The FDIC Podcast – All about Risk

BRIAN SULLIVAN Welcome back to the FDIC podcast. And if you're new to this conversation, nice to have you. I'm Brian Sullivan that the Federal Deposit Insurance Corporation. This is a place where we talk about our banks and your money. And today it's all about risk. A lot of people think of risk as a bad thing while others consider risk to be unnecessary path toward reward. Still, *all* agree too much risk is a bad thing.

The FDIC recently published its *2021 Risk Review*, a comprehensive summary of emerging risks in the U S banking system. And joining us today to talk about these risks are two of the editors of that Risk Review, Krishna Patel and Kathy Kain the FDIC's research division. Krishna, Kathy, welcome.

KATHY KALSER: Nice to be here Brian.

KRISHNA PATEL: Yeah, thanks, Brian. We welcomed the opportunity to discuss these risks.

BRIAN SULLIVAN Krishna let's begin with you. Tell us what this 2021 risk review is all about.

KRISHNA PATEL: Well. so the 2021 Risk Review summarizes conditions in the U S economy, financial markets and the banking sector, and in particular, it presents key credit and market risks to the banks.

So, credit risks are those risks that relate to bank lending. So, for example, the banks, extended variety of different types of loans – consumer loans, mortgages, business, or commercial loans and agricultural loans. But each of these have different risk profiles and the report pretty much covers how these different types of loans present risks to the banks.

On the market risk side…market risks are those that relate to financial market conditions overall. And sort of talk about development such as changes in interest rates and overall funding conditions, you know, how tight how easily banks can obtain funding. So the report focuses on all of these risks and it particularly the effects of these risks on community banks, as the FDIC is a primary federal regulator for most of the roughly 4,500 community banks in the United States.

BRIAN SULLIVAN: Well, you know, 2020 was really a year, like no other. How did the pandemic impact the risks you just talked about?

KRISHNA PATEL: Well, the banks face unique challenges during the pandemic. So, you know, this pandemic broke out early last year and financial market stresses intensified suddenly in March with a broad based sell-off in equity and bond markets and declines in interest rates.

The result was an abrupt change in financial market conditions and the U.S. economy…widespread business closures and reduced economic activity resulted in a surge in the unemployment rate with many borrowers unable to make their loan payments. Banks faced uncertain economic outlook and potential for *much* higher loan defaults.

At the FDIC we were really concerned about possible bank failures last year. Thankfully that didn't happen. Fortunately banks entered the pandemic with strong capital and liquidity levels. The banking sector remained relatively resilient pretty much throughout 2020 and was actually a source of stability for the economy, even as it was challenged by broader economic and financial market weakness.

From an operational perspective, banks responded to challenges, you know, when their physical offices were not accessible and you know, their employees had to stay at home. So, they were able to circumvent these challenges and meet their consumer's needs. So the overall banks were relatively stable.

BRIAN SULLIVAN Right, and so many bank branches were closed, right. Kathy, can you tell us more about the credit risks that are mentioned in this report? What, for example, what does the report say about the risks that the different types of loans that, that borrowers took out and their ability to *repay* those loans during the crisis?

KATHY KALSER: Thanks, Brian. When we say the term credit risk, we're really referring to the risks that borrowers will not be able to repay their loans. And as Krishna mentioned, banks lent to many different types of borrowers. For example, consumers, businesses of all sizes, homeowners and farmers are a few examples.

During the pandemic, the industry faced the potential for heightened credit risks, meaning the risk that borrowers couldn't repay their loans, particularly in sectors or areas that were hardest hit by the pandemic. And banks with higher loan exposures, meaning more loans to risky sectors, could be more vulnerable to credit risk problems.

BRIAN SULLIVAN: Right, right. Well, when you break down the loan portfolios of banks, did some categories of loans perform better or worse than, than maybe we expected?

KATHY KALSER: Sure. At the onset of the pandemic, the nation banks faced the potential for serious loan quality deterioration across many types of loans as the economy suddenly weakened. For example, agricultural loans seem to be vulnerable at the very start of the pandemic. If you recall, restaurants closed, people stayed in their homes, they didn't go out, but despite a very volatile environment last year, agricultural loans, farm loans, remained resilient. Initially the farmers had to adjust to supply chain disruptions and the change in eating habits. And that created initial drop in the demand for many food products. But prospects improved for farmers in the second half of the year with the help

of a record level of government assistance and from a banking its perspective at the FDIC farm loan asset quality was sound last year.

Now, a couple other sectors also surprised us. It may seem like a long time ago, but at the very start of the pandemic, housing activity slowed considerably amid great uncertainty about jobs, the economy, and actually people's health…people didn't leave their homes. But after declining sharply at the start of the pandemic, housing sales picked up strongly…low mortgage rates and increased demand for homes as people adjusted to working from home…and working remotely and being with their kids and the family…and home changed preferences for home and this all contributed to increase demand for new homes.

And also we had a limited inventory of homes for sale, which also contributed home price, strong home price gains and this limited inventory of homes is vastly different in this cycle than in the prior housing cycle.

BRIAN SULLIVAN: Well, how about the commercial real estate sector?

KATHY KALSER: You read my mind, I'd like to comment about the commercial real estate sector last year. Now, hopefully you'll you either have, or will be able to enjoy a nice summer vacation this year. But last year, most of us had to cancel our summer vacation plans and that hurt hotels and other leisure properties…many hotel rooms stayed empty. In addition, business travel declined and actually business travel still remains weak. And so that hurt hotel and lodging properties.

On the retail side, online shopping has been increasing for years *well* before the pandemic, but it accelerated during the pandemic and that hurt retail stores and shopping malls, those remained empty.

And if we have a moment, I also wanted to talk about office properties. Today the three of us are working from different locations. We're not in the same office that we'd usually be. And office properties remain mostly vacant last year. And this includes a range of different type of properties across geographies and other areas. So lots of changes ahead in the office sector.

Now, while commercial real estate market conditions have improved this year, from last year, we really have to wait and see how everything falls out from the pandemic and how behaviors change to see the overall effect on commercial real estate properties and on the ability of CRE borrowers to pay their loans.

BRIAN SULLIVAN: Right, right. Krishna. Well, some of these risk factors we've been talking about were obviously associated with the pandemic, what were the risks in the banking sector that *predated* this global health crisis?

KRISHNA PATEL: Right. So actually there were a couple of key risks that predated the pandemic and still continue to be risk factors today. First, I'd like to say the low interest rate environment that challenges the community bank and banking sector profitability, and then the vulnerabilities to corporate debt.

So the banking industry, particularly community banks, were already challenged by the low interest rate environment for more than a decade before the pandemic hit last year. As you know, banks make a profit from interest that they earn on the loans that they make, net of any interest that they pay on deposits.

Now, when interest rates were near zero over the past decade, this was particularly challenging for this type of business model. So in this environment, as interest rates fall, banks' interest income decline but interest that they pay on deposits can't fall any further because they're stuck at zero. So then they get squeezed, in a sense, as the interest that they are on the loans declines, but then they're still paying the same for deposits. As a result, bank net interest margins fall. This reduces their profitability and may actually encourage risk-taking behaviors from the banks as they try to find innovative ways to make up for the decline in income. And if they can't earn profits, unprofitable banks may merge with other banks or fail altogether. So this is a challenge, one key challenge, that still remains within the banking system.

And another one is exposures to the corporate debt. So what what's happening here? Well, corporations have become highly indebted and many risky corporations are vulnerable to default. Corporate debt has increased during the pandemic time as interest rates fell even further, and the corporations had a need to borrow more cash, all which encouraged more borrowing at the end of the day.

Right now, conditions are pretty stable. The economy is improving and so this is good for corporate debt overall, but this still remains a vulnerable sector and an area of potential risk to the banks.

BRIAN SULLIVAN: Kathy, one of the big surprises of 2020 was the *explosion* in bank deposits. People put their money into the bank, which I guess is a good thing, right? They express their confidence in, in putting their money in a safe place and banks are, and have been generally speaking, a safe place to put their money, given that they those bank deposits are insured. That helped banks weather this storm, didn't it?

KATHY KALSER: Yes, Brian. Thanks. During 2020 banks, our record amount of deposits flow into banks. For the industry bank deposits grew by $3.3 trillion, over 22% in 2020. And although the largest banks capture the majority of the growth, deposits at community banks also rose those rose 16% and exceeded $2 trillion in 2020.

Brian, numerous factors contributed to the increase in deposits. For example, when a national state of emergency was first announced early in the year, many consumers decreased spending, and increased savings as a result of what we talked about…canceled vacations, less dining out, reduced transportation expenses, a myriad of reasons of why spending went down. And some of that money made it back into their bank savings accounts, which helped banks. And on the business side, corporations also were concerned about the economy and they increased their cash. They borrow on corporate lines and other funding sources and put that money into banks. So they had a cushion to absorb whatever shocks…to help absorb shocks.

Now, many of the federal programs created to mitigate the economic stress, particularly the CARES Act, also contributed to deposit growth. Government assistance provided individuals with stimulus checks and increased unemployment benefits. And it also provided thousands of small businesses access to Paycheck Protection Program loans, also called PPP loans, and a large share of those loan funds were deposited into the banking system. So, both consumers and businesses and small businesses put new-found money into their bank accounts.

Now, traditionally banks use this new money, this liquidity that comes to the system, to fund lending. But last year loan growth was tepid and it primarily consisted of the PPP loans that I just mentioned. And the weak lending outlook was consistent with a weak economy. No one knew what demand would be for the economy. So absent the PPP loans, lending was down. So deposits stayed…the banks used the deposits instead of funding loans to increase their liquidity. And they invested in invested in short-term securities and other cash-like investments.

Now while many community banks ended 2020 with a lot of liquidity, the stickiness of the deposits, meaning how long will these deposits stay in the bank, is unknown. And we don't know that both from the consumer standpoint and the business standpoint. And we'll have to see how that plays out this year as the economy, economic activity increases.

BRIAN SULLIVAN: Krisha if we stepped back, you know, we've been talking about these various indicators of the health, and the risks to the banking sector…net interest margin, the 'stickiness' of these deposits that Kathy just mentioned. But if we back up just a bit, is there anything you can tell our listeners about the overall risk climate to the banking industry now?

KRISHNA PATEL: Yeah. So I'd say that overall, the banking industry rate remains pretty strong despite the many and very unique challenges that came about from the pandemic last year. The number of banks on the FDIC's problem bank list, which is a list of banks that we're seeing facing particular problems, remain relatively flat throughout the pandemic and remains near historic lows.

Nevertheless the continued low interest rate environment, as I discussed before, along with weak loan demand overall will continue to present challenges for the banking industry in the near term. For now you know, depending on how the pandemic evolves, but as long as things are pretty stable, I would say that the banking industry is well positioned, I would say.

BRIAN SULLIVAN Well, it'll be something we'll pay close attention to in the, in the future. Kathy Kalzer, Krishna Patel, thank you both for stopping by to talk about the risks to our banking sector.

KRISHNA PATEL: Thanks for having us. Thank

KATHY KALSER: Thank you.