Risk Landscape Review, Pt. 1 of 2: Key Market & Operating Risks

FDIC risk management

Summary: The FDIC recently published its 2023 Risk Review. In the first article of this two-part series, we summarize the report highlights related to the economic, financial markets, and banking industry conditions over the past year. We also discuss key market, operational, and climate-related financial risks and their potential impact on CFIs.

Did you know there is a pirate stock exchange in Somalia? The village of Harardhere has set up its own stock exchange where anyone can choose to invest in over 72 "maritime" companies. If the pirates are successful in their mission, everyone shares in the spoils. Talk about incredibly high risk for potentially high returns. While investing in piracy can be quite lucrative, there is no regulation, a lot of corruption, and it is, of course, based on illegal activities.

A world away from piracy on the high seas, the FDIC published its annual Risk Review Report in early August 2023. Alongside reviewing the US economy, financial markets, and banking industry, this report considers the key emerging risks for financial institutions across five broad risk categories: market, operational, credit, crypto-asset, and climate-related financial risks.

In this article, the first of two focusing on the report, we summarize some of the highlights related to the economy and market conditions, as well as the associated market, operational, and climate-related financial risks and their potential impact on community financial institutions (CFIs).

Economy, Market, and Banking Industry Overview

The FDIC's 2023 report suggests that, overall, the US banking industry has demonstrated resilience in the face of weaker economic conditions, high inflation, rising interest rates, and financial market stress during 2022 and Q1 2023.

Slow economic expansion. While the US economy continued to expand during 2022 and into 2023, it did so at a much slower rate than in 2021, fueling considerable concerns about the possibility of a recession. Growth in 2022 continued to be hampered by ongoing disruptions to supply chains. Inflationary pressures increased to some of the highest levels in decades during 2022, but moderated somewhat in 2023, in part due to falling energy prices. While the labor market has been strong, with growth in payroll employment and wages, labor shortages in many industries have persisted. Job openings were at historical highs in early 2022 — 12MM in March of 2022, according to the US Bureau of Labor Statistics — but some of this market tightness began to ease in the early part of 2023.

Financial markets tighten. With interest rates rising above market expectations, high inflation, and recessionary concerns, it's unsurprising that financial markets tightened significantly in 2022. Bond market volatility persisted into the start of 2023, but performance is reportedly improving. Similarly, stocks performed worse in 2022 than in any year since 2008, but rebounded in late 2022. Stocks continued this upward trend into 2023, with projected earnings growth of another 7.6% in Q4 2023. While market conditions have stabilized to a degree, interest rates and funding costs remain high.

Bank resilience. Financial institutions have been resilient during these uncertain economic times, and banking performance moderated somewhat in early 2023 after a period of market stress. Bank net interest income and net interest margins (NIM) increased substantially in 2022 as interest rates rose; however, higher funding costs and higher outflows of deposits resulted in NIM declines in Q1 2023. Asset quality metrics for Q1 2023 indicate that the industry remains well capitalized. That said, the quantity of unrealized securities losses remains elevated.

Of course, prolonged periods of inflation and higher interest rates can weaken and challenge prevailing economic conditions. This can pose risks for CFIs through slowing demand for credit, reduced demand for new business, or a reduction in asset quality and increased credit risks.

Key Market Risks

1. Liquidity and deposits. While liquid assets remain above pre-pandemic levels, CFIs have seen these decline during 2022 and into Q1 2023 — partly due to higher loan growth and unrealized securities losses. Although CFIs have experienced some growth in deposit levels (in comparison to a decline across the rest of the industry), this was outpaced by loan growth. The resulting contraction of liquid assets increased wholesale funding (such as through the Federal Home Loan Bank and brokered deposits) among CFIs during 2022 and early 2023. As such, high unrealized losses remain a concern for CFIs.

Continued inflation and higher interest rates still pose a liquidity risk for CFIs, particularly if securities portfolios depreciate further, loan growth is maintained, and core deposits continue to reduce. We look at some strategies CFIs could consider to help manage liquidity constraints in this BID article.

2. Net interest margins and interest rate risk. Strong loan growth and higher interest rates supported an increase in NIM in 2022, albeit from 2021's record lows. This trend reversed slightly during Q1 2023 as funding pressures increased and loan growth slowed. Notably, despite reporting lower net interest income in Q1 2023, CFIs continue to report higher NIM than the banking industry as a whole.

The sharp interest rate rises resulted in investment portfolio depreciation, particularly among financial institutions with a higher share of long-term assets. Those banks also reported lower growth in NIM compared to other financial institutions.

Given the persisting uncertainty about 2023's economic outlook, loan growth may be subdued — providing less support to net interest income and NIM. If interest rates continue to rise or remain high, CFIs may find managing NIM more challenging as they compete for deposits. This recent BID article discussed ways in which CFIs can increase deposit stickiness in the current climate.

Critical Operational Risks

The FDIC's report emphasizes that "operational risk remains one of the most critical to banks," particularly in relation to cybersecurity and illicit financial activities.

1. Cybersecurity is one of the top near-term risks for financial institutions. The FDIC outlines how the increase and sophistication of cyberattacks pose a serious challenge and considerable operational risk for financial institutions. This risk is further complicated by the correlation found between geopolitical events in 2022 and an increased likelihood of cyberattacks on financial institutions.

Banking software infrastructure continues to be vulnerable to cyberattacks, particularly ransomware and threats against third-party providers. Ongoing advances in technology require CFIs to continuously improve their cybersecurity and find ways to reduce risk and service disruption. Earlier this year, we discussed some proposed cybersecurity regulatory changes and how they could influence CFIs' cyber strategies.

2. Illicit financial activity risks. The report emphasizes that robust and appropriately designed and executed customer due diligence policies, anti-money laundering controls, and programs countering terrorism financing compliance are key to reducing the US financial system's susceptibility to illicit financial activity. Over-reliance on third parties to perform these checks and compliance services can be an additional risk source.

Climate-Related Financial Risks

Changing climate conditions — particularly the increasing frequency and intensity of severe weather events and natural disasters — continue to pose risks to the financial system and CFIs. The cost of severe climate and weather events has risen steadily since reporting began in 1980, and 2022 was among the costliest years recorded for climate-driven disasters.

In its report, the FDIC highlights its expanded efforts to understand climate-related finance risk. It also continues to support the industry to consider these dangers and implement the necessary risk management practices to meet the needs of their communities.

Institutions interested in exploring these risks in more detail can access the full 2023 Risk Review here. In part two of this series, we summarize the key credit risks identified by the FDIC.

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ECONOMY & RATES

Rates As Of: 09/20/2023 02:47PM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.56	0.00	1.14
6M	5.51	0.03	0.75
1Y	5.47	0.11	0.76
2Y	5.16	0.30	0.73
5Y	4.59	0.33	0.58
10Y	4.41	0.30	0.53
30Y	4.45	0.23	0.48

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.31	8.50	5.32