The FDIC Podcast – Looking Back on 2021

BRIAN SULLIVAN: Welcome back to the FDIC Podcast. I'm Brian Sullivan at the Federal Deposit Insurance Corporation and today we're going to look back at 2021 and how our nation's banks fared in a year that was still very much impacted a global pandemic and its economic consequences.

The FDIC has just came out with its latest *Quarterly Banking Profile*…a report card of sorts on the condition of our nation's banks. And *this* quarter, the folks in the FDIC research division took a deep look on the entire year of 2021. And returning to the FDIC Podcast to tell us what all this means are Pat Mitchell and Meg Hanrahan, two senior financial analysts who, along with a staff of others, produce this banking profile. Meg and Pat, welcome!

MEG HANRAHAN: Thank you.

PAT MITCHELL: Thanks Brian.

BRIAN SULLIVAN: Well, let's begin with you, Pat. More than 4,800 FDIC-insured commercial banks and savings associations reported their aggregate net income was $64 billion in the fourth quarter of last year and $279 billion for all of 2021. Sounds like the banks are doing okay, right? Help us to put this into some context…what's driving all of these earnings?

PAT MITCHELL: Sure. Yes. It was a good year for the banks, especially from an earnings perspective, but getting behind those numbers, it becomes a little less clear and a little less positive. I'd still characterize as positive overall. So first, the largest driver was a decrease, a significant reduction, in provisions between 2020 and 2021. And the way that works is when you take provisions, it's actually an expense and it reduces income. So the reduction, between 2020 and 2021 actually resulted in an increase in net income. So these…

BRIAN SULLIVAN: …so provisions are what they set aside, sort of as a rainy day fund.

PAT MITCHELL: Sure. I think that's a fair way of characterizing it.

BRIAN SULLIVAN: Well, it's safe to say that if banks are provisioning *less*, earning *more*, does that mean they're more confident that they have sufficient reserves on hand to protect them against future credit losses?

PAT MITCHELL: Yeah, absolutely. They definitely feel that feel a lot more confident. You know, and there's a good reason for that. If you think of 2020, we can all look back and think about how dark things seemed and how really uncertain…

BRIAN SULLIVAN: … at least in the first half…

PAT MITCHELL: Absolutely. And even in the second half, I mean, we are still having significant increases in coronavirus cases. Deaths were increasing and you just started seeing the rollout of the vaccinations. And so 2021, we've had significant rollout…anybody really use one of the access to the vaccination has received them and you've seen a significant reopening of the economy and that's resulted in really strong economic outcomes.

You look at unemployment. Unemployment is extremely low. You can see GDP growth has tended to either meet or exceed expectations throughout all of 2021. So all of that's resulted in a stronger economy than many people would have expected in 2020.

BRIAN SULLIVAN: Okay. And all of this played out in our banking industry. Now, in announcing these results, FDIC Acting Chairman Martin Greenberg did sound a cautionary note…

FDIC ACTING CHAIRMAN MARTIN GRUENBERG:

> "Despite the positive trends, several challenges persist for the banking industry. The trajectory of the pandemic and the longer-term economic and banking industry effects remain uncertain. In addition, rising interest rates and geopolitical uncertainty could negatively affect bank profitability, credit quality, and loan growth going forward. In particular, rising interest rates could adversely impact real estate and other asset values and borrowers' repayment abilities. These will be matters of ongoing supervisory attention by the FDIC over the coming year."

BRIAN SULLIVAN: So Pat, given what the Acting Chairman just said, we're still optimistic but we do have to be mindful that this coming year, the year ahead, still has some uncertainties…and golly, all you have to do is look at the news today, right?

PAT MITCHELL: Absolutely. Absolutely. And all of those uncertainties will play into banks decision-making and how they might provide for losses in the future.

BRIAN SULLIVAN: Right. Meg, last year we talked about this thing called "net interest margin" and how important it was. It was at or near historic lows. First, remind us, what is net interest margin and why is it so important?

MEG HANRAHAN: Well, the net interest margin reflects the net rate of return on the banks' earning assets. So it's the interest in. Less the interest expense. So what they earn on their loans and securities…less what they pay out on deposits. And you divide that by the earning assets, those assets that generate those earnings or cost those funds. And the reason why it's so important and it gives us a measurement as to what is the capacity of the bank, because those typically are the core areas where a bank will it money. What is the capacity of those earnings to cover other expenses? So we'd like to see a little higher number. And as you mentioned, yes, we were anticipating, or we were seeing some very low numbers in 2020. We actually, though, hit the all-time low in the second quarter of 2021. And that's an all-time low for the Quarterly Banking Profile at 2.50 percent…

BRIAN SULLIVAN: …this goes back to the '80s, right?

MEG HANRAHAN: …yeah, 1984. So it goes all the way back then. So that's the lowest level we've had since then. And what we did it see a pop up a little in this fourth quarter…it's now to at 2.56 percent but still a very low number.

BRIAN SULLIVAN: So when it's compressed like that, then that might suggest that banks may not be earning more in interest to cover their expenses?

MEG HANRAHAN: That's right. What we are seeing, though, are some positive trends. I mean, one issue that's affecting the net interest margin is this we're in a very low interest rate environment. So your loans are being put on the books at lower rates. The banks also had a huge amount of deposits coming in, so they didn't have a lot of lending to do so they were putting it in cash, which doesn't earn anything, or securities which may be a lower yielding asset. So it was kind of a combination of the low yielding, or low-rate environment, as well as the mix in the assets on the balance sheet changed or brought down that net interest margin. But as I mentioned, it did go up, and it is at 2.56. So we'll see, as, you know, banks begin to put more loans on the books or can grow their securities portfolios that maybe we'll see that margin increasing

BRIAN SULLIVAN: …and if that margin increases…is it more likely to increase in a higher interest rate environment?

MEG HANRAHAN: Yes, it will increase more in a higher rate environment. Partly because now the banks will put on loans at a higher interest rate than they did before. They'll purchase securities that are at a higher interest rate than they were before. The bonus on this period is deposit rates are at their all-time low also. The aggregate is only 0.15 percent and there's so much in the industry, banks may not feel compelled or pushed that they have to raise their deposit rates at the same time that they're raising their asset yield. So they may see their net interest margin rise without having to change deposit rates.

BRIAN SULLIVAN: So last year, I recall when we were talking about 2020, you said that really outside of the *Paycheck Protection Program*, banks really weren't doing lot of their own lending, right? Uh, demand was very low. People were staying inside, you know, after all and, and public loans were being made to businesses through the small business administration. Well, now that the paycheck protection program is now behind us, or at least in the past, are banks getting back to lending?

MEG HANRAHAN: They sure are. And you kind of mentioned people staying at home. So one of the categories that's growing is credit cards. People are back out there using their credit cards, uh, spending again that we kind of really slowed down in 2020. But we've saw annual loan growth of 3.5 percent in 2021. And as you mentioned, the *Paycheck Protection Program* has ended. So what we're seeing with those loans is that they're being paid back, or forgiven and they've declined approximately $312 billion in 2021. So if we take those out…cause you know, that's showing a negative…but if we take those and exclude those loans, we actually see that loans grew for the year 6.6 percent! So much better. Yeah, much better. So we're definitely seeing banks lending again.

BRIAN SULLIVAN: Pat, one of the big stories of 2020 was the big inflow of deposits into our bank. Meg just pointed that out. People, as we mentioned, were staying inside and they were getting their stimulus payments and they were putting their money into the bank in numbers that we hadn't seen. Is that still happening or is deposit growth slowing down?

PAT MITCHELL: Yeah, so it's slowing down, but it still remains strong. So in particularly, even in 2021 first quarter, you still had a lot of that and that you still had some large stimulus payments that went into the system, but even throughout the rest of 2021, we've seen strong growth, not as strong, slower, but very strong. So deposits really have, or provide the banks with a lot of flexibility as Meg mentioned and really provides them a lot of liquidity.

BRIAN SULLIVAN: Right. And that's what they would need if times were to turn around on us.

PAT MITCHELL: Yeah. And in fact, the higher interest rate environment that we talked about, I mean, what's, what's unclear is how depositors' might react in that environment. But the banks have…as Meg mentioned…the banks have so many deposits right now that they have a lot of flexibility in terms of deciding what to do with those deposits.

BRIAN SULLIVAN: Now not every bank is the same of course…some are more heavily geared toward credit cards, as you mentioned, ag lending…the farm banks out there… some are deeply invested in home mortgages or commercial real estate. When you look at 2021, Pat, do any of these portfolios leap out at you as is doing very well or maybe we should be looking at?

PAT MITCHELL: The answer is yes. We want to look at them all. I mean, this is just that this is our nature. However, let's talk about that a little bit. There are some that stand out more than others. The consumer right now, as we've talked about, appears strong. Our farmers have actually had a very good year. And then when you look at the real estate market, we all see it's very strong right now. So again, we worry about them all, but the one I'd say that we're most focused on right now, really, in terms of trying to see how it will play out is the commercial real estate market. So when you think of that…all the people that have changed their behavior in terms of not going in the office, in terms of teleworking more and how will that affect office space ultimately, and how will that play out in the commercial real estate market?

Some of that still has to happen…now, so far….the performance has remained strong, but still there's some of these…I'll call them transition back to the pandemic…it's still unclear ultimately how office might be affected and retail and other areas. So I think that the commercial real estate to me is probably the biggest question and the biggest unknown.

BRIAN SULLIVAN: Yeah. We'll Meg, you look at the performance of loans, are people paying their loans back, right? And they're doing that?

MEG HANRAHAN: Yeah they are. And that's probably part of the reason why the provisions have gone down so low…it's part of the economy. But also, bankers thought, oh, all these customers are going to go delinquent with this pandemic …businesses are going to close…

BRIAN SULLIVAN: …and that's why we saw provisions shoot up last year…

MEG HANRAHAN: Yeah! And the reality is now we have a very low non-current rate at 0.89 percent. So loans are performing very well. Every portfolio has seen declines in their non-current loans. So, you know, a lot of good performance. So, but you know, we are pessimists sometimes. So with Pat, we do have some concerns about some portfolios.

BRIAN SULLIVAN: Well, you guys are born to look at things this way, right? And of course, once again, all we have to do is turn on our TVs to see the global uncertainty that's taking place and how that might shake out in our own economy. Now that we've talked about 2021 and, and it seems like everything's on firm footing, are there any challenges we should be mindful of? I mean, the Acting Chairman pointed out some…but I asked you this last year, Meg, what keeps you up at night?

MEG HANRAHAN: I would say probably for me, if rates rise, that's going to be some concerns for us. There are a couple of things, you know, aren't…we do hope that the Net interest margin will increase. But again, as I kind of talked about the mix of the balance sheet…40 percent of the assets on balance sheets reprice or mature in more than three years. Meaning…if rates go up… they're going to stay at the rate that they're currently at. So that's a concern. That's not going to help the Net interest margin. We also saw that some of the medium- or long-term rates rose in the last quarter of 2021 and we saw that securities portfolios at these banks had depreciation. So if that continues, securities that were previously purchased may see more, you know, greater depreciation and potentially affects some banks' liquidity position. So that's definitely something we're going to be looking at is what is going to be the effect. And that may slow down loan lending too…if people feel rates are getting too high, they may not be able to afford to buy that new house at the new rate or refinance their corporate debt.

BRIAN SULLIVAN: Pat, what are your cautionary notes for 2022?

PAT MITCHELL: You know, I think Meg caught them all. I mean, obviously we're all watching the geopolitical landscape that that's obviously front and center. But between the Net interest margin being at the lowest level, the risk of higher interest rates and the commercial real estate…as I mentioned, I think those are the things that are probably biggest on my mind in terms of looking at 2022.

BRIAN SULLIVAN: I want to thank you both for coming back again, as you did last year, to give us a tour down, the year that was. Meg Hanrahan and Pat Mitchell, thank you so much for joining us.

MEG HANRAHAN/PAT MITCHELL: Thanks so much. Brian.