RESEARCH & ANALYSIS

US community banks still face margin pressure even as focus turns toward credit

Thursday, May 16, 2024 1:16 PM CT

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Market Intelligence

Even as the Federal Reserve ends its tightening cycle and pivots to trimming rates, bank liquidity and the value of deposits remain at the forefront for most community bankers, according to the 2024 US Community Bank Market Report.

The Take

Community banks continue to aggressively compete for deposits, even with interest rates expected to fall in the second half of 2024. Community banks have sought to retain their customers with higher rates, and that has resulted in funds moving into higher-cost products, while regulators are encouraging institutions to hold more liquidity, leading to pressure on net interest margins. That pressure should subside in the second half of 2024, but as it gives way, community banks will feel headwinds from higher credit costs.

Click here to read the full 2024 US Community Bank Market Report.

Click here to access data exhibits and the US community bank projections template.

Community bank aggregate profitability metrics (%)

	2023A	2024P	2025P	2026P	2027P	2028P
Efficiency ratio	62.33	64.83	62.37	62.27	62.12	61.55
Net interest margin	3.48	3.32	3.47	3.46	3.47	3.46
ROAA	1.11	0.94	0.99	1.06	1.12	1.16
ROAE	11.49	9.24	9.63	10.28	10.82	11.23
YOY earnings growth	-9.4	-12.1	8.7	9.9	8.3	6.9

Data compiled May 2, 2024.
A = actual; P = projected.
Community banks defined as institutions with less than $10 billion in assets in a given period.
Sources: S&P Global Market Intelligence; proprietary estimates.
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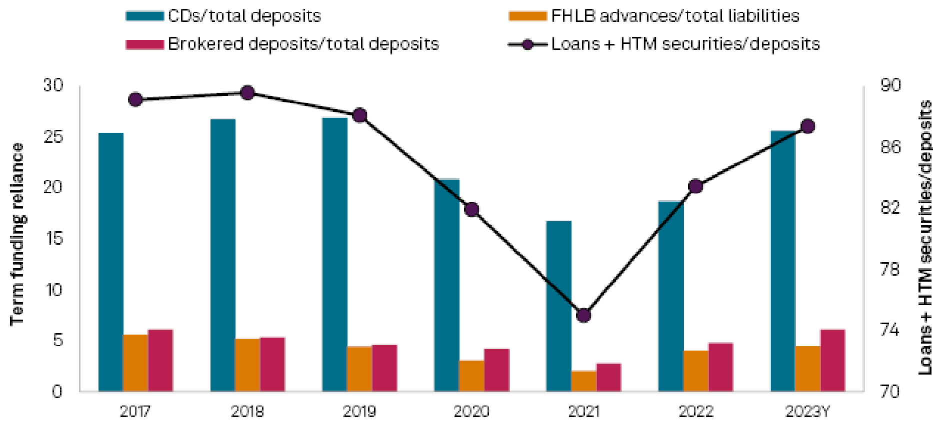
Liquidity pressures not as acute but deposits remain in focus

Community banks have not faced the same level of deposit outflows as their larger counterparts but have felt the same pressure to defend their deposit bases with significantly higher rates.

Community banks have increased what they paid for deposits and narrowed the gap with higher-yielding alternatives in the treasury and markets. That spread is evident when looking at the difference between the average fed funds rate and the industry's cost of deposits, which peaked in the second quarter of 2023. By the fourth quarter, the gap had declined by 16 basis points, and we expect that spread to narrow further in 2024 and decrease even more significantly in 2025.

Regulators have also pressured banks to bolster their liquidity in the aftermath of the large bank failures in 2023 and have encouraged institutions to hold more cash and maintain multiple levers to pull to access funding.

Community banks increasing their reliance on CDs, wholesale funding (%)



Data compiled May 2, 2024.
HTM = Held-to-maturity securities.
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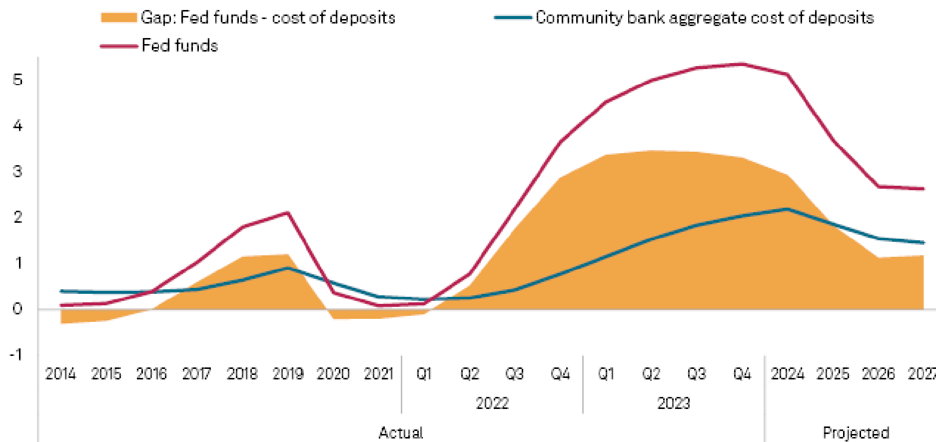
Deposit costs have also risen as funds continue to move out of noninterest-bearing deposits and into higher-cost products for institutions, such as brokered deposits and certificates of deposits. Interest-bearing deposits have risen 5.2% over the last two years, while noninterest-bearing deposits have fallen 15.5%. The decline pushed the community bank aggregate's noninterest-bearing concentration down to 23.9% of total deposits at year-end 2023 from 27.3% at year-end 2022 and 28.0% at year-end 2021. We expect noninterest-bearing deposits to decline further in 2024, dipping to 21.5% of deposits.

Rate cuts by the Federal Reserve will offer modest relief in community banks' funding costs late in 2024, but more substantial rate cuts — which are expected to occur in 2025 — will be needed to drive deposits costs notably lower. Fierce deposit competition should persist amid regulatory pressures and higher-for-longer interest rates as banks place a higher value on deposits than other forms of funding. However, deposit costs should remain relatively sticky even as rates decline as banks continue to prize deposits and face regulatory pressure to do so.

Many bank depositors have also become more rate-sensitive as rate hikes have woken up many customers, who became accustomed to receiving rates below 1% to 2% on their deposits in the aftermath of the global financial crisis. Younger consumers, in particular, had never received those rates since deposit rates remained muted between 2009 and 2022.

We expect deposit costs to rise in the first half of 2024. The Fed is expected to pivot to easing rates in the second half of the year, leading to modestly lower deposit costs. Funding costs will drop in 2025, when project betas, or the percentage change in fed funds that banks pass on to their customers, to reach 23%, well below the level witnessed in 2023 as community banks feel the sting of higher-cost CDs originated when rates were higher remaining on their books.

Deposit outflows slowing at community banks as spread between fed funds, cost of deposits narrows (%)



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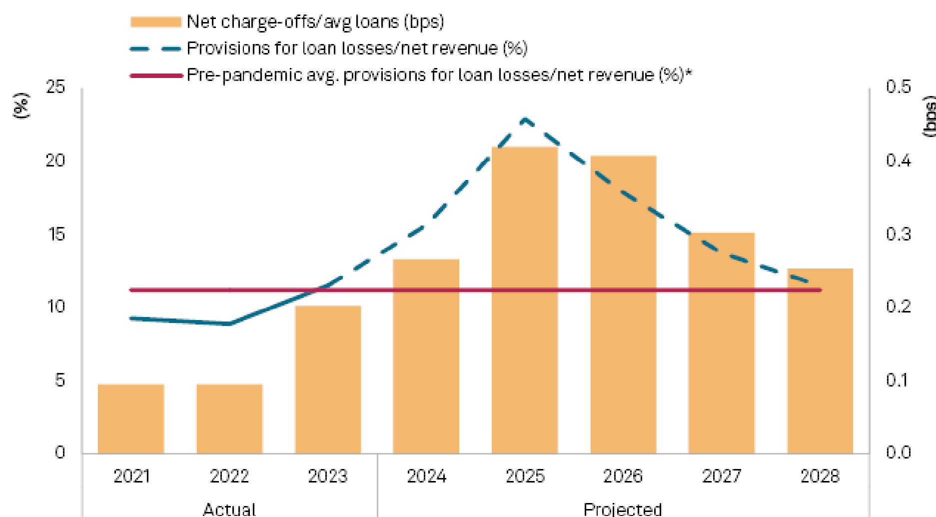
All eyes on commercial real estate

Credit costs remain historically low for community banks who continue to see minimal stress in their borrowing base. However, borrowers will begin to feel the impact of substantially higher rates, particularly in the commercial real estate segment, resulting in higher credit losses.

While we do not expect considerable deterioration in credit quality, we do see greater delinquencies and charge-offs in the future. Banks have tried to prepare for slippage by tightening lending standards and building reserves for loan losses. We expect relatively slow loan growth in 2024 as institutions approach new originations with greater caution. Rising funding costs and regulatory pressures to reduce commercial real estate concentrations could also give some community banks pause to grow their balance sheets notably. We also expect banks to continue to build reserves as they work to shore up their balance sheets to clear any potential hurdles ahead.

Regulators have reiterated the importance of banks maintaining strong risk management of their CRE portfolios, particularly for institutions with elevated CRE concentrations. The number of banks exceeding regulatory guidance for CRE concentration fell for the third consecutive quarter, dropping by 11 sequentially to 532 in the fourth quarter. We expect that number to decline further as banks slow CRE loan growth, engage in risk transfer trades or selectively prune positions. While regulators are scrutinizing banks' exposure to the asset class, they are also allowing institutions to work out issues with borrowers and offer extensions in some cases.

Still, regulators have subjected some banks with elevated CRE concentrations that have produced greater stress or those seeking to grow through deals to higher indidividual minimum capital requirements. Provident Financial Services Inc. for instance, issued $225 million in subordinated debt as part of the conditions needed to close its pending merger with Lakeland Bancorp Inc. FirstSun Capital Bancorp and HomeStreet Inc. also recently amended their merger agreement, which included a slew of changes, including raising more capital in conjunction with the deal, due to regulators sensitivity to commercial real estate and the higher-for-longer interest environment.



Data compiled May 2, 2024.
* Average of provisions for loan losses/net revenue from 2014-2019.
Net revenue = net interest income + noninterest income - noninterest expense.
Community banks defined as institutions with less than $10 billion in assets in a given period.
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CRE delinquencies have risen off historically low bases and banks have increased reserves against their CRE portfolios, particularly related to office credits. Losses on CRE portfolios have risen as well but remain well below levels witnessed during the Great Recession. Loss content will be location-specific and differ across the subcategories of the asset class, but community banks will feel some pain in their commercial real estate books, particularly as borrowers digest the impact of higher interest rates, less credit availability and lower occupancy since the pandemic. The test will come when many CRE credits mature and some borrowers struggle to refinance loans at significantly higher rates.

We expect credit quality to slip and lead to higher charge-offs, with losses peaking in 2025 and then lingering in 2026 due to extension of terms. However, even with net charge-off losses in 2024 expected to jump 30% from 2023 levels, losses and the reserves required to fund them should prove a modest hit to earnings as opposed to the headwind that would occur during a severe downturn.

We expect provisions to rise to 15.6% of net revenue in 2024, up from just 11.5% in 2023 and then rise further to 22.9% in 2025. From 2013 to 2019, banks' provisions equated to 9.5% of net revenue on average.

Scope and methodology

The outlook discussed in this article is based on a proprietary S&P Global Market Intelligence model that utilizes the actual results of nearly 10,000 active and historical commercial and savings banks and savings and loan associations. The outlook is based on management commentary, discussions with industry sources, regression analysis, and asset and liability repricing data disclosed in banks' quarterly call reports. While taking into consideration historical growth rates, the analysis often excludes the significant volatility experienced in the years around the credit crisis.

The outlook is subject to change, perhaps materially, based on adjustments to the consensus expectations for interest rates, unemployment and economic growth. The projections can be updated or revised at any time as developments warrant, particularly when material changes occur.

Community banks operating in a slow growth environment

	2024	2025	2026	2027	2028
Unemployment rate (%)	3.85	4.21	4.49	4.49	4.39
GDP growth (%)	1.69	1.45	1.75	1.85	1.75
Fed funds (%)	5.12	3.69	2.67	2.63	2.63
10-year Treasury (%)	3.91	3.46	3.28	3.20	3.18

Data compiled April 25, 2024.
Data for the federal funds rate, 10-year Treasury yield, unemployment rate and GDP are based on 4-point averages of estimates provided by IHS Markit.
Actual reported data used when available.
Source: IHS Markit.
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