FIG in Focus

Volume 9 / January 2024

Welcome to FIG in Focus

This newsletter is part of Adeva Partners continuous learning platform.

Things to watch out for in **Bank Credit** in **2024**

CLICK BELOW TO ACCESS EACH ARTICLE

With 2024 just getting under way, the Adeva Financial Institutions team put our heads together to come up with what we see as the key trends impacting bank credit in **2024**.

In this issue, we identify the following four areas:

- **Securities valuations** will ease and reduce pressure on equity.
- **Bank net interest margins (NIM)** are close to peaking.
- **Consumer credit** is weakening and will impact earnings sooner rather than later.
- **Commercial real estate losses** could be devastating for over-exposed banks.

Disclaimer: Our training is designed to equip participants to make their own credit judgements. In this issue we have made some predictions of our own based on information provided in public disclosures. The opinions expressed are those of the writer and should not be used as a basis for taking a lending or investment decision

ADEVA TRAINING AND CONSULTING

Securities valuations will ease and reduce pressure on equity

The good news first!...

In 2022 and 2023 stocks of government bonds held for liquidity under available for sale/fair value through other comprehensive income negatively impacted capital due to the positive duration of these securities. This was most famously the cause of the failure of Silicon Valley Bank in March 2023, although many other banks have suffered substantial unrealised losses on securities portfolios.

With the yield curves of virtually all major currencies, except JPY and CNY, and showing strong inversion, we would expect falling rates over 2024 to be positive for fixed income security valuation, reducing the unrealised losses which many banks are now carrying in their equity reserves.

Bank net interest margins (NIM) are close to peaking

Bank NIM's have improved strongly since the Pandemic, not least because of policy rate increases over the past eighteen months. However, as discussed above, with yield curves now inverted, profitable intermediation is increasingly challenging at the margin with short-term interest rates exceeding long-term.

Pressure on NIM will also likely be caused by intense competition for swap-priced products such as mortgages, customer optionality continuing to raise the cost of deposits, and a reduction of lending appetite in higher risk premium sectors.

Consumer credit is weakening and will impact earnings sooner rather than later

From record lows in the Pandemic era, partly resulting from debt forbearance measures, consumer credit has been steadily deteriorating since mid-2021. In the UK owner occupier mortgages in arrears rose by 19% in the 12 months to Q3 2023. For buy to lets the equivalent increase was 100%.

In the USA, data from the St. Louis Federal Reserve shows US bank consumer loan delinquencies increased by one third over the preceding 12 months and no sign of peaking yet.

Continued.../

With new accounting standards now in place in requiring banks to make higher loan-loss allowances on distressed loans, this could impact earnings and capital earlier than in previous cycles.

To put things in historical perspective, the most recent rise only puts US consumer delinquencies at 2.55%, roughly where they were going into the Pandemic in Q1 2020. In 2009, US consumer delinquencies peaked at just under 5%, so there is a way to go yet, but the pressure on consumers from rising prices, taxes and debt service through higher rates is unlikely to slow the upward trend in the near term.

We will revisit this topic in the near future, based on 2023 year-end data.

Commercial real estate losses could be devastating for over-exposed banks

Rising interest rates and post-Pandemic working patterns threaten to resurrect one of the most ancient of bank bogey-men, the commercial real estate sector.

Recently published research by the US National Bureau of Economic Research (NBER) showed that this was particularly acute in the office sector, where loan by loan analysis showed that 56% of loans exceeded 80% Loan to Value (the maximum level at which they are typically deemed able to be refinanced without sponsor equity injections). The vast majority of these loans were already in excess of the property value, with anecdotal evidence suggesting that secondary properties in many locations are ‘competitively obsolete’ due to post-Pandemic working patterns.

The NBER report went on to apply the real estate stress to the balance sheets of the bank lenders. It estimated that the 20% CRE default rate seen in the aftermath of the 2008 Financial Crisis could wipe out the capital of almost 500 small to medium US banks. Whilst 20% defaults may be on the pessimistic side, the failure of First Republic Bank in May last year shows the risk to banks with both an over-exposure to commercial real estate lending and a volatile deposit base.

Author: **Andrew Berry**

Would you like to hear more Adeva Partners?
Join our FIG in Focus newsletter, follow us on LinkedIn or scan here