SECTION 1
Executive Summary

The banking industry demonstrated resilience despite weaker economic conditions, sharply higher interest rates, high inflation, and financial market stress in early 2023. Stress in certain large banking institutions along with severe liquidity strains resulted in the failure of Silicon Valley Bank and Signature Bank in March and First Republic Bank in May.[4] The FDIC, Federal Reserve, and Treasury took swift and decisive action to restore public confidence in the banking system, but banking conditions remained stressed and vulnerable to additional adverse market developments.

Weaker economic conditions and higher interest rates in 2022 continued through early 2023. The U.S. economy expanded at a markedly slower pace in 2022, with growth decelerating to less than half of the strong growth in 2021 and increased expectations for recession. Disruption to supply chains impeded economic growth in 2022. While these pressures abated and inflation moderated by early 2023, labor supply shortages remained. The economy has been supported by strong labor markets and continued growth in personal incomes, even as other sectors such as housing began to slow.

Interest rates rose sharply in 2022 as the Federal Reserve raised short-term interest rates to combat sustained high inflation. Treasury yields rose across all maturities. Shorter-term interest rates rose more than longer-term interest rates, causing the yield curve to invert in 2022 and remain inverted at most tenors through first quarter 2023. An inverted yield curve makes lending conditions more challenging for banks.

Financial market conditions tightened considerably starting in 2022 on rising interest rates, high inflation, and concerns over a potential recession. Bond markets faced several challenges as rising interest rates and bond market volatility weighed on both new issuances and performance. Stocks generally performed worse in 2022 than in any year since 2008. Although corporate earnings largely surpassed expectations in 2022, financial market conditions worsened throughout the year due to strong inflationary pressures and a tight labor market. The failure of three large banks, two in first quarter 2023 and one in the second quarter, introduced a renewed bout of stress primarily in the banking sector. Financial market conditions stabilized to some degree by the end of first quarter, but interest rates and funding costs remained elevated.

Despite these challenges and the market stress in early 2023, the banking industry demonstrated resilience, but industry performance moderated from 2022. Bank net income was roughly unchanged in first quarter 2023 after excluding accounting gains associated with the acquisition of two failed banks. Banking sector profitability moderated in 2022 after strong gains in 2021 as increased provision and noninterest expenses offset higher net interest income. Net interest margins (NIMs) improved in 2022 as interest rates rose, but NIMs began to decline in first quarter 2023 as higher funding costs offset increased asset yields on an aggregate basis. Deposit outflow from the banking industry, which started in mid-2022, continued at a faster rate in first quarter 2023. However, asset quality metrics for the banking industry overall remained favorable through first quarter 2023, and the industry remained well capitalized. After surging in 2022, the volume of unrealized securities losses moderated in first quarter 2023 but remained elevated.

[4] The banking failures included Silicon Valley Bank of Santa Clara, CA on March 10, 2023; Signature Bank of New York, NY on March 12, 2023; and First Republic Bank of San Francisco, CA on May 1, 2023.

Key Risks to Banks

Credit Risks: Asset quality remained generally favorable as of first quarter 2023 despite modest deterioration. Weaker economic conditions and higher interest rates may challenge bank loan portfolios, including credit card, commercial and industrial, residential real estate, and commercial real estate (CRE) loans.

- **Agriculture:** The agricultural sector had another strong year with record profits despite widespread drought conditions. Loan growth and higher loan yields boosted farm bank earnings in first quarter 2023 following a down year in 2022. Stronger farm sector financial conditions led to improved farm bank asset quality through first quarter 2023, but higher interest rates and production costs pose challenges in 2023.

- **Commercial Real Estate:** Banks have substantial exposure to CRE lending as CRE loans comprised a quarter of total loans held by the banking industry as of first quarter 2023. CRE loans as a share of total industry assets have grown and approached their 2009 peak. Most CRE property types performed well in 2022, but some challenges continued into 2023, particularly among office properties. With a structural decline in office demand and weak rent growth, some borrowers may have difficulty refinancing. Longer-term leases, which are prevalent in the office sector, helped to insulate office properties from reduced occupancy earlier in the pandemic, but more office leases are scheduled to expire over the next three years in some large markets. While aggregate banking industry CRE asset quality metrics remained favorable in first quarter 2023, challenges to loan performance include higher interest rates, difficulty refinancing particularly for loans secured by some office properties, and economic uncertainty.

- **Consumer Lending:** Consumer debt increased, owing primarily to strong growth in credit card balances. While a strong labor market supported consumer incomes, consumers faced higher inflation that constrained budgets. Consumer savings declined, and declines in equity prices pressured some consumer balance sheets.

  Potential signs of consumer loan problems emerged at banks, as the total past-due rate on credit cards and auto loans rose. While asset quality remained generally favorable, trends in consumer loan performance could deteriorate in 2023 if the labor market or economic growth weakens. Auto loans in particular showed concerning asset quality trends that may worsen if auto prices normalize from high levels.

- **Energy:** Energy prices softened during the second half of 2022 as oil prices receded from earlier highs and were more stable through early 2023. Despite the decline in prices, the energy industry remained profitable, supporting employment in energy-concentrated states. Bank loan exposure to oil and gas firms continued to decline in 2022 from 2021 levels. Community bank asset quality in energy-concentrated states continued to improve through first quarter 2023. Despite strength in 2022, the outlook for conditions in the energy sector weakened by year-end and remained uncertain in early 2023.

- **Housing:** The housing market began to slow in mid-2022 as mortgage rates rose sharply. Through early 2023, home price appreciation declined from 2022 highs. But home prices nationally remained elevated and above the pre-pandemic level, aided by strong demand and a limited supply of homes for sale. High home prices and increased mortgage rates continued to reduce the affordability of homes, particularly for first-time home buyers. With the sharp rise in long-term mortgage rates, mortgage originations declined last year and through first quarter 2023, but banks reported higher residential mortgage loan balances and increased residential construction and development lending. Asset quality metrics for residential mortgage loans remained favorable, but early signs of potential credit deterioration have emerged.

- **Leveraged Lending and Corporate Debt:** Corporate borrowing conditions deteriorated in 2022 and through first quarter 2023 as high inflation, rising interest rates, and an economic slowdown challenged corporate borrowers. Corporate debt issuance slowed sharply. Issuance of leveraged loans, a subset of the corporate debt market, declined normalizing from the record issuance in 2021. Slowing economic growth and continued high interest rates could weigh on corporate debt markets and pose credit risk for the banking industry, while limited near-term corporate debt maturities should mitigate some risks. Rising corporate defaults would affect holders of corporate debt securities, including banks.

- **Nonbank Financial Institution Lending:** Bank lending to nonbank financial institutions (NBFIs) continued to increase, led by growth in the larger banks. Community bank exposure to nonbank entities, primarily in the form of line of credit facilities to nonbank mortgage lenders, remained limited and declined through first quarter 2023, according to supervisory observations. The banking industry is increasingly exposed to the broad and varied risks from nonbank business activities. Asset quality of NBFI loans remained favorable in first quarter 2023, but banks remain vulnerable to adverse developments in nonbank institutions.

- **Small Business Lending:** Small business conditions weakened from high inflation and labor market shortages. Conditions varied across industries as consumer spending patterns shifted toward services. Small business loans declined in 2022, primarily reflecting the winding down of lending under the Paycheck Protection Program. While asset quality remained sound, small businesses reported concerns about the weaker outlook, which may be a source of risk for banks during 2023.

Market Risks: Market risks were primarily related to the effects of higher interest rates. Deposit outflows along with high levels of unrealized losses could pressure liquidity for some banks in 2023. The banking industry benefited from strong loan growth and higher NIMs in 2022, but higher funding costs reduced NIMs in early 2023.

- **Liquidity and Deposits:** Higher unrealized losses made securities portfolios a less effective liquidity source. Deposit levels continued to grow among community banks in 2022 through first quarter 2023 despite the overall decline in deposits for the banking industry. Community bank loan growth remained strong and outpaced deposit growth, causing liquid assets to contract and wholesale funding to increase. High interest rates remain a significant source of liquidity risk for banks.

- **Net Interest Margins and Interest Rate Risk:** Higher interest rates initially supported higher NIMs, particularly as loan growth strengthened. These trends began to reverse in first quarter 2023, as funding pressures rose and loan growth slowed. The sharp rise in interest rates in 2022 caused widespread depreciation in securities portfolios, and banks with a higher share of long-term assets reported higher depreciation in investment portfolios and lower growth in NIMs than other institutions.

Operational Risk: Operational risks, including cybersecurity risks and risks related to illicit financial activity, remained elevated across the banking industry.

- Operational risk remains one of the most critical risks to banks. Geopolitical events continue to increase the likelihood of cyber attacks on banks. The banking industry's software infrastructure remains vulnerable to cyber attacks including ransomware attacks and threats against third-party service providers. Robust customer due diligence policies and anti-money laundering and countering the financing of terrorism programs reduce the U.S. financial system's susceptibility to illicit financial activity risks.

Crypto-Asset Risk: Crypto-assets present novel and complex risks that are difficult to fully assess.

- The crypto-asset sector experienced significant market volatility in 2022. Growth in the crypto-asset industry corresponded with an increasing interest by some banks to engage in crypto-asset activities. The FDIC has been generally aware of the rising interest in crypto-asset-related activities through its normal supervision process. However, as this interest has accelerated, the FDIC determined that more information was needed to better understand the risks associated with these activities. The FDIC, in coordination with the other federal banking agencies, continues to closely monitor crypto-asset-related activities of banking organizations. As warranted, the FDIC will issue additional statements related to engagement by banking organizations in crypto-asset-related activities. The FDIC also has developed processes to engage in robust supervisory discussions with banking organizations regarding proposed and existing crypto-asset-related activities and provide case-specific supervisory feedback.

Climate-Related Financial Risk: Climate-related financial risk includes physical risk and transition risk. The *Risk Review* is a retrospective look at risks, and the discussion in this section focuses on physical risk from severe weather and climate events.

- In 2022, severe weather and climate-related events included three hurricanes, an extensive wildfire, and a prolonged drought in the West. Estimated damages from severe weather and climate events in 2022 were among the most costly. The FDIC is expanding efforts to understand climate-related financial risk in a thoughtful and measured manner that emphasizes a risk-based approach and collaboration with other supervisors and the industry. The FDIC recognizes that risk management practices in this area are evolving and will continue to encourage banks to consider climate-related financial risk in a manner that allows them to prudently meet the financial services needs of their communities.