Risk Landscape Review, Pt. 2 of 2: Key Credit Risks

FDIC risk management credit risk

Summary: This is the second part of our summary of the FDIC 2023 Risk Review. We take a closer look at the FDIC's findings on potential credit risks for the banking industry and community financial institutions.

Camino de las Yungas in Bolivia is arguably one of the world's most notorious and dangerous roads. A thin gravel track over 22 miles long that climbs to over 10K ft above sea level, it has many hairpin turns and vertical drops, as well as limited visibility. The risks to drivers are numerous, and many accidents and fatalities have occurred over the years.

While maybe not as full of risk as this particular road, 2022 and 2023 have seen some difficult economic conditions that have presented the banking industry with a fair share of credit risks. In our second of two articles focusing on the FDIC's annual Risk Review Report, we summarize some of the key credit risks and their potential impact on community financial institutions (CFIs).

Credit Risk by Sector

As highlighted in the first article of this two-part series, the FDIC acknowledges the banking industry's resilience in the face of challenging economic conditions, high inflation, rising interest rates, and market stress. However, it warns that the persistence of these conditions could create credit issues that may impact bank loan portfolios later in the year — particularly in relation to credit card, commercial and industrial, residential real estate, and commercial real estate (CRE) loans.

Here is a summary of some of the key credit risk areas covered in the report that are most relevant to CFIs.

1. Agriculture. This sector has demonstrated continued strength recently, achieving record profits in 2022, despite widespread drought conditions. Due to high interest rates and rising expenses, farm income is expected to decline in 2023, but remain elevated above its long-term average. Average farm values have also continued to rise over the past year.

CFIs hold 69% of all agriculture loans. Growth in loans and higher yields supported stronger farm bank earnings in the first quarter of 2023. Liquidity ratios at farm banks decreased but remain high. The strong financial conditions in the agricultural sector resulted in improvements in overall farm bank asset quality; however, higher interest rates and production costs could pose challenges to CFIs in the coming months.

2. Commercial Real Estate. The banking sector has considerable exposure to CRE lending, with CRE loans forming the largest loan category for almost half of all financial institutions. According to Goldman Sachs, CRE loans reached more than $3T by the end of Q1 2023. CFI lending is important to the CRE industry, as CFIs carry an outsized proportion of CRE loans: CFIs hold 28% of all CRE loans, compared to holding only 15% of loans overall.

Encouragingly, the FDIC report highlights that four of the five CRE property categories performed well in 2022. That said, there were some challenges and increasing risks in Q1 2023, particularly for the office sector. With a continued decline in the demand for office space and weak rent growth, borrowers may struggle to refinance.

In summary, the report suggests that while overall asset quality metrics for the CRE sector were favorable into Q1 2023, CFIs cannot ignore the risks and challenges to loan performance. These include higher interest rates, economic uncertainty, and difficulties refinancing, especially in larger, more urban markets with active office sectors.

3. Energy. Oil markets were volatile in 2022, although the oil price began to drop in H2 2022 and into Q1 2023. Despite the resulting softening in energy prices, the industry remained profitable. Employment grew at a faster rate in energy-concentrated states compared to non-energy states at a combined 3.7% for nonfarm employment. The report demonstrates that CFI asset quality in energy-concentrated states continued to improve into Q1 2023.

That said, bank loan exposure to oil and gas continues to fall. Although strong in 2022, the outlook for the energy sector has weakened and is more uncertain for the rest of 2023.

4. Housing. As interest rates rose, so did mortgage rates. This saw a slowing in the housing market and a decline in mortgage originations. While home prices remain elevated — largely driven by high demand and low supply — the uncertain economic situation and high mortgage rates saw a marked decline in house price appreciation in early 2023.

Despite high mortgage rates and home prices making it difficult for first-time home buyers to make a home purchase, financial institutions reported higher residential mortgage loan balances and increased construction and development lending.

While asset quality metrics for residential mortgage loans remained favorable, the FDIC's report indicates that there are some early warning signs of potential credit deterioration that CFIs would do well to stay abreast of.

5. Leveraged lending and corporate debt. The tough economic conditions have resulted in stress in both the corporate bond and leveraged loan markets where prices and issuances have declined. Defaults and distress ratios also rose in early 2023; however, these are still low in comparison to previous periods of stress.

Continued slow economic growth combined with high interest rates could pose a credit risk for the banking industry. The industry has direct exposure to corporate debt risks through investments, bilateral loans, participation in syndicated loans, and lending to those who originate private credit. Lower corporate profitability in the face of continued economic uncertainty could adversely affect repayment and increase refinancing risks. There is also the possibility that borrowing costs could continue to rise, should interest rates rise, too.

6. Small business lending. Labor market shortages and high inflation were the top concerns for small businesses in 2022 and Q1 2023, but conditions varied across industries as consumer spending patterns changed.

CFIs remain an important source of small business lending and held an outsized share of the banking industry's total small business loans in 2022 — 23.6%, to be exact. However, financial institutions reported continued decline in small business loans in 2022, partly reflecting the winding down of the Paycheck Protection Program. Meanwhile, small businesses reported weaker conditions in Q1 2023 as well as concerns about business conditions in the near term. This uncertainty and weaker outlook may be a source of credit risk for CFIs during 2023.

Despite recent economic challenges, CFIs continue to be generally well placed to serve their customers from a credit risk perspective, but continued uncertainty risks remain. CFIs should review their portfolios carefully and stay in regular contact with their customers so that they're best able to support them while also mitigating credit risk.

Institutions interested in reviewing these risks in more detail may want to read the full 2023 Risk Review.

INDUSTRY INSIGHTS FROM PCBB

Love reading the BID? PCBB provides other industry insights in the form of podcasts, white papers, case studies, and other content focused on topics critical to the success of community financial institutions. Check them out today!

ECONOMY & RATES

Rates As Of: 09/21/2023 08:39AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.56	0.00	1.14
6M	5.51	0.03	0.75
1Y	5.45	0.09	0.74
2Y	5.12	0.25	0.69
5Y	4.61	0.35	0.61
10Y	4.48	0.37	0.60
30Y	4.56	0.35	0.59

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.30	8.50	5.32