Section I: Executive Summary

The banking environment improved in 2021 as the U.S. economy recovered from a severe recession in 2020. The U.S. economy expanded in 2021, surpassing the pre-pandemic output peak in second quarter. However, the recovery was uneven across industries and regions. Labor markets improved, but labor-force participation rates remained weak and signs of labor shortages emerged in key industries. Global supply chain disruptions contributed to substantially higher inflation, pressuring consumer budgets and business costs. Economic growth slowed during the second half of the year, in part due to the expiration of government programs that supported consumers and businesses. Most baseline forecasts call for a modest deceleration in U.S. economic growth in 2022 from the effects of higher inflation and increased geopolitical uncertainty following Russia's invasion of Ukraine.

Financial market conditions were generally supportive of the economy and banking industry in 2021. Corporate credit conditions remained favorable and corporate debt issuance remained strong amid low interest rates. Issuance of high-yield bonds and leveraged loans reached record highs. Equity markets rose and Treasury yields edged higher on economic and monetary policy developments. But financial market conditions deteriorated in early 2022 when tensions between Russia and Ukraine intensified.

Banking sector profitability increased in 2021 as expenses declined and noninterest income rose. Banks reported substantially higher net income in 2021 primarily due to lower credit loss provisions. Net interest income for the industry improved in the second half of 2021 but remained below the 2020 level. Asset growth was concentrated in cash, interest-bearing balances, and securities, while loan growth remained weak. Stronger economic conditions helped support the improvement in asset quality during the year. Among community banks, net income rose and surpassed the pre-pandemic level in 2021, even as net interest income declined.

Key Risks to Banks

Credit Risks: Credit conditions improved in 2021, helped by various government support programs for businesses and consumers, improving economic conditions, and supportive financial market conditions.

- **Agriculture:** The agricultural sector had a strong year in 2021. The sector benefited from higher commodity prices, farm incomes, and farmland values that helped support agricultural loans held by the banking industry, particularly farm banks. Farm banks are defined as community banks with substantial exposure to the agricultural sector. Profitability of farm banks remained favorable despite weak loan demand and margin compression. Asset quality among farm banks improved in 2021, as loan repayments increased and loan extensions declined. Despite the current strength, rising production costs and supply chain problems that affect the agriculture sector may pose challenges to the banking sector in 2022. The conflict between Russia and Ukraine has created uncertainty about the prospects for exports of key agricultural commodities.

- **Commercial Real Estate:** The commercial real estate (CRE) sector was generally resilient to pandemic developments during the year, and most property types rebounded from the initial setback in 2020. Industrial and multifamily properties performed relatively well, while office and some lodging and retail subtypes continued to struggle. The banking industry reported record high CRE loans in fourth quarter 2021, and community banks remain heavily involved in lending to this industry. While CRE asset quality remained strong, expiration of pandemic-related financial assistance and shifts in the market demand for CRE properties may affect future performance.

- **Consumer Debt:** Consumer incomes and balance sheets remained strong during the year and supported consumer lending. Pandemic-related fiscal support programs boosted personal income in 2021 and lowered household debt burdens. Bank consumer loan balances grew in 2021, led by auto loans and other non-credit card consumer loans. Asset quality across all consumer loan categories improved. Community banks reported lower noncurrent rates than noncommunity banks for auto loans and credit card loans and higher noncurrent rates for other non-credit card consumer loans. Despite general improvements in 2021, consumer loans remain sensitive to pandemic developments and could be a source of risk for the banking industry.

- **Energy:** The energy market rebounded in 2021, supporting energy lending conditions. Strong global oil consumption and limited production contributed to higher oil prices in 2021, but U.S. oil production was slow to return to pre-pandemic levels. The recovery of mining employment in energy-concentrated states was sluggish, and U.S. crude oil production did not increase until mid-year as the market drew down existing inventory. Direct bank lending to oil and gas (O&G) firms declined in 2021, as the energy market relied more on corporate debt markets for funding. Although community banks have limited direct exposure to O&G firms, community banks that operate in energy-concentrated markets are exposed indirectly through their lending to consumers and businesses that rely on the energy sector. Increased geopolitical uncertainty has contributed to higher energy prices in early 2022. Russia's invasion into Ukraine raises prospects for a significant global energy supply shock and increased market volatility. The conflict could also reshape energy policy and planning.

- **Housing:** The housing market continued to strengthen during the year, supporting mortgage lending. Home price growth set a new record in 2021 driven by strong demand, limited inventory of homes for sale, and low mortgage rates. Asset quality among bank residential mortgage portfolios improved, helped by continued government support and forbearance programs. Banks reported lower mortgage delinquency rates, with community banks reporting lower delinquency rates than noncommunity banks. Mortgage lending by nonbank financial institutions continued to grow and outpaced bank lending. While housing market conditions were favorable in 2021 and supported mortgage asset quality, headwinds including increased mortgage rates from near-record lows may challenge the sector's momentum.

- **Leveraged Lending and Corporate Debt:** Corporate debt market conditions remained relatively stable in 2021 and corporate debt levels continued to grow. Banking sector exposure to the corporate debt market is generally through holdings of corporate debt and collateralized loan obligations, lines of credit to corporations, and participation in the arranging of leveraged loans and corporate bonds. Banks remain vulnerable to potential distress in the corporate debt markets, particularly if interest rates rise and challenge the financial conditions of highly leveraged corporations. While community banks generally have limited direct exposure to the corporate debt market, the banking industry remains vulnerable to adverse corporate debt market developments.

- **Nonbank Lending:** Bank lending to nonbank financial institutions reached a record high in 2021. Nonbank lending activity is concentrated in the largest banks; community banks have limited exposure. While the risks of bank lending to nonbank financial institutions is relatively moderate, lending to nonbank institutions exposes banks to broader risks from the financial system.

- **Small Business Lending:** Small business conditions improved during the year, helped by improving economic conditions, a rebound in consumer spending, and continued government support, particularly the Paycheck Protection Program (PPP). Small business loans remained a large share of the community bank loan portfolio, and community banks remained active participants in the PPP program in 2021. However, aggregate small business loan growth declined in 2021 when the PPP ended in the second half of the year. Excluding PPP loans, small business commercial and industrial lending grew, especially among community banks. Despite the improvements in small business conditions, small businesses remain vulnerable to pandemic developments that may threaten asset quality.

Market Risks: Market risks remain moderate overall. Low interest rates continue to challenge net interest margins and banking sector profitability. Liquidity levels in the banking industry remained strong and were supported by historically high levels of deposits and bank reserves.

- **Interest Rate Risk and Net Interest Margins:** Low interest rates and excess liquidity continued to reduce bank net interest margins (NIMs), which fell to a record low in 2021. Banks sought to increase interest income by holding more long-term securities. Community banks invested in longer maturing assets with higher yields, which helped bolster NIMs compared to noncommunity banks. While higher interest rates could benefit banking industry interest income, they could be a source of risk for banks with substantial exposure to longer-term assets.

- **Liquidity and Deposits:** In 2021, banking sector deposits, including deposits held by community banks, reached the highest level since data collection began in 1984. The growth in deposits resulted in high levels of cash on bank balance sheets while lending growth remained slow, contributing to higher levels of liquid assets. As liquid assets grew, banks reduced their reliance on wholesale funding. These conditions will continue to support bank balance sheets as the banking industry and economy recover from the pandemic.

Operational Risks: Operational risks, including cybersecurity risks and risks related to illicit financial activity, remain elevated for the banking sector.

- The number of ransomware attacks in the banking industry increased in 2021, and banks continued to discover vulnerabilities to their software and computer networks. The number and sophistication of cyber attacks also increased with remote work and greater use of digital banking tools. Moreover, threats from illicit activities continue to pose risk management challenges to banks.

Climate-Related Financial Risk: The effects of climate change present emerging risks to the banking industry.

- Climate-related financial risks include physical risks from harm to people and property and transition risks from the shifts in policy, sentiment, and technology associated with a transition toward reduced carbon reliance. In 2021, severe climate-related events resulted in $145 billion in damages, the third most-costly year since 1980. Two hurricanes, several wildfires, and a serious drought affected many local communities and the banks that operate there. Severe climate-related events can disrupt local economic conditions and present risk across the banking industry, regardless of an institution's size, complexity, or business model. This discussion of climate-related financial risks focuses only on physical risks to communities and banks from severe climate-related events in 2021, as transition risk is a longer-term, prospective risk that is beyond the scope of this retrospective review.