Four Threats to Your Profits as Margins and Deposits Shrink

FDIC profitability risk management industry update

Summary: Bank bottom lines have started to slip. The challenge going forward is to maintain favorable results by actively managing risks. We unveil four threats to your profit in the current market and how they're already impacting the banking industry.

In some industries, trends are decided on ahead of time. Take the fashion industry, for instance. Color and fashion trends are set by select committees in the fashion world. One of those committees meets twice a year to discuss color trends with Pantone, a company that supports and manufactures color for a wide variety of industries. Pantone is directly responsible for the color of nearly half of all the clothing sold in the US.

Not all trends are decided ahead of time, however. Some are observed or noted after gathering months' or years' worth of data — particularly in the banking industry. For the financial world, Q1 metrics and trending practices can help predict what impacts on profits financial institutions may face — and how they can protect their profits.

Quarterly Banking Results

Financial institutions continued to show solid profits in the Q2 FDIC quarterly banking profile, published in September, but there are troubling undercurrents. Net interest margin (NIM) and deposits have shrunk and unrealized losses persist. So even though profits looked okay in the latest data dump, financial institutions may be challenged to keep the numbers up, all while avoiding excessive risk in the search for gains.

The challenges continue to be manageable for banks. In comments accompanying the release of the FDIC quarterly banking profiles in September, FDIC Chairman Martin Gruenberg said the banking industry "continues to be resilient." But he also cautioned that FDIC officials were keeping a close watch on trends to see how well financial institutions handled the mounting challenges from inflation, rising interest rates, and market movements — particularly the commercial real estate market.

Community financial institutions (CFIs) look slightly better than the industry as a whole, in terms of net income. There are still reasons for caution, however, as CFIs faced the same pressures as the rest of the industry.

Challenges to Watch Out For

Here are four key pressure points that could impact profits:

1. **Unrealized losses on securities.** This remains one of the thorniest problems facing financial institutions, and it was on the rise in the latest FDIC report. Bonds bought before the rapid rise in interest rates are now worth far less, if cashed in before maturity. Those paper losses aren't necessarily harmful unless there is a run by depositors, such as what happened at Silicon Valley Bank. Those unrealized losses at CFIs rose 9.3% in Q2.
2. **Inflation.** Rising inflation puts pressure on a bank's NIM because it increases the cost of deposits. The squeeze prompts financial institutions to pull back on lending, and that combination cuts into profits. In this

environment, financial institutions must scramble to compete for deposits while also trying to protect profits. Total bank deposits have now declined for five straight quarters, as of the end of Q2, according to the FDIC report.

3. **Commercial lending.** The FDIC continues to monitor impacts on bank portfolios from commercial lending. Although commercial real estate vacancy rates have been high, the non-current loan rate at financial institutions has only ticked up slightly. The small increase has been led by commercial real estate loans. Profitable commercial lending is a driver of CFI profits, so keeping a close eye on these loans and striving to work with borrowers could be increasingly important for CFIs.
4. **Expenses.** Non-interest expenses rose slightly in the report. Financial institutions, like other businesses, are seeing a rise in all manner of business expenses, including salaries and benefits. Being aggressive with expense control should be a key goal during a period of rising inflation.

The banking industry has continued to perform relatively well throughout a challenging year. However, potential market risks are lurking, and CFIs will need to monitor these trends and create strategies to circumvent any threats and protect profits.

ACHIEVE 360-DEGREE CUSTOMER RELATIONSHIP VIEW

ECONOMY & RATES

Rates As Of: 11/14/2023 05:40AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.55	-0.04	1.13
6M	5.48	-0.06	0.72
1Y	5.27	-0.17	0.56
2Y	4.90	-0.19	0.47
5Y	4.51	-0.34	0.51
10Y	4.51	-0.43	0.63
30Y	4.66	-0.44	0.69

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.32	8.50	5.32