ALM FIRST
for a partnership built on trust.

ASK ALM FIRST

January 2019

Alec Hollis
Director, ALM Strategy Group

What risks should my depository be focused on in 2019?

Financial depositories should avoid complacency in 2019 and keep liquidity, repricing, and interest-rate risk in mind despite strong performance in 2018. Widening net interest margins (NIMs), along with tax cuts for banks, led to record profits for financial institutions in 2018, as the most recently available data below show.

Quarter Ended	Credit Unions			Commercial Banks		
($,000,000)	Sep 30, 18	Jun 30, 18	Sep 30, 17	Sep 30, 18	Jun 30, 18	Sep 30, 17
Profitability Ratios						
Return on Assets (ROA)	1.02	0.89	0.81	1.42	1.41	1.12
Return on Equity (ROE)	9.52	8.49	7.61	12.51	12.42	9.82
Net Interest Margin	3.58	3.51	3.43	3.35	3.32	3.19
Earnings						
Net Interest Income	$11,544	$11,126	$10,399	$126,424	$124,744	$116,950
Operating Revenue	$16,652	$16,070	$15,066	$190,113	$191,973	$176,112
Net Income	$3,692	$3,221	$2,774	$58,206	$57,287	$44,489
Balance Sheet						
Total Assets	$1,457,083	$1,446,366	$1,379,990	$16,502,524	$16,388,909	$16,077,618
Total Loans & Leases	$1,037,423	$1,013,134	$947,500	$9,273,784	$9,206,216	$8,860,282
Total Loans / Assets	71.20	70.05	68.66	56.20	56.17	55.11
Total Loans / Deposits	84.83	82.89	81.34	73.31	73.29	72.00
Net W / Tang. E Ratio	11.22	11.02	10.90	9.45	9.46	9.49
Asset Quality						
Net Charge-Offs / Avg Loans	0.55	0.61	0.55	0.43	0.46	0.45
Delinquent Loans / Loans	0.67	0.67	0.79	0.98	1.03	1.17
PLL / Avg Assets	0.44	0.47	0.52	0.25	0.26	0.30
Reserves / Gross Loans	0.88	0.91	0.92	1.22	1.23	1.27
Other						
Cost of Funds	0.79	0.71	0.64	0.86	0.75	0.53
Efficiency Ratio	68.27	69.35	69.73	55.06	55.52	55.79
Noninterest Expense Ratio	3.13	3.10	3.06	2.60	2.66	2.53

The U.S. depository system experienced growth in profitability towards the end of 2018, benefitting from widening net interest margins and declining provisions for loan losses relative to average assets. ROA and ROE for both commercial banks and credit unions were at the highest levels in years. Total net income and net interest income saw notable increases as well.

Balance sheet growth continued, as credit union total assets surpassed $1.45 trillion and total commercial bank assets surpassed $16.50 trillion. Loan growth was strong, pushing average loan-to-deposit ratios to 84.83% and 73.31% for credit unions and banks, respectively.

Capitalization remains at a robust level, with average net worth ranging from 9.45% of assets for banks to 11.22% of assets for credit unions.

Key Risks to Consider

Net income for the industry expanded to a historically high figure, led primarily by net interest income, but also by lower net charge-offs and provisioning expenses. Loan volume was persistently strong, with liquidity becoming a primary risk target for some institutions, as deposit growth plateaued after years of cyclical growth.

Liquidity in the Limelight

While financial institutions experienced nice increases in their NIMs, much of this is attributed to increasing allocation to credit-risky loans as opposed to favorable changes in repricing. Overall, loan balances have increased more quickly than deposits. A significant portion of the increase in loans was funded with non-deposit funding. This persistent loan growth has pushed the industry allocation to loans much higher, thus leading to healthy increases in yield on earning assets.
This trend has resulted in discussions around how to fund marginal loan growth without the steady inflow of deposits that characterized the previous decade. An obvious (perhaps too obvious) answer to strong loan demand might be to stem the flow by hiking loan offer rates. However, it is understandable that many depositories would like to avoid turning away valuable business relationships.

Another clear avenue for funding marginal loan growth is wholesale funding and leveraging. The financial services industry has certainly tapped this source over the last year, and this in part is what puts regulators on alert for liquidity risk signals. If loan growth continues, more and more depositories will need to either leverage or shed assets and loan sales might become a much higher priority, something we have helped financial institutions accomplish at ALM First.

Repricing and Interest Rate Risk

As discussed above, favorable repricing is only a small part of the story for the NIM increases. For credit unions, who saw loan yields increase only 16 basis points (bps) relative to a 15 bps increase in cost-of-funds (COF) year-over-year, 94% of the increase in loan yield was matched with COF increases. Commercial banks, on the other hand, saw a 46 bp rise in loan yield with a 33 bp increase in COF; thus, 72% of the bank increase in loan yield was matched with COF increases.

The impact to deposits due to higher interest rates is still unfolding and represents a key risk to depositories. Historically, deposit costs maintained a much higher correlation with short-term market rates. As discussed widely, this correlation is far lower in this current tightening cycle. Should deposit rates respond according to historical relationships, NIMs could tighten as quickly as they widened. Since deposit betas are beginning to rise, testing the sensitivity of earnings, economic value, and liquidity to changes in depositor behavior remains an important and timely exercise.