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Economics Group

Interest Rate Weekly

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Small Banks Step up to the Plate in the Lending Game

Despite struggling to regain lost share of total banking assets, small banks have made considerable strides in ramping up their lending activity in recent years. Commercial real estate and mortgages have led the way.

Small Banks Staging a Comeback

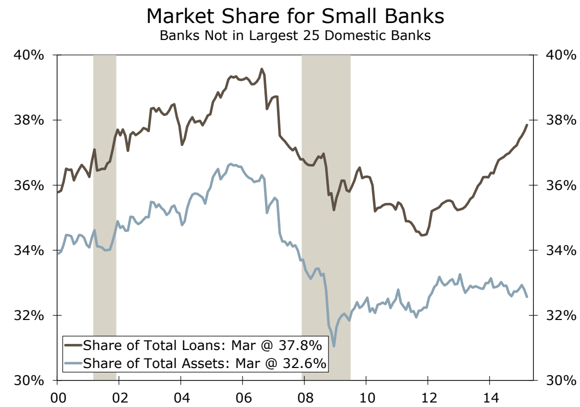
After losing a considerable share of total bank assets and total bank lending during the Great Recession, small banks have struggled to regain their prerecession share of total banking assets (top chart).[1] However, smaller institutions' share of total lending assets has recovered nicely, particularly in the past two years, and is now just 1.7 percentage points below its prerecession peak. Interestingly, small banks' lending assets as a share of total assets have not moved as drastically over this time period, but the same metric for large banks has trended downward (middle chart). However, the decline in lending assets as a share of total assets among large banks does not imply that these institutions are lending less; in aggregate, lending has actually grown at a fairly healthy clip among large banks over the past few years.

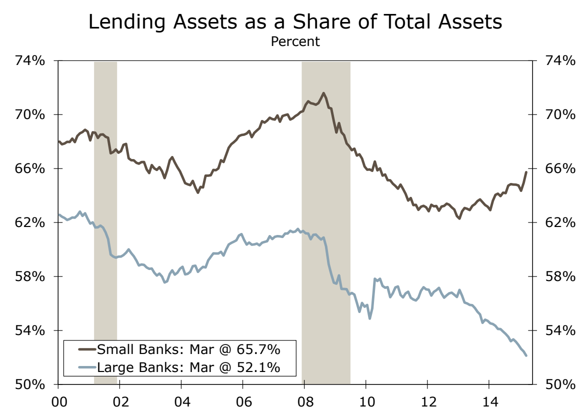
The stark divergence has been more a result of the Fed's quantitative easing programs, which have created a massive amount of bank reserves. Since the Fed transacted primarily with larger banks for these programs, smaller banks received relatively less cash assets compared with their larger counterparts during the implementation of these programs. Regardless, loan growth at small banks has outpaced growth at larger institutions in recent years (bottom chart). What has been driving this trend?

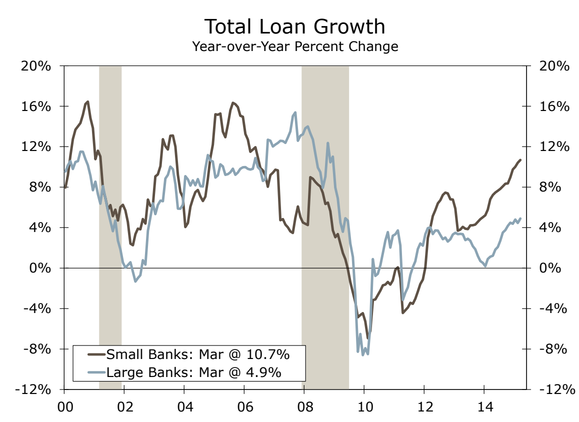
Commercial Real Estate and Mortgage Lending Lead the Way

Small banks have shown robust growth in most lending categories, but the two primary drivers of loan growth since the end of the recession for these small banks have been the commercial real estate (CRE) and mortgage markets. Interestingly, small banks' market share in the CRE space has been steadily increasing since at least 2004. This likely reflects the fact that there are a large number of small banks that specialize in CRE lending, whereas larger banks tend to be more diversified in their lending activities.

Another market where small banks have seen a resurgence in lending activity is in mortgages. Despite a slow initial recovery, mortgage lending growth at small banks has been positive nearly every month for the past three years, while growth has lagged at larger banks. More stringent capital requirements have likely played a key role in this shift, as holding mortgages has become more costly for larger financial institutions. Growth in mortgage lending among these smaller players should support home buying activity, particularly in smaller communities where these banks tend to have their operations. Fortunately, we have seen delinquency rates in the mortgage and CRE markets continue to trend downward, thanks to tighter standards and healthier household and corporate balance sheets, which bodes well for the health of these small banks going forward.







Source: Federal Reserve Board and Wells Fargo Securities, LLC

[1] We use the Federal Reserve's definition of a "small bank"—a bank not classified as one of the 25 largest banks by assets.

Wells Fargo U.S. Interest Rate Forecast

	Actual					Forecast						
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	3.95	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.13	0.55	0.86	1.15	1.43	1.81	2.28
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.27	0.63	0.91	1.22	1.52	1.85	2.35
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.30	0.69	0.99	1.24	1.57	1.89	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.70	0.87	1.07	1.26	1.71	2.00	2.46
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.68	1.78	1.89	2.01	2.19	2.31	2.59
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.19	2.35	2.41	2.46	2.53	2.77	2.89
30 Year Bond	3.56	3.34	3.21	2.75	2.54	2.77	2.89	2.99	3.09	3.18	3.39	3.58

Forecast as of: April 24, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.3	2.9	N/A
FOMC	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1
PCE Inflation			
Wells Fargo	0.9	2.1	N/A
FOMC	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: April 24, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: March 18, 2015

Source: Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

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