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Economics Group

Interest Rate Weekly

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Widening Net Interest Margins Boost Bank Revenue

Slowly rising interest rates have had a dual effect at commercial banks. While a widening net interest margin has helped boost operating revenue and earnings, net charge-off rates continue to gradually increase.

Higher Net Interest Income Helps Lift Earnings

The Federal Reserve has been gradually tightening monetary policy since December 2015, raising the federal funds rate to 1.50 percent from 0.25 percent over that period. As a result, the net interest margin at banks has widened, helping boost revenues and earnings figures. The *Quarterly Banking Profile* report, released by the FDIC, offers a comprehensive look at the 5,737 commercial banks and savings institutions insured by the FDIC in the U.S. and forms the basis for today's Interest Rate Weekly.

Banking Profits on the Rise

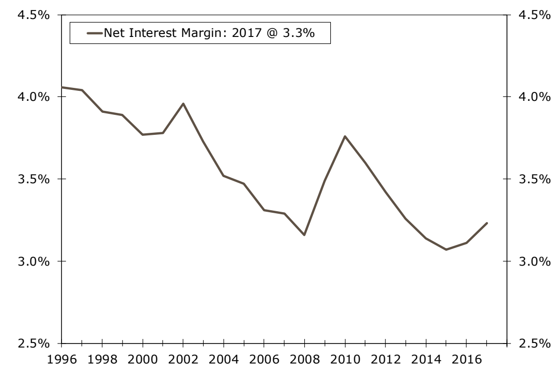
Quarterly net income for U.S. commercial banks rose to $47.9 billion in Q3-2017, an increase of $2.4 billion from a year ago. Drilling down a little deeper, net interest income was up 7.4 percent in Q3-2017 – of all banks, 83.5 percent reported year-over-year increases in this metric. A key factor for improving incomes is a widening net interest margin, or the difference between the interest income generated by banks and the amount of interest paid out to their lenders, relative to the amount of their assets. In Q3 the net interest margin increased to 3.30 percent from 3.18 percent a year ago (top graph). Nearly two-thirds of banks reported higher net interest margins than a year earlier, a trend that is likely to continue as the Fed prepares to hike rates three times in 2018.

Rising Rate Risks

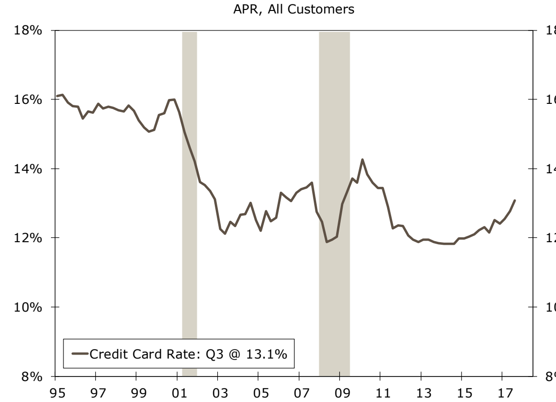
As expected, as the federal funds rate rises, interest rates on consumer products follow (middle graph). Likewise, higher real interest rates on credit cards and auto loans are correlated with higher delinquency rates and uncollectable loans. In Q3, banks charged off $11 billion in uncollectible consumer loans (bottom graph), up 8 percent from a year earlier, marking the eighth consecutive quarter that charge-offs have increased. By product, credit card charge-offs were up 21.9 percent, while charge-offs of auto loans were up 29.1 percent from a year earlier. Charge-offs of C&I loans and residential mortgage loans were 20.6 percent and 72.0 percent lower, respectively. While the average net charge-off rate rose marginally to 0.46 percent from 0.44 a year earlier, and still remains relatively low, this upward trend should continue as the Fed continues along its tightening path. As a result, banks are increasing their provisions for loan and lease losses and have done so in 12 out of the last 13 quarters. In Q3, banks' loss provisions increased 20.9 percent, year over year, an indication that banks are keen on preparing for a surprise delinquency disaster and have the capital to do so, both of which are encouraging signs.

A less accommodative stance on monetary policy, and thus higher interest rates, have far reaching economic implications. While certain market participants such as banks may see an uptick in earnings on the back of a higher net interest margin, consumers who finance purchases with credit may start to feel the squeeze.

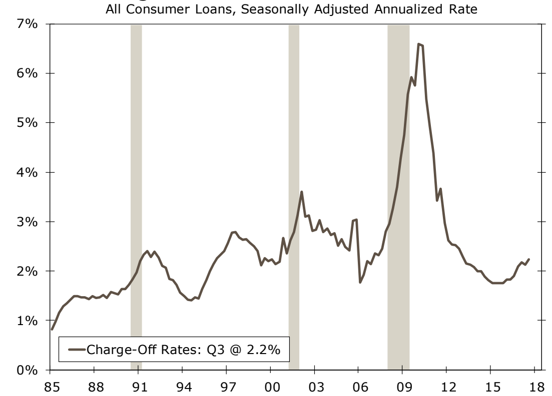
Net Interest Margin at Commercial Banks



Credit Card Interest Rate
APR, All Customers



Charge-Off Rates at Commercial Banks
All Consumer Loans, Seasonally Adjusted Annualized Rate



Source: FDIC and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual				Forecast							
	2017				2018				2019			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50	2.50	2.75	2.75
3 Month LIBOR	1.15	1.30	1.33	1.69	1.90	2.15	2.40	2.40	2.65	2.65	2.90	2.90
Prime Rate	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.25	5.50	5.50	5.75	5.75
Conventional Mortgage Rate	4.20	3.90	3.81	3.94	3.97	4.05	4.22	4.35	4.45	4.50	4.62	4.67
3 Month Bill	0.76	1.03	1.06	1.39	1.60	1.85	2.10	2.15	2.35	2.40	2.60	2.65
6 Month Bill	0.91	1.14	1.20	1.53	1.70	1.95	2.20	2.25	2.45	2.50	2.70	2.75
1 Year Bill	1.03	1.24	1.31	1.76	1.80	2.05	2.25	2.30	2.50	2.55	2.75	2.80
2 Year Note	1.27	1.38	1.47	1.89	2.00	2.25	2.45	2.60	2.70	2.80	2.93	3.00
5 Year Note	1.93	1.89	1.92	2.20	2.39	2.58	2.75	2.85	2.90	2.97	3.10	3.17
10 Year Note	2.40	2.31	2.33	2.40	2.52	2.65	2.82	2.95	3.05	3.10	3.22	3.27
30 Year Bond	3.02	2.84	2.86	2.74	3.05	3.25	3.37	3.50	3.53	3.56	3.66	3.70

Forecast as of: January 10, 2018

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

	2017	2018	2019
Change in Real Gross Domestic Product			
Wells Fargo	2.4	2.8	2.6
FOMC	2.4 to 2.5	2.2 to 2.6	1.9 to 2.3
Unemployment Rate			
Wells Fargo	4.1	3.8	3.7
FOMC	4.1	3.7 to 4.0	3.6 to 4.0
PCE Inflation			
Wells Fargo	1.7	2.1	2.1
FOMC	1.6 to 1.7	1.7 to 1.9	2.0
"Core" PCE Deflator			
Wells Fargo	1.5	1.8	1.9
FOMC	1.5	1.7 to 1.9	2.0

Forecast as of: January 10, 2018

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: December 13, 2017

Source: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities

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