FINANCIAL INTELLIGENCE *from* FHLBank Topeka

FHLBank Tenth District Credit Union Trends

Quarterly Analysis / Q1 2022

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The purpose of this analysis is to provide financial and performance trend data for member institutions headquartered in FHLBank's Tenth District comprised of Colorado, Kansas, Nebraska and Oklahoma.

Executive Summary: Where are we today?

The terms "unprecedented times," "uncertainty" and "unchartered waters" continue to dominate the rhetoric of today's economic environment. Chatter about a looming recession, or at a least a slowdown, continue to creep into conversations.

Covid cases are on the rise (again) and the reinstatement of earlier protocols are being considered in some parts of the country. Lockdown measures remain in place abroad in China but the outlook to reopen has improved. Geopolitical risks have provided yet another market disruption and international conflict has added to ongoing price pressures. Supply-side constraints are pushing input costs higher.

Households are feeling the pain as inflation continues to erode purchasing power. Income growth has not kept pace with spending. Consumers have turned to savings to help support spending habits as fiscal stimulus support has faded and preference for spending on discretionary items – furniture, entertainment, hospitality, etc. – has started to wane. Personal savings rates diminished quickly over the past five months, returning to levels not seen since 2008-2010.

The domestic labor market has remained a source of strength for the economy as Americans go back to work. Although, much of the job growth has been replacing those lost during the pandemic and less on new job creation. The pace of new jobs is moderating as the Federal Reserve (Fed) continues to raise rates and consumers are starting to pull back. The ability for businesses to pass increased costs on to the consumers is waning, presenting a challenge for plans to hire and invest.

The Fed is faced with an economy that needs cooling. The Fed has embarked on a daunting mission of trying to navigate a soft landing for the economy through an aggressive tightening of monetary policy. The Fed remains committed to reigning in inflation and has asserted it will continue to raise rates until inflation noticeably slows, even as equity markets remain volatile and signals of economic weakness have started to emerge.

Equity market momentum has declined in 2022. Bank stocks have lagged the broader market year-to-date after a strong 2021 performance. Soaring inflation, Fed action and talk of a possible recession has challenged markets. However, in May, bank stocks reversed course with positive returns, recouping losses seen during the first few months of the year. The market value of many bank bond portfolios has been pummeled this year.

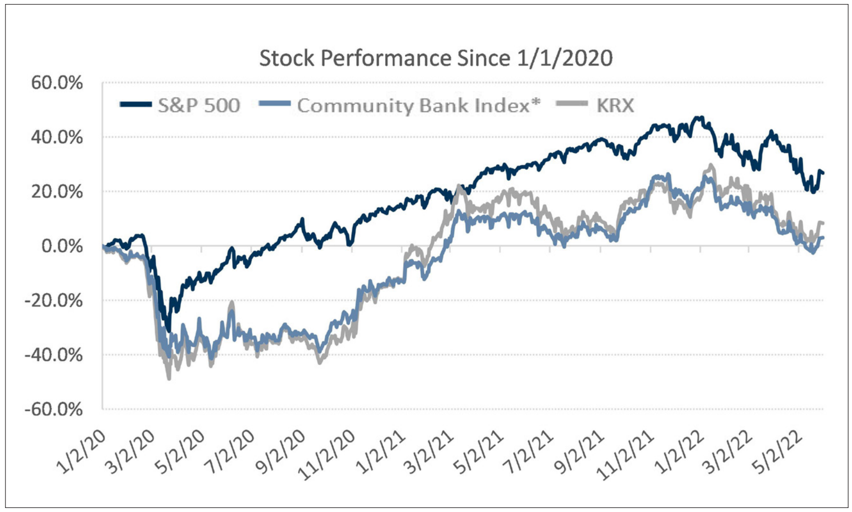
Source: S&P Global Market Intelligence

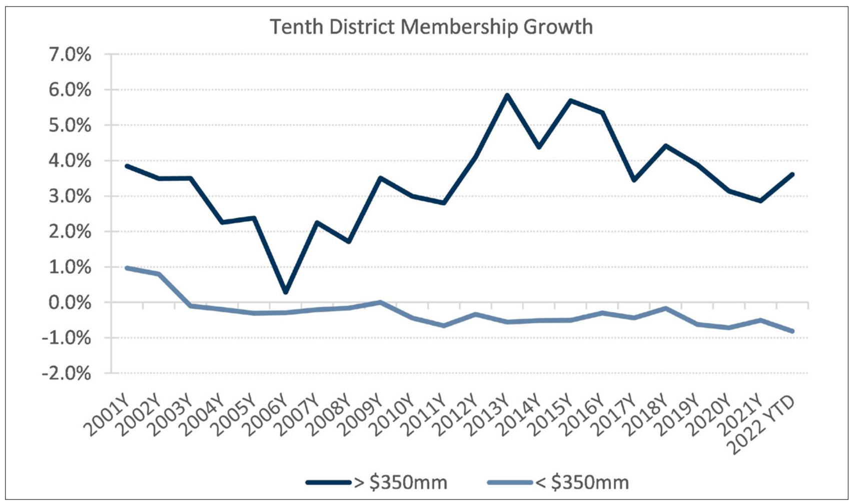
Tenth District (District) collective membership continued to grow during the first quarter 2022, growing 2.5% quarter-over-quarter, and the average number of members per credit union in the District also pushed higher. However, on a median basis, membership declined each of the past three years and during the first quarter.

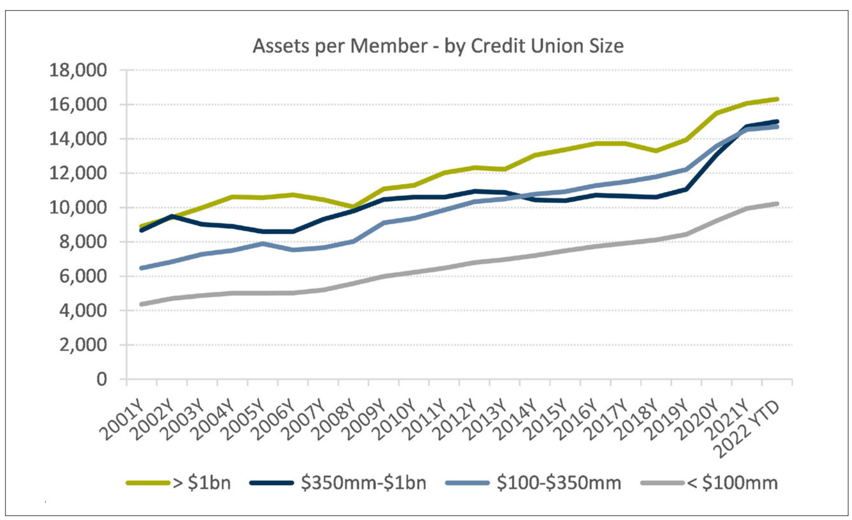
Smaller credit unions have faced membership growth challenges since the turn of the century while credit unions with assets greater than $350 million have maintained a higher level of membership growth over the past several years.

Despite the struggle to expand membership, smaller institutions have still been able to continually grow assets per member throughout the years. Asset growth per member accelerated throughout the pandemic for all asset segments.

Membership growth reflects the shift seen in the composition of credit unions based on asset size. Financial institutions across the industry continue to feel pressure to add scale to invest in technology and compete with a growing number of non-traditional competitors, create operational efficiencies, generate stronger earnings power and adhere to growing regulatory compliance. Credit unions remain very active in the bank merger and acquisition (M&A) space with nine deals announced so far this year — on pace to exceed the record 13 announcements in both 2021 and 2019. Since the beginning of 2015, 60 credit union-bank acquisitions have been announced, not including terminated deals.







Source: S&P Global Market Intelligence. Stock performance through May 31, 2022.
**Community Bank Index created by FHLBank Topeka and consists of 74 select publicly traded community banking institutions (assets < $10 billion).*

The credit union industry has faced notable headwinds in getting transactions approved from state bank regulators in some states. Colorado, Iowa and Mississippi have completely barred credit unions from purchasing state-chartered banks. Two pending acquisitions have been blocked or denied in Minnesota and Nebraska. However, a transaction in Tennessee was recently approved after facing a strong bank lobby to reject the purchase — a win for credit unions who are actively seeking a bank merger partner.

Competition has widened in the banking arena, challenging the traditional operating environment for financial institutions. In addition to investing in technology and digital channels, building partnerships with fintech firms provides an opportunity to drive growth and profitability by reaching new potential credit union members and increasing product offerings.

Banking Themes

Liquidity positions moved lower during Q1 2022, falling for the fourth consecutive quarter since peaking on March 31, 2021. Loan demand picked up from the slowdown in the fourth quarter 2021 while the pace of share/deposit growth reached a four-quarter high. The District median loan-to-share/deposit ratio slid for the second consecutive quarter. Margins remain under pressure, despite the rise in interest rates. Asset quality concerns remain muted, and capital positions remain on solid footing.

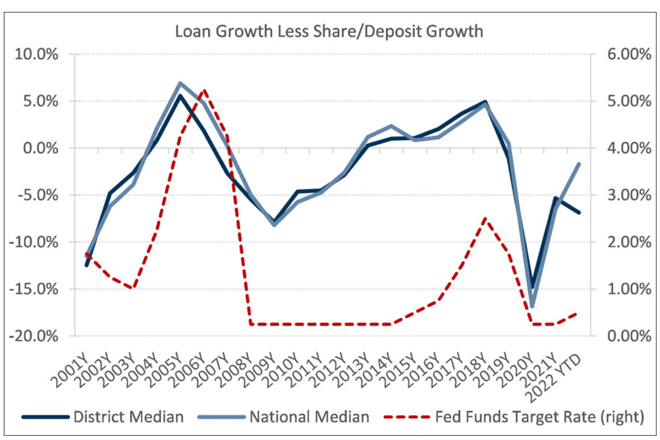
Loan growth was positive for the fourth consecutive quarter, averaging 4.8% on a median basis. Four quarters of positive loan growth was last observed in 2018. First quarter loan growth has historically been the slowest over the course of the year, but this year is also marked with red-hot inflation and rising interest rates.

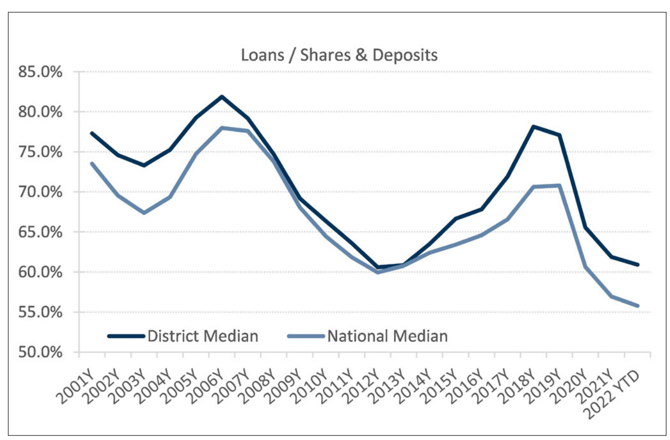
Loan growth was primarily attributed to used vehicle lending, residential lending and commercial lending. Strong commercial loan growth continued during the first quarter 2022, growing $1.5 billion or 42.4% year-over-year. New vehicle lending posted positive growth during the first three months of 2022, reversing an eight-quarter trend of declining aggregate balances. Borrower loan utilization remains at a decade low with unused loan commitments nearing 9% of total loans.

A slowdown in mortgage banking activity is on the horizon as interest rates rapidly rise, refinance opportunities dissipate and mortgage originations decline. Lowering mortgage banking revenue guidance has become a common theme across the industry for the foreseeable future. Expenses related to mortgage operations have also come in to focus as institutions prepare to combat segment headwinds.

Although loan growth continues to chug along, lower-yielding assets represent a still growing portion of balance sheet composition on the asset side. Aggregate cash and cash equivalent positions moved lower in the first quarter 2022 to $7.6 billion – a six quarter low – down from $9.2 billion at year-end 2021. Institutions continued to build their securities portfolios to take advantage of the yield curve shift and grow earning assets.

The median liquid assets-to-assets ratio for the District has fallen 6.2% since peaking at 28.4% in the year-





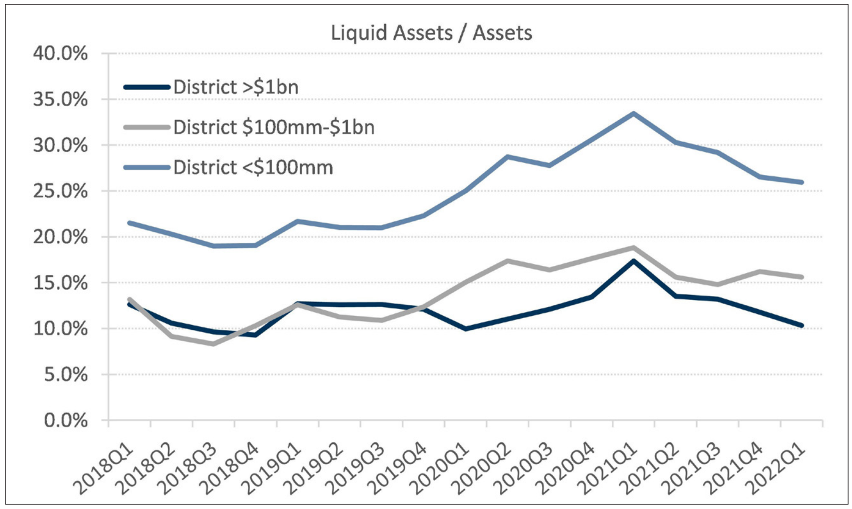
Source: S&P Global Market Intelligence.

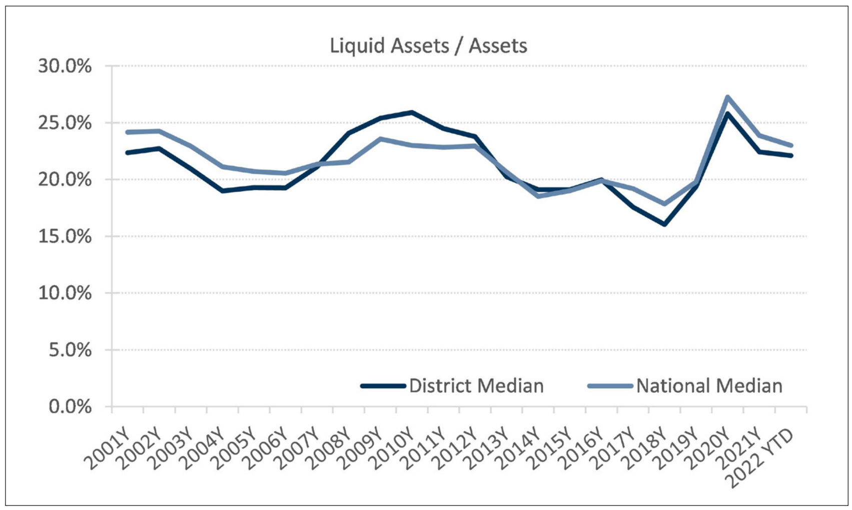
ago quarter. The largest and smallest credit unions with assets greater than $1 billion and with assets less than $100 million, have seen ratios shrink the greatest amount from their peak levels.

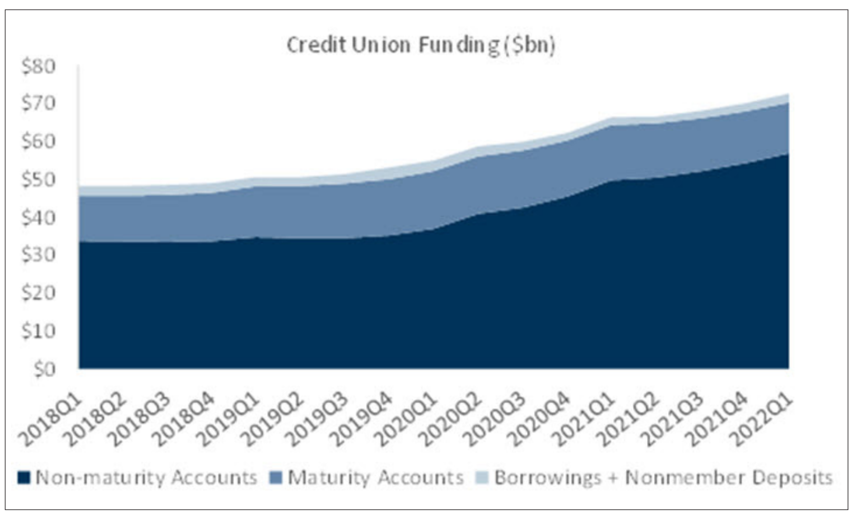
The swift rise in interest rates has had a significant negative impact on the market value of bonds in credit union portfolios, hitting capital with unrealized losses in the available-for-sale portfolio. Held-to-maturity (HTM) portfolio balances jumped during the first quarter as some institutions looked to avoid the impact of volatility. However, classifying securities as HTM restricts the flexibility management has in managing the portfolio.

On the share/deposit front, non-maturity accounts continue to represent a greater portion of financial institutions' funding. Total shares/deposits in the District grew nearly $20 billion in the past eight quarters, all in non-maturity accounts. The stability of these shares/deposits is unknown and could be vulnerable as the Fed ratchets up interest rates and continues to shrink its balance sheet. On a median basis, share/deposit growth outpaced loan growth for the second consecutive quarter.

A need for wholesale funding may arise for more institutions in future periods as excess liquidity is deployed and loan demand persists. Aggregate FHLBank advance funding moved higher for the third consecutive quarter and was predominately concentrated in credit unions with assets greater than $350 million.







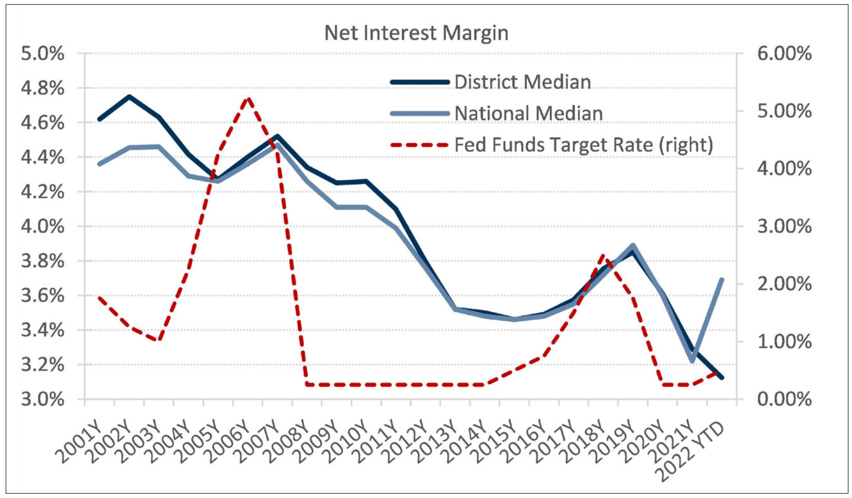
Source: S&P Global Market Intelligence.

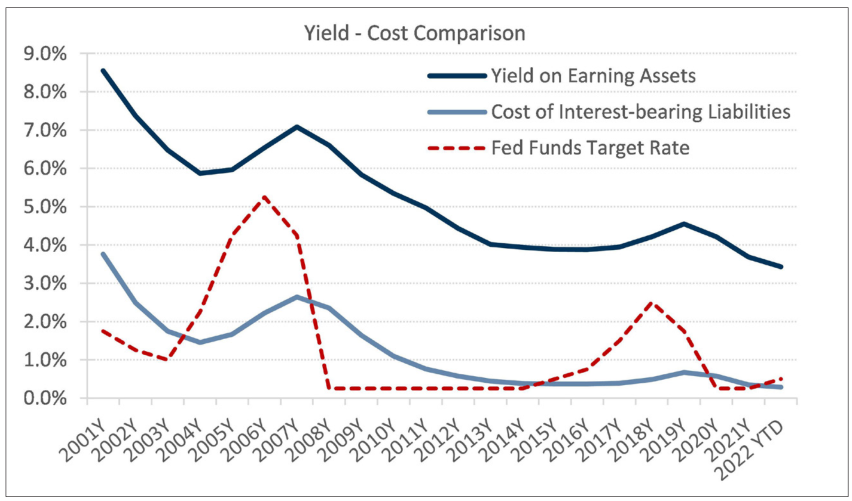
Net interest margins plunged lower during Q1 2022 across the District, even as rate liftoff commenced. Rate hikes will be especially favorable for asset sensitive institutions. As loan growth continues, net interest income will get a boost as new loans are originated at higher rates and interest rates move above loan floors. Higher yields in the bond market should also offer further support to margin growth in 2022.

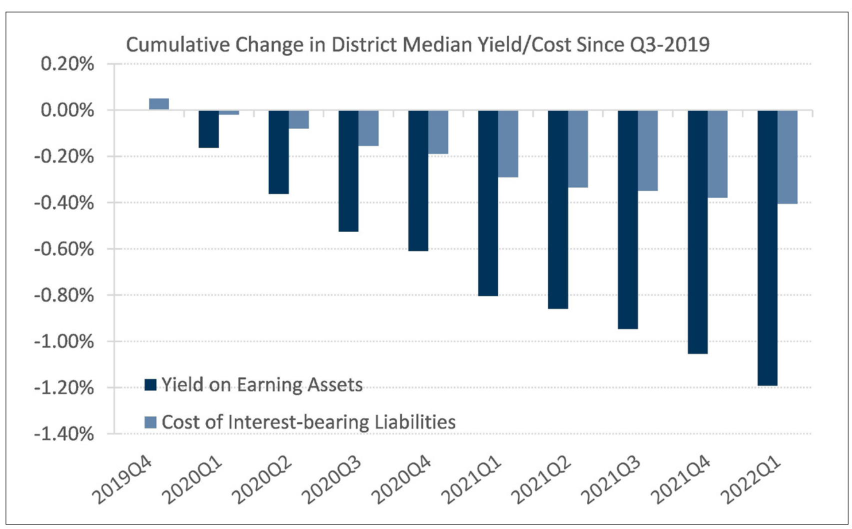
Fierce loan competition has kept pressure on loan yields and remains a headwind to margin expansion. All institutions — banks, credit unions, insurance companies, nonbank lenders — are seeking quality higher-earning assets to put on their balance sheet. Institutions are not only competing on rate but on loan structure, such as longer amortization and interest-only periods.

Cost of funds remain historically low and creeped lower during first quarter 2022 despite an increase in rates. An inflection point for share/deposit costs is nearing. Share/deposit betas are now a recurring topic of discussion. Some expect share/deposit betas will be lower than in past tightening cycles due to excess liquidity sitting in the banking system. However, competition with non-traditional credit union and bank entities may challenge that expectation. The rapid pace of rate hikes may also alter share/deposit pricing decisions compared to the past hiking cycle.

Efficiency ratios improved in first quarter 2022 due primarily to a decline in noninterest expense.





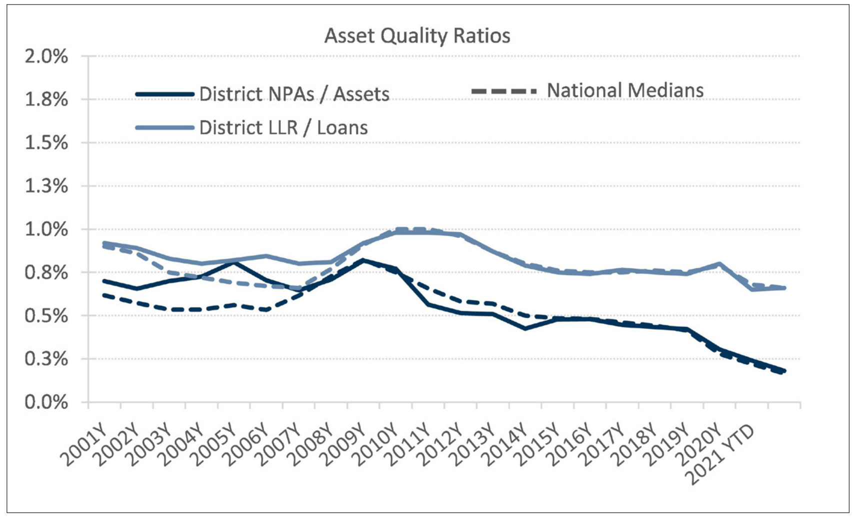


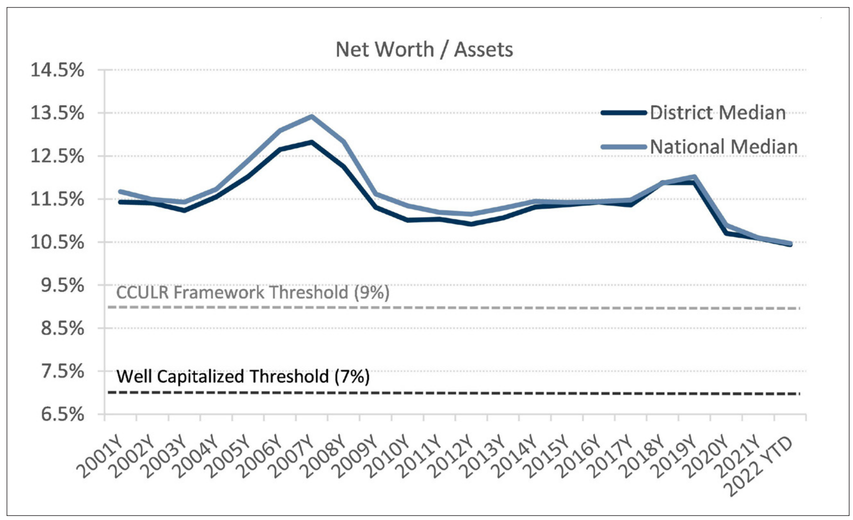
Source: S&P Global Market Intelligence.

Noninterest income declined for the second consecutive quarter and is expected to be strained from fee-income generating lines of business-like mortgage banking. Many institutions are facing regulatory and competitive pressures to revisit their overdraft and nonsufficient fund fees — placing additional stress on operating revenue.

Aggregate provisions across the District moved slightly higher during the March 2022 quarter but remained at historically low levels. Most credit unions did not have a provision during the first quarter, some boosted reserves and others reported negative provisions. Resilient credit quality, less uncertainty around the economic impact of COVID and the economic recovery to date support current loan loss reserve positions. However, persistent elevated inflation concerns, emerging geopolitical risk and ongoing supply chain challenges could spark a return to positive provisions in upcoming quarters.

Although capital positions have declined through the pandemic as asset growth soared, credit unions remain well-capitalized. As of March 31, 2022, the threshold for complex credit unions was increased from $50 million in assets to $500 million. Complex credit unions are now subject to risk-based capital requirements but can elect to opt-in to a new Complex Credit Union Leverage Ratio (CCULR) framework and not calculate a risk-based capital ratio if the complex credit union meets the qualifications and has a net worth-to-assets ratio of 9% or higher.





Looking Ahead

A cautious sentiment towards the economic environment is growing and many say a slowdown, or recession, is inevitable. The timing and severity, however, remains unknown. The banking industry is on solid footing with strong fundamentals and are well-positioned to weather looming macroeconomic and geopolitical risks.

In FHLBank Topeka's April Financial Intelligence article **Smart Moves for Every Scenario**, Oklahoma Regional Manager Drew Simmons says, "The question financial institutions need to ask right now is how their balance sheet and liquidity will respond to the volatile scenarios that could play out over the next 18 to 24 months. If history is any indication, the inversion of the treasury curve will result in some form of a recession."

The time is here to prepare, not predict, for an evolving rate environment. Drew explains how in **an additional FI article**.

Source: S&P Global Market Intelligence.