FDIC PODCAST

The Risks of Banking

BRIAN SULLIVAN: Welcome to the FDIC podcast. I'm Brian Sullivan with the Federal Deposit Insurance Corporation, and it's that time again to talk about the risks to the banking sector. Banking is, after all, a risk business and managing risk is what responsible banking is all about. The FDIC's *2024 Risk Review* is out...it's an annual summary of risks to the banking system, focusing on community banks, since the FDIC is the primary federal regulator for most of the roughly 4,500 community banks in the United States.

Recently, I sat down with John Anderlik and Kathy Kalser, two senior economists with the FDIC to talk about risk. I began by asking Kathy to describe the FDIC's annual Risk Review and what it sets out to do…

KATHY KALSER: Brian, this is a report that the FDIC has put out for several years. It is a review of banking conditions and risks in 2023 with an eye toward how conditions or risks may evolve this year. The report begins with an overview of economic and financial conditions last year and how banks performed under those conditions. Then the report discusses risks that banks face during 2023 and continue to face in 2024. Risks are discussed across five broad categories—market risk, credit risk, operational risk, crypto asset risk, and climate-related financial risks. Monitoring these risks is among the FDIC top priorities.

BRIAN SULLIVAN: John, last year we saw three large regional bank failures and we continue to experience a somewhat higher interest rate environment. Looking broadly at the market risks that Kathy just mentioned, what does this year's Risk Review tell us about the conditions of the U.S. economy, the financial markets out there, and the banking industry?

JOHN ANDERLIK: Brian, going back to the spring of last year when those three banks failed, things didn't look great for the banking industry. If you recall, there were worries of more bank runs. The Fed was still raising interest rates, and many economists expected the economy to slow substantially or even go into recession by the end of the year. And recessions tend to hit businesses and consumers and their lenders pretty hard.

But banks ended up showing a lot of resilience as the year progressed. The banking industry's earnings remained high in 2023 as higher net interest income more than offset higher provisioning expenses. In addition, asset quality for the industry and community banks remain favorable and capital levels increased in 2023. I think it's safe to say that banks benefited from the strong economy we ended up experiencing last year—inflation moderated, the labor market remained strong, and consumer spending was pretty robust. And importantly, we avoided a recession or anything really even close to one.

That said, financial markets were a bit tough on banks last year, mainly because interest rates ended the year five percentage points higher than they were at the beginning of 2022.

BRIAN SULLIVAN: You know, I have to imagine that higher interest rates are a bit of a two-edged sword for banks, are they not?

JOHN ANDERLIK: They are. With higher market interest rates, banks can charge more interest on the loans they make, but they also have to pay more for deposits. And demand for loans slows down as well. Then there are investments banks make, primarily in bonds that are interest rate sensitive. As interest rates go up, the value of these bonds goes down. The way the accounting for these bonds works, these are paper losses or unrealized losses until the bonds are sold. The big run up in interest rates over the past two years, especially in mortgage rates, caused unrealized losses on securities that banks own to increase dramatically. And unless rates come down, these losses will slowly filter through bank earnings by way of lower interest income. In extreme cases, some banks may find they need to sell bonds at a loss to meet liquidity needs.

BRIAN SULLIVAN: You mentioned liquidity. Let's talk about that. Kathy, the bank failures of last year really exposed the capacity of banks to stay ahead of very sudden runs on deposits. Are we seeing the buildup of uninsured deposits continue in the banking system and does that give you cause for concern?

KATHY KALSER: Brian, total deposit levels, which includes both insured adventure deposits, declined for 2023, which affected banking industry liquidity positions. But total deposits *increased* in the fourth quarter of last year for the first time in seven quarters. There was a buildup of both uninsured and insured deposits during the pandemic as stimulus programs boosted the money supply. Uninsured deposits then declined in every quarter of 2022, and in 2023, especially in the first quarter of 2023, after two bank failures that resulted in heightened investor attention to uninsured deposits.

Now, while uninsured deposits declined last year, *insured* deposits continue to increase in 2023 but at a slower rate than normal. The overall decline in Bank deposits and a shift toward higher yielding deposit accounts put upward pressure on bank funding costs and interest expense. And in response, many banks reduced securities to fund deposit outflows, where they pledged securities to ensure access to liquidity lines and turned to higher cost borrowings to cover anticipated liquidity needs. The overall banking industry's liquidity position, however, stabilized in the fourth quarter of 2023. So to answer your question, I am now able to sleep better at night.

But we're watching community banks. Community banks have increased their reliance on wholesale funding to support continued strong loan growth, which has resulted in weakened liquidity positions and at year-end, these levels were the lowest level since 2009. And we continue to monitor this situation closely.

BRIAN SULLIVAN: John, let me ask you, are banks still lending or has demand sort of dropped off, given higher interest rates and reports of stricter underwriting?

JOHN ANDERLIK: Well, Brian, 2023 told us two tales when we look at it. On one hand, looking at the banking industry overall, loan growth slowed substantially last year. The industry only grew loans by 1.8 percent, which was lower than inflation, and about half of that was on credit card loans. The Fed Senior Loan Officer Surveys tell us that not only are bankers tightening their underwriting standards, but the loan demand is weak as well. The higher interest rate environment is likely playing a role in the reduced loan demand. On the other hand, what we draw down to community banks, we see that these smaller banks grew their total loans by 7.8 percent last year, though that was down from a very robust 14.4 percent of 2022. Community banks were active in making residential, commercial real estate, and construction loans last year.

BRIAN SULLIVAN: When it comes to all the loans that banks are making. Which loan categories are you looking closely at regarding the risks that they present to the industry? Kathy, let's begin with you.

KATHY KALSER: In the Risk Review, we discuss lending types by types of loans and at the very top of the list is commercial real estate lending. Now, last year, most commercial real estate markets were resilient, but markets for office and retail malls remained weak and while commercial real estate loan quality for the industry, the banking industry as a whole, remained favorable at year end of 2023, weakness emerged, particularly among office properties held in large bank loan portfolios.

BRIAN SULLIVAN: Well if commercial real estate tops your list, John, I guess what comes next?

JOHN ANDERLIK: So, Brian, after CRE, the next two portfolios we discussed in the report were residential real estate loans and consumer loans. I'll give you a quick synopsis of consumer lending since that's one of my fortes. In this report, we take a close look at consumers' financial situations and how their bank loans are faring. Household finances were solid in 2023 as incomes and net worths were higher, despite a declining savings rate.

But consumer loan growth at banks slowed in 2023 as banks tightened lending standards and households reduced their demand for loans. And not only did consumer lending slow down last year, consumer loan *performance* also weakened in 2023. Much of consumer loans at banks is in the form of credit cards or auto loans, and the pass-through rate for credit cards and auto loans ended the year at the highest level since 2011.

BRIAN SULLIVAN: Well, Kathy, what about, you know, John earlier mentioned residential real estate. Higher interest rates clearly slowed demand for home loans, did they not?

KATHY KALSER: Brian, you're absolutely right. They did. After mortgage rates increased sharply in 2022 from historic lows, rates remain high throughout last year. Higher mortgage rates contributed to a slowdown in housing activity, but housing prices increased during the year as supply of homes for sale remained very tight.

But looking at mortgage loans on banks' books, credit quality remained sound last year. But we are beginning to see early signs of stress, particularly across community banks.

BRIAN SULLIVAN: You know, John, when you were with us last on the FDIC podcast, we focused on farm loans. How's the ag banking sector doing?

JOHN ANDERLIK: Well, Brian, you and our listeners may not realize this, but farm banks make up about one fifth of all banks in the nation. So we monitor the country's agricultural sector very closely. Ag conditions remain strong in 2023. These conditions supported agricultural lending, favorable asset quality, and higher loan concentrations at the small banks that make these loans. Farm real estate values continue to be very high. But we may see a slowing in the rate of appreciation.

And while I have the floor, I'll also touch on a couple of other lending areas that we monitor and we covered in the report. Small business lending—small businesses reported dual challenges of high inflation and tight labor markets, but steady consumer spending helped support business conditions in 2023. Over the year, small business asset quality remained relatively sound.

And on the corporate debt and leveraged lending fronts. Corporate debt increased in 2023 as market conditions improved, while bank lending to businesses continue to tighten.

BRIAN SULLIVAN: Kathy, what does the Risk Review have to say about bank lending to non-bank and lending in the energy sector?

KATHY KALSER: For non-banks, bank lending to non-banks moderated in 2023. Despite favorable asset quality measures, sudden changes in market conditions may pose potential direct and indirect risks to non-banks and to their lenders. So that's something we're watching.

On the energy side, economic conditions in energy-producing states were generally favorable in 2023, aided by higher oil production in the U.S. Bank loan exposure to oil and gas firms, although, continued to decline. Community bank asset quality and energy producing states deteriorated slightly, but loan delinquency rates remained low by historical standards.

BRIAN SULLIVAN: The Risk Review also looks closely at other risks and so as we as we bring this discussion to a close, John, some of those risks are more obvious to some than others.

JOHN ANDERLIK: Thanks. Yeah, we have a section on operational and cyber risks. There are a lot of operational risks that banks are dealing with. Ransomware and supply chain attacks continue to threaten banks and other third parties. Geopolitical events continue to increase the likelihood of cyberattacks on banks. Despite a general decline in the use of checks, believe it or not, check fraud continues to rise. And finally, adoption of quantum computing and artificial intelligence potentially pose new risks to critical infrastructure systems.

BRIAN SULLIVAN: For a couple of years now, the Risk Review has also touched on climate-related financial risk. Kathy, what are climate-related financial risks and how might they impact banks?

KATHY KALSER: The Risk Review does specifically discuss physical-related, climate-related financial risks that banks face. And this means that climate events, the risks that climate events have on a bank's physical infrastructure and on properties that borrowers may use to secure their loans from banks.

In 2023, the number of billion dollar climate events reached the highest level since 1980. While insurance policies may cover some or all of losses associated with many severe climate and weather events, these policies are becoming more expensive or in some cases unavailable, which increases risks to the banking industry.

So I want to thank you both, John Anderlik and Kathy Kalser for joining us again on the FDIC podcast.

JOHN ANDERLIK AND KATHY KALSER: Yeah, thanks, Brian. Thanks, Brian. A pleasure.