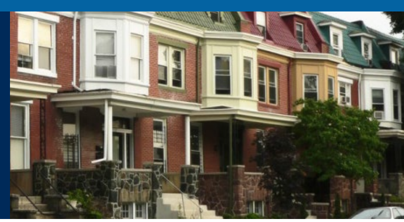
Economic and Banking Conditions Update
South Carolina, 5th District, and the Nation - 2Q 2021



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Disclaimer and Technical Notes

Disclaimer: The opinions expressed in this publication are those of the authors. Opinions are intended only for informational purposes, and are not formal opinions of, nor binding on, the Federal Reserve Bank of Richmond or the Board of Governors of the Federal Reserve System.

Technical Notes: This report is based upon preliminary data from 2Q 2021 and prior Consolidated Reports of Condition & Income (call reports) as well as other bank examination sources, and focuses on commercial banks headquartered in the Fifth Federal Reserve District (Maryland, North Carolina, South Carolina, Virginia, West Virginia, and Washington, DC). Commercial banks with total assets greater than $10 billion are excluded from the average calculations. Data in the highest 2.5 percent and lowest 2.5 percent of values are also excluded to account for outliers.

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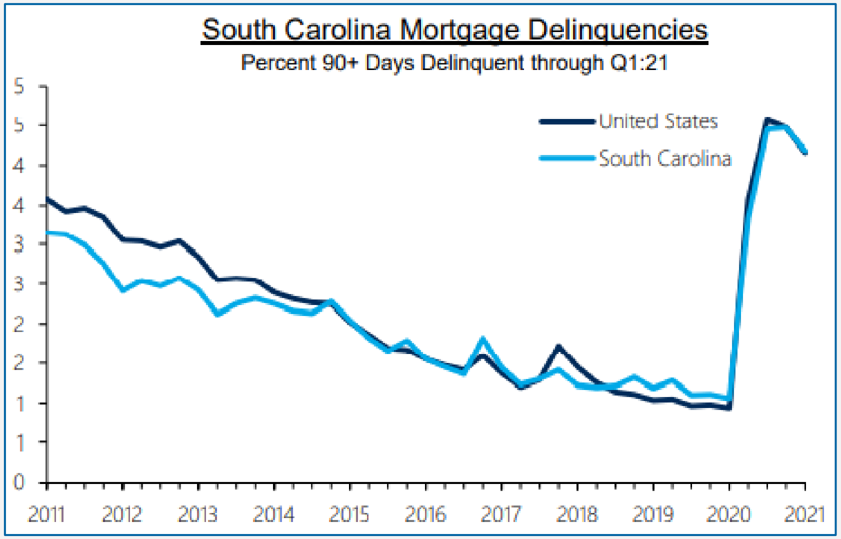
Recent economic indicators reflected growth in South Carolina's economy.

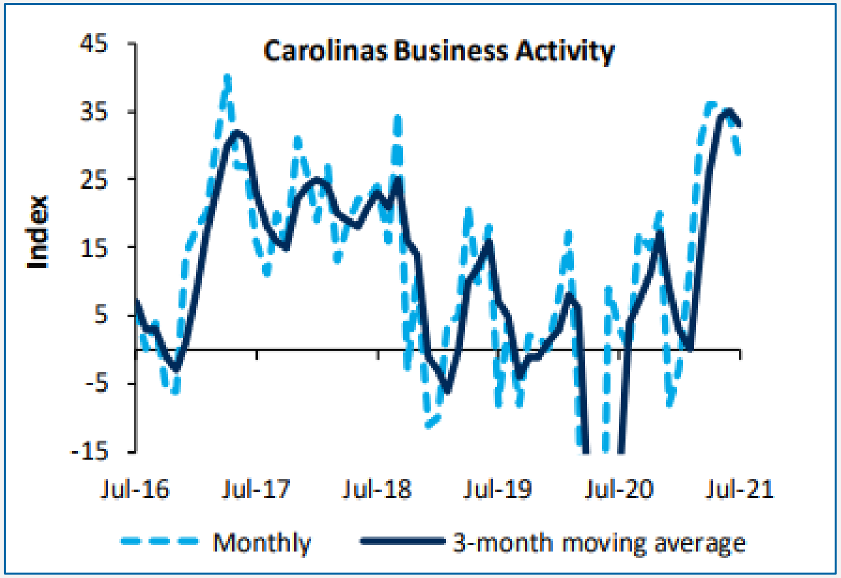
August Summary: Employment rose, the unemployment rate decreased, and housing markets strengthened.

- **Labor Markets**: On net, South Carolina added 6,300 jobs (0.3 percent) in June. Total payroll employment increased by 95,900 jobs (4.7 percent), on net, since June 2020, but was down 3.5 percent from before the pandemic. Meanwhile, the unemployment rate decreased by 0.1 percentage point to 4.5 percent in June and was 3.2 percentage points below its reading from June 2020.
- **Housing Markets**: Residential permitting activity rose 42.3 percent from May to June and was 54.2 percent above its year-ago level. Housing starts rose 40.2 percent in June and were up 58.5 percent from June 2020. Meanwhile, home values appreciated 1.4 percent in May and 12.4 percent over the year.
- **Business Conditions**: Business conditions in the Carolinas improved in July. Both sales and demand indexes suggested growth even though the demand index fell slightly (from 34 in June to 28 in July). Firms reported increased capital spending and were optimistic that conditions would continue to improve in the near future.

Labor Market Conditions

Unemployment Rate (SA)	June 21	May 21	June 20
United States	5.9	5.8	11.1
Fifth District	4.9	5.0	8.7
South Carolina	4.5	4.6	7.7
Charleston MSA	3.6	3.6	7.6
Columbia MSA	3.6	3.5	6.3
Florence MSA	4.1	4.0	7.1
Greenville-Anderson MSA	3.4	3.3	7.3
Hilton Head Island MSA	3.3	3.3	6.4
Myrtle Beach MSA	5.0	4.7	10.7
Spartanburg MSA	3.9	3.8	8.3
Sumter MSA	4.5	4.5	7.7





Source: A Monthly Update of the Fifth District Economy – August 2021 Federal Reserve Bank of Richmond. For the full report link here: [Snapshot - Federal Reserve Bank of Richmond](). Business condition surveys are conducted by the Federal Reserve Bank of Richmond. Latest results can be found here: [Regional Survey of Business Activity]().

Top Risks Identified

- **<u>Balance Sheet Management:</u>** Sustained low rates and flat yield curves are presenting challenges for most banks. Deposit inflows have surged over the past year, challenging traditional liquidity model scenarios that help determine the stability of deposit funds. Additionally the pandemic negatively impacted non-PPP loan demand with the low rate environment also pressuring loan yields, thus squeezing bank margins for asset sensitive banks. Loan repricing and refinance activity in the down-rate environment has outpaced the decline in funding costs, which have little room to move downward – further exacerbating asset-sensitivity. As these loans mature or receive forgiveness and management teams make decisions on how to deploy excess liquidity, the earnings environment may remain challenged until organic loan demand rebounds fully.

- **<u>Credit Risk</u>:** Most lending categories have an increased level of exposure, namely Commercial Real Estate. Concentrations may become a greater issue if vacancy rates increase or market segments, such as travel and leisure, deteriorate. Given the financial hardship caused by the pandemic, consumer debt, including residential mortgages, may be strained if the hardship continues. Currently NPLs and loan losses remain low, and decreased provision and slowing ALLL growth signal an improving outlook on the economic environment.

- **<u>Cybersecurity:</u>** Security of sensitive information has been a top risk and the pandemic has increased cyber-risk. With more remote work being performed by employees and vendors, the possibility of a breach via remote access systems has increased. Cyber-criminals are increasing exploitation of known social engineering vulnerabilities amid pandemic confusion while looking for weaknesses in critical infrastructure. Additionally, attackers are using targeted phishing schemes that give the appearance of legitimate coronavirus related emails. It is critical that supervisors assess firms' ability to manage cybersecurity risks. This includes evaluation of governance, third-party and supply chain risk management, information security controls, and crisis management and event response.

- **<u>Financial Fraud and Consumer Harm</u>**: Fraudsters continue to seek ways to exploit the pandemic at the expense of banks and their customers. Fraud activity is spiking, particularly for government assistance programs such as unemployment benefits and PPP. Consumer financial health remains a top concern as the most vulnerable Americans have suffered substantial financial challenges over the past year. Loan modification or deferral fees, along with inconsistent credit scoring/reporting of deferred loans as derogatory accounts, could present potential fair lending and UDAP issues if not applied consistently. Complaints to the CFPB about financial firms more than doubled in 2020, with more than half of the grievances made against the 3 biggest credit reporting agencies.

For full risk descriptions see Appendix

Summary of Community Banks

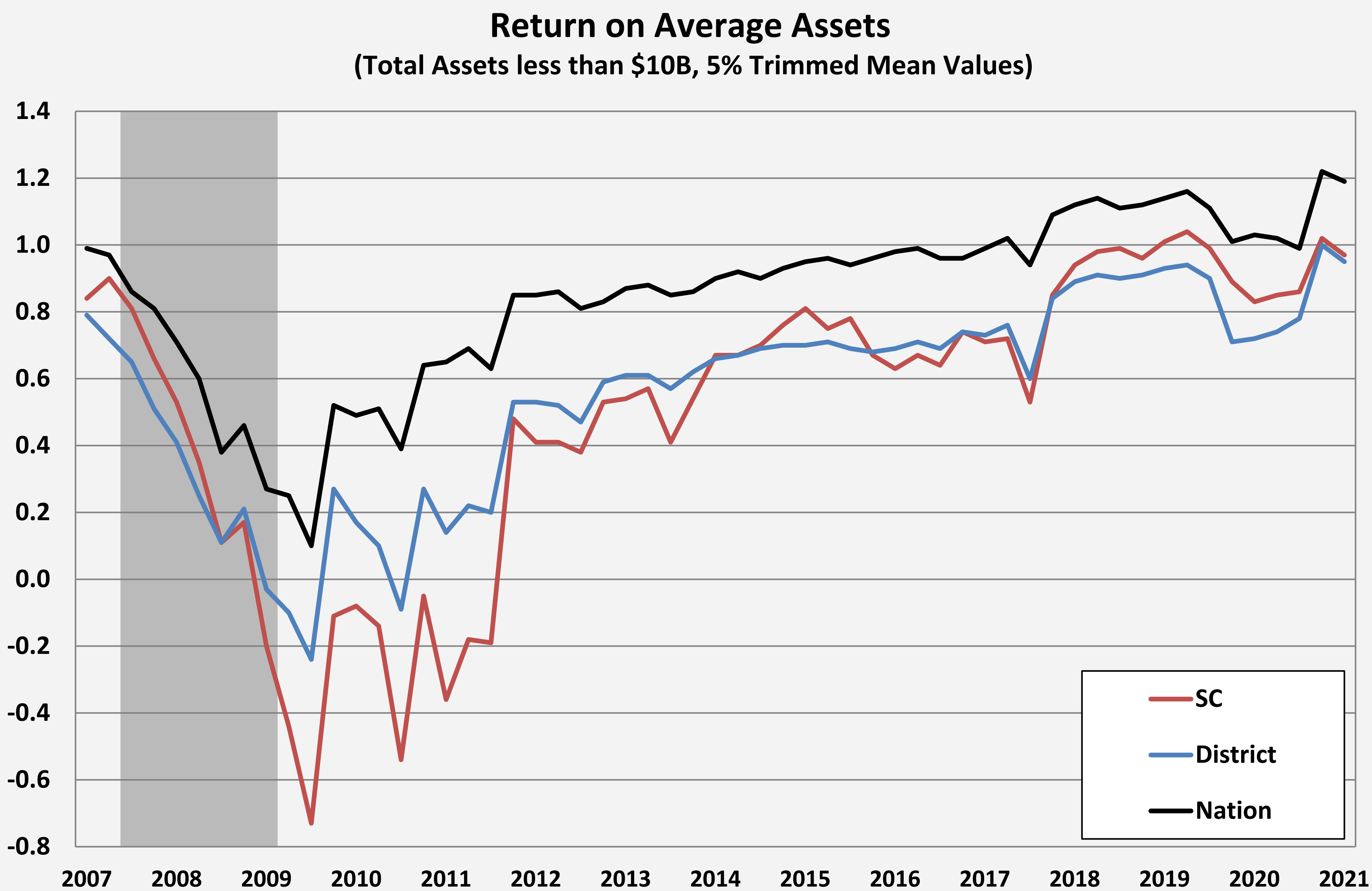
Community Banks by Charter Type in Nation		
Charter Type	Count of Banks	Total Assets (in $bn.)
State Member Bank	688	$578.8
National	703	$592.1
Non Member Bank	2,834	$1,681.2
Total	4,225	$2,852.1

Community Banks by Charter Type in Fifth District		
Charter Type	Count of Banks	Total Assets (in $bn.)
State Member Bank	49	$50.4
National	25	$28.3
Non Member Bank	114	$95.4
Total	188	$174.0

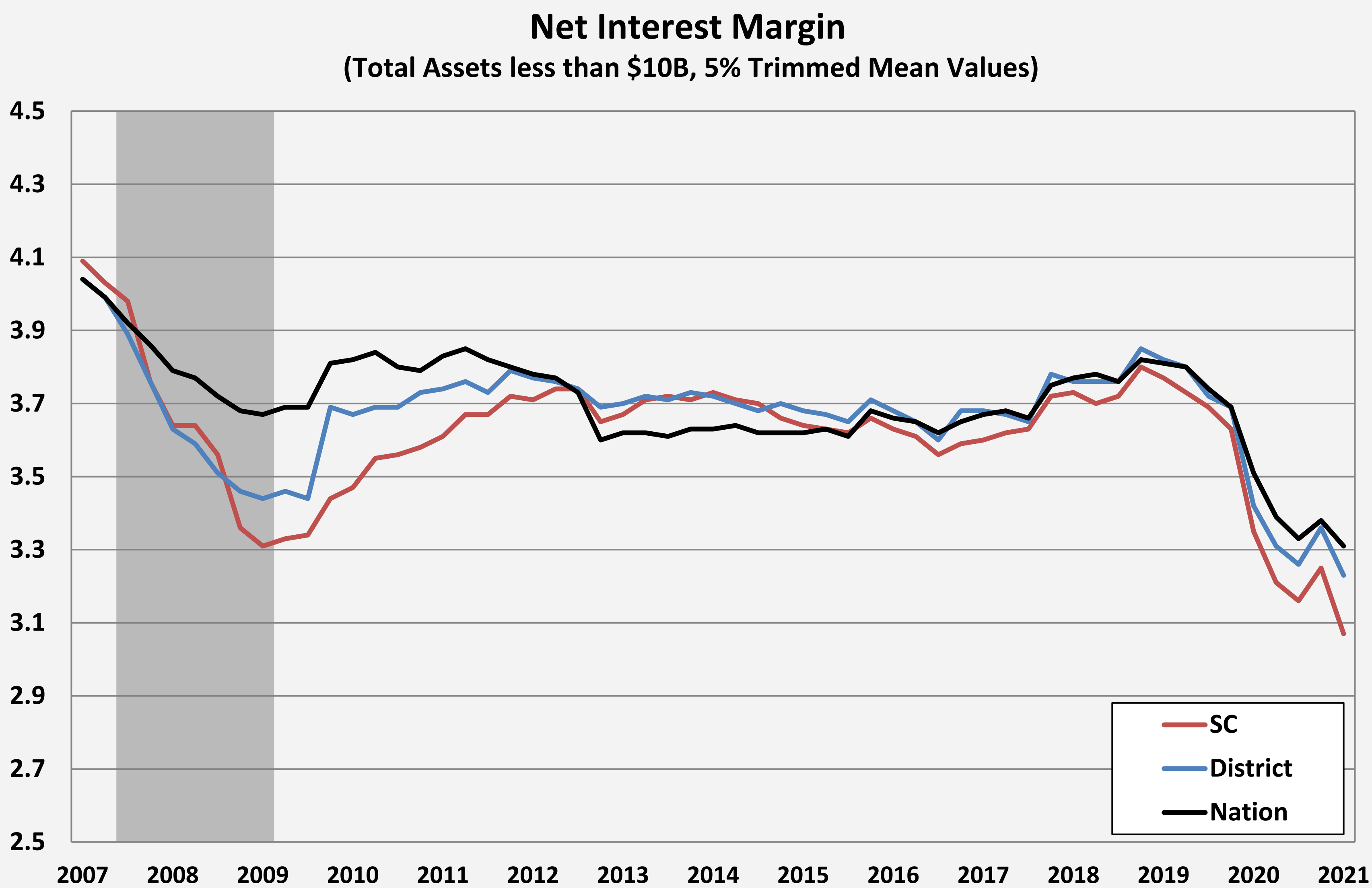
Number of Banks by Charter Type in South Carolina		
Charter Type	Count of Banks	Total Assets (in $bn.)
State Member Bank	0	$0.0
National	3	$2.7
Non Member Bank	30	$21.4
Total	33	$24.1

Note: Structure as of 2Q 2021. Above charts include banks with assets less than $10 billion.

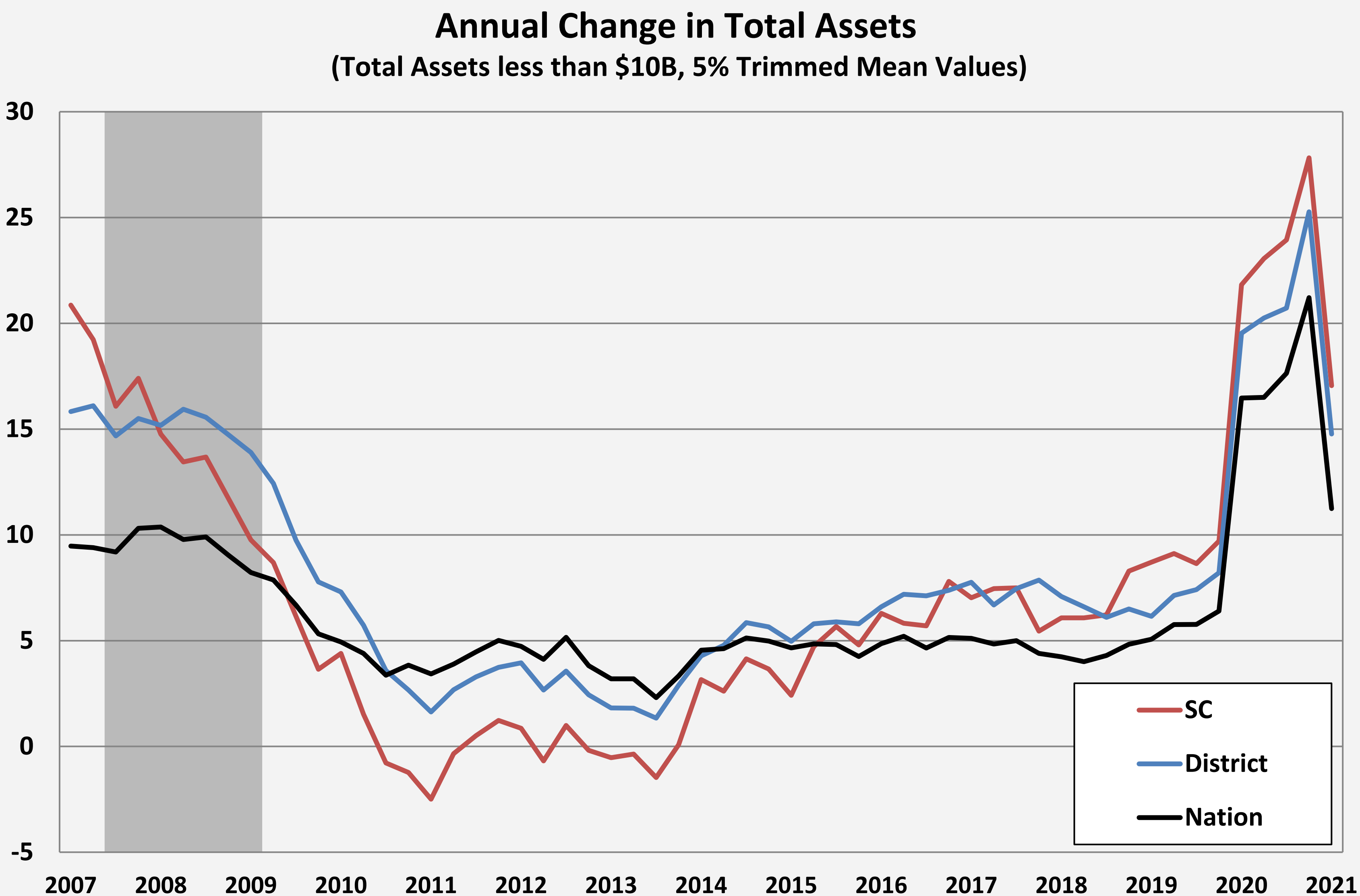
Earnings: Return on Average Assets



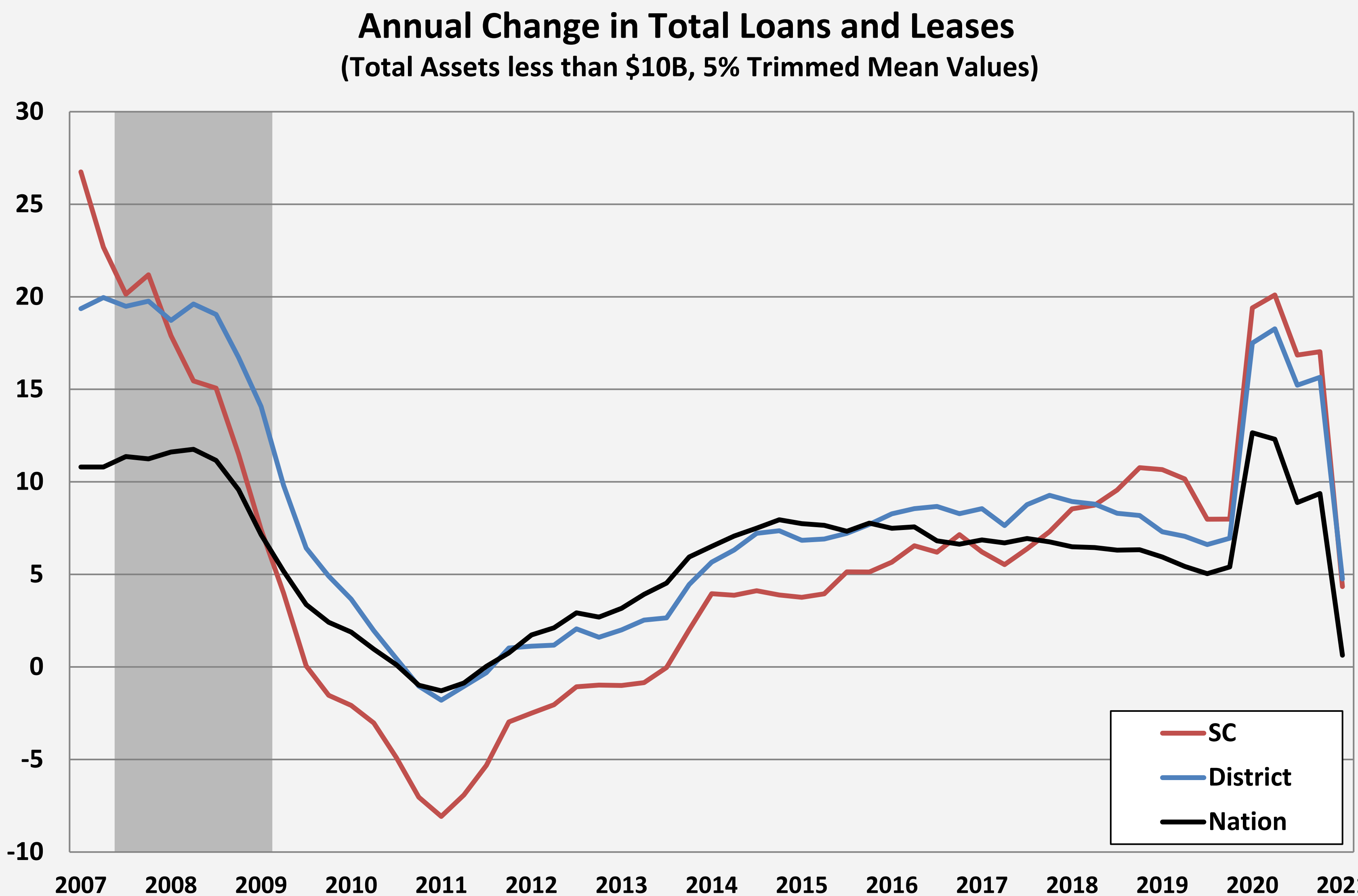
Earnings: Net Interest Margin



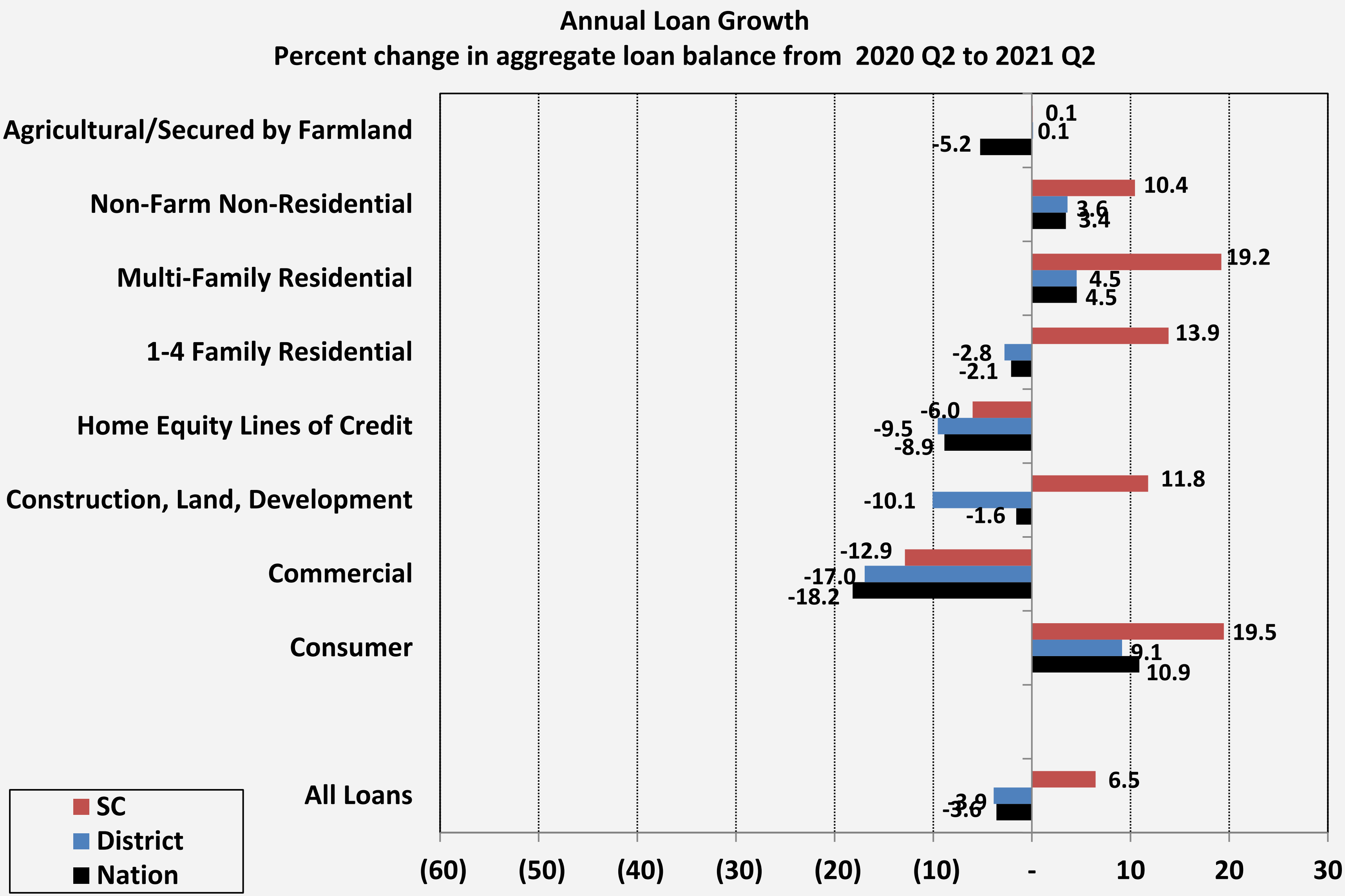
Balance Sheet: Asset Growth



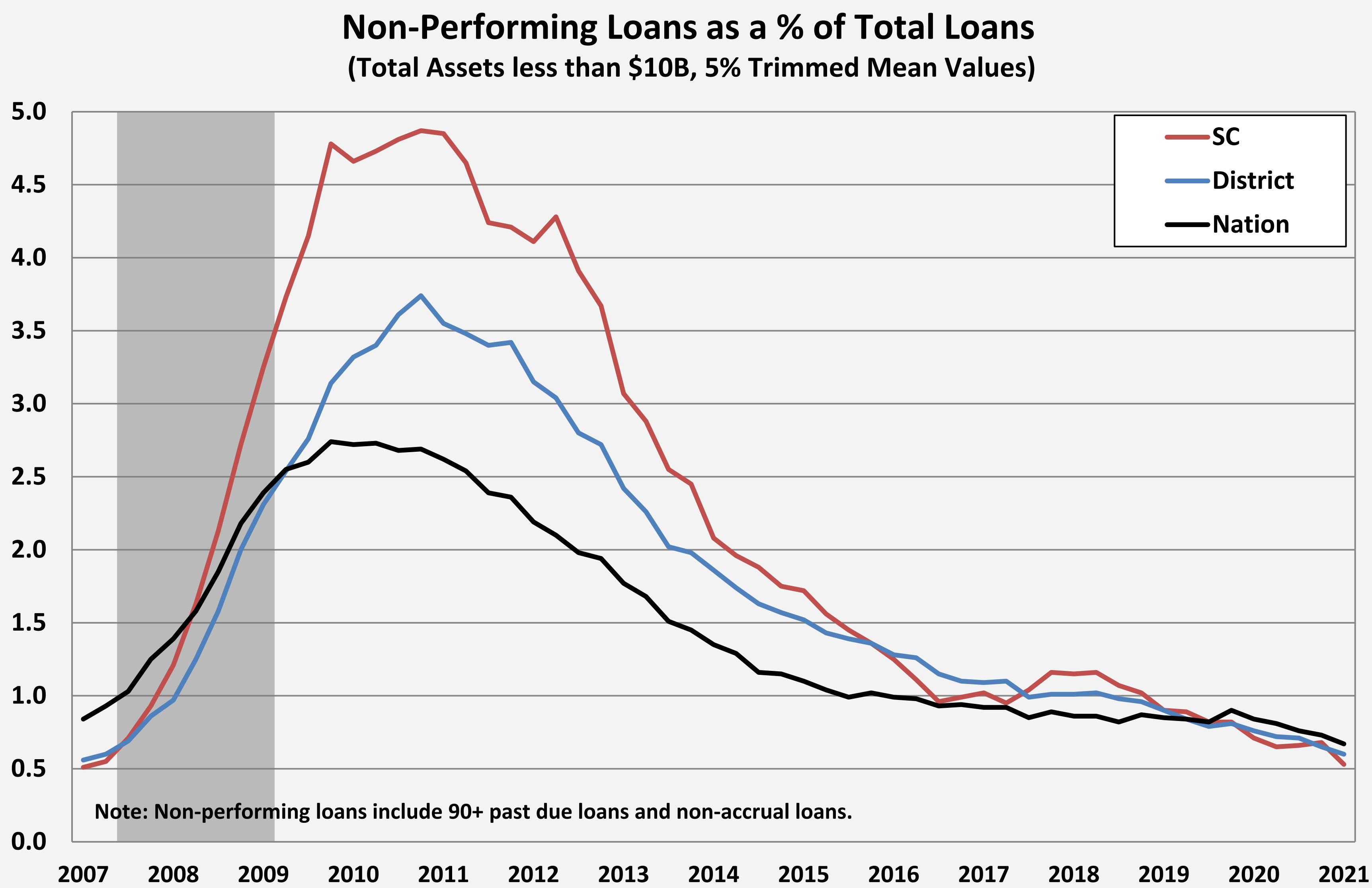
Balance Sheet: Loan Growth



Balance Sheet: Loan Growth by Category



Credit Quality: Non-Performing Loan Ratio



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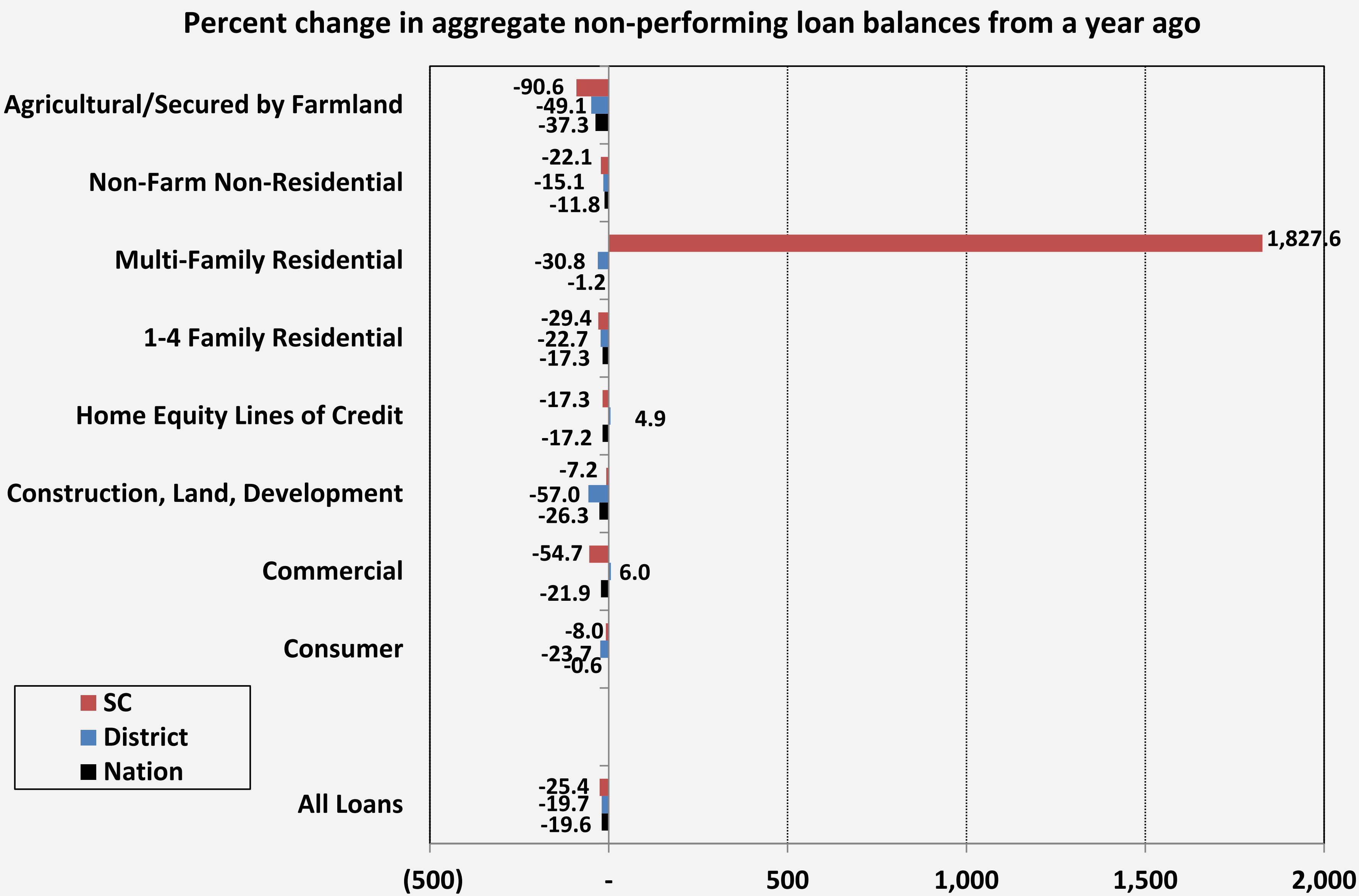
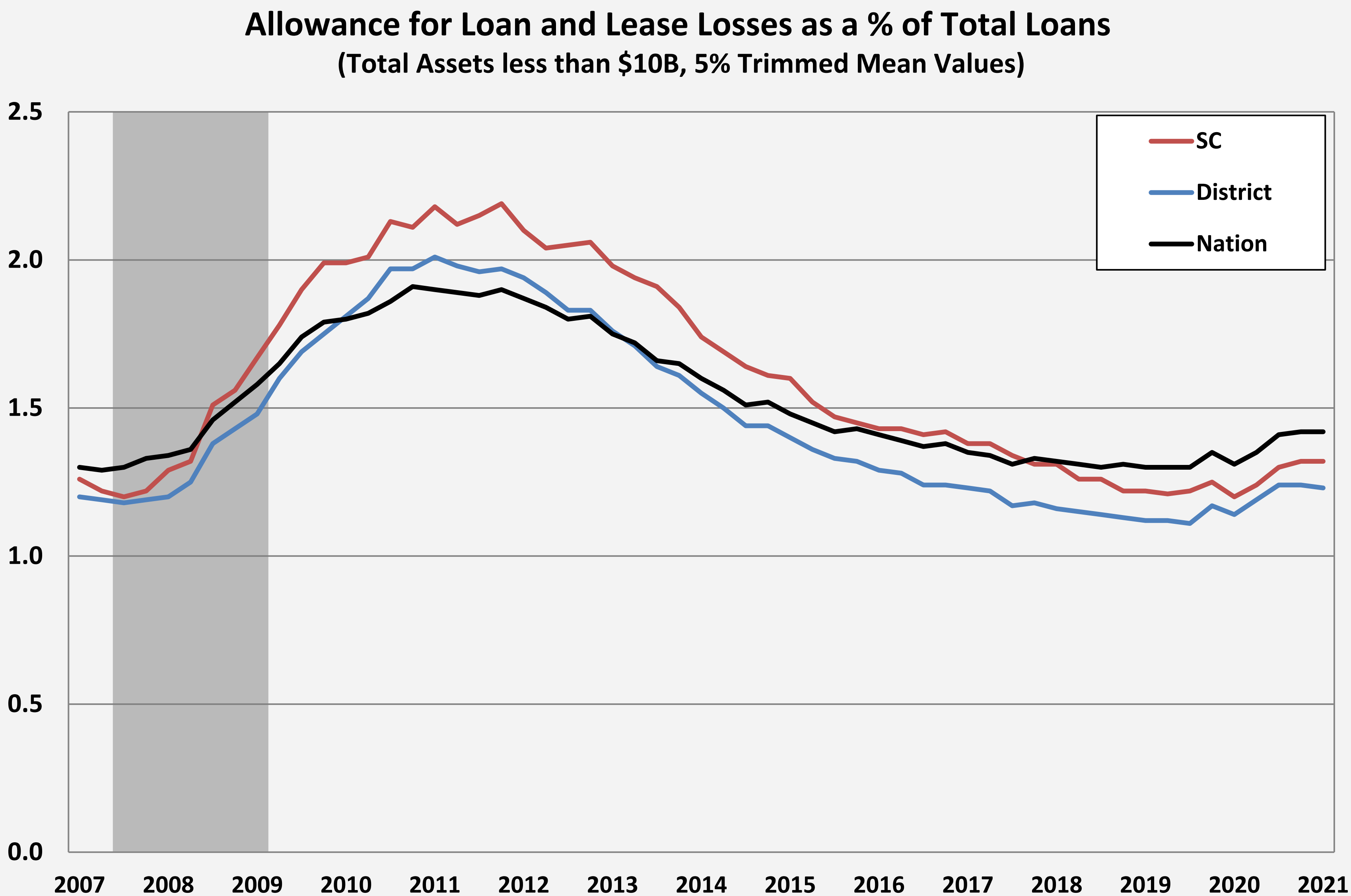
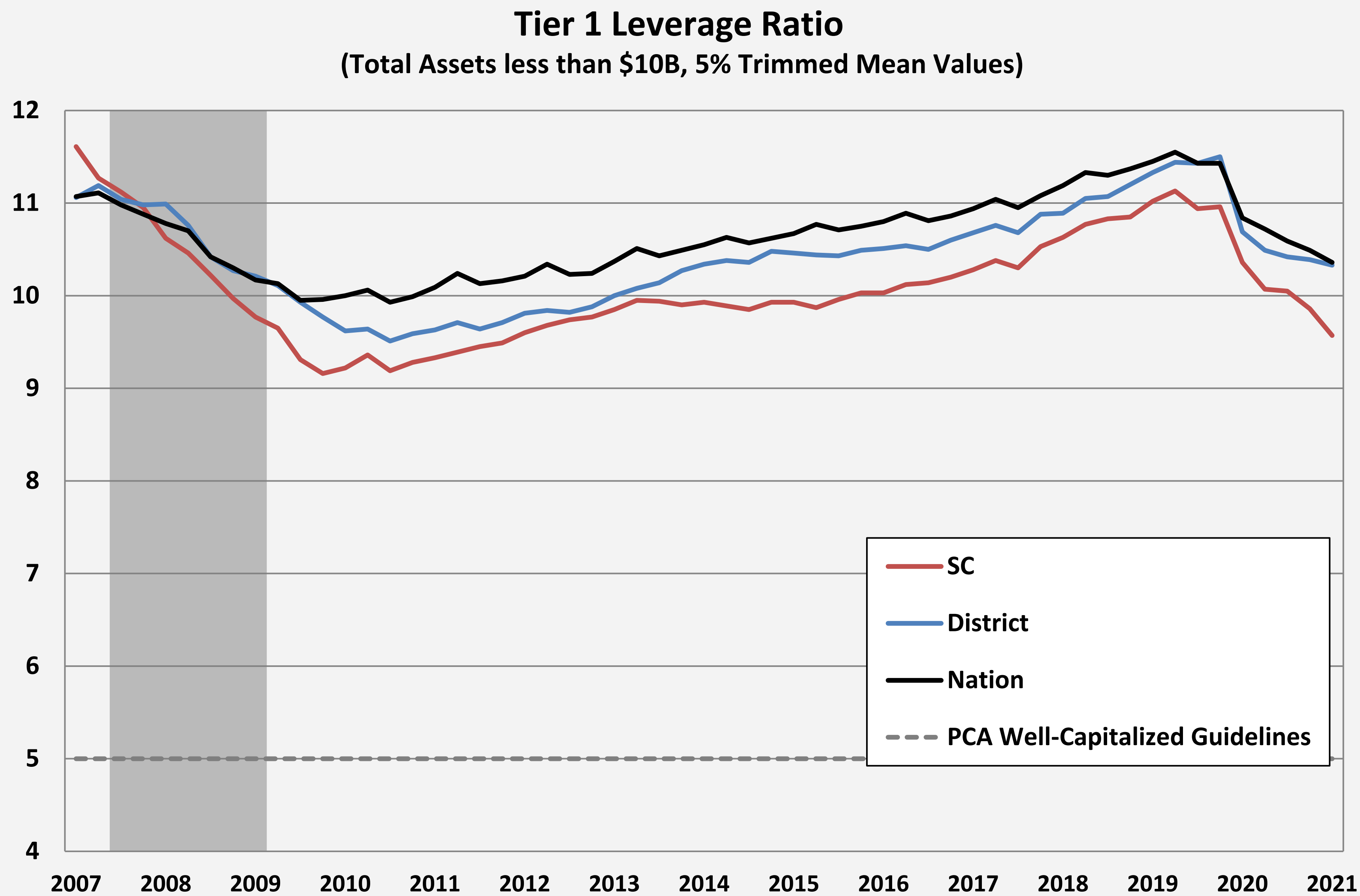


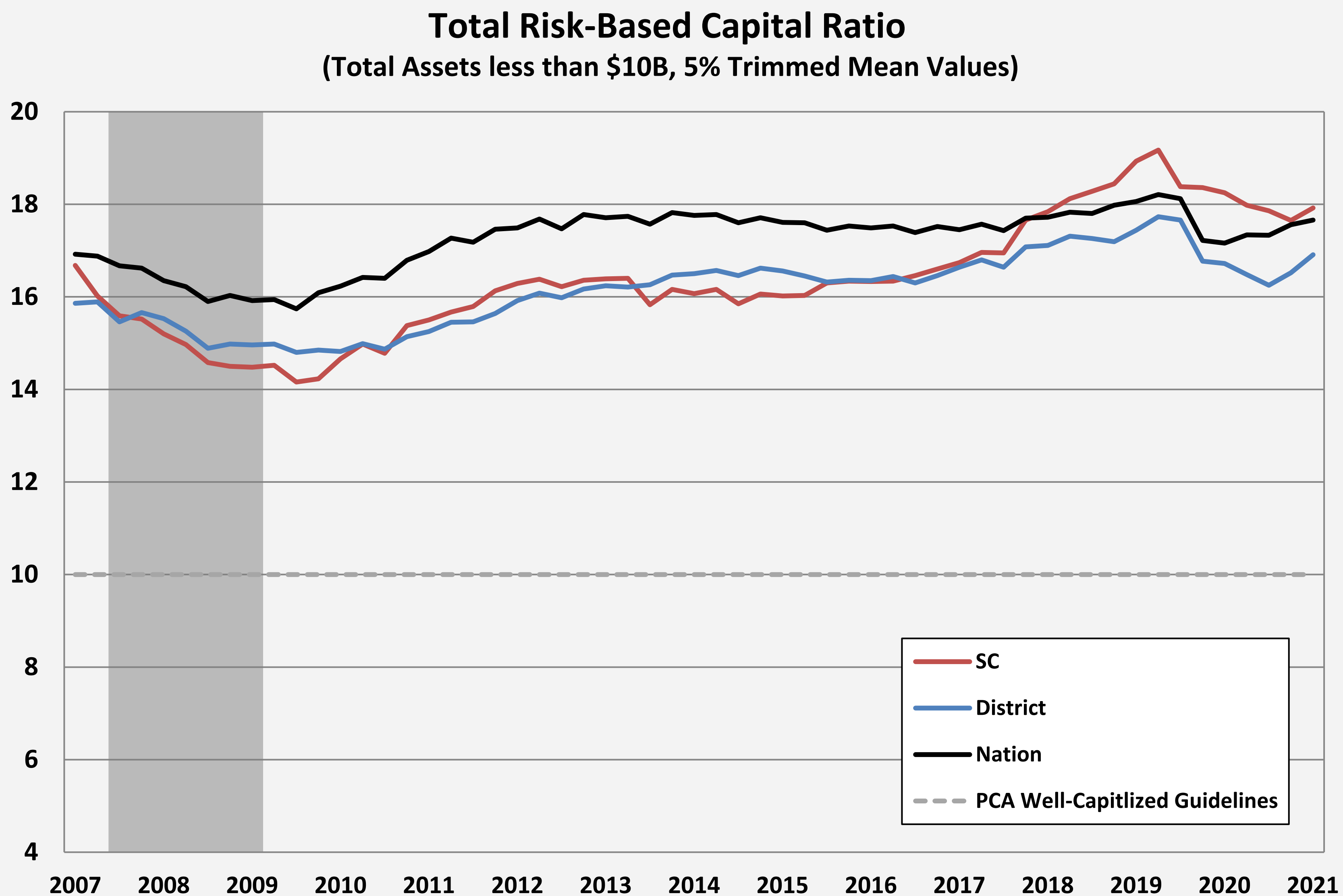
Credit Quality: Allowance for Loan and Lease Losses to Total Loans



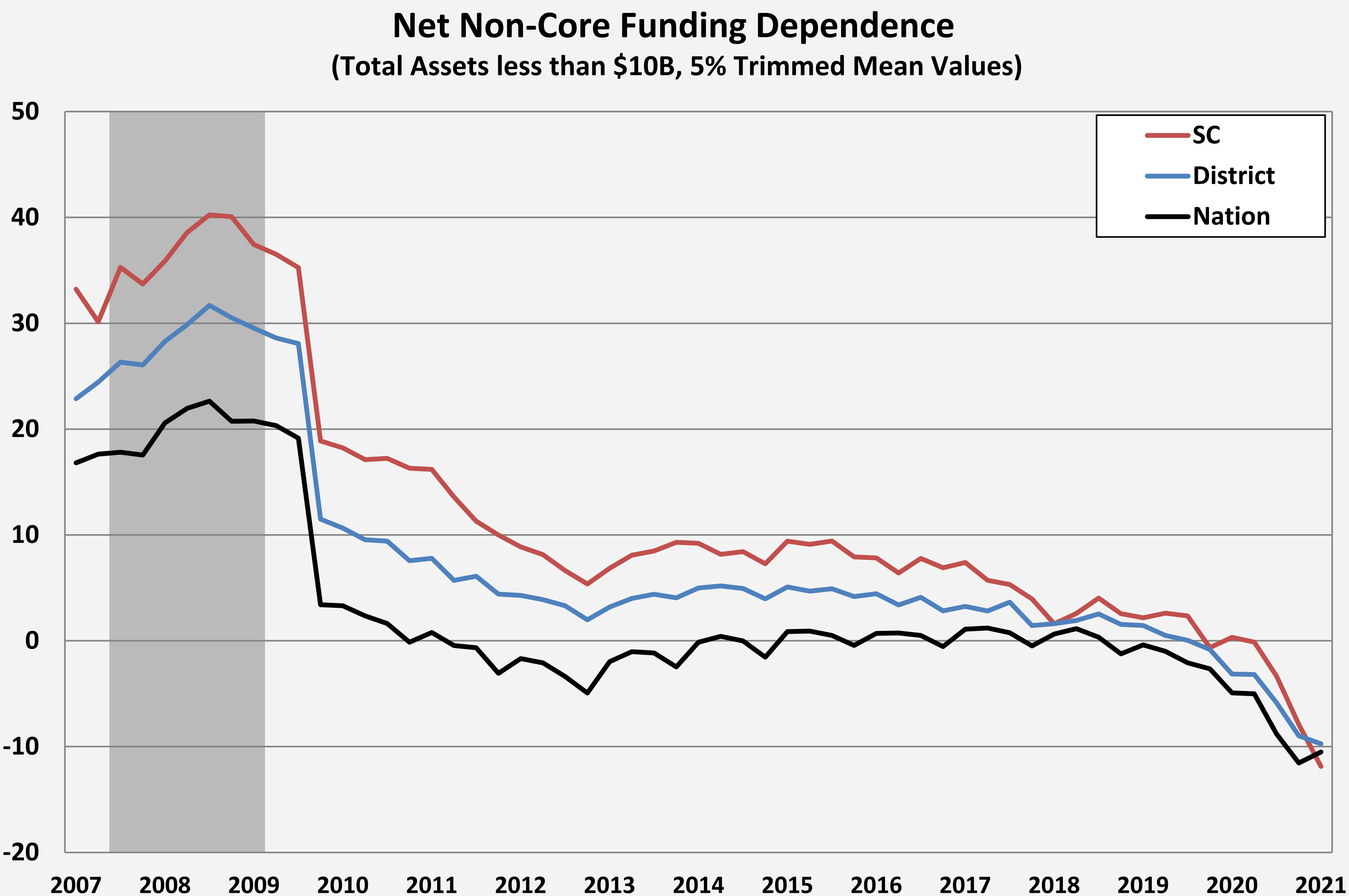
Capital: Tier 1 Leverage Ratio



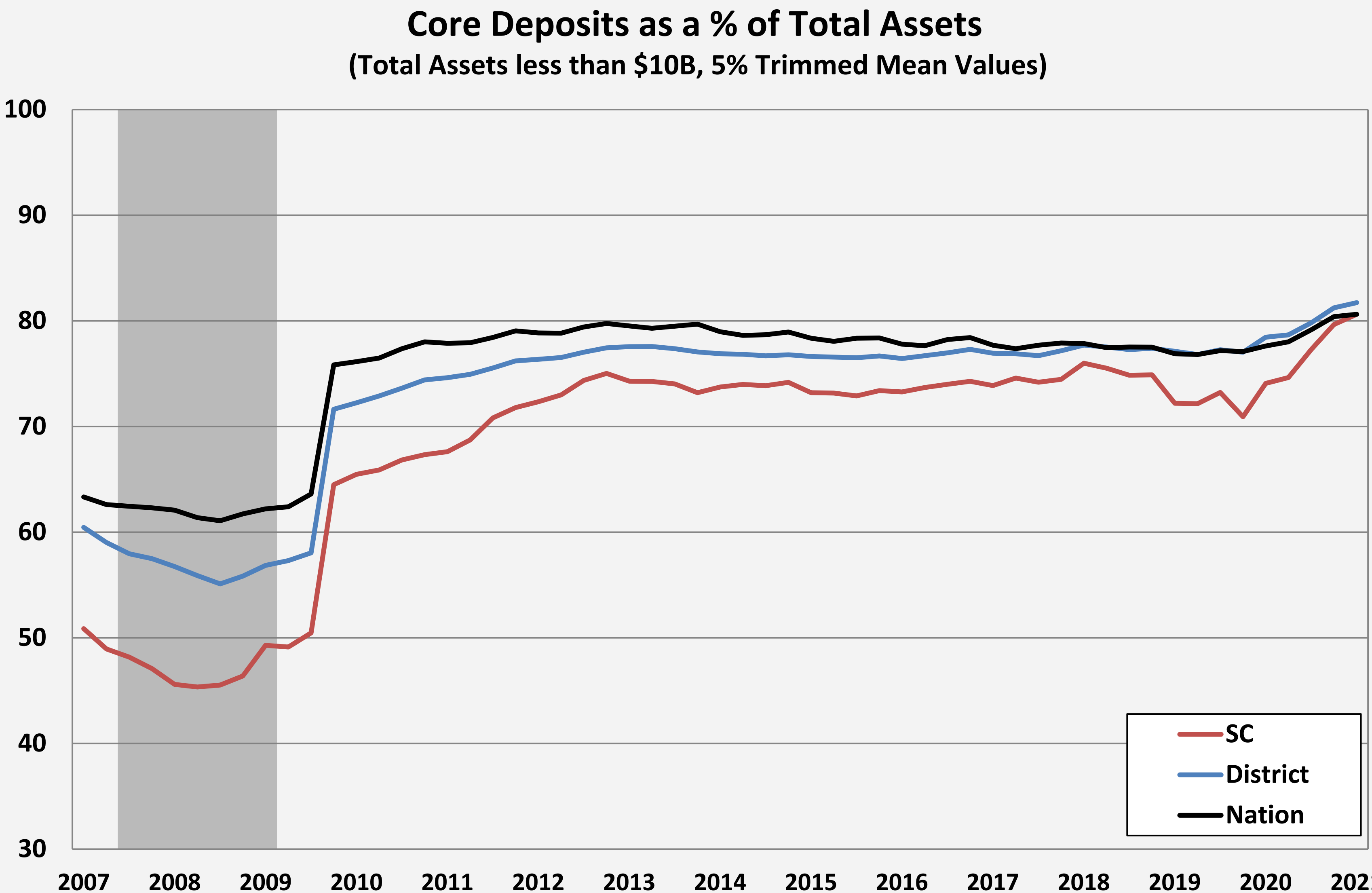
Capital: Total RBC Ratio



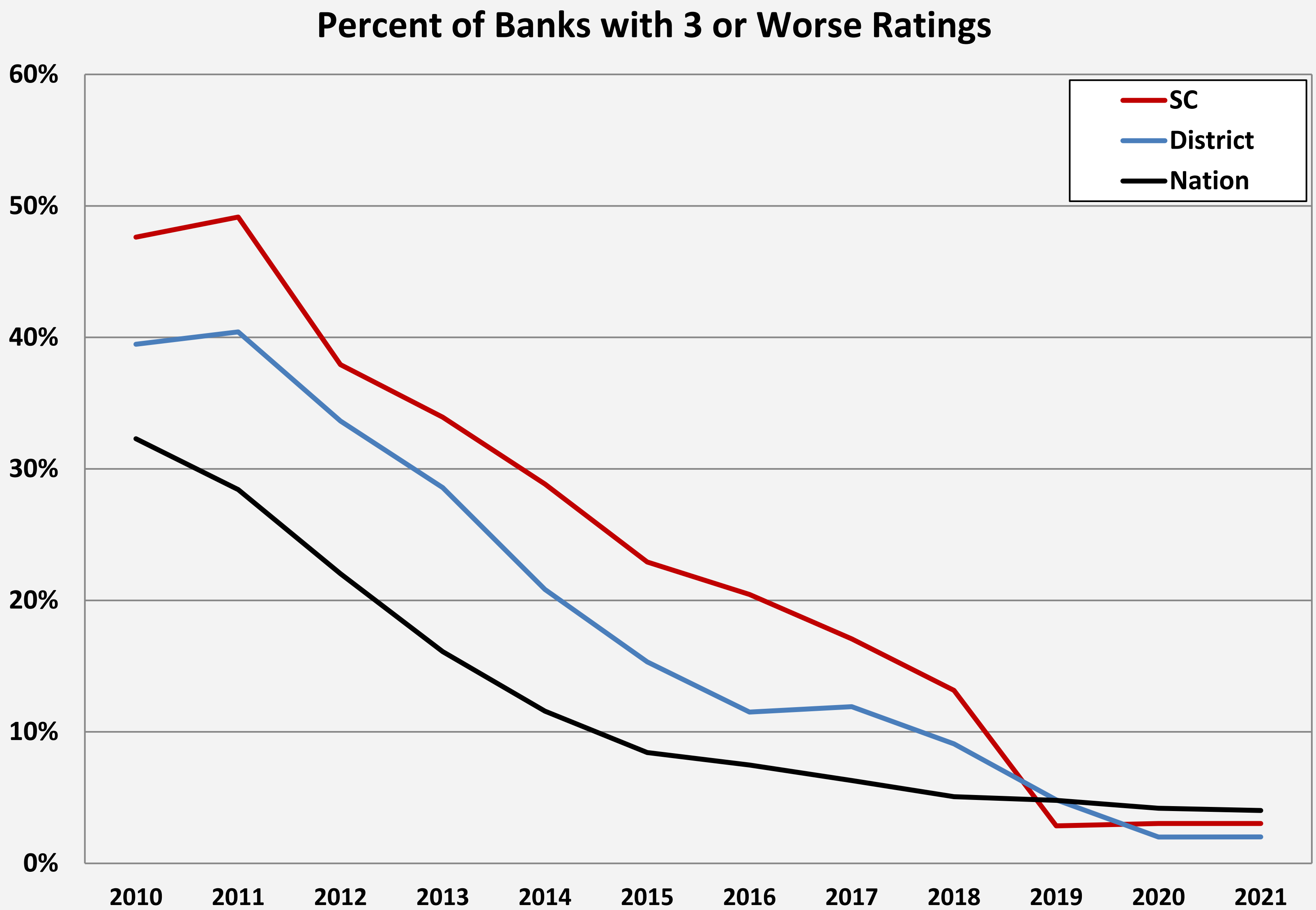
Liquidity: Net Non-Core Funding Dependence



Liquidity: Core Deposits



CAMELS Ratings



Appendices

Top Risks Identified

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For full risk descriptions see following pages

Top Risk Definitions

Balance Sheet Management: This trend is increasing as banks struggle to develop strategies around current and long-term income sources while simultaneously managing risk.

- Sustained low interest rates and flat yield curves are presenting challenges for most banks, requiring strategies for managing balance sheets under various scenarios which could develop in coming months.
- Liquidity surged into banks in the past year in the form of deposits, forcing institutions to model worst case scenarios to determine fund stability, and how to make the distinction between stable and non-stable deposits in a low rate environment. Investments have traditionally been an important earning asset; however, yields are down, and banks are exploring new portfolio management strategies which could increase risk.
- Sensitivity will also be a major factor as it is currently unclear how these deposits will react if rates rise.
- Banks are responding to the possibility of steepening yield curves by investing in short term low yield assets.
- If banks do not have models which efficiently optimize balance sheets, they could miss out on net margin opportunities and, subsequently, net income.
- Capital levels have grown since the 2008 crisis aided by a positive economic environment but there are concerns around capital redemptions, which may require more explicit scrutiny to protect against excessive dividends and other negative impacts to capital.
- In the 5th District, resumption of share repurchase activity continued in Q1 with 10 firms reporting repurchases of greater than 0.50% of outstanding common shares. RBO dividends continue to rise from the prior quarter but remain fully supported by rising net incomes. In addition to capital redemptions, our district has noted an uptick in dilution of the quality of capital by issuing debt and utilizing proceeds to repurchase shares of common equity (i.e. swapping tier 1 for tier 2). Other concerns include accretion of income from acquisitions and negative or zero loan loss provisions artificially propping up margins.

Top Risk Definitions

Credit Risk: This trend is increasing as uncertainties persist around commercial real estate, particularly in non-owner-occupied properties where the global pandemic has negatively impacted vacancy rates and consumer traffic has decreased. Maturity default risk remains high, and term default risk has increased for Retail, Hospitality and Office properties.

- Widening gaps between price and property income growth increases the risk of price declines from market deterioration and/or lack of investors.
- Proper collateral valuation is more difficult with occupancy changes, making it more challenging to underwrite credits (new credits, renewals, refinances, etc.), determine appropriate write-downs and adequacy of the reserve.
- Long-term viability of office properties is a concern as companies re-evaluate their workforce plans and implement alternative work arrangements and hybrid models, which will affect vacancies and valuations of office buildings when leases expire.
- Remote workers may feel less compelled to live near their employer, prompting flight to cheaper suburbs and affecting vacancies and valuations for multi-family properties in urban centers.
- Business travel will likely never revert to pre-COVID levels as employers utilize more virtual tools, affecting long term valuations of hotels, especially flags catering to business travel.
- Shopping online has replaced a significant portion of retail traffic, negatively impacting shopping malls and other brick and mortar retail establishments.
- Modifications and Deferrals have significantly declined from their 2020 peak, but payment performance issues may be masked by past stimulus, rent and foreclosure moratoriums and longer-term modifications.
- Both commercial and retail delinquency rates held steady in the first quarter, but some experts expect credit deterioration to emerge later in the year>
- While credit conditions for C&I loans are improving, banks began loosening C&I loan underwriting standards for large and medium-size borrowers: according to the FRB's Senior Loan Officer Opinion Survey (SLOOS), a net 15% of surveyed banks did so in 1Q21, compared to a net 5.5% of surveyed banks tightening standards in the prior quarter.

Top Risk Definitions

Cybersecurity: The trend is increasing due to the evolving security threat landscape, the increasing sophistication of attackers and techniques and the economic uncertainty and fear caused by the pandemic and subsequent national shutdown. Financial institutions have been persistently targeted in ransomware attacks.

- Institutions are challenged to balance the needs of the customer and the increasing threats to information security given the continuously evolving technologies and the amount of data that is being shared between vendors and financial institutions.
- Increased activity in the cyber-criminal sector to leverage COVID concerns from consumers, and to take advantage of financial aid programs under false pretenses is an additional concern.
- Cyber-criminals are increasing their exploitation of known social engineering vulnerabilities, as well as looking for weaknesses in critical infrastructure, and cyber-attacks have become more sophisticated and persistent, which makes implementing, maintaining, and updating controls more difficult.
- The Solar Winds breach underscores the focus that cybercriminals and nation states are putting on third-party providers as an avenue for them to enter government entities and financial institutions.
- It is critical that supervisors assess firms' ability to manage cybersecurity risks. This includes evaluation of governance, third-party and supply chain risk management, information security controls, and crisis management and event response.

Top Risk Definitions

<u>**Fraud and Consumer Harm:**</u> Risks trends and fraud activity continue to increase as evidenced by law enforcement alerts and internal SAR reports, and banks may not have the infrastructure, resources, or expertise to effectively deter or control the impact.

- The risk to control systems is compounded by increased transaction volumes arising from rapid deployment of multiple government assistance programs, particularly unemployment and PPP
- Model data is also currently skewed by atypical volumes, which could inhibit trend and monitoring processes.
- The pandemic and associated economic downturn are creating potential for adverse impacts among certain population segments by creating disparities in treatment and widening the impact in underserved financial markets
- Remote work and staffing changes may result in bank employees being unable to perform normal duties or impede their access to tools and documentation needed to maintain adequate internal controls.
- Loan modification or deferral fees could present potential fair lending issues if not applied consistently. Some banks are attaching conditions to consumer loan deferrals, including a negative impact on credit scores, and reporting the deferred loan as a derogatory account to credit reporting agencies. These conditions could prevent consumers from obtaining future credit and engenders the potential for claims of bad faith
- Some banks may try to make up for lost fee income by assessing increased ATM fees. If these fees are centered in underserved markets, it would create the potential for unfair and unequal treatment and the potential for UDAP risks if those fees are not properly disclosed
- Banks could be exposed to charges of unfair lending practices by assessing different fees for the same product (for example, charging extra fees on smaller loans)
- Finally, if banks do not adapt to intensifying competition, economic uncertainties and a changing technological landscape by making strategic adjustments to adapt to the new environment, they may face uncertain futures. This increasing trend may result in more banking deserts and under-served communities.

The Federal Reserve Bank of Richmond

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We provide:

- Fair, consistent, and tailored supervision with dedicated points of contact

  A dedicated portfolio officer and central points of contact provide timely communication and responses to questions and possess in-depth institutional knowledge.

- Knowledgeable and responsive staff and risk specialists

  Our staff go through a rigorous training program and have broad expertise due to the range of banks (size, risk profiles, and operating models) in the Fifth District.

- Committed outreach and education programs

  We proactively communicate expectations, risk topics, and other pertinent supervisory and regulatory issues with our institutions before examinations to avoid surprises, and we host a variety of informative conferences, seminars, and training opportunities.

- One local federal regulator for your bank AND holding company

  The Federal Reserve is the sole federal regulator for holding companies and their subsidiary banks that have elected state membership.

- Fed Stock dividend, supervision without fees, access to Fed services and a voice in district board representation

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To find out more, please visit us at https://www.richmondfed.org/banking/overview

Federal Reserve Resources

- **Supervision News Flash** helps you stay abreast of **topics and trends affecting financial institutions**. We share **insights on what our examiners, analysts and economists are seeing** both within the Richmond Fed's portfolio as well as trends from across the entire System. Sign up and read past issues at **RichmondFed.org**

- **Ask the Fed®** is a free program covering the **latest financial and regulatory developments** for senior banking officials and boards of directors. Ask the Fed® has monthly conference calls that feature Fed experts and guest speakers on top banking issues of the day, with time at the end for questions and comments. **stlouisfed.org/askthefed/**

- **Bank Board of Directors Desktop** is The Federal Reserve System's free online training curriculum to help bank directors **quickly develop an understanding of their role** in performing bank oversight responsibilities. Also included are links to web based resources, including data, publications, events and the federal banking agencies that bank directors may find useful in performing their bank oversight responsibilities. **bankdirectorsdesktop.org**

- The **Richmond Fed's website** includes a banker education section with links to fraud awareness, speakers' bureau, resources for financial institution directors, introduction to regulatory reporting. Look under Education for Bankers.

Federal Reserve Resources

- **Community Banking Connections** covers issues that community banks face, providing resources on key supervisory guidance, highlighting new regulations and offering perspectives from bank examiners and other Federal Reserve staff **communitybankingconnections.org**

- **FedLinks** articles highlight key elements of a supervisory topic to improve clarity and understanding about the topic and examiner expectations for applying related supervisory guidance. FedLinks articles are **most helpful for bank holding companies and banks with assets of $10 billion or less**. **communitybankingconnections.org/fedlinks.cfm**

- **The BSA Coalition** is a forum in which experts at financial institutions, regulatory and law enforcement agencies and other organizations can discuss and debate questions, guidance and day-to-day issues affecting the development and implementation of **effective Bank Secrecy Act/Anti-Money Laundering programs**. **bsacoalition.org**

- **Outlook Live** is The Federal Reserve System's **audio conference series on consumer compliance issues and hot topics** such as CRA, HMDA and fair lending compliance; service member financial protection and compliance consideration for vendor risk management. Live sessions are scheduled throughout the year, and archives of past presentations are available on the website. **consumercomplianceoutlook.org/outlook-live**

- **Consumer Compliance Outlook** is a Federal Reserve System publication dedicated to consumer compliance issues. **consumercomplianceoutlook.org**