The Risks of Banking

BRIAN SULLIVAN: Welcome to the FDIC Podcast, I'm Brian Sullivan with the Federal Deposit Insurance Corporation. This is a podcast where we talk about our banks and your money. And today we're going to be revisiting the issue of risk. Risk is a fact of life in banking; bankers and bank regulators are forever trying to manage those risks.

And the FDIC recently published its *2022 Risk Review*, a comprehensive summary of emerging risks in the U.S. banking system. And back to break these risks down are two of the editors of that report, Krishna Patel, and Kathy Kalser with the FDIC's insurance and research division. Ladies, welcome back!

KRISHNA PATEL/KATHY KALSER: Thanks Brian.

BRIAN SULLIVAN: Krishna you first. Let's. Let's start with, what is this risk review all about?

KRISHNA PATEL: Well first of all, thank you for inviting us back to speak on banking sector risks. We really enjoy speaking about this to everyone. The 2022 Risk Review provides a retrospective summary of conditions in the U.S. economy, financial markets and the banking sector. And continues to cover some of the core risks of areas of credit by which we mean loans, and market, which we mean interest rates, and financial market risks as of year-end in 2021, similar to our previous report.

We discuss emerging risks that were observed in 2021. And we also cover two additional risk areas in this year's report. These are new risk areas…operational risk and climate-related financial risks.

BRIAN SULLIVAN: Well, we're going to get to those in just a second cause they, they sound interesting. But what's the major takeaway in the 2022 risk review? Any differences between your findings from 2021 versus prior years?

KRISHNA PATEL: Well, since our last report, credit and market risks moderated overall, thanks to an improving economy and substantial government support programs that helped reduce credit risk. And these credit risks were lower for consumer and business loans including mortgages, credit card loans, commercial real estate loans, and agricultural loans. And we'll get to that in a bit more detail later.

The report also find small business conditions improved that small businesses continued to take on more loans, even as government support through that *Paycheck Protection Program*, for example, ended. Real estate prices continue to increase nationwide in 2021.

And across all different types of properties including residential real estate, agriculture and commercial real estate. So those are new trends during the year. But that said, the reopening of the economy and increasing consumer demand contributed to higher inflation in 2021. And that continued into 2022.

But corporate debt continued to rise in 2021, particularly as businesses took advantage of low interest rates to borrow more in the markets. Funding costs also declined for banks and deposits continue to increase. So liquidity risks were relatively low during the year.

BRIAN SULLIVAN: Yeah, you mentioned deposits. Kathy, deposit growth was a big story in last year's report. A *lot* of people put money into the banks in the early part of the pandemic and last year, did that continue in 2021?

KATHY KALSER: Well, Brian, first, I want to thank you for having us back again. We always enjoy discussing risks and banking industry conditions with you. But to answer your question, yes. In 2021 bank deposits, including deposits held by community banks, reached the highest level since data collection began in 1984. Deposits continue to increase in first quarter of 2022 and remained elevated compared with historical levels. But while deposit levels are high, deposit growth rates are well below the unprecedented growth rates reported during 2020 and first quarter of 2021.

The record level of deposits contributed to strong liquidity positions across the banking industry, including our Nation's community banks.

BRIAN SULLIVAN: Now I get that this is a look back at the risks, the emerging risks that you noticed in 2021. And from that point of view, have credit and market risks settled down a bit from the early days of the pandemic in 2020 when folks like you were *really* concerned about where they may have headed?

KRISHNA PATEL: Yeah, that's a very good question. So overall risks have abated from earlier stages of the pandemic, but soon some new risks have come into the picture. But overall conditions improved during the year. The banking sector remains strong with strong capital and a steady income and improvement in asset quality. And all of this enabled banks that continue to support the economy. And it is important to note that no banks failed in 2021. Towards the end of the year, however, expiring government programs and higher inflation posed new challenges for the banking sector and remain with us today.

BRIAN SULLIVAN: Right, right. So, Kathy, let's talk about that. I know that you indicated that this was a retrospective report on the risks in the system, but are you seeing anything in those risks that might suggest how banks will fare in a higher interest rate environment?

KATHY KALSER: Well, Brian, as Krishna said, the banking industry continued to report generally favorable credit quality metrics and strong levels of capital and liquidity last year and through the first quarter of this year. Which should help banks navigate challenges this year. These challenges include inflationary pressures that affect both consumers and businesses, higher interest rates, geopolitical developments, and continuing pandemic concerns. And the FDIC is closely watching these challenges and the potential effects on the banking industry and the communities that the banks serve.

But for example, let's talk about housing markets. Home prices increased at a record rate in 2021, far exceeding the peak growth rate during the last housing cycle. And while housing demand was very strong, the supply of homes for sale remained very tight, which further contributed to strong home price growth. In 2021, asset quality among bank residential mortgage portfolios improved in part helped by continued government support and forbearance programs.

But we are monitoring how factors, including a rise in mortgage rates from near record lows, declining home affordability, and the end of pandemic-related support programs and other headwinds may challenge the housing sector's momentum this year.

BRIAN SULLIVAN: Well, you just touched on the single family residential market, but how about commercial real estate? You know, folks are increasingly returning to work in greater numbers, but has the pandemic put a chill on demand for leased office space for example?

KATHY KALSER: Well, let's talk about commercial real estate for a moment. Asset quality of commercial real estate loans held by banks also remained strong in 2021. However, the end of various assistant programs and shifts in the demand for properties continue to present challenges.

Now across commercial real estate types conditions are strongest among industrial and multi-family properties. While broadly speaking conditions for lodging and retail properties have improved from lows reached during the pandemic. Office properties, particularly those in larger gateway cities, will take longer to adjust and respond to the post-pandemic work environment, their increased remote work and other factors. And this presents a continuing risk.

BRIAN SULLIVAN: Hey Krishna. So what do these challenges mean for banks and their customers?

KRISHNA PATEL: The outlook calls for inflations remain elevated. Now we've been dealing with inflation higher inflation since last year and associated with that are higher interest rates. Interest rates and financial market conditions continue to tighten this year, which has caused economic growth forecasts to slow and recession risks to rise. Higher inflation constraints consumer and business budgets and high interest rates and a weaker economy caused market risks to rise for the banking industry. Higher interest rates combined with potential economic slowdown may reduce the number of loans demanded by consumers and businesses alike. Of course, higher inflation means higher prices for homes, higher prices for autos and pretty much everything else.

Which could raise the cost of loans and increase borrower debt burdens overall. The banks may see higher income with improved net interest margins. If they can charge more for loans relative to how much they need to pay for deposits. So in terms of income from those loans, banks might be better off.

BRIAN SULLIVAN: So earlier we had touched upon some new sections that were added to this year's Risk Review. Kathy, tell us about the climate-related risks that this report touches upon.

KATHY KALSER: Sure. Brian, and actually I'm glad you asked about climate-related financial risks. Identifying and assessing climate-related financial risks to the banking industry and the financial system is a top priority for the FDIC. Severe weather events can disrupt local economic conditions and present risk across the banking industry, regardless of an institution's size, complexity, or business model. In fact in 2021, severe weather events resulted in an estimated $145 billion in damages making 2021, the third most costly year since 1980.

And I think it's important to clarify that the term climate-related financial risks refers to both physical risks *and* transition risks associated with climate change. So first, physical risks generally refer to the financial losses resulting from harm to people and property from severe weather events, such as hurricanes, wildfires, and drought. And physical risks can also include long-term climate shifts such as higher average temperatures.

Transition risks refer to financial risks to certain institutions for industry sectors that arise over time from the process of adjusting toward a lower carbon economy. And these transition risks may be prompted by changes in climate and environmental policy, technology, or market centers. It's important to note that the FDIC's 2022 Risk Review focuses only on *physical* risks from severe weather events that occurred in 2021. Which affected communities and the banks that serve those communities because transition risk is a longer term prospective risk that is beyond the scope of the reports retrospective review.

BRIAN SULLIVAN: Krishna, the report also includes a new section on operational risks. What are operational risks and why should we be so concerned about them?

KRISHNA PATEL: Yes. So the report focuses on two main categories of operational risks. Essentially those would include risks associated with cyber threats to banks, and it also includes risk related to illicit financial activity. We wanted to highlight these risks because they remain elevated for the banking sector in particular. The number of ransomware attacks and the banking industry increased in 2021.

BRIAN SULLIVAN: Well, let's see if we can wrap this all up. This 2022 Risk Review looks at a number of emerging risks. We've touched upon cyber and climate-related risks, rising interest rates, rising prices and what inflation could mean for the banking sector…and most importantly, banking customers. They all sound like significant risks. Are banks well-positioned to manage and mitigate these risks?

KATHY KALSER: Hey, Brian, it's important to, to note that the FDIC continues to closely monitor banking industry conditions at both a macro level and at an institutional level. As well as the potential effects on local communities as these many risks and challenges that we discussed with you today evolve and as new risks emerge.

BRIAN SULLIVAN: Well, ladies, thank you so much for joining, coming back to the *FDIC Podcast* and talking about the emerging risk to our banking system and the 2022 Risk Review, Kathy Kalser and Krishna Patel, thank you both so much for joining us.

KRISHNA PATEL: It was a pleasure again. Thanks Brian.

KATHY KALSER: Always a pleasure, Brian. Thanks so much for having us.