MARKET OBSERVATIONS
APRIL 2023

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Banking

Banking is a core activity in the economy and in financial markets, receiving deposits, making loans and investing. Banking supports immediate and future business activities and basic consumer needs of housing, vehicles and education. The banking system has evolved through the disintermediation of the 1970s, the S&L crisis of the 1980s, the housing implosion of the Great Recession and the zero-interest-rate-policy of the 2000s. Higher interest rates have bolstered banks in the past. But the recent rapid rise in rates along with technology-enhanced money transfers revealed new risks from an old source. A review of trends in banking can provide perspective for economic activity and investing ahead.

PERSPECTIVE

While lending is a primary banking activity, investing in high quality bond investments is important as well. Chart I shows the mix between lending and investing over the recent past. Across this period, bank investments in U.S. Treasury and federal agency bonds averaged 21% with a low of 14% in mid-2008 during the mortgage lending boom and an early-2022 high of 30%. This level resulted from a 50% increase in investments in less than two years. Lending in that same period increased less than +1%. Unfortunately, the highest exposure to bonds coincided with the launch of a Federal Reserve policy that resulted in the most rapid interest rate increase in decades. With rapidly rising rates came dramatically falling values for existing bonds.

Banks can carry some investments at cost until they are sold. Whether triggered by better return opportunities or liquidity concerns, excessive and abrupt withdrawals of deposits forced bank bond sales in the first quarter of 2023. Whether sold or not, the reality of falling bond prices from higher interest rates was fully exposed. Chart II shows the magnitude of price declines for a range of U.S. Treasury bond maturities over this period of rising rates. Also shown is the bank common equity capital ratio at the start of this period. While the decline in value of a 3-year maturity Treasury was meaningful, such an exposure did not threaten equity capital. The decline in value of a 10-year maturity equaled equity capital and a 30-year maturity exceeded it by 2-to-1.

With pressure from deposit outflows and falling bond values, bankers were forced to look more closely at their loan portfolios. Did the assumptions underlying existing loans remain sound? Was there any meaningful change in loan delinquencies? What is the impact on existing borrowers from rising interest rates and/or a curtailment of the amount of available lending? Chart III shows the trend in bank lending standards over time. Whether causal or not, there is a clear correlation between the tightening of lending standards and the shaded periods of economic recession. Lending standards have tightened as rapidly as interest rates have risen, and have reached a cautionary level.

INVESTMENT IMPLICATIONS

The pursuit of lower inflation through higher interest rates has come at the cost of reduced portfolio values, while accompanying recession uncertainty continues. Rising interest rates have impacted institutions and individuals alike. Risk-taking is inherent in both lending and investing. A clear understanding of and tolerance for risks taken is essential. Whether for bank lending or personal investing, a range of risks must be managed if financial goals are to be achieved over desired time horizons.

CHART I

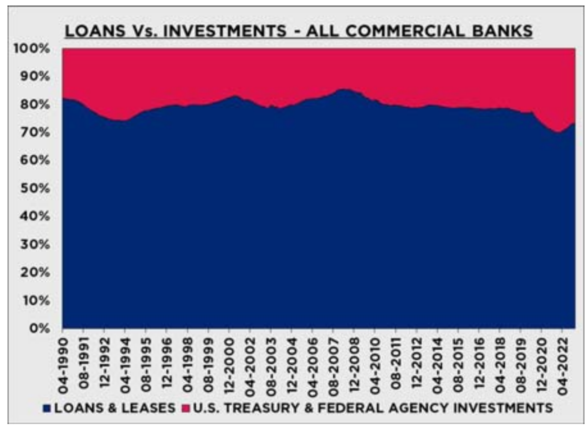

CHART II

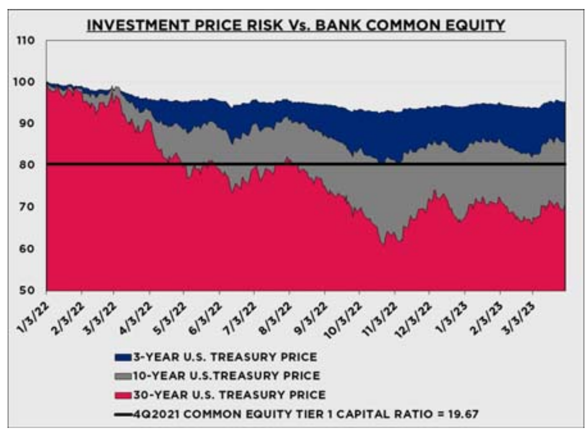

CHART III