Preparing for the Changing Risk Landscape

Observations from the Risk Council

October 26, 2022

Anthony Cain, S&R

“Hope for the Best, Plan for the Worst”

FRB Chair Powell’s post FOMC September remarks foretell tough banking conditions

- Unemployment rate is expected to increase to 4.4%, *about 1.5 million jobs are projected to be lost*
- A housing correction is not out of the question, *some analyst estimate homes are overvalued by 15%*
- Inflation is already hurting households at the lower end of the income and wealth spectrum
- “…not sure whether this process will lead to a recession or if so, how significant that recession would be.”

The Fed has raised rates 300bps so far this year and may further increase rates by year-end

- Rates have risen at the fastest pace since 1994 – 95, when rates increased 350bps in a single year
- The industry is out of practice with managing through a fast-increasing interest rate cycle

What to Expect

High inflation and rising rates are already having some impact on banking conditions, the impact is expected to increase as rates continue to rise

- Declining asset and collateral values
  - Banks with long duration fair valued assets are experiencing an erosion of GAAP capital and could face increased liquidity and funding challenges
- Growing revenue challenges
  - Reduced mortgage origination and refinancing activity
  - NIM pressure from potentially waning loan demand and declining loan performance as well as long dated low yielding assets coupled with rising funding costs
  - Higher provision expenses for credit losses
- Credit headwinds due to higher payment costs, less consumer demand, and higher unemployment
  - Interest sensitive borrowers – consumers and businesses with high leverage starting to see higher delinquency rates (e.g., auto)
  - Certain industries, specializing in non-consumer staples, could be more impacted
  - CRE is a perennial concern when rates rise
- Persistent staffing issues – talent attraction and retention as well as a lack of experienced staff

What to Watch

Banking industry entered the uncertain macroeconomic environment in generally good financial condition, but potential trends to watch include

- Loosening underwriting standards and changing business strategies
  - The July SLOOS report indicated tighter lending standards to businesses and unchanged lending standards to households. However, supervisors are noting some banks are loosening lending standards to "pre-pandemic levels" and some are planning to grow HELOCs to generate additional revenues

- Increased pace of deposit outflows
  - Record deposit levels have remained remarkably stable to date, but many of the factors contributing to record deposits levels during the pandemic no longer exist (e.g., Fed asset purchases, government stimulus, high personal savings rate)
  - Rate sensitive money could leave banks not following the yield curve as it shifts upward

- Risk management quality
  - Few banks are rated unsatisfactory and MRA issuances are at low levels; however, some horizontal reviews identified credit grading issues and the level of unrealized losses on AFS investment holdings raises questions about the quality of banks' asset/liability management

Questions