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iFlow

SHORT THOUGHTS

February 20, 2024

Smaller US Banks In The Spotlight

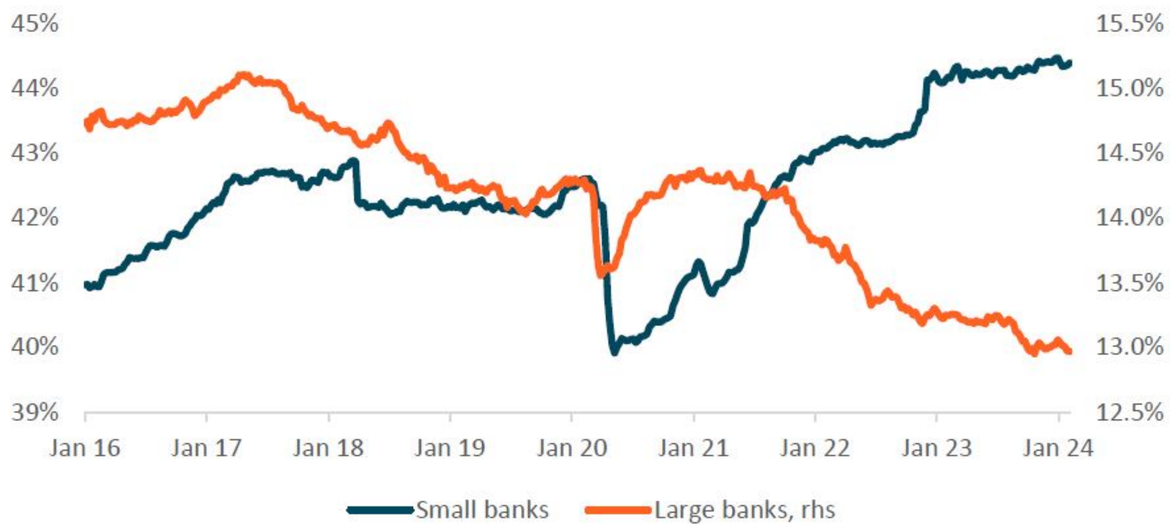
Exposure To CRE, Small Businesses Weigh On Profitability

- Smaller banks' CRE exposure more than 3 times higher than large banks' exposure
- Small banks' loan growth (to mostly small- and medium-size businesses) almost nil
- The above have implications for the real economy and bank profitability

Commercial real estate (CRE) risk in the United States is mainly borne by smaller US banks. Smaller banks in the Federal Reserve’s taxonomy include those banks not among the 25 largest commercial banks in the US, ranked by assets. If CRE risks materialize this year, these smaller – mostly regional – lenders will likely bear the brunt of the fallout. We see this as one reason why the KBW Regional Banks Index has been underperforming the broader MSCI US Banks index since the regional bank crisis of last March.

Smaller banks’ exposure to CRE loans is around 45% of their total loans, near the highest it has ever been. Larger banks, by contrast, only report about 13% CRE exposure in their loan portfolios. Moreover, the weight of CRE loans in small bank portfolios has increased from 40% right after the depths of the COVID lockdowns, while larger banks have been reducing this proportion significantly over the same period. The chart below illustrates these trends.

Disproportionate Exposure To CRE In Smaller Banks' Loan Portfolios



Source: BNY Mellon Markets, Federal Reserve Board of Governors

A recent paper (December 2023) by the National Bureau of Economic Research assesses CRE risks in the US banking system and calculates that 44% of all office loans display negative equity. The authors calculate that if default rates on CRE loans hit 10% (roughly what was recognized during the GFC), it would result in approximately $80bn in bank loses. This is a sizeable chunk for a system that has already recognized significant mark-to-market losses on asset portfolios generally, mainly as a result of higher interest rates. As a result, the paper argues, “CRE distress can induce anywhere from dozens to over 300 mainly smaller regional banks joining the ranks of banks at risk of solvency runs.”

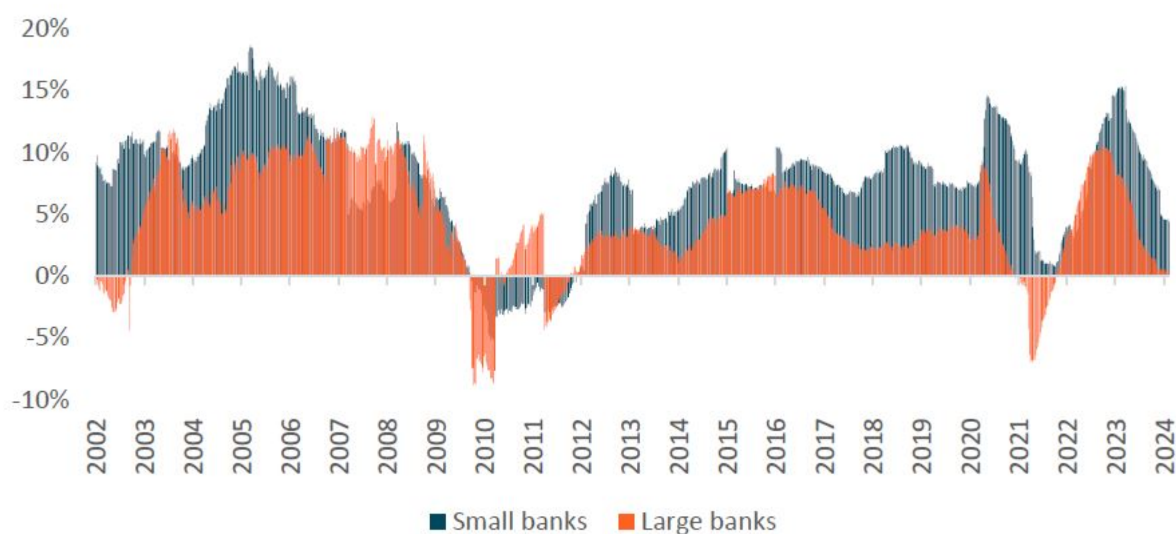
Among other things, including direct effects on bank solvency and liquidity, banks have generally been cutting loan provision across all products, to the point where smaller banks’ annual loan growth through mid-February 2024 is approaching zero. Even banks which may not develop solvency or liquidity concerns have been reducing balance-sheet size, reining in credit provision, and suffering significant profitability concerns. The chart below shows loan growth for both large and small banks for most of the 20th century. Aside from the Global Financial Crisis and the COVID lockdowns, credit growth has never been this weak.

As an aside, this is what we suspect Fed Chair Powell means when he has continually talked about tighter financial conditions as a result of Fed policy over the last two years. In actual fact, financial conditions as measured by traditional financial conditions indices have been loosening since October of last year. We think that when Powell says that conditions have done the opposite of the indices, it’s likely the lending channel to which he is referring.

This has implications – in addition to those for these smaller, CRE-exposed banks – for the real economy as a whole and is a reason we suspect that the economy will slow sufficiently to allow for Fed rate cuts as early as May. Smaller/regional banks also provide most of the

credit to small- and medium-sized business. The most-recent data from the FDIC suggest that banks with less than $250bn in assets account for nearly half of all commercial and industrial lending, so these financing channels appear at risk. Moreover, nearly half of all businesses in the US employ less than 500 people, so the small/regional bank credit channel is disproportionately connected to the real economy.

Credit Growth Slowing - Especially For Small Banks



Source: BNY Mellon Markets, Federal Reserve Board of Governors

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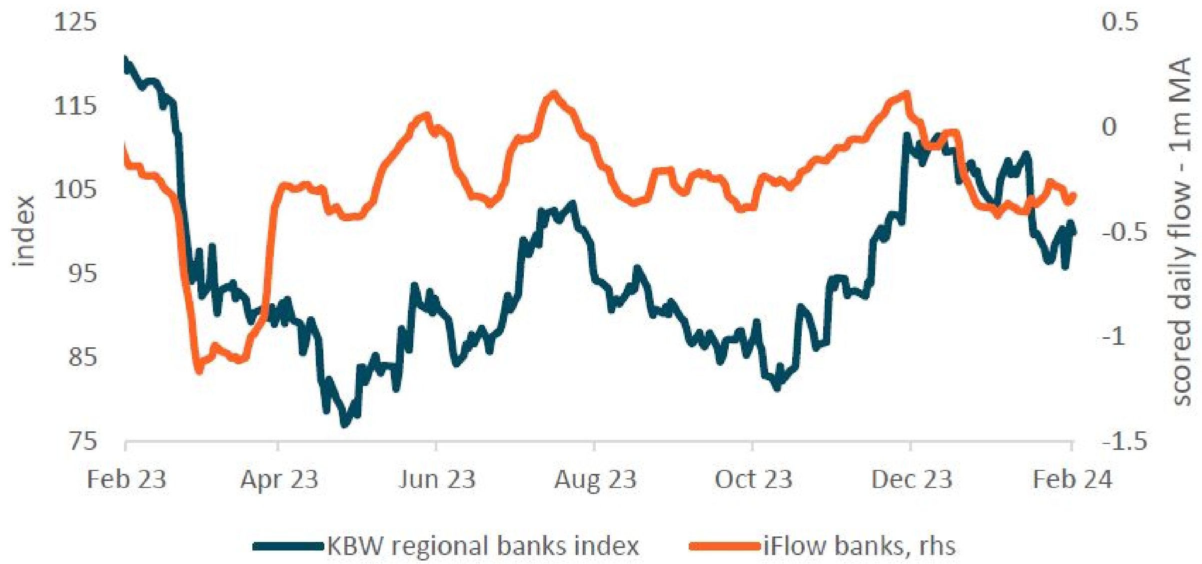
The market seems unwilling to confront these risks. Investment Grade corporate spreads have tightened significantly since the regional banking stresses of last March/April, from as wide as around 175bp in early May 2023 to just 124bp currently. IG bank spreads have narrowed further, from around the same levels as the broader index to just 112bp currently.

Indeed, the real pain for banks has been in the banking sector equity indices, which have barley recovered from the regional banking stresses last year. The KBW Regional Banking Index is down significantly since the beginning of last March, and while it had made tentative steps to retrace higher during the past 12 months, the most recent episode of stress involving NYCB saw it resume its slide. Our iFlow data similarly shows recent demand for stocks in the bank industry also weakening. While this aggregate of our custody flow data includes both large and small lenders in the GICS classification 401010, we find it a good barometer of the faith that real money investors have in lenders, including smaller ones.

Profitability Concerns Weaken Demand For Small Banks



Source: BNY Mellon Markets, Bloomberg, iFlow

Please direct questions or comments to: iFlow@BNYMellon.com

John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN

bnymellon.com

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