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Banking Challenges for 2023

There is currently a wide range in the outlook for the 2023 U.S. economy which translates into many uncertainties and challenges for bank performance. We believe it is useful to outline and highlight five of them below.

Virtually all of these, in one way or another, hinge on the course of inflation and the corresponding monetary response of the Federal Reserve. Hence, the monthly rollout of CPI data should be critically watched for signs of relief or concerns.

The outcome should narrow considerably during the first half of the year. Bank earnings calls in January with their forward, 2023 guidance, will likely attract investor questions on the following five issues.

Margin Management: Revenue growth will eventually become an uphill battle for banks when the Fed stops raising rates, which is likely sometime in 2023. When and at what level are still open for discussion. Net interest margin expansion in 2022 dramatically helped drive net interest income to unprecedented levels from rising rates. It is helpful to frame margin outlook in three phases.

Phase One is the current period of Fed Policy Rate increases that will eventually end in a pause to allow the cumulative effect of higher rates to influence basic economic demand and hopefully further attenuate core inflation. The consensus on that rate peak is probably in the vicinity of 5%, suggesting timing during the first quarter of 2023. The remainder of Phase One should further widen net interest margins but at a decelerating pace as deposit costs advance further, eating into the net effect of higher loan yields.

Phase Two will be the period of plateau without further hikes as the cumulative rate increases have had ample time for impact, as the Fed recognizes the considerable lag expected between rate tightening and the impact on inflation. The Fed has made it abundantly clear that this pause is the wisest course to prevent overreach in high rates on the economy and a potentially hard landing. During this period, net interest margins will begin to slowly decline as deposit costs continue to advance while loan yields flatten.

The duration of this phase will be determined by the macroeconomic pattern and the course of inflation. It could well last for the bulk of 2023. But no one knows. The plateau level for the Policy Rate is also likely to be above what market analysts expect, warns the Fed, which calls into question the 5% consensus. We recently presented to over a dozen bank CEOs, after which they were surveyed for their thoughts on a rate peak. They unanimously chose 6%. Somewhere during Phase Two it should become clearer whether the economy is heading for recession and whether that recession will be shallow or deep, after the cumulative effects of Fed tightening are fully felt.

Phase Three is the critical phase and will be based on the Fed's strategy to properly reduce or remove monetary tightening, assuming it has been effective enough to assure eventual inflation reduction toward their target of 2%. Also there is the possibility that this target could be raised, perhaps to 3%. During this period net interest margins will decline. How much depends on what the Fed considers to be an appropriate neutral stance or, if the economic damage was sufficient, whether they must move back to actual accommodation. The latter would further damage net interest margins and presumably the damage will also more harshly constrain loan growth and thus net interest revenues.

Analysts have generally mapped their earnings estimates to show higher year-over-year earnings in 2023 followed by a some decline in 2024. They have not reflected any serious damage from loan losses, which will be dependent on a soft landing. Through these Three Phases, banks can partially modulate margin impact through the use of hedging, which many are already employing, as well as liquidity management. This will be challenging, particularly during Phase Three.

Tangible Capital Optics: During the past three quarters the concurrent rise in market interest rates has dramatically impacted tangible common equity (TCE) ratios. For the first time in recent memory this impact included meaningful markdowns on loan portfolios, as well as investment securities. While TCE is not considered a regulatory capital ratio under Basel III guidelines, it is now damaged enough from AOCI accounting to present an optically unattractive measure that we believe is attracting U.S. regulatory attention according to some banks we have spoken with.

The TCE ratio decline is already severe. One in four banks among the top 200 have a TCE ratio below 6% and one in eight are below 5%! Most will argue this is an accounting distortion as the causative markdowns accrete back to equity over time. The damage could worsen, depending on the course of long rates.

Banks with strong regulatory capital ratios and sound credit will probably not attract undue criticism initially on their TCE levels and regulators may continue to view the TCE calculation as a primarily transitory phenomenon. An area to watch, for example, are banks with high CRE concentrations, e.g. those in the vicinity of 500% of capital, that are also experiencing

contracting deposit liquidity. So far regulators have not criticized their capital adequacy. In combination with rising AOCI marks this could change.

Decades ago, an accepted category of bank capital included “regulatory goodwill” which had counted as capital ... until regulators abruptly reversed their tolerance and then it did not.

One area of more pronounced regulatory impact from low TCE ratios is in mergers and acquisitions. Purchase accounting more severely marks balance sheets as it includes marks on both held for sale and held to maturity earning assets. This has driven the prospective TCE ratio into very low single digits for some and has helped scuttle several planned or contemplated consolidation transactions.

While it may be premature to suggest regulatory disfavor over weak TCE will lead to a round of common equity raising, it cannot be ruled out.

Ebbing Deposit Funding: One hallmark of second and third quarter bank results was a clear deceleration, or in many cases an actual decline, in end of period deposit balances. The shrinkage is primarily among interest bearing categories. Commercial non-interest-bearing deposits are faring better due to generally increasing levels of corporate liquidity for the moment.

There are three probable macro explanations for a further absolute decline in deposits. First is the ongoing depletion of consumer deposits from the excess savings that resulted in the generous American Recovery Plan (ARP) of 2021. Some estimates of excess savings peaked at just under \$2.7 Trillion and we believe there is something short of \$1 Trillion remaining, which could well be gone by mid-2023 if consumers continue to spend out of savings.

The second factor is ongoing Quantitative Tightening, which has the effect of shrinking the national deposit base. There is also a possible third cause stemming from higher rate alternatives that are increasingly outside the banking system.

This ebb in bank deposit funding should prove more pronounced in 2023 while loan momentum presumably remains positive. This can challenge the overall cost of loan and liquidity funding and speed up cumulative deposit betas to higher ground.

Weakening Economic Demand: A slowdown in the U.S economy is virtually certain in 2023 and will likely result in an actual but perhaps shallow recession. This would deplete momentum in banking’s dominant source of revenue growth: loans.

Part of the weakening will simply be from slower consumer spending when the ARP stored savings benefit runs out. Personal Consumption Expenditures (PCE) have been running at a 92% relationship to Disposable Personal Income (DPI) for about a year and a half. The pre-

pandemic level of this percentage was steadily 89%. This suggests a potential 3% contraction in the largest component of GDP before any influence from the Fed's tightening measures.

The Fed's impact on 2023 economics has been discussed ad nauseum. Surprisingly it still produces almost contradictory yet articulate interpretations ranging from minimal impact to a strong contraction. We believe the reason for this wide ranging outlook stems from threefold uncertainties, each with nearly no precedent in postwar history: the Pandemic and its economic and social distortions; Federal Government spending (relative to GDP) exceeding that of WWII; and the Ukrainian war. Each of these even separately has little semblance to an economically comparable past, yet all have influence over a monetary-driven "soft landing."

Nevertheless, the behavior of inflation in the months ahead should quickly narrow the outlook for 2023. November's downside surprise in CPI was certainly encouraging, with the headline rate down to 7.1% versus an expected 7.3% year over year, and 0.1% month over month versus the expectation of 0.3%.

Credit Containment: The Fifth and final challenge we see for banks is containing credit deterioration during a weakening or recessionary economy. We take it as a given that the 2023 environment will drive currently pristine loan portfolios to deteriorate. To what degree will clearly depend on how much economic weakening or the depth and duration of any recession. But either environment will ultimately produce a loan loss cycle.

Banks have partially recognized this risk and have been gradually increasing loan loss reserves. This will undoubtedly have to continue until it is possible to better gauge the potential risk. As is well known, bank management teams conduct stress testing based on a range of assumptions, as required under FASB accounting methodology for Current Expected Credit Losses (CECL), which is the forward looking standard now employed to reflect embedded losses in their loan portfolios based on a range of economic projections.

Since the latter is arguably unknowable with any precision, most have performed a fairly granular, but mathematically weighted average of future losses, by loan categories, that includes a range of macroeconomic estimates from a base case up to a worst-case scenario. These scenario assumptions are usually determined by Moody's or a comparable independent source. Hence while current loss reserves reflect more stress, they do not reflect a full recession.

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