathering bank, industry and economic data from an extensive list of sources. Industry tools like Bloomberg, S&P Global Market Intelligence and regulatory filings are utilized in obtaining data and other relevant information. Additionally, a number of publications focusing on the banking industry and local and national economy are monitored daily.

### Step 2: Analyze Data

We use proprietary models to assess industry trends and help isolate institutions that may be out-of-step with peers or disproportionately affected by changes in the current operating environment. We routinely meet with bank management to discuss operating results, trends, and uncover insights that may not be apparent in financials.

### Step 3: Assign PMA Rating and Concentration Limits

After all of the data has been gathered and analyzed, each bank is rated on a scale of 1 to 5 (with 1 being the highest and 5 being the lowest). Deposit limits such as day limits on the term for an individual deposit and aggregate dollar limits on deposits per bank are also applied.

### Step 4: Ongoing Risk Management

Risk management procedures include deposit restrictions and collateral requirements. PMA's Credit Committee, which includes members of PMA's senior management, meets formally on a quarterly basis, to review credit reports and recommendations for PMA Ratings and deposit limits. PMA actively manages and adjusts bank's ratings and deposit limits throughout the life of the deposit.

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