Section I: Executive Summary

Consensus forecasts suggest U.S. economic growth will slow in 2019 from recent highs, as the economic expansion enters its tenth year. Economic growth strengthened to above trend in 2018, thanks primarily to tax cuts and increased consumer spending. Strong labor market conditions also supported the economic expansion, as hiring continued and wages improved. Business investment increased in 2018, reflecting the health of the overall economy. Tariffs on traded goods reduced U.S. exports, and uncertainty about global trade may contribute to slower future growth if consumers and businesses delay purchase or investment decisions. Other factors affecting the outlook include ongoing political risks in Europe and a global economic slowdown that began in 2018.

Financial markets reflected expectations for slower economic growth, and volatility returned to financial markets in 2018 and early 2019, following several years of steady, positive performance. The U.S. Treasury yield curve flattened significantly in 2018 as the Federal Open Market Committee raised the target range for the federal funds rate four times during the year. The average net interest margin improved for the banking industry in 2018, as average asset yields generally increased more rapidly than average funding costs. However, 31 percent of banks reported a decline in their net interest margin in 2018, as their average funding cost generally increased faster than their average asset yield. Asset yields have declined for a number of banks as the yield curve flattened. Growth in the leveraged loan market accelerated over the past two years as demand from yield-seeking investors increased. Concerns about reduced underwriting standards escalated with an increase in the prevalence of loans with weak covenants and less rigorous documentation standards. The stock market was adversely affected by price volatility in 2018, and several indices ended the year with negative annual returns. Despite strong earnings reports, bank stocks were volatile and underperformed relative to broader indices as interest rate expectations dampened the market outlook.

FDIC-insured institutions performed well in 2018. The strong financial condition of banks contributed to a declining number of institutions on the Problem Bank List and no bank failures during the year. Net income for FDIC-insured institutions increased 44 percent from 2017 to a record $236.7 billion in 2018, driven by higher net operating revenue and a lower effective tax rate. Loan growth continued and loan performance metrics remained strong for both the banking industry as a whole and community banks. However, slower growth in the broader economy is beginning to affect the banking industry. Loan growth has slowed over the past three years, particularly in real estate-related portfolios. In addition, agriculture loan noncurrent rates are rising amid low commodity prices and farm incomes. Still, banks held more and higher-quality capital than they did during the financial crisis, in part because of post-crisis regulatory capital requirements.

Consolidation within the banking industry accelerated in 2018. The pace of net consolidation rose in 2018 for the first time since 2015 and remains relatively high by historical standards. Net consolidation is primarily driven by voluntary inter-company mergers. In 2018, 230 charters were merged out of existence and seven were acquired by credit unions. Consolidation activity was partially offset by new chartering activity: eight newly chartered and insured institutions were established in 2018, the most since 2010.

Community banks continue to report lower consolidation rates than noncommunity banks. When acquisitions have occurred, community banks have typically been acquired by other community banks.[3] In the ten years ending 2018, the share of community banks that were acquired by other community banks was 68 percent. Community banks also reported lower rates of attrition compared with noncommunity banks: 4.7 percent of community banks that reported financial results at year-end 2017 exited the industry in 2018, compared with 5.4 percent of noncommunity banks.

[3] The FDIC identifies community banks not by total asset size, but instead by a broader set of criteria related to traditional lending and deposit gathering activities and limited geographic scope. See FDIC Community Banking Study at **https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf**.