INTERIM JOINT COMMITTEE ON BANKING AND INSURANCE

Minutes of the 1st Meeting
of the 2022 Interim

June 2, 2022

Call to Order and Roll Call

The 1st meeting of the Interim Joint Committee on Banking and Insurance was held on Thursday, June 2, 2022, at 2:00 PM, in Covington, Kentucky at the Northern Kentucky Convention Center. Senator Jared Carpenter, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jared Carpenter, Co-Chair; Representative Bart Rowland, Co-Chair; Senators Ralph Alvarado, Donald Douglas, Jason Howell, Morgan McGarvey, and Brandon J. Storm; Representatives Danny Bentley, Joseph M. Fischer, Patrick Flannery, Deanna Frazier Gordon, Derek Lewis, Matt Lockett, Shawn McPherson, Michael Meredith, Michael Sarge Pollock, Rachel Roberts, Sal Santoro, Tom Smith, Cherlynn Stevenson, and Ken Upchurch.

Guests: Pam Goetting, Northern Kentucky Market Director, Heartland Bank; Lee Crume, President & CEO, Northern Kentucky Tri-ED; Ballard Cassady Jr., President & CEO, Kentucky Bankers Association; Robert R. Hawkins, CFA, Chief Investment Officer, Wealth Management & Trust; Christy Carpenter, President, Bluegrass Community Bankers Association; and Gary Broady, Executive Director, Bluegrass Community Bankers Association

LRC Staff: Jessica Sharpe, Breanna Patterson, and Elizabeth Hardy

Introduction

Pam Goetting, Northern Kentucky Market Director of Heartland Bank, gave a brief introduction and thanked the committee for the opportunity to sponsor the event and for coming to Northern Kentucky.

Discussion of recently enacted legislation – local license fee for motor vehicle sharing and rentals

Lee Crume, President and CEO of the non-profit Northern Kentucky Tri-ED, discussed the motor vehicle license fee statute, KRS 68.200. This statute was initially enacted in 1994 and allows a fiscal court or legislative body of an urban county government to collect a three percent fee on gross rental car charges. It is a reliable source of funding for local economic development and is largely paid by visitors to the community. The original legislation was limited because the rate had not been changed since it was enacted, it did not address technological changes, and it lacked flexibility for economic disruptions. 22 RS HB 8 modernized the statute by applying the fee to car sharing companies and transportation network companies, which enables all technologies to support local economic development.

Impact of economic condition on banking industry and credit markets

Ballard Cassady Jr, President and CEO of the Kentucky Bankers Association, introduced Robert Hawkins, Chief Investment Officer of Wealth Management & Trust, who discussed economic conditions and their impact on financial institutions. The year 2022 was the worst start to the stock market since 1933 as well as the worst bond market and largest bear market for bonds since 1980. This is a reaction to inflation caused by COVID-19 pandemic stimulus legislation and market impacts caused by the Russian invasion of Ukraine.

With regard to the economic outlook, financial conditions are tightening. Mr. Hawkins discussed a graph that projected increasing federal funds rates, with a prime rate of about 5.5 to 6 percent by the end of 2022 and 6.5 to 7 percent by the first half of 2023. This tightening makes financing for municipalities more expensive and has resulted in the economic forecast being downgraded by approximately 25 percent. The unemployment rate is positive and better than expected, but inflation raised significantly and is higher than expected.

While the year started with quite a few headwinds, many are starting to abate. One bright spot is that COVID-19 lockdowns are ending. Mr. Hawkins is expecting inflation and the Russia-Ukraine war to continue to impact the economy over the next two to three years. These impacts include high grain and oil prices and supply chain issues caused by bottlenecks.

Mr. Hawkins discussed two charts depicting a period of high inflation during the 1970s and early 1980s and a third chart predicting the inflation forecast through 2024. There is concern that the Federal Reserve will have to resort to a “Volckler moment,” which refers to the former Federal Reserve Chairman Paul Volckler shocking the market by suddenly increasing interest rates up to 20 percent in the 1970s to combat high inflation. However, subsequent studies have revealed that you only have to raise rates to the level of inflation, so a Volckler moment this time would not be so high. The best case scenario is that inflation starts to decrease rapidly while the worst case scenario is that a recession begins and the market crashes. It is more likely that inflation will decrease gradually and the Federal Reserve will continue to hike rates at 0.5 percent increments.

Mr. Hawkins next discussed several positive economic tailwinds. The job market is showing signs that it is coming into equilibrium, with low-wage workers and mothers returning to the workforce and wages normalizing. Another tailwind is that consumers are in a strong economic position. Consumers have more cash than debt for the first time in 30 years and are spending more than the rate of inflation. Finally, federal legislation is providing infrastructure funds to the states. Kentucky is getting around $7 billion to spend on infrastructure, such as roads and broadband, over the next five years, which represents about 3.4 percent of Kentucky's gross domestic product (GDP).

Kentucky's economic outlook is mixed. The state is looking at a slowdown with increasing interest rates, but we are not likely to have a "Volcker moment." Also, there are the silver linings of the strong consumer, infrastructure spending, and peak corporate earnings and profits. The biggest issue for Kentucky is that the pension funding gap is growing wider, with Kentucky ranking worst among the states for pension under-funding. However, Kentucky may be able to use its budget surplus to work on the pension gap. Kentucky also has high debt per capita to GDP, so debt might be more costly here in the future.

Next, Mr. Hawkins explained that financial institutions are in fantastic shape. Balance sheets are strong, banks have been conservative and were assisted with stimulus spending, and according to Chase Bank data, consumer debt payments are at their highest level ever, with very few nonpayments. An area of concern is that life insurance companies are using a lot more leverage. Another area to note is that global systemically important banks probably face greater risk and have more collateral damage from lending to other global institutions affected by the Russia-Ukraine conflict. There is also concern with the shadow banking market, where hedge funds are financing private equity loans and collateralized loan obligations, but Kentucky banks have little exposure to this.

As for the lending environment, it is good. There is an oversupply of deposits in the state, credit quality is fantastic, and depositors are being paid next to zero for their deposits. Meanwhile, the prime rate has increased, resulting in increased net interest margins. If the Federal Reserve makes additional increases to the prime rate, then the increase in net interest margins could flatten out, resulting in banks lending less. The biggest issue for banks is that loan demand is mixed due to consumers having more cash and savings.

In response to Chairman Carpenter's question, Mr. Hawkins first discussed a recent statement by Jamie Dimon, CEO of JPMorgan Chase, that the market is becoming more bearish. Mr. Hawkins believes Mr. Dimon is building up a fortress balance sheet so that JPMorgan Chase can make acquisitions and hedge against uncertainty in Europe.

In response to Chairman Carpenter's comments regarding the impact of rising interest rates on the real estate market, Mr. Hawkins explained that the Federal Reserve has been taking certain actions to bring rates down and counteract a perceived housing bubble, but that it prefers to avoid market interference. There is evidence that the housing market is slowly starting to reach equilibrium. He believes the Federal Reserve will try to gently address the economic issues in a deliberative fashion.

In response to Chairman Carpenter's question about rising fuel prices, Mr. Hawkins believes that Europe is going to have a bigger issue because of sanctions on oil from Russia, with spill-over effects into the U.S. Certain global events could alleviate the issue.

Christy Carpenter, President of the Bluegrass Community Bankers Association, discussed the current economic conditions for community banks. In her local community, banks continue to see people travel and spend money, despite the increasing price of gas, goods, and services. While some are bracing for inflation on the horizon, others are incurring debt that will have to be repaid in the future. She advocated for the creation of more childcare opportunities to increase job market participation and support single parents. Kentucky's low unemployment number does not accurately reflect the reality that many people cannot afford to work. The market for manufacturing in her community is strong because employers have decreased employment requirements and do not do as much extreme drug testing, which is a positive thing because it gives a whole new area of the community a chance to get back into a workforce that they've been restricted from because of their past.

Ms. Carpenter spoke about community banks' efforts to educate customers about fraud and the risks of certain loan products. Debit card fraud has decreased at her bank, but social media scams are on the rise, so the bank is educating customers about these types of scams. Community banks are also struggling with refinance loans because individuals find lower rates from nonbank lenders. The goal is to focus on education of customers and the community because there can be more risk, cost, and fees associated with these products. She concluded with a story about making a loan to a person she believed in because that is what community banks do.

Gary Broady, Executive Director of the Bluegrass Community Bankers Association, discussed what he sees in talking with community bankers. The Federal Reserve got behind because they thought inflation in 2021 was transitory but it is here to stay. Inflation and rising interest rates have caused significant depreciation in securities portfolios at banks. First quarter numbers for community banks show some negative trends - net income is down 14 percent year over year, non-interest income is down, loan sales are down 61 percent from what they were the year prior, and net interest margin is down by 15 basis points from the prior year. Community banks have a lot of excess liquidity because of the federal Paycheck Protection Program and government stimulus. Most banks will avoid raising interest rates on deposits for as long as possible. As far as commercial and industrial loans, most of them are variable rate loans that are tied to prime. When these loans come due in three to five years, there will be an increase in loan expenses that will likely be passed on. In January 2021, the 30-year mortgage rate was 2.65 percent and the average new home price was $401,700. Today, the 30-year mortgage rate is 5.25 percent and the average new home cost is $570,300. Assuming a 20 percent down payment, that represents a 95 percent increase in the monthly mortgage payment.

Chairman Carpenter commented on the increased cost and scarcity of materials over the last year which then trickles down to the price of a new home.

There being no further business, the meeting was adjourned.