Section II: Economic, Financial Markets, and Banking Industry Overview

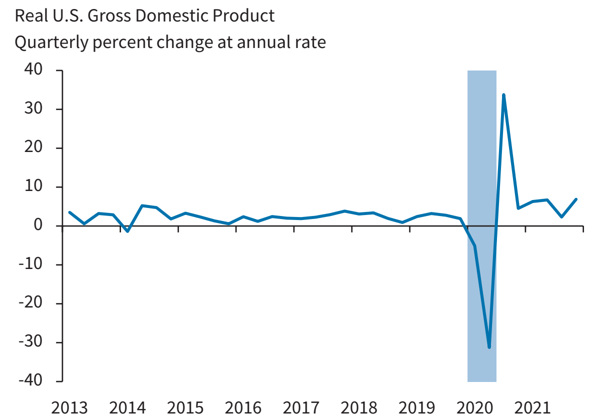
Economy

- *The U.S. economy expanded in 2021, surpassing the pre-pandemic output peak in second quarter, as an uneven recovery continued across industries and regions.*
- *Labor markets strengthened as the unemployment rate fell. But labor shortages surfaced in key industries and labor force participation rates remained low.*
- *Inflationary pressures and supply chain issues increased in the second half of the year, creating challenges for businesses and posing risks to banks.*
- *The expiration of government programs that supported consumers and businesses was a headwind to economic growth in the second half of 2021.*
- *Reduced assistance to consumer and business borrowers, prolonged pandemic conditions, and higher inflation may create increased risks for banks.*

The economic recovery continued in 2021, and output surpassed the previous peak in the second quarter. The economy expanded in each quarter in 2021, building off strong growth in the second half of 2020 after a deep recession brought on by the COVID-19 pandemic (Chart 1). Real gross domestic product (GDP) increased 5.7 percent in 2021 after decreasing 3.4 percent in 2020. The pandemic continued to affect the rate of recovery in 2021. The rollout of vaccines in the spring supported economic growth, boosted consumer sentiment, and allowed for the lifting of some restrictions on activity. Government assistance in the form of forgivable loans to businesses through the PPP and increased social benefits to households was a tailwind to the economy in 2021. The economic recovery and broader reopening that occurred during the summer months led to strong consumer spending (Chart 2). However, GDP growth slowed in the third quarter with the resurgence of the pandemic and as government assistance programs

Chart 1

Gross Domestic Product Expanded in 2021 in Spite of the Pandemic



Source: Bureau of Economic Analysis (Haver Analytics).
Note: Shaded area indicates recession.

expired. Economic growth accelerated in the fourth quarter as inventory accumulation and renewed consumer spending led gains.

Federal supplemental unemployment insurance, which had supported people who were unemployed due to the pandemic and covered jobs that were not traditionally eligible, ended in September. While GDP growth improved in fourth quarter on inventory accumulation and renewed consumer spending, the resurgence of the pandemic at year-end weighed on economic activity and sentiment.

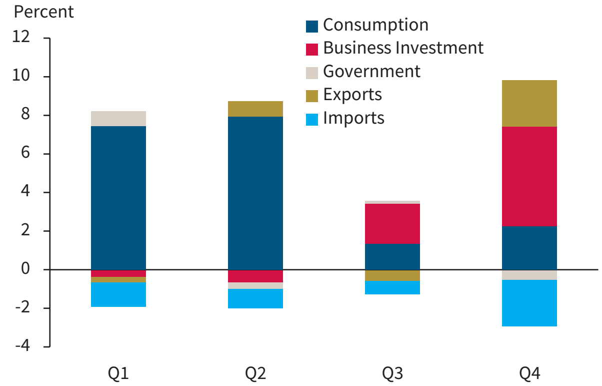
The unemployment rate fell from 6.4 percent in January to 3.9 percent in December, as labor markets recovered more quickly than expected. However, increased economic activity nationwide led to a strong demand for workers and a subdued labor force led to a shortage of workers. Job openings increased across industries, reaching record levels since data collection began in 2000. Wages increased faster than in previous years as firms offered more pay to attract workers. The labor force participation rate ended the year up from its pandemic lows but still 1.5 percentage points below the February 2020 level. The labor force participation rate remained low for workers aged 65 or more and women aged 25 to 54, while participation improved for other groups.

Individual states and industries have faced an uneven economic recovery as the pandemic continued to weigh on business operations. Factors that affected particular industries and the speed of reopening at the state and local level continued to weigh on the recovery in 2021. States with a higher share of populations and industries most affected by the pandemic, such as leisure and hospitality, were slower to recover (Map 1).

Chart 2

Consumer Spending Drove Economic Growth in the First Half of 2021 but Slowed in the Second Half

Contribution to Change in Gross Domestic Product

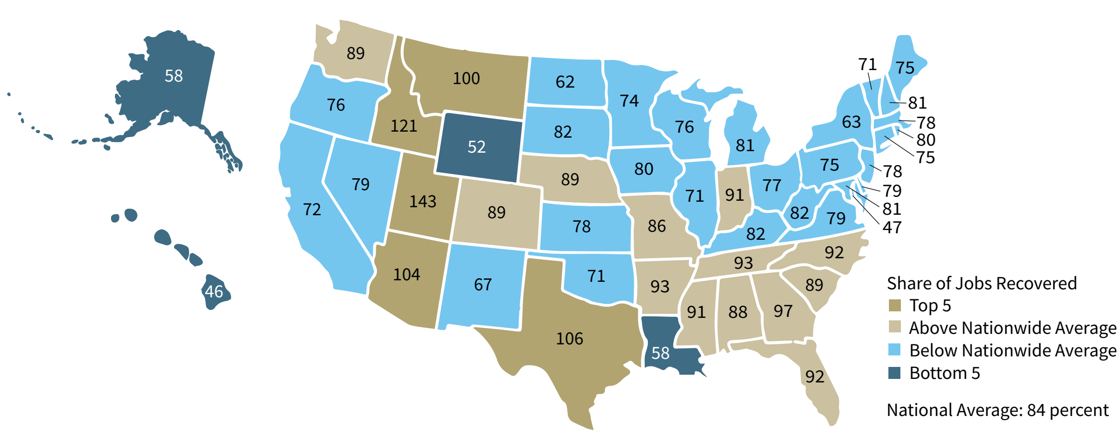


Source: Bureau of Economic Analysis (Haver Analytics).
Note: Data are for 2021.

Map 1

The Recovery in Jobs Lost Has Been Uneven Across States

Percentage of Jobs That Were Lost Between March and April 2020 That Were Recovered as of December 2021



Source: Bureau of Labor Statistics (Haver Analytics).
Note: Among the Bottom 5 is Washington, D.C., which has recovered 47 percent of jobs lost.

Supply chain challenges surfaced early in 2021 and worsened over much of the year as pandemic conditions altered demand and affected production. Consumer spending on both durable and nondurable goods was strong throughout 2021. As sentiment rebounded, demand outstripped supply and global supply chains were constrained by the ongoing pandemic. The global shortage in semiconductor processors continued, increasing production times for a range of durable goods including automobiles. Delays and backlogs at ports due to a shortage of workers and other factors increased shipping times and cost of transportation, adding to supply chain challenges. After dropping sharply in 2020, manufacturing activity recovered in 2021 despite supply chain challenges.

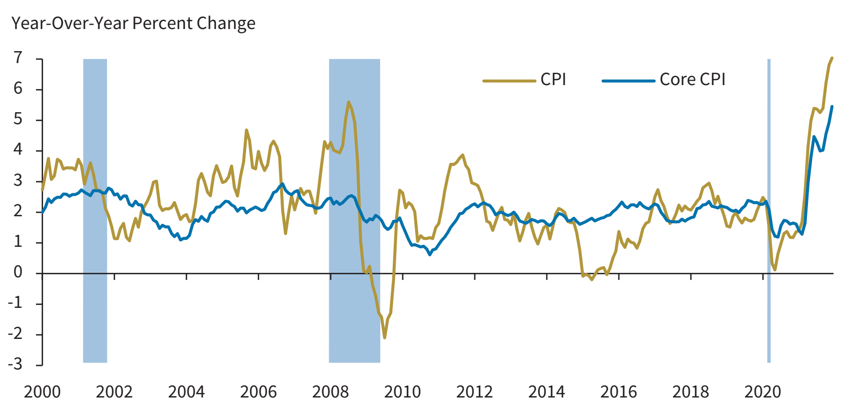
Inflationary pressures increased in the second half of the year as strong demand and supply chain challenges reduced the availability of goods and increased costs. Both the headline consumer price index (CPI), a measure of overall inflation in the United States, and core CPI, which excludes more volatile food and energy prices, increased rapidly in the second half of 2021 (Chart 3). Increasing price pressures first emerged in industries most affected by the pandemic, including travel and used automobiles. As the recovery progressed and producer prices remained elevated, inflation rose in broader segments of the economy, including food and shelter. Tight labor markets and the inability of businesses to hire workers in key sectors, including restaurants and leisure, led to faster wage growth. The headline CPI inflation rate rose to 7.0 percent in December, the highest rate since the early 1980s.

Government support programs that helped boost economic activity in 2021 waned during the second half of 2021 and monetary policy tightened. Government pandemic-related support enacted in 2020 continued in 2021. Additional rounds of support through the American Rescue Plan, passed in March 2021, provided direct payments to households, enhanced unemployment insurance, and additional funding for small business loans. Enhanced unemployment insurance ended in September, though some states ended it earlier on the strength of labor markets. Relative to its effect on GDP in previous quarters, direct government support was less of a boost to growth in the second half of 2021. By the end of 2021, 80 percent of PPP loans had been fully or partially forgiven.

The Federal Reserve continued to conduct accommodative monetary policy to support the economy through asset purchases and left the federal funds rate unchanged in 2021. Near the end of the year, as the labor market tightened and inflation rose, the

Chart 3

Both the Headline and Core Consumer Price Index Reached Multi-Decade Highs



Source: Bureau of Labor Statistics (Haver Analytics).
Note: Shaded areas indicate recession. CPI measures average change over time in prices consumers pay for a basket of goods and services. Core CPI excludes more volatile components, including food and energy.

Federal Reserve tightened monetary policy by reducing the pace of monthly net asset purchases. In addition, as financial conditions normalized in 2021, the Federal Reserve stopped extending credit through its pandemic-era lending facilities.

Reduced assistance to borrowers and prolonged pandemic conditions may create credit risk for banks. Improvement in the labor market and government assistance programs supported both businesses and consumer credit conditions and increased the demand for loans. The curtailment of federal assistance may make it challenging for some borrowers to stay current on loans, particularly if their savings run out. In addition, banks with lending exposure to industries vulnerable to the pandemic may face asset quality deterioration after government support programs end.

Continued inflationary pressures also pose risks to some lenders. Economic conditions remain uncertain and vary greatly across sectors and geographies. The outlook for banks should improve with overall economic conditions as supply chain pressures abate and demand normalizes, but banks face downside risks from inflation or slower-than-expected economic growth. Higher inflation may pose credit risk to banks if it limits the ability of borrowers to stay current on loans, particularly if borrower incomes do not rise and business sales decline as consumers reduce spending. Higher inflation also leads to higher nominal interest rates, which affect both assets and liabilities on a bank's balance sheet. Traditionally, the liabilities on a bank's balance sheet tend to reprice more quickly than longer-term assets, which can weigh on NIMs and expose banks to increasing pressure from interest rate risk, particularly those that issued longer-term loans in search of higher yields, as discussed later in this report.

Financial Markets

- ***In 2021, the focus of financial markets gradually shifted from the pandemic to inflation. Market conditions deteriorated in early 2022 upon heightened geopolitical risks.***
- ***Bank reserves held at the Federal Reserve reached an all-time high in December 2021 due to Federal Reserve asset purchases and a steep decline in Treasury cash balances. Corporate credit conditions remained favorable. Corporations took advantage of low interest rates in 2021 by borrowing more in capital markets, issuing a record amount of high-yield bonds and leveraged loans.***
- ***Banking sector risks from financial markets moderated in 2021. While financial market conditions deteriorated in early 2022, funding conditions remained generally favorable.***

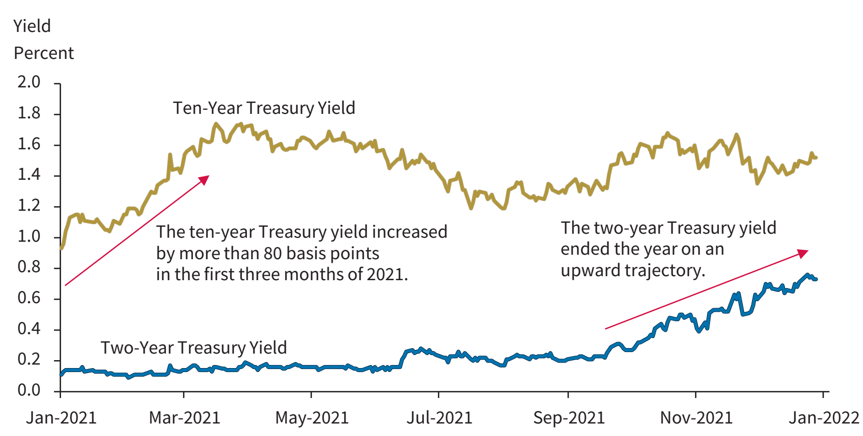
In 2021, the focus of financial markets gradually shifted from the pandemic to inflation. In early 2021, market movements reflected anticipation of the effects of a reopening of the economy, as much of the U.S. population began to receive vaccinations. In later months, a resurgence of the pandemic dampened the outlook, and inflationary pressures increased owing to supply chain issues and stronger consumer spending. While markets reacted negatively to the prevalence of new COVID-19 variants, by year-end market participants showed more concern about higher inflation and the effect on the outlook for interest rates and the economy.

Financial market conditions deteriorated in early 2022 when tensions between Russia and Ukraine intensified. Commodity prices increased and inflation expectations rose further. Corporate bond spreads widened and prices declined for leveraged loans and equities, among other assets. Financial market activities declined, with lower corporate bond issuance, municipal bond issuance, and initial public offerings in equity markets.

Treasury yield curve shifts in 2021 reflected an improving economy and monetary policy developments. Early in 2021, the U.S. Treasury yield curve steepened as expectations grew for the economy to reopen. The two-year Treasury yield remained below 20 basis points for the first five months of the year, as market participants generally expected that pandemic-related inflation would be temporary (Chart 4). On the longer end of the curve, ten-year Treasury yields increased more than 80 basis points in the first three months of the year, from 0.93 percent on December 31, 2020, to 1.74 percent on March 31, 2021.

Chart 4

The Spread Between the Ten-Year and Two-Year Treasury Yields Narrowed as the Year Ended, Flattening the Yield Curve



Source: Federal Reserve Board (Federal Reserve Economic Data).

Toward the end of 2021, medium-term interest rates, such as the two-year and five-year, rose as the Federal Reserve shifted its monetary policy stance. The Federal Reserve reduced the pace of its asset purchases in November 2021 and further reduced the pace in subsequent months. These moves increased market expectations for the Federal Reserve to begin raising short-term interest rates as early as March 2022. As markets anticipated short-term rate increases, the two- and five-year Treasury yields increased, and the yield curve flattened between the two-year and ten-year Treasury yields. The flattening of the Treasury yield curve also accelerated in early 2022 reflecting expectations for higher near-term inflation and slower economic growth.

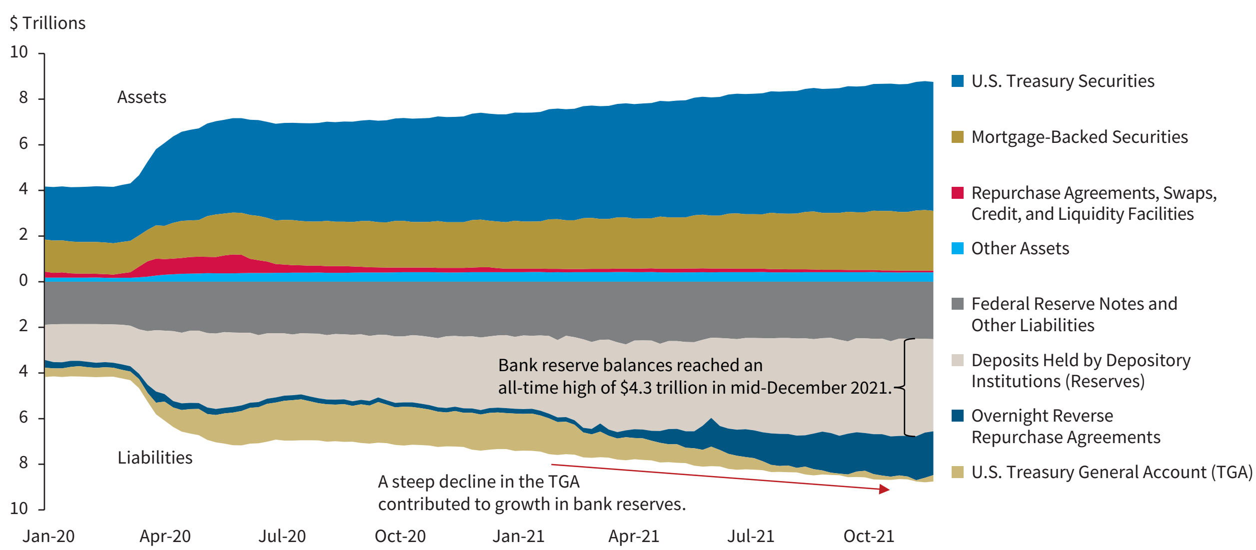
Cash in the financial system grew during the year, pushing overnight rates even lower. The growth in cash was largely a result of Treasury's $1.5 trillion drawdown of cash balances that shifted cash into private markets and the Federal Reserve's continued asset purchases, which totaled $1.5 trillion during the year (Chart 5). The abundance of liquidity put downward pressure on overnight interest rates.

The Secured Overnight Funding Rate (SOFR), a broad repurchase agreement (repo) benchmark and the Federal Reserve's preferred replacement for the London Interbank Offered Rate (LIBOR), fell to 0.01 percent in March (Chart 6). Overnight secured funding rates continued to hover near zero until the Federal Reserve implemented a technical adjustment in June to lift the rate paid on bank deposits at the Federal Reserve and the rate on its overnight reverse repurchase agreement (ON RRP) facility.

Throughout the pandemic, Federal Reserve asset purchases resulted in higher bank reserves. The impact of Federal Reserve asset purchases on bank reserves was mitigated somewhat in 2020 by large increases in the Treasury General Account (TGA) as the Treasury Department issued debt to market participants, effectively absorbing some of the liquidity in the banking system. However, in 2021, the TGA declined as Treasury security issuance declined and the government increased spending, shifting the liquidity into the private market. Bank reserve balances rose to an all-time high of $4.3 trillion in December 2021. A high level of low-yielding bank reserves can challenge bank earnings.

Chart 5

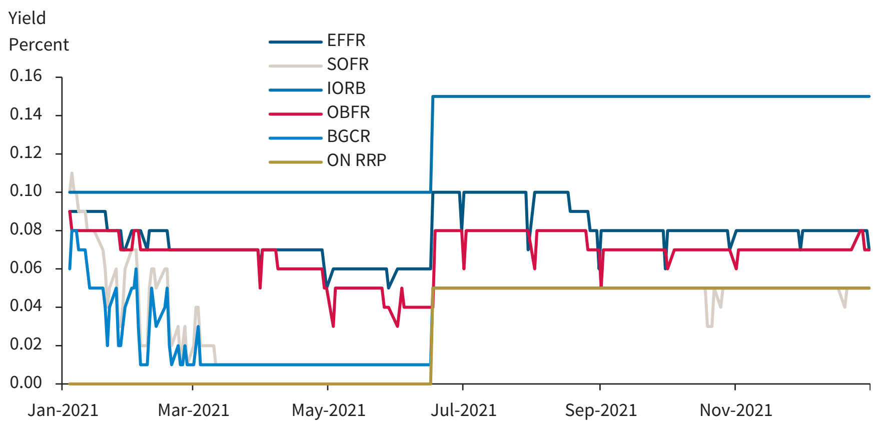
Federal Reserve Asset Purchases Resulted in Higher Bank Reserves



Source: Board of Governors of the Federal Reserve System H.4.1 Statistical Release.

Chart 6

Excess Liquidity Kept Overnight Interest Rates Low in 2021



Source: Federal Reserve Bank of New York.
Note: IORB=Interest on Reserve Balances Rate. EFFR=Effective Federal Funds Rate. OBFR=Overnight Bank Funding Rate. SOFR=Secured Overnight Financing Rate. BGCR=Broad General Collateral Rate. See Federal Reserve Reference Rates at https://www.newyorkfed.org/markets/reference-rates. Data through December 31, 2021.

Corporate credit conditions remained favorable in 2021. Corporations took advantage of low interest rates by borrowing at high levels and issuing a record amount of high-yield bonds and leveraged loans. Corporate credit spreads were low throughout the year for both investment-grade and high-yield bonds. Corporations issued $1.96 trillion in corporate bonds, surpassing pre-pandemic levels but trailing the 2020 record issuance. Investment-grade issuance declined 20 percent year over year, down from a record level in 2020. High-yield issuance increased 15 percent year over year to a record-setting $485 billion (Chart 7).

Leveraged loan issuance totaled $615 billion in 2021, surpassing the previous annual record by more than 20 percent. Loans funding mergers and acquisitions reached a record $331 billion for the year. Demand for leveraged loans was strong, particularly toward the end of the year when investors sought products with variable rates to protect against rising interest rates.

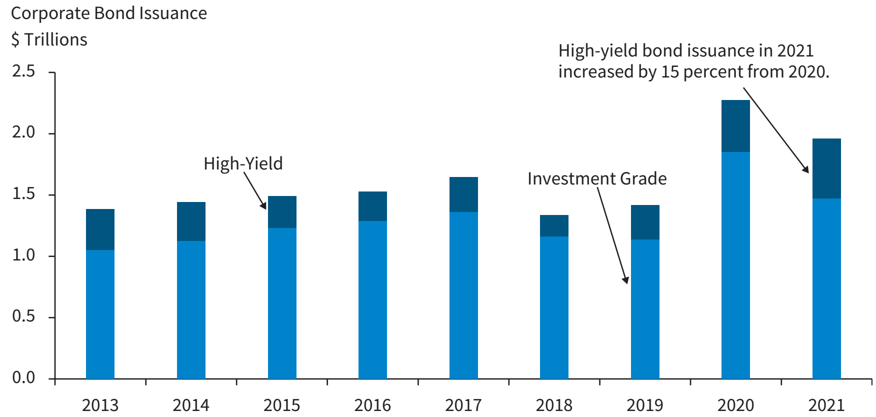
Borrowing conditions remained favorable in 2021, despite the Federal Reserve reducing its direct support for the corporate bond market.[2] Burgeoning signs of economic growth lowered perceptions of credit risk, keeping corporate bond spreads low throughout the year. Higher inflation and expectations for rising interest rates also encouraged corporate borrowing as corporations looked to lock in debt at low rates. Corporate bond spreads rose in early 2022 to mid-2020 levels, as geopolitical events reduced market risk appetite.

Like corporations, municipalities took advantage of low interest rates by issuing a near-record amount of bonds. At $480 billion, municipal bond issuances for 2021 were slightly below the record-setting 2020 level. Most of the municipal bonds issued—$319 billion compared with $275 billion in 2020—were to fund new capital projects. Borrowing conditions remained favorable for municipalities despite the Federal Reserve reducing its direct support for the municipal bond market in 2021.[3] Government support programs for state and local governments and low interest rates propelled municipal borrowing. Expectations for possible tax increases encouraged investors to seek municipal bonds that offered tax-exempt interest payments. Taxable bond issuance declined approximately 18 percent over

[2] The Federal Reserve ceased purchases of corporate bonds at the end of 2020 and began selling holdings of corporate bond exchange-traded funds in June 2021.
[3] The Federal Reserve ceased purchases of municipal bonds at the end of 2020.

Chart 7

Borrowing Conditions Were Favorable in 2021 as Corporations Issued Record Amounts of High-Yield Bonds



Source: Securities Industry and Financial Markets Association.

the past year, while nontaxable bond issuance increased approximately 8 percent.

Equity indices performed well in 2021. The Standard and Poor's (S&P) 500 Index posted total returns of 28.7 percent for the year, while the Dow Jones Industrial Average returned 20.9 percent and the NASDAQ Composite returned 22.2 percent. All 11 sectors of the S&P 500 posted double-digit returns, helping the S&P 500 notch 70 record-high closes and finish with double-digit gains for the third straight year.

Following an underperformance in 2020, bank stocks outperformed the S&P 500 in 2021. The KBW Bank Index, which includes 24 of the largest U.S. banking organizations, had a total return of 36 percent. The broader S&P 500 Financials sector was the third-best performer of the 11 S&P sectors, with a return of 34.9 percent in 2021. Bank stock performance in 2021 largely tracked the increase in longer-term Treasury yields that support bank income. Much of the outperformance relative to the S&P 500 can be attributed to the first three months of the year, a period in which the ten-year Treasury yield rose by more than 80 basis points.

Similar to banks, commodities and energy companies posted strong gains in 2021. The Bloomberg Commodity Index gained 27 percent in 2021, led by 50 percent or higher increases in prices for coffee, lumber, heating oil, crude oil, and gasoline. The S&P 500 Energy sector rebounded from the worst-performing sector in 2020 to the top performer in 2021, with returns of 54.4 percent.

Overall, financial markets were stable in 2021 and market conditions were generally supportive of banking conditions. Conditions deteriorated in early 2022, as geopolitical tensions driven by Russia's invasion of Ukraine altered many of the financial market trends observed in 2021. Geopolitical tensions and tightening financial conditions create a heightened level of uncertainty for the banking sector. While inflation and rising interest rates come with the risk of asset repricing, many banks could benefit from easing pressure on net interest margins. However, in the near term, low interest rates and high amounts of liquidity are likely to continue to pressure bank earnings.

Banking Industry

- ***Banks reported higher net income in 2021 primarily due to negative provision expense.***
- ***NIM decreased, reflecting the low interest rate environment.***
- ***Loan growth improved from 2020 levels, reflecting improved economic sentiment.***
- ***Asset quality metrics continued to improve.***

Banks reported higher earnings in 2021 primarily due to negative provision expense. Industry net income for 2021 rose 89.7 percent ($132.0 billion) from 2020 levels to $279.1 billion (Chart 8). The banking industry reported aggregate negative provision expense of $31.0 billion for 2021 as banks reassessed the risk of the pandemic and economic uncertainty on their loan portfolios. Negative provision expense was significantly less than the positive $132.3 billion in provision expense reported in 2020. Similar to the improved earnings, the return on average assets (ROA) ratio for the banking industry improved to 1.23 percent in 2021 from 0.72 percent in 2020.

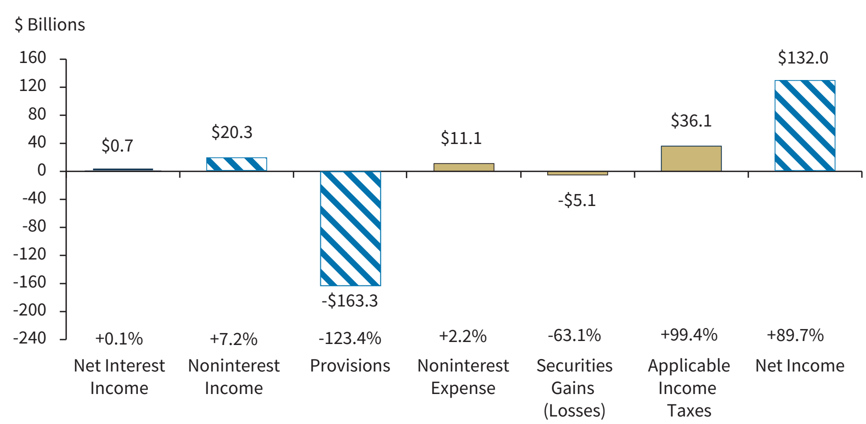
Community bank net income increased 29.3 percent in 2021 to $32.7 billion. The improvement was due to rising net interest income in combination with lower provision expense (Chart 9). Stronger loan growth and recognition of deferred PPP loan fees contributed to the rise in net interest income. Provision expense for community banks, while lower than the 2020 level, was $1.1 billion for 2021. The average ROA ratio for community banks also increased, from 1.09 percent in 2020 to 1.25 percent in 2021.

Despite the negative provision expense for the industry in 2021, the allowance for expected credit losses (ACL) remained higher than the pre-pandemic level at year-end 2019. The ACL as a percentage of total loans and leases was 1.58 percent, well above the 1.18 percent at year-end 2019.

NIM declined in 2021 despite a slight increase in net interest income and strong asset growth. Net interest income for the industry rose $687 million (0.1 percent) to $527.4 billion from 2020 but remained below the pre-pandemic level of $546.7 billion in 2019. Yields on earning assets dropped 52 basis points from 2020 to 2.71 percent, while the cost of funding those assets

Chart 8

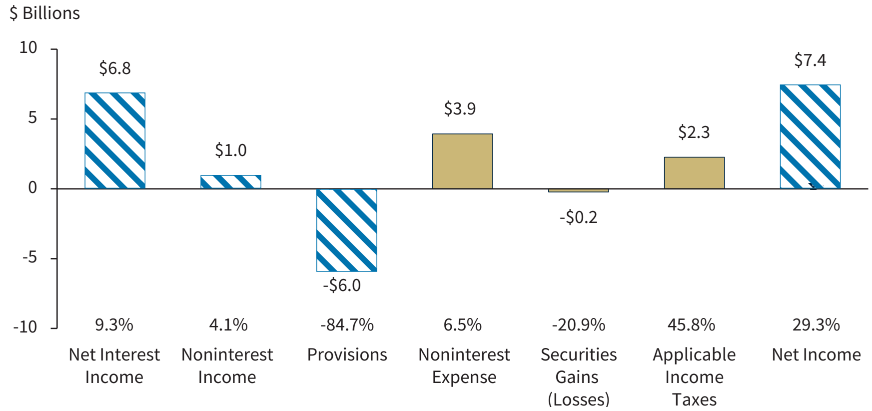
Negative Provision Expense Was the Primary Driver of Improved Full-Year Net Income in 2021



Source: FDIC.
Note: Solid bar depicts the item had a negative effect on net income; striped bar depicts the item had a positive effect. Data reflect full-year 2021 vs full-year 2020 income.

Chart 9

Higher Net Interest Income Drove Higher Net Income at Community Banks



Source: FDIC.
Note: Solid bar depicts the item had a negative effect on net income; striped bar depicts the item had a positive effect. Data reflect full-year 2021 vs full-year 2020 income.

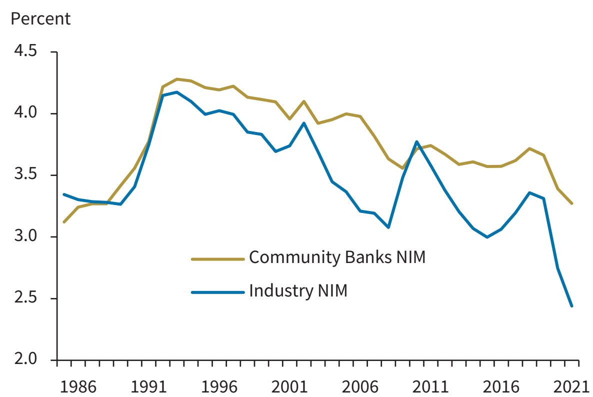
dropped 24 basis points, bringing NIM down from 2.82 percent in 2020 to 2.54 percent in 2021 (Chart 10). Community bank net interest income rose by $6.8 billion from 2020, or 9.3 percent, on relatively higher loan growth and recognition of deferred PPP loan fees. Growth in earning assets, however, still outpaced community bank net interest income gains, reducing the NIM. The average community bank NIM fell 12 basis points to 3.27 percent last year from 2020. Low interest rates, slow loan growth, and substantial growth in low-yielding assets kept net interest income low.

Low-yielding assets—cash and balances due from other institutions—remained high for the industry at $3.6 trillion. These assets grew 12 percent or $370 billion in 2021, well below the substantial growth of $1.5 trillion in 2020. Elevated levels of low-yielding assets will continue to be a drag on NIM.

Improvement in noninterest income further bolstered the rise in net income. Noninterest income for the industry rose $20.3 billion (7.2 percent), outpacing the rise in noninterest expense of $11.1 billion (2.2 percent) in 2021. Increased bank card and interchange fees of $8.6 billion and loan servicing fees of $6.6 billion contributed most to the higher levels of noninterest income. Noninterest expense growth was primarily driven by increases in salaries, which were up 6.1 percent or $14.5 billion during the year, and consulting fees, which were up by 47 percent or $2.5 billion.

Chart 10

Net Interest Margin Continues to Decline Despite an Increase in Net Interest Income



Source: FDIC.

Loan balances rose from 2020, but growth in lower-yielding assets drove balance sheet growth. Loans grew 3.5 percent in 2021, slightly higher than the 3.3 percent growth rate in 2020. While growth in 2020 reflected about $408 billion in PPP loans added to bank books, 2021 growth reflected $312 billion in PPP loans forgiven or repaid and removed from bank books. Excluding PPP loans, the loan growth rate in 2021 would have been 6.6 percent. Community banks would have recorded a loan growth rate of 7.6 percent excluding PPP versus the reported total loan growth rate of 2.0 percent. This PPP-adjusted community bank loan growth rate was higher than the industry overall and higher than the merger-adjusted loan growth rate of 5.5 percent reported in fourth quarter 2019. Industry loan growth occurred in most categories, with the largest dollar increases in loans to nondepository institutions, consumer loans, and CRE loans. Despite widespread loan growth, loans were less than 50 percent of total assets, 8 percentage points lower than the five-year average from 2014 through 2019. Community banks also saw a decline in the ratio of loans to assets, from 71 percent at year-end 2019 to 62 percent at year-end 2021.

Bank balance sheets continued to hold historically high levels of safe and liquid assets in 2021. Cash and balances due from other institutions rose $370 billion, almost as much as loans, in 2021 (Chart 11). With the rise of medium- and long-term interest rates in 2021, banks invested heavily in long-term assets including securities that grew 22 percent to $6.2 trillion and mortgage-backed securities that were up 17 percent to $3.6 trillion. Banks may have invested in longer-term assets to improve NIMs.

Longer-term assets, those with maturities greater than three years, increased to 39 percent of assets compared with 36 percent pre-pandemic (Chart 12). Eighty-seven percent of banks increased their holdings of assets with greater than five-year maturities.

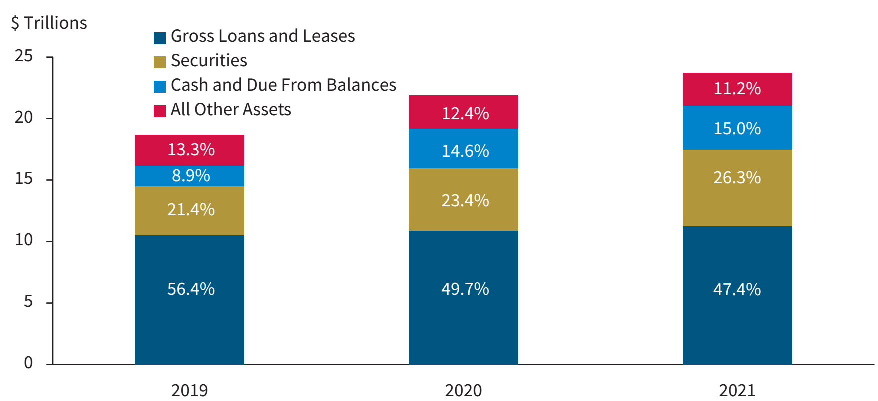
Community banks also increased their holdings of assets with maturities over three years, which reached 52 percent of total assets at year-end 2021.

Asset quality metrics continued to improve in 2021. Noncurrent loan rates and net charge-off rates declined in 2021 to pre-pandemic lows. The noncurrent loan rate for the industry fell to 0.89 percent at year-end 2021, below the 1.19 percent reported in 2020 and less than the pre-pandemic rate of 0.91 percent in 2019 (Chart 13). Noncurrent rates declined across all loan types, with 1–4 family residential loans seeing the greatest decline. The annual average net charge-off rate for the industry declined from 0.50 percent to 0.25 percent in 2021. The dollar volume of net charge-offs was below the 2020 level in all loan categories except multifamily and 1–4 family construction. However, the decline in ACL exceeded the decline in noncurrent loans in 2021. As a result, the reserve coverage ratio for noncurrent loans (ACL as a percentage of noncurrent loans) declined modestly from 184 percent in 2020 to 179 percent but remained well above the pre-pandemic level of 130 percent.

Community banks also reported improvement in asset quality metrics for the year. The noncurrent loan rate of 0.58 percent for community banks was down 19 basis points from 2020. The noncurrent loan rate declined

Chart 11

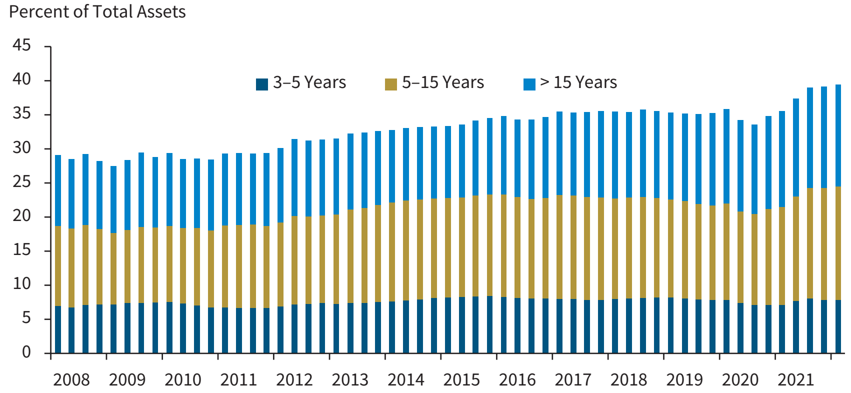
Since the Pandemic Began, Most Bank Asset Growth Has Been in Securities and Cash Accounts



Source: FDIC.
Note: Bars show total gross loans, securities, cash and due from balances, and all other assets amounts from bottom to top. Percent of total assets is represented on the bars. 2020 and 2021 do not sum to 100 percent due to rounding.

Chart 12

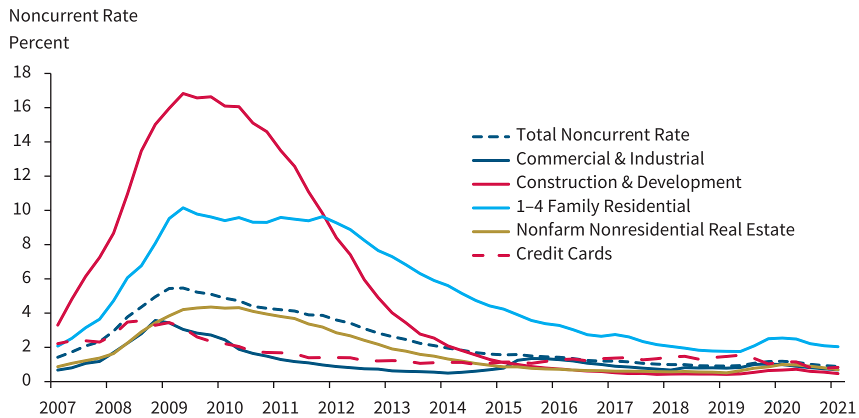
Assets With Maturities Greater Than Three Years Have Increased to Almost 40 Percent of Total Assets



Source: FDIC.
Note: Date labels are centered under the first quarter of each year. Data start in fourth quarter 2007.

Chart 13

Despite Early Concerns at the Onset of the Pandemic, Noncurrent Rates Are at Low Levels



Source: FDIC.
Note: Percent of loans that are 90 days or more past due or in nonaccrual status.

for all major loan portfolios except the commercial and industrial (C&I) portfolio, which saw a modest 5 basis point increase to 0.71 percent. The annual net charge-off rate declined to 0.09 percent, down 6 basis points from 2020.

Improvements in the economy were evident in the decline in the number of "problem banks" to 44 at year-end 2021 from 56 at year-end 2020. In addition, no banks failed in 2021 while four failed in 2020.

Although banking industry conditions remained strong, challenges remain. Rising interest rates, continued transition through the pandemic, and geopolitical tensions may negatively affect bank profitability, credit quality, and loan growth going forward. In particular, rising interest rates could adversely affect real estate and other asset values and borrower repayment capacity.