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A Fresh Look at the Banking Industry

The years following 2020's unprecedented challenges marked a period of recovery and adaptation for the U.S. banking sector. As the economy rebounded from the COVID-19 pandemic, the Federal Reserve hiked interest rates aggressively from near-zero levels in 2022 through 2023, peaking at a target range of 5.25%–5.50% to combat persistent inflation. By late 2024, with inflation easing toward the Fed's 2% target, rate cuts began, bringing the federal funds rate to 4.00%–4.25% as of September 2025, with markets anticipating another 25-basis-point reduction in October. The massive influx of stimulus deposits from 2020–2021 has largely dissipated, giving way to more normalized deposit growth, though balance sheet management challenges remain. Drawing from my background as a former bank examiner, I'll revisit the industry through the lens of the Uniform Financial Institutions Rating System aka the CAMELS ratings, to assess its current health.

Capital — Capital cures many ills! The asset growth of the pandemic impacted capital ratios; however, over the last several years, we have seen increasing capital ratios as asset growth has leveled off for many, and earnings retention has increased. Pressure on capital ratios in the near term could come from a possible economic recession, asset quality-related issues, and losses.

Asset Quality — Asset quality continues to be the most unpredictable CAMELS element, shaped by economic shifts and sector vulnerabilities. While the broader industry has avoided the massive loan losses feared during the pandemic, delinquency rates have ticked up modestly. Past-due and nonaccruals have risen from the pandemic lows—largely from credit cards, commercial and industrial, and multifamily CRE loans—but remain below historical norms. The length and severity of the next economic recession, alongside the strength of underwriting practices and credit administration, will likely drive the amount of asset quality problems we see in the future.

Management — Management is easily the most subjective component of all the CAMELS components. Bank leadership has faced a barrage of challenges, from pandemic disruptions to rapid monetary tightening. Community banks have demonstrated exceptional adaptability and continue to play a vital role in supporting local economies.

Earnings — The industry was riding high in 2018 and 2019 after record years of profitability through expanding net interest margins, low provision expenses, and lower tax rates. Zero bound short-term interest rates, combined with high levels of low earning cash liquidity, have put margins back under pressure. The average community bank saw significant margin compression in 2020 and 2021. However, in 2022, margins rebounded strongly alongside the Fed rate hikes. In early 2023, the continued rate hikes put tremendous pressure on banks' liquidity and deposits. As a result, banks' cost of funds soared, and their margins compressed quickly. In early 2025, margins finally saw relief as the yield curve steepened with the most recent Fed rate cuts and lowered cost of funds. With expanding margins, earnings performance to date in 2025 has been strong, with a vast majority of banks commenting on how they are above their budgets. With many banks above their budget, some have or are considering restructuring their balance sheets by selling lower-yielding bonds at a loss and buying back at today's higher yields, making up the loss within a reasonable timeframe.

Liquidity — The industry's liquidity position has undergone a dramatic reversal from record highs during the COVID stimulus era to the lows of liquidity in the last couple of years. This shift reflects the combined impact of ultra-low rates during the pandemic and the Fed's subsequent 525 basis points of tightening beginning in March of 2022. The last few quarters, liquidity levels have increased somewhat as deposit competition has eased slightly. Some are facing the dilemma of holding too much short-term

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cash and liquidity at a time when the Fed already cut rates 125 basis points, with more cuts likely on the way.

Sensitivity to Market Risk — During my six-year career as an FDIC bank examiner, I bugged banks to show me their 300 and 400 basis point interest rate scenarios within their interest rate risk models. It seemed farfetched and somewhat comical at a time when short term rates were near zero and the Fed didn't increase rates post Great Financial Crisis until December of 2015. Fast forward to March 2022, when the Fed's aggressive tightening cycle put bonds at unrealized losses and put pressure on the economic value of equity. Margins compression ensued in late 2022 and throughout 2023 with the prolonged inverted yield curve. As the Fed continues with more rate cuts, banks should be more focused on their exposure to falling rates after several years of being hyper focused on their rising rate interest rate risk position. Reengaging with the bond portfolio and having an investment portfolio strategy should be a key priority of the ALCO. Utilizing the bond portfolio is the best tool to manage asset duration and interest rate risk position.

The last five years have brought a challenging and dynamic economic and interest rate environment. Community banks have continued to show just how resilient they are. Banks need to prepare for a lower rate environment. The speed and magnitude of the rate cuts to come will be driven by economic data points that speak to the overall health of the economy. Bank leadership must remain proactive to navigate the complexities and challenges of this continually evolving industry.

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