2022 Review, Pt. 1 of 3: An Unstable Market's Impact on Lending

lending stress testing credit risk

Summary: This year has seen record inflation, ongoing interest rate hikes, and economic recovery, followed by anxiety over a possible recession. In this first installment of our three-part review of 2022, we look at this turbulent market and how it has impacted lending.

Most charts list the movie "Avatar," released in 2009, as the highest grossing movie of all time with $2.9B in revenue. However, if you adjust for inflation, "Avatar" slips to number two, and "Gone with the Wind," which was released in 1939, moves to the top spot — grossing $3.9B in modern terms. It cost $3.85MM to produce at the time — significantly less than the cost of today's major blockbusters.

Inflation, of course, affects a lot more than just the price of a movie ticket. The biggest impact on the economy can be seen in sectors like business and real estate, including the lending market. Here we review the key factors impacting lending this past year.

The Turbulence of the Market

In 2022, the US economy continued to bounce back from the lows of the pandemic, and some indicators of economic activity grew steadily in the first half of the year. For example, consumer spending remains positive, despite consumer confidence dropping to 100.2 in November. However, high inflation, interest rate hikes, and geopolitical shifts leave the economy in a somewhat precarious state.

1. **High inflation rate.** This year has been marked by high inflation, driven by post-pandemic increases in demand, supply shortages, a tight labor market, and the war in Ukraine. After reaching a peak of 9.1% in June, the annual inflation rate dropped for the fourth consecutive month to 7.7% in October, but remained above the forecast rate of 7.6%. This is mainly due to decreasing energy prices. Meanwhile, the core consumer price index (CPI) — which excludes energy and food prices — has increased 6.6% YoY. According to the Conference of State Bank Supervisors' (CSBS) annual survey of community bankers, over half of the respondents thought that inflation would continue to be high, but that its challenges would be manageable.
2. **Rising interest rate.** In its battle to curb inflation, the Federal Reserve (Fed) raised the interest rate at six consecutive meetings this year, bringing it to a target range of 3.75-4.00% in November. This 3.75% rise in one year hasn't occurred since the 1980s. Beyond that, intervention from the central bank will depend on inflation — which the Fed is committed to returning to 2% — and labor market conditions. Generally, interest rate increases benefit community financial institutions (CFIs), as their portfolios are focused on higher-yielding loans that reprice faster than deposits after a rate change. However, CFIs should remain watchful over their portfolios as the effect of tightening monetary policy trickles down to all aspects of lending.
3. **Continued geopolitical uncertainty.** The war in Ukraine, continued supply chain disruptions, high energy costs, and fears that further interest rate hikes could lead to a recession have generated an uncomfortable feeling in the markets throughout the year, in turn, generating uncertainty in the lending market.

Effects of the Market on Lending

1. **Sluggish loan demand.** In the first half of 2022, total loan demand grew, building on the slow recovery teed up in Q4 2021. Total commercial bank loans were up 3.7% in Q2 and 2.5% in Q3 to $11.7T, with both commercial and industrial loans (C&I) and credit card loans increasing. In the first half of the year, publicly traded banks with less than $10B in assets *"reported a median 8.5% loan growth, against a 0.7% decline in loans last year."* However, there are fears that loan demand will taper off, as the Fed's monetary policy starts to bite and supply chain disruptions continue. Supply constraints particularly hit smaller businesses, which means CFIs are more likely to be affected by low loan demand.
2. **Pressure on net interest margin (NIM).** NIMs fell to a record low in 2021. Rising rates led to an uptick in NIMs in the first half of 2022, but the speed of the rate hikes means that NIMs are likely to be compressed, as the cost of funds increases faster than loan repricing. As such, for 88% of CSBS' survey respondents, NIM pressure ranked as a very important or extremely important risk this year — first among external risks.
3. **Credit quality risks.** This past summer, we discussed the key credit risk challenges by sector and market, despite signs of improvement from 2020. Throughout this year, loan delinquencies have decreased, reaching a historic low of 1.20% in Q3 of 2022. However, increasing cost of funds driven by prolonged inflation and accompanying interest rate hikes could impact credit quality, too. CFIs are encouraged to conduct stress testing to understand potential vulnerabilities in their portfolios and ensure they have an airtight capital plan in place. This is particularly relevant in the commercial real estate sector (CRE), where CFIs have high concentrations — they hold roughly 30% of the total CRE market, despite having only 12% of the banking industry's total assets. Consumer credit should also be watched carefully, as late payment rates on various consumer loans have been gradually increasing in the last few months.

The conditions that have dominated 2022 are likely to continue as the Fed persists with its tightening to rein in inflation. However, CFIs that remain watchful over their portfolios are well positioned to support their communities in weathering this uncertain economic environment. In the second part of this trilogy, we'll examine how the labor and talent market have changed in 2022. The third and final part will discuss the cybersecurity challenges the financial sector encountered this year.

TWO APPROACHES TO STRESS TEST YOUR LOANS

Now more than ever, it is important to stress test loans of all types from multiple perspectives. Choose your approach and get expert help, as needed. Learn more about credit stress testing today.

ECONOMY & RATES

Rates As Of: 12/06/2022 06:37AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.36	-0.01	4.30
6M	4.73	0.03	4.54
1Y	4.72	0.01	4.34
2Y	4.37	0.06	3.63
5Y	3.75	0.02	2.49
10Y	3.55	-0.06	2.03
30Y	3.56	-0.18	1.65

FF Market	FF Disc	IORB
3.83	4.00	3.90
SOFR	**Prime**	**OBFR**

3.81	7.00	3.82