Key Credit Risk Challenges for the Year Ahead (Part 2 of 2)

by Steve Brown industry economy credit risk CRE

Summary: In this second part of our summary of the FDIC 2022 Risk Review, we take a closer look at the FDIC's findings on potential credit risks for the banking industry and community financial institutions. While credit conditions for banks have improved in 2021, we examine the increased credit risk in certain sectors and markets linked to pandemic-related challenges, rising inflation and the war in Ukraine.

Did you know that the concept of "banking" has been around since as far back as Babylonian times? The need for money services increased dramatically during the Middle Ages, as economic activity increased. But it wasn't all plain sailing. During the late Middle Ages and Renaissance period, most bank failures were due to rulers taking out huge loans to pay for wars at unrealistic interest rates of 45% to 60%—and then simply refusing to repay them.

Thankfully the modern banking industry tends to take a more informed view of credit risk, in part with the help of the FDIC's annual Risk Review. Following on from last Wednesday's (7/13) summary of key market, operational and climate-related risks , today we look at what the FDIC's 2022 Risk Review has to say about credit risk.

Overall, credit conditions for banks improved in 2021, thanks to a combination of government support programs for businesses and consumers, improving economic conditions, and a supportive financial market environment. Looking forward, certain sectors and markets pose increased potential credit risks linked to pandemic-related challenges, rising inflation and the war in Ukraine.

Credit risk by sector and market

Agriculture. Higher commodity prices, growing farm incomes and farmland values helped to support agricultural loans held by banks during 2021. That was particularly good news for community banks, which hold 69.8% of all agricultural loans—worth more than $125B. Despite weak loan demand and margin compression, profitability remained good for those community banks focused on this sector. Increases in loan repayments and declining loan extensions helped to improve asset quality. However, the FDIC warns that rising production costs and supply chain problems within agriculture may pose challenges for the banking sector this year.

Commercial real estate (CRE). Most property types recovered from the pandemic-related setbacks experienced in 2020, although some fared better than others. Banks reported record-high CRE loans in Q4 2021, with community banks holding 29% ($796B) of total CRE loans—10% up YoY and 31% higher than the previous year's peak. The proportion of CRE loan volume held by community banks rose to 65% for those headquartered in rural or smaller metropolitan areas. Although CRE assets remained strong, expiring pandemic support and changing demands for CRE property may affect future performance.

Consumer debt. Consumer lending was well-supported by strong consumer incomes and balance sheets last year as fiscal support programs boosted personal income, lowering household debt burdens. At the same time, consumer loan balances with banks grew amid improving asset quality. Despite these general improvements, consumer loans remain vulnerable to pandemic-related issues. This could be a source of significant risk for community banks, given they comprise 65% of all banks with “concentrations” of consumer loans.

Energy. The energy market rebounded in 2021, supporting overall lending conditions in the sector. However, the conflict in Ukraine is leading to supply issues and increased market volatility. While community banks have limited exposure to oil and gas firms, those operating in energy-concentrated markets are exposed indirectly via lending to consumers and businesses reliant on the energy sector.

Housing. The housing market strengthened throughout 2021, supporting mortgage lending. Record house price growth was driven by increasing demand, limited supply, and low mortgage rates. Banks overall reported lower mortgage delinquency rates, with community banks reporting the lowest such rates. However, mortgage lending by nonbank financial institutions outpaced that of banks. The FDIC warns that headwinds caused by increasing mortgage rates after near-record lows may challenge the sector’s momentum.

Corporate debt and nonbank lending. The wider banking industry remains vulnerable to adverse corporate debt market developments, particularly if rising interest rates challenge the financial conditions of highly leveraged corporations. However, community banks’ direct exposure to corporate debt is relatively limited. Similarly, community banks have minimal exposure to lending activity to nonbank lenders and nonbank financial institutions where the FDIC views the risk of lending to be “relatively moderate.”

Small business lending. Community banks continued to be an important source of funding to small businesses during 2021, with loans to small businesses forming a large share of their loan portfolios. Small business loans across all banks declined last year compared to 2020, mainly due to the Paycheck Protection Program ending in H2 2021. Excluding PPP, community bank lending to commercial and industrial small businesses grew 10.9% to achieve a 25.6% share of small business loans. Despite improved conditions for small businesses, they remain vulnerable to pandemic-related developments that may threaten asset quality and adversely affect banks.

Although CFIs continue to be generally well positioned to serve their customers from a credit risk perspective, these risks will continue to cause uncertainty and challenges. CFIs should review their portfolios carefully and keep updated on their customers’ situations, in order to help them, while mitigating credit risk.

The full 2022 Risk Review is available on the FDIC’s website.

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ECONOMY & RATES

Rates As Of: 07/20/2022 01:34PM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	2.51	0.79	2.45

6M	3.04	0.53	2.85
1Y	3.17	0.39	2.78
2Y	3.24	0.29	2.51
5Y	3.17	0.13	1.91
10Y	3.03	0.01	1.51
30Y	3.16	-0.02	1.26

FF Market	**FF Disc**	**IOER (Interest on Excess Reserves)**
1.58	1.75	1.65

SOFR	**Prime**	**OBFR (Overnight Bank Funding Rate)**
1.54	4.75	1.57