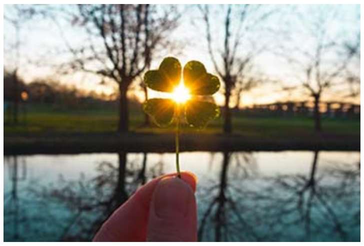

Emerging Risks for the Banking Industry (Part 1 of 2)

cyber security industry update economy

Summary: The FDIC recently published its 2022 Risk Review. We summarize some of the report highlights relating to market, operational, and climate-related risks emerging within the banking industry, and discuss their potential impact on community financial institutions.

Over the years, many people around the world have tried to use different symbols and charms to ward off evil or improve their luck. During the late 19th century and early 20th century, one such talisman was the fumsup neck charm, a tiny metal cherub-faced doll with a wooden head that allowed the wearer to "touch wood" to avoid misfortune. These charms were most popular during WW1, when they were given to soldiers for luck on the battlefront.

Fortunately, rather than relying on lucky charms to ward off potential problems, community financial institutions (CFIs) can refer to the Federal Deposit Insurance Corporation's (FDIC) annual Risk Review for a thorough picture of emerging threats and risks within the banking system.

The FDIC recently published its 2022 Risk Review based on what it observed during 2021. Today, we take a closer look at the FDIC's overview of economic conditions, along with its findings on key market, operational, and climate-related risks for the banking sector. Next Wednesday, July 20th, we will review the FDIC's assessment of credit risk.

Economic overview

According to the FDIC's report, the banking environment improved overall during 2021, as the US economy recovered from severe recession in 2020. So, the outlook for banks should continue to improve. However, they face downside risks from lower-than-expected economic growth, while rising inflation could impact on credit risk. The CPI interest rate rose to 7% in December 2021 and a modest deceleration in economic growth is widely predicted for 2022.

Financial market conditions during 2021 were "*generally supportive*" of the banking industry with the associated risks "*moderated.*" Although financial market conditions deteriorated in early 2022 due to the conflict in Ukraine, the report suggests that "*funding conditions have remained generally favorable.*"

Banks' profitability increased due to declining expenses in the form of lower credit-loss provisions and rising non-interest income. Net interest income improved across the industry during the second half of the year, but didn't exceed 2020's level. Community banks' net income increased and exceeded pre-pandemic levels, up 29.3% to $32.7B in 2021, despite lower net interest income.

Market risk

The FDIC reports that, overall, market risks remain "*moderate.*"

Until the recent increases, low interest rates have continued to present a potential challenge to net interest margins and banking sector profitability. To increase interest income during 2021, many community banks invested in longer maturing assets with higher yields, which helped support their net interest margin (NIM) compared to the rest of the sector. Community bank NIM fell by an average of 12bps to 3.27% last year, less than half the decline experienced by other banks. However, the FDIC warns: "*While higher interest rates could benefit banking industry interest income, they could be a source of risk for banks with substantial exposure to longer-term assets.*"

Liquidity levels across the industry remain strong, supported by historically high levels of deposits and bank reserves. Last year banking sector deposits reached their highest level since 1984, with community banks reporting 29% deposit growth. Alongside slow lending growth, this contributed to a major increase in liquid assets — resulting in a general decrease in reliance on wholesale funding. The FDIC suggests that community banks "*with sufficient liquidity and effective risk management programs are well equipped to meet potential funding demands.*"

Operational risk

According to the report, operational risks around cybersecurity and illicit financial activity "*remain elevated.*"

Ransomware attacks increased last year amid growing numbers of sophisticated cyberattacks from criminals, compounded by geopolitical tensions, an increase in remote work and the use of digital tools. Meanwhile, banks continue to find vulnerabilities in their software and networks. The threat of software security and computing services provided by third-party suppliers being compromised poses a "*serious risk.*" The FDIC also advises that criminals are increasingly developing new and innovative ways to launder funds.

CFIs must continue to be extra vigilant to combat these threats. This recent BID article outlines six ways institutions could bolster their cybersecurity.

Climate risk

The 2022 Risk Review acknowledges that climate-related financial risk is a key emerging issue for the banking industry. The increasing number of severe climate-related events that have the capacity to harm people and property are also impacting many community banks. Climate-related events resulted in $145B in damages during 2021.

The FDIC stresses that identifying and assessing climate-related financial risk in the banking industry is one of its top priorities.

Institutions interested in reading more about these risks can access the full 2022 Risk Review here. We take a look at the key credit-related risks identified by the FDIC in the second part of this series.

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ECONOMY & RATES

Rates As Of: 07/13/2022 04:50AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	2.22	0.50	2.16
6M	2.78	0.27	2.59
1Y	3.19	0.41	2.81
2Y	3.18	0.22	2.44
5Y	3.14	0.10	1.87
10Y	3.06	0.04	1.54
30Y	3.22	0.04	1.32

FF Market	FF Disc	IORB
1.58	1.75	1.65
SOFR	**Prime**	**OBFR**
1.54	4.75	1.57