Truist Advisory Services, Inc.

Fixed income perspective from the Investment Advisory Group

Bank ratings downgrades highlight challenges, but banking system remains sound

August 8, 2023

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Highlights

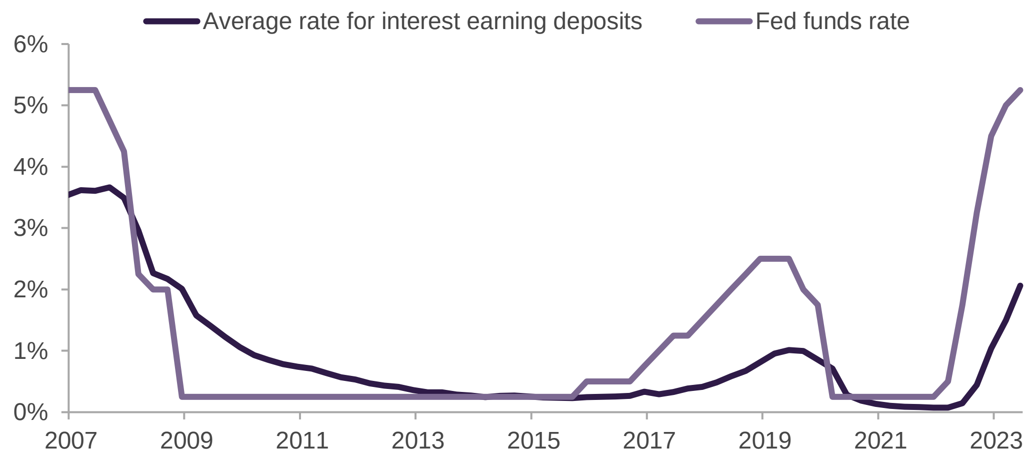
- On August 7th, **Moody's Investors Service downgraded its assigned bond ratings for ten small and midsize U.S. banks.** Simultaneously, six banks were changed to "Review for Downgrade," and eleven lenders were placed on "Negative Outlook."

- Moody's cited three primary challenges within the banking industry: **higher funding costs,** the **potential for increased regulatory capital requirements** for banks with over $100 billion in assets, and **rising risks within commercial real estate loan portfolios.** These issues are likely to persist in the near term, making additional downgrades likely.

- While Moody's downgrades are not surprising, they are likely to revive some concerns around the health of U.S. banks. **In our view, the U.S. banking system remains sound and resilient.** Broadly speaking, Moody's negative rating decisions reflect not a structural danger, but rather a dimmer near-term outlook towards bank profitability and slower expected economic activity (i.e., loan demand).

The Fed's fight against inflation is creating the highest average bank funding costs since 2008.

Bank funding costs vs. Fed funds rate



Data source: Truist IAG, Bloomberg

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Wealth

Our take

Moody's cited three primary reasons behind its negative ratings actions on Monday night: higher funding costs, the potential for higher regulatory capital requirements, and rising risks within commercial real estate loan portfolios. These pressures moved to the forefront of investors' and rating agencies' minds as three regional banks failed in March and May. Since then, Fed action to stabilize the banking industry and resilient economic activity helped ease broad-based fears around U.S. banks. However, the challenges that banks face cannot be resolved overnight.

Higher funding costs – The Fed's aggressive rate hike campaign has significantly increased the short-term interest rates that virtually all banks pay clients for deposits. Banks utilize cash deposits as a source to extend new loans. The higher cost of attracting deposits erodes a measure known as net interest margin – the amount of interest a bank is earning on its loan portfolio relative to what it is paying on deposits. Additionally, the move to higher U.S. interest rates has lowered the value of many fixed-rate assets held on their balance sheets.

The Fed's fight against inflation is not complete. Over the very near term, we expect the Fed to hold the Fed funds rate at elevated levels until inflation carves a clear path lower. Therefore, banks' funding pressures will persist until traders are convinced the Fed is preparing to lower its benchmark rate. As the Fed begins to normalize interest rate policy, bank funding costs and balance sheets will find relief.

Increased capital requirements – This potential regulatory change is a long-term positive for the strength of the U.S. banking system. The increased capital requirements will provide the banking industry with further protection against severe economic disruptions. As of now, banks with over $100 billion in assets will have until 2028 to comply. In the near term, raising capital levels may hinder some banks' ability to lend or require the issuance of new debt, thereby raising interest costs. The regulatory changes have the best interests of the long-term strength of the banking system at heart but will require upfront costs for qualified banks over the next half-decade.

Commercial real estate (CRE) – Work and living preferences have changed dramatically since the pandemic. As a result, some commercial real estate values are falling, particularly among office and retail properties, which are often financed by banks. Broadly speaking, smaller lenders tend to have a greater exposure to CRE loans and are typically concentrated within their respective geographic footprints. The largest U.S. banks tend to have less exposure, but there are individual exceptions. Nearly $1.5 trillion in commercial mortgages are coming due over the next three years. Borrowers' ability to refinance these loans may be complicated by higher borrowing costs and lower property values. Banks with disproportionately large CRE loan portfolios may see an uptick in borrowers missing interest and/or principal payments in the next few years. Credit rating agencies will be monitoring CRE loan performance closely.

Bottom line

The U.S. banking industry's challenges cited by Moody's are well known. On balance, we believe the banking system remains sound and resilient. However, the swift move to higher short-term interest rates, slowing economic growth, and uncertainty around the commercial real estate sector present profitability challenges for some banks in the near term. Lower interest rates and a rosier growth outlook will provide relief but will require time to emerge. We continue to emphasize an up-in-quality bias within fixed income portfolios in anticipation of further credit spread widening within the investment grade and high yield corporate sectors.

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CN5867497.1 EXP8-2024