SECTION 2
Overview of the Economy, Financial Markets, and Banking Industry

Economy

- **The U.S. economy continued to expand in 2022 and first quarter 2023 but at a notably slower pace than in 2021, and recession concerns increased.**
- **Labor markets remained strong, with higher growth in payroll employment and wages, but showed signs of moderating late in 2022 and into 2023.**
- **Inflationary pressures increased and supply chain issues continued, challenging businesses and consumers.**
- **Monetary policy tightened in response to inflation; higher market interest rates may weaken economic conditions and pose risks for banks.**

Economic growth slowed markedly in 2022, but the economy avoided a recession. Full-year growth was 2.1 percent in 2022, down from 5.9 percent in 2021. The slowdown reflected a contraction in real gross domestic product (GDP) in the first and second quarters of 2022 (Chart 1). Despite these declines, an economic recession was not officially determined as other economic indicators were strong.[5] The contraction during the first half of 2022 was due primarily to declines in exports and government spending. Inventory investment, mainly in retail trade and residential investment, also declined during the year. Economic growth turned positive in the second half of 2022 supported by government spending and a strong rebound in exports, particularly in energy. Continued growth in consumer spending also helped support economic growth. After peaking in third quarter 2022, economic growth slowed through first quarter 2023, when GDP increased at an annual rate of 1.3 percent. Consumer spending rose despite continued high inflation, while inventories and residential fixed investment declined. During 2022, professional forecasters increased the odds of a recession in the next 12 months, despite the economy's positive growth in the third and fourth quarters. The odds of a recession beginning in 2023 remained elevated.[6]

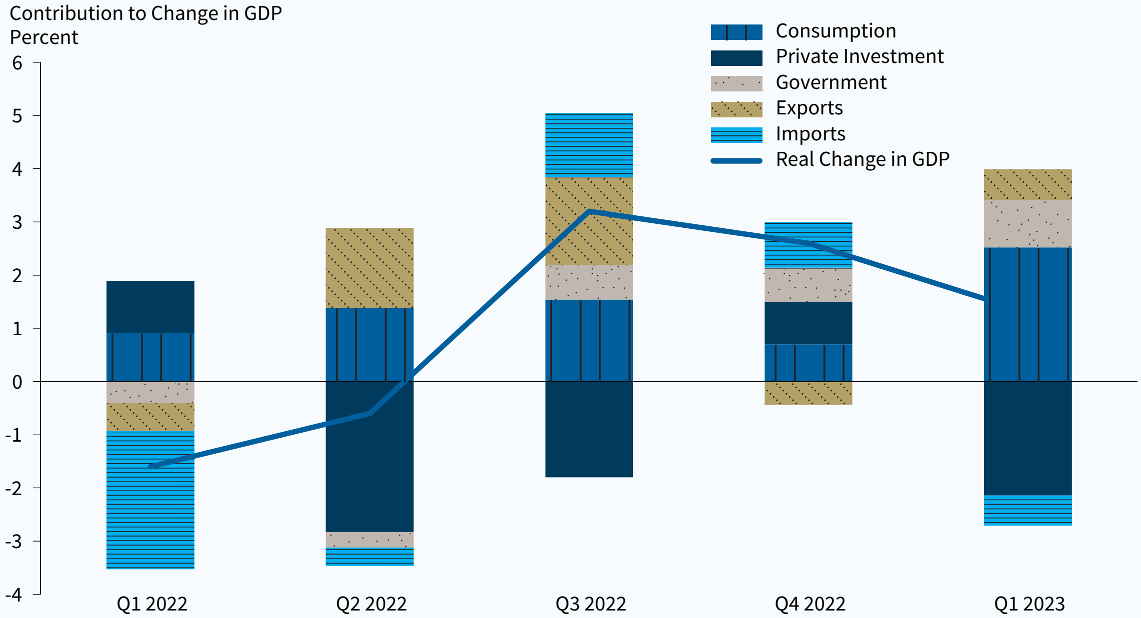
Supply chain bottlenecks continued to impede economic growth in 2022. While U.S. manufacturing output continued to grow since pandemic-related restrictions eased in 2021, producers continued to experience backlogs and long delivery times in 2022. These conditions resulted in higher producer prices, which contributed to increased prices overall last year. Other countries also continued to experience supply chain disruptions, including lockdowns in China that had ripple effects throughout global production chains. Slowing global demand in the final months of 2022 brought backlogs and delivery times for domestic production closer to historical norms. Conditions improved further in first quarter 2023 as shipping costs and production delays continued to fall.

[5] Recessions in the United States are characterized by a broad-based decline in activity as determined by the National Bureau of Economic Research Business Cycle Dating Committee and include indicators for the labor market, consumer and business spending, industrial production, and incomes.

[6] Blue Chip economic forecasts included a special question on the odds of a recession from June to September that increased every month.

CHART 1

After Contracting in the First Half of 2022, Growth Resumed at a Lower Pace



Source: Bureau of Economic Analysis (Haver Analytics).
Note: Data are quarterly through first quarter 2023.

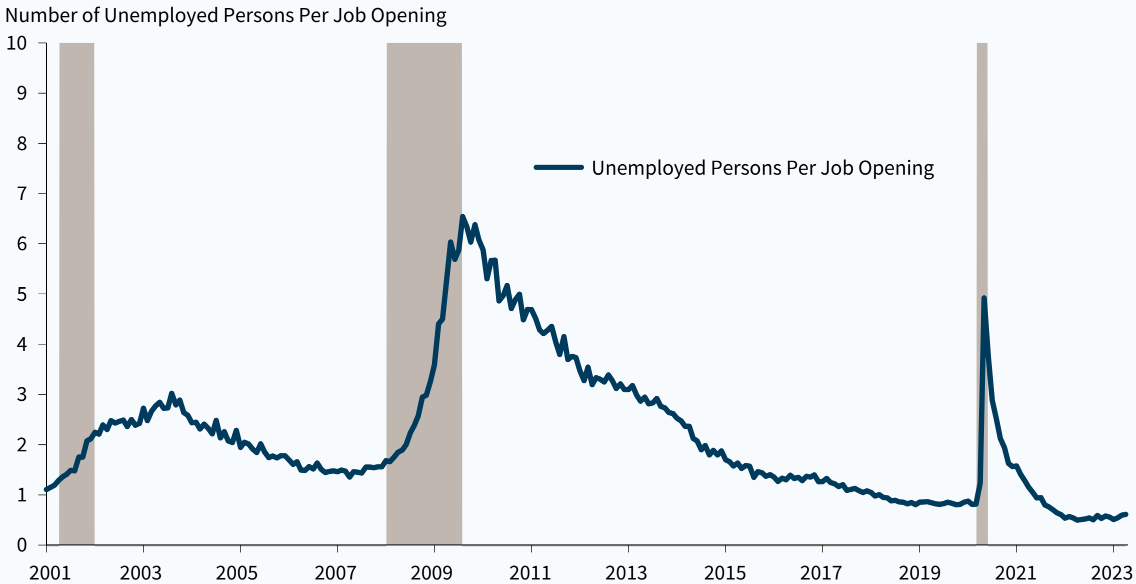
The labor market remained tight, and many industries continued to face labor market shortages last year as job openings reached an all-time high in first quarter 2022. While job openings remained historically elevated through first quarter 2023, labor market tightness began to ease. The ratio of unemployed workers to job openings remained below one and near historic lows, suggesting there are not enough workers available to fill all open positions in the economy (Chart 2). The labor force participation rate edged up but remained below its pre-pandemic level in each month of 2022 and the first three months of 2023 due to pandemic-related factors and retirements.[7] The unemployment rate remained near historic lows during 2022 and through the first quarter of 2023, one of the many signs of continued labor market tightness. Payroll job growth remained solid, though the monthly average declined throughout last year. In July 2022, payroll employment surpassed the peak set in February 2020 before the onset of the COVID-19 recession. The pace of job gains varied among specific industries with some ending 2022 well above pre-pandemic employment levels from March and April 2020. Payroll growth continued in first quarter 2023, although at a slower pace than one year earlier. Wage growth remained strong in 2022 and broadened across industries, but it subsided in the second half of the year. Wage growth slowed in first quarter 2023 but remains above levels consistent with the Federal Reserve's target inflation, feeding into inflationary pressures.

Inflationary pressures continued to increase in the first half of 2022, reaching the highest levels in decades, but moderated through early 2023 partly due to lower energy prices (Chart 3). The consumer price index (CPI) peaked at 9.1 percent in June 2022 and recorded the largest 12-month increase since November 1981. Inflation in the early months of 2022 was driven by an acceleration in food and energy prices. Energy prices remained high into early summer 2022 with gasoline peaking above $5 a gallon nationally before falling in the second half of the year. Annual core CPI, which excludes the more volatile categories of food and energy, also peaked last June at 5.9 percent. Increasing rents and rent equivalents

[7] The pre-pandemic level is defined as February 2020 for this section on the economy.

CHART 2

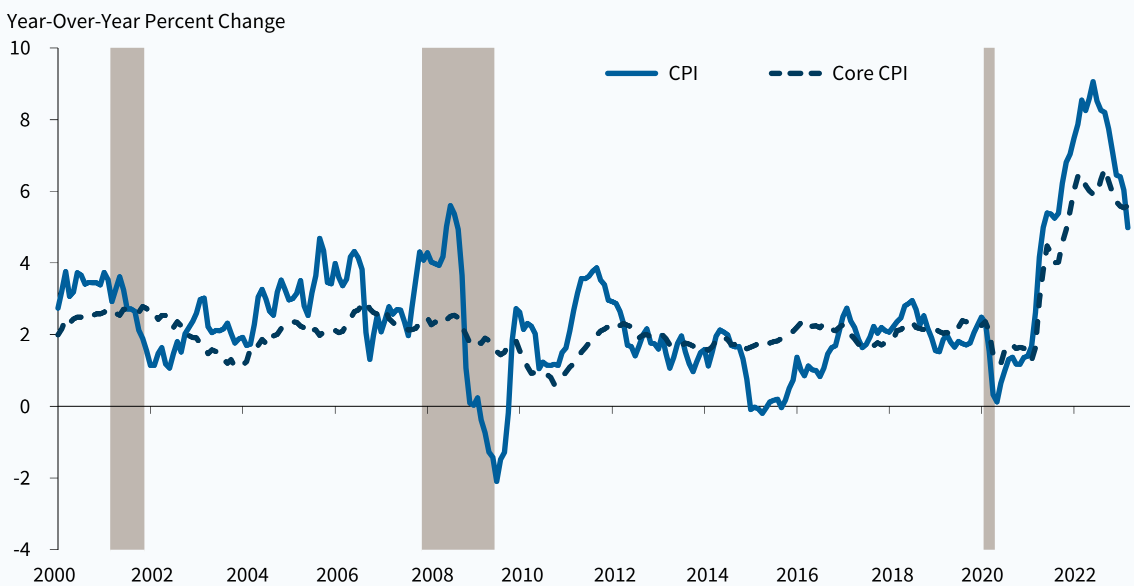
Labor Markets Remain Tight and the Number of Unemployed Persons Per Job Opening Is Near Historic Lows



Source: Bureau of Labor Statistics (Haver Analytics).
Note: Shaded areas indicate recession. Monthly data as of March 2023.

CHART 3

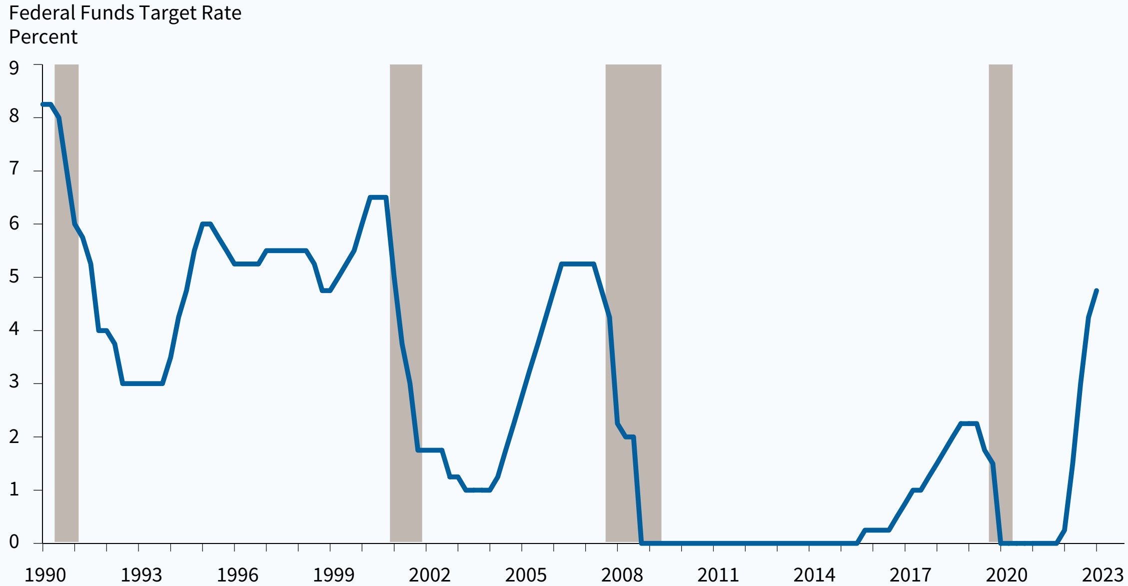
Both Headline and Core Consumer Price Index Peaked in Mid-2022 at Multi-Decade Highs and Remain Elevated



Source: Bureau of Labor Statistics (Haver Analytics).
Note: Shaded areas indicate recession. Monthly data as of March 2023.

CHART 4

The Federal Reserve Began Increasing the Federal Funds Rate in March 2022 and Hiked Rates at Each Subsequent Meeting



Source: Federal Reserve Board (Haver Analytics).
Note: Data point to lower limit of federal funds target rate. Quarterly data as of March 2023.

in the second half of the year added to inflationary pressures for shelter, a core component of CPI. Prices for many other categories that contributed the most to inflation moderated in first quarter 2023. However, inflation remained well above the Federal Reserve's 2 percent target in early 2023.

In response to sustained high inflation and a strong labor market, the Federal Reserve Federal Open Market Committee (FOMC) tightened monetary policy at seven of eight FOMC meetings held in 2022—every meeting but January. The 75 basis point hike in the federal funds rate in June 2022 was the largest one-month increase since 1994 (Chart 4). The federal funds rate ended December 2022 in a range of 4.25 to 4.5 percent, up from 0 to 0.25 percent at the start of the year. Rate hikes continued in February and March 2023 and ended first quarter in a range of 4.75 to 5.0 percent. The FOMC also ceased net asset purchases in early March 2022 and began reducing its securities holdings in June, which further contributed to tighter financial conditions. The Federal Reserve communicated its commitment to doing whatever necessary to restore price stability and maintain a strong labor market.

As the federal funds rate increased, shorter-term interest rates rose more than longer-term interest rates, and interest rate spreads between shorter- and longer-dated bonds fell. The Treasury yield curve inverted in July 2022 and remained inverted at most tenors for the rest of 2022 and into 2023. An inverted yield curve often heightens discussion of whether a recession will occur soon, as the yield curve has inverted before almost every recession since World War II. Even without a recession, an inverted yield curve makes lending conditions more challenging for banks.

Prolonged inflationary pressures and higher interest rates challenge economic conditions and may pose risks to banks. While higher interest rates may improve earnings for some lenders, weaker economic conditions could slow demand for business and consumer credit and impede asset quality. Industries vulnerable to higher interest rates, such as autos and housing, could weaken; new business formations could slow; and household and business spending could decline. As highlighted in the FDIC's *2022 Risk Review*, higher inflation could pose credit risks to some lenders if borrowers cannot stay current on loans due to higher prices, particularly if household incomes do not keep pace with rising expenses or if businesses face declining sales due to a reduction in consumer spending. These conditions may contribute to a more challenging operating environment for banks throughout 2023.

Financial Markets

- **Financial market conditions began to tighten considerably in 2022 as interest rates rose sharply and concerns about the economic outlook grew.**
- **Bond markets faced several challenges in 2022 as higher interest rates and volatility weighed on both new issuances and performance. While bond market volatility persisted in early 2023, performance improved and issuance picked up relative to much of 2022.**
- **Equity market volatility rose in 2022, and equity prices declined for banking stocks in early 2023.**
- **While financial market conditions contributed to banking stress in early 2023, broader financial markets were largely unaffected by bank failures.**
- **Financial market conditions stabilized to some degree by the end of first quarter 2023, but interest rates and funding costs remained elevated.**

Interest rates began to rise sharply in 2022, exceeding market expectations. Several major central banks increased interest rates to combat inflation in 2022, with the Federal Reserve raising short-term interest rates more aggressively than at any time in the past 40 years. The 425 basis point increase in the target range for the federal funds rate in 2022 was far higher than the 100 basis point increase markets expected at the beginning of the year (Chart 5). Along with rate increases, the Federal Reserve began to significantly reduce its balance sheet in June 2022, and the Federal Reserve's asset holdings fell $364 billion by the end of the year. The reduction in the Federal Reserve's asset purchases further contributed to rising market interest rates.

Rates across the U.S. Treasury yield curve increased, and portions of the curve inverted in 2022. Treasury yields rose sharply in 2022, with the two-year Treasury yield rising 368 basis points to 4.41 percent and the ten-year yield rising 236 basis points to 3.88 percent (Chart 6). Other maturities on the Treasury yield curve increased at a similar rate. Much of the yield curve was inverted in the second half of 2022, meaning yields on shorter-term securities were higher than yields on longer-term securities. The two-year Treasury yield was higher than the ten-year yield from July through the end of the year, exceeding the ten-year yield by as much as 84 basis points in early December and by 107 basis points on March 8, 2023. Real interest rates, which exclude the component of yields that reflect inflation expectations (as measured by yields on Treasury Inflation-Protected Securities), also moved significantly higher in 2022.

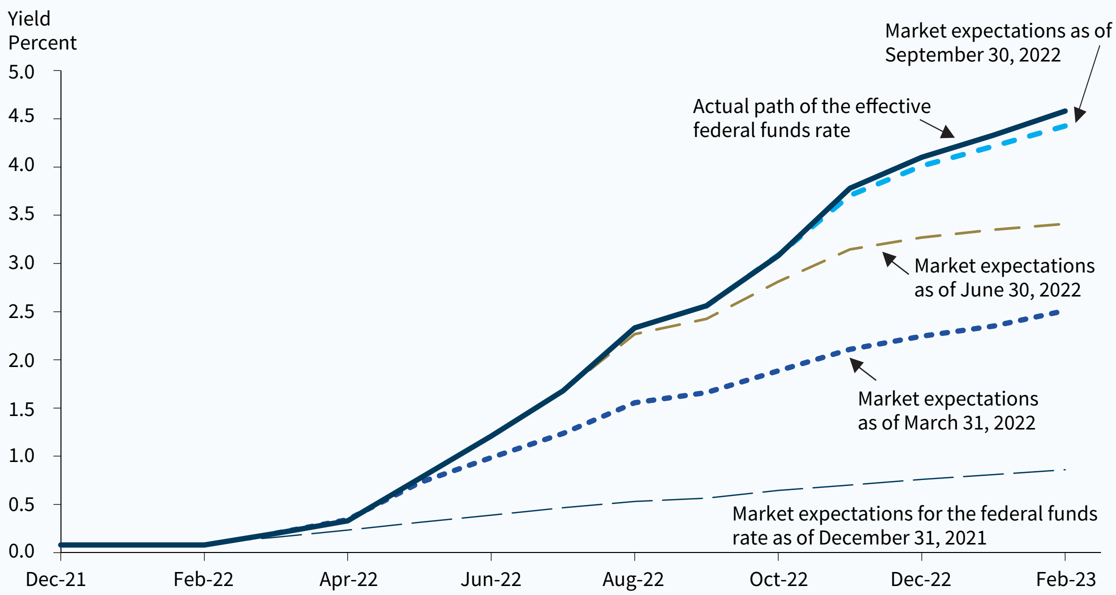
Despite federal funds rate increases that continued through at least May 2023, rates across U.S. Treasury yields did not sustain a comparable increasing trend from October 2022 through May 2023. Yields decreased during the market stress that occurred in March 2023. Treasury volatility heightened in the spring of 2023 as traders weighed expectations for persistent inflation, which tends to increase rates, against expectations for an economic slowdown, which has the opposite effect.

Rising interest rates, inflation, and a potential recession all contributed to financial market stress in 2022. Financial asset prices dropped substantially across most asset types in 2022. Globally, stocks and bonds lost more than $30 trillion in a year marked by sustained periods of heightened volatility. Even commodity prices, which initially added to inflation and caused interest rates to rise, fell significantly in the second half of 2022. Prices of many financial assets began to rebound in fourth quarter 2022 and into first quarter 2023. Overall, financial market conditions stabilized to some degree by the end of first quarter 2023, but interest rates and funding costs remained elevated.

The corporate bond market began to face several challenges in 2022 as rising interest rates and bond market volatility weighed on both new issuances and performance. While bond market volatility persisted in early 2023, performance improved and issuance picked up relative to much of 2022. Investment grade issuance fell 16.2 percent year over year in 2022 on a dollar basis, down for the second consecutive year. High-yield bond issuance fell 77.0 percent year over year, down from record issuance in

CHART 5

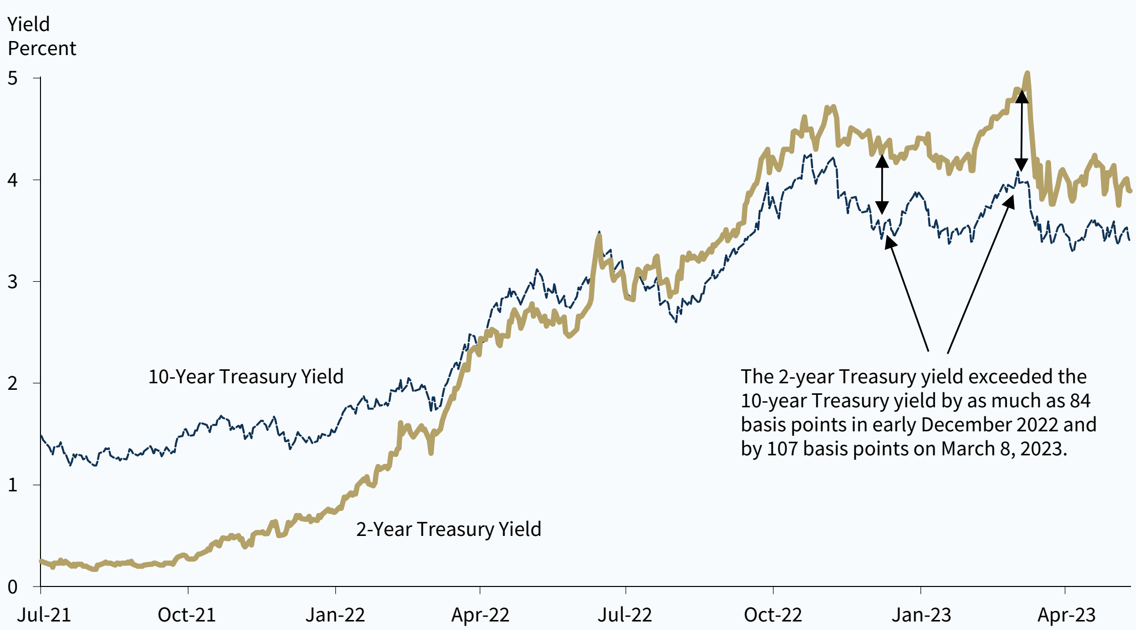
The Actual Path of the Effective Federal Funds Rate in 2022 Exceeded Market Expectations



Sources: Bloomberg and Federal Reserve (Federal Reserve Economic Data).
Note: Market expectations for the federal funds rate are derived from the 30-day federal funds futures contract price in which the implied rate is 100 minus the futures price. Data are monthly through February 2023.

CHART 6

Interest Rates Across the U.S. Treasury Curve Increased in 2022



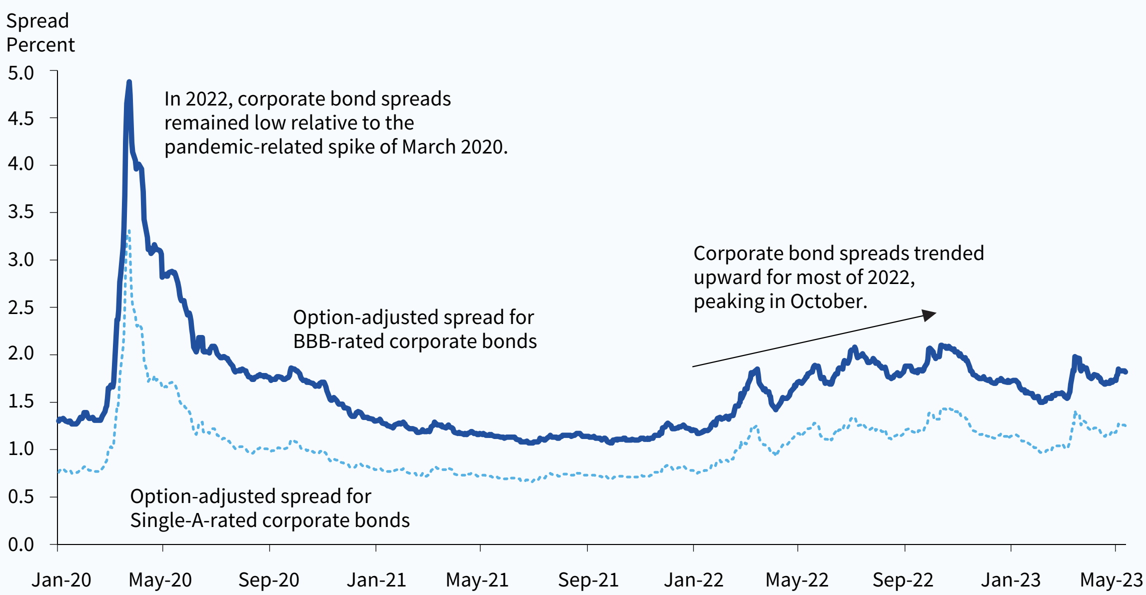
Source: Federal Reserve Board (Federal Reserve Economic Data).
Note: Data are daily through May 11, 2023.

2021, as recessionary fears and rising interest rates dampened investor appetite. Yields on corporate bonds rose significantly in 2022, resulting in negative investment performance for both investment grade and high-yield corporate bonds. Investment grade bonds produced a total return of negative 15.4 percent in 2022, and high-yield bonds managed a total return of negative 11.2 percent.[8] Corporate bond spreads also rose. The ICE BofA Single-A U.S. Corporate Index Option-Adjusted Spread rose 36 basis points, and the BBB U.S. Corporate Index Option-Adjusted Spread rose 51 basis points during the year (Chart 7). Despite rising spreads, default rates for corporate bonds did not worsen in 2022 and ended the year at 2.0 percent, well below the 4.7 percent long-term average. Continued consumer spending, a low unemployment rate, solid corporate earnings, and ample liquidity helped keep default rates low over the year. In first quarter 2023, corporate bond issuance increased relative to fourth quarter 2022 but was down 14.9 percent year over year.

The municipal bond market experienced a sell-off and closed 2022 at $4.0 trillion outstanding, roughly the same size as in 2021. Municipal bond prices decreased in 2022, with the Bloomberg Municipal Bond Index down 8.5 percent for the year. New issuances for municipal bonds declined 21.3 percent in 2022 from 2021 issuance levels. Higher interest rates created significant challenges for raising new debt or refinancing existing debt. A decline in taxable municipal bond sales, which are particularly sensitive to higher interest rates, also drove the drop in issuances. Municipal bond funds experienced significant outflows in 2022 as municipal retail investors pulled their money to stem losses. In fourth quarter 2022, the lack of new issuances and easing concerns over inflation helped to soften some of the selling pressures, resulting in the municipal bond market recovering more than a third of its losses by year-end. Despite a recovery in prices, municipal bond issuance remained subdued in first quarter 2023.

CHART 7

The Spread Between Corporate Bond Yields and Benchmark Interest Rates Increased in 2022



Source: ICE Data Services, LLC (Federal Reserve Economic Data).
Note: Data are daily through May 12, 2023.

[8] Investment grade bond results as measured by the ICE BofA U.S. Corporate Index. High-yield bond results as measured by the ICE BofA U.S. High Yield Index.

Commodity prices moderated in 2022 after rising earlier in the year and continued to decline in first quarter 2023. Commodity prices increased 8.7 percent in 2022 but were volatile early in the year. Driven by booming demand, commodity prices were already rising in 2022, and fears of supply shortages from the war in Ukraine caused the trend to accelerate. Commodity prices increased 45.9 percent through early June 2022 but declined 25.5 percent from June 9 through the end of last year. The price pattern of peaking in the first half of 2022 and declining through the first quarter 2023 was consistent across a variety of commodities, including oil, grains, industrial metals, and lumber.

Stocks generally performed worse in 2022 than in any year since 2008 but began to rebound in October 2022 and continued on an upward trend through first quarter 2023. The Standard and Poor's (S&P) 500 Index ended 2022 with a total return of negative 18.1 percent. The Dow Jones Industrial Average reported a total return of negative 6.9 percent, and the NASDAQ reported a total return of negative 32.5 percent. Although corporate earnings largely surpassed expectations in 2022, financial market conditions worsened throughout the year due to inflationary pressures and a tight labor market. Stocks largely rebounded in early 2023, while stock market volatility declined.

Bank stock performance was similar to the broader market in 2022 despite higher interest rates, but bank stocks declined in early 2023 following bank failures. The KBW Bank Index, which consists of 24 national U.S. money centers and regional banks, ended 2022 with a total return of negative 21.4 percent. The KBW Bank Index lagged the S&P 500 for most of the year despite starting the year strong. The S&P Financials Sector Index, which reflects 67 constituents of the S&P 500, had a total return of negative 10.5 percent. The S&P Financials Sector Index mirrored the performance of the S&P 500 for most of 2022 but outperformed during the fourth quarter's bear market rally.

Bank stock performance diverged from the broader market following the failures of Silicon Valley Bank and Signature Bank of New York in March 2023. The KBW Bank Index had a total return of negative 25.1 percent year-to-date through May 15, 2023, while the S&P Financial Sector Index had a total return of negative 5.6 percent over the same period. Some bank stock prices declined in excess of 50 percent from early March through early May. While broader financial market conditions stabilized in early 2023, financial market conditions for banks remained tight.

Banking Industry

- **The banking industry was resilient in first quarter 2023, with high net income even after a period of stress and adjusting for one-time acquisition gains.**
- **Net interest income and net interest margin (NIM) substantially increased in 2022 as market rates rose, but higher funding costs amid shifts in deposit flows and intensified competition for deposits led to a decline in NIM in first quarter 2023.**
- **Community banks reported lower net income in first quarter 2023 from the prior quarter. Despite NIM compression, community banks continued to report a higher NIM than the banking industry overall.**
- **Unrealized losses on securities portfolios declined in first quarter 2023 from 2022 highs but remained a significant risk to bank liquidity and access to funding sources.**
- **After strong loan growth across several portfolios in 2022, loans held by the banking industry declined slightly in first quarter 2023.**
- **Despite modest weakening, overall asset quality metrics remained favorable through first quarter 2023; however, the banking industry continued to face key downside risks.**

Despite the period of stress in early 2023, the banking industry was resilient.[9] Net income for the first quarter remained high even after excluding accounting gains associated with the acquisition of two failed banks during the quarter (Chart 8). Quarterly net income in first quarter 2023 grew 16.9 percent from fourth quarter 2022; excluding the effects on incomes of the acquirers of the two failed banks, quarterly net income for the industry was roughly the same as in the prior quarter. Strong growth in noninterest income more than offset the effects of lower net interest income and increased noninterest expense.

Net income for community banks declined 4.2 percent in first quarter 2023 from the prior quarter in large part due to lower net interest income and noninterest income. These declines more than offset the benefit of decreased provision and lower noninterest expenses. Community bank quarterly NIM improved on an annual basis in first quarter 2023 but declined from the prior quarter. The rising cost of deposits quarter over quarter more than offset an increase in yields on assets and constrained community bank NIM. In first quarter 2023, net income reported by community banks increased 6.1 percent from the year-earlier quarter, driven by higher net interest income. Higher interest rates benefited community bank earnings through most of 2022 before the meaningful rise in funding costs during first quarter 2023, which more than offset yield gains.

Banking industry results for first quarter 2023 included only the first few weeks of the banking stress that began in early March and continued after the quarter's end. As a result, this year's first quarter earnings did not fully capture the effects of the industry's response to that stress, which continued into the second quarter. Changes in flows and competition for deposits, as well as lending conditions and reliance on more expensive funding sources, will influence banking conditions through the rest of 2023.

Net income for the banking industry in 2022 was lower than in 2021, as higher provision expense and noninterest expense offset improved net interest income.[10] Industry net income fell 5.8 percent to $263.0 billion in 2022 but remained above pre-

[9] On March 8, 2023, Silvergate Bank announced its intent to self-liquidate. On March 10, 2023, Silicon Valley Bank (SVB) was closed by the California Department of Financial Protection and Innovation (CADFPI). Contagion effects from SVB's failure began to spread through traditional media, social media, and short sellers to other banks with perceived similar risk characteristics, notably those with high levels of uninsured deposits, concentrations of customers in the venture capital and tech industries, and high levels of unrealized losses on securities. Contagion effects initially manifested in large declines in stock prices and then in deposit outflows at certain other banks. For two of these banks—Signature Bank and First Republic Bank—deposit outflows became deposit runs and exposed other weaknesses that could not be overcome, leading to their failure. On March 12, 2023, Signature Bank of New York was closed by the New York State Department of Financial Services (NYSDFS). On May 1, 2023, First Republic Bank was closed by the CADFPI.

[10] Noninterest expense rose 5.4 percent, primarily due to rising labor costs and higher advertising and marketing expenses, as noninterest income fell 3.1 percent due to lower net gains on loan sales.

pandemic averages (Chart 8).[11] Provision expense, the amount set aside by institutions to protect against future credit losses, rose $82.6 billion, from negative $31.0 billion in 2021 to positive $51.6 billion in 2022. Provision expenses increased as loans grew and concerns about the economic outlook increased. Pre-provision net revenue, a measure of core profitability, rose 21.7 percent because of substantial growth in net interest income.[12] In 2022, both pre-provision net revenue and net interest income reached record highs since data collection began in 1984.

Community banks also reported marginally lower net income in 2022, down 0.3 percent to $30.4 billion, as higher net interest income did not offset lower noninterest income, higher noninterest expense, realized losses on securities, and higher provision expense.[13] Similar to the banking industry overall, pre-provision net revenue among community banks rose on strong growth in net interest income.

Rising interest rates contributed to record gains in NIM for both the banking industry and community banks in 2022, but NIMs compressed in first quarter 2023 as competition for deposits increased funding costs. Net interest income grew 20.0 percent in 2022 as strong growth in interest income outpaced growth in interest expense. In 2022, the full-year industry-wide NIM expanded 41 basis points to 2.95 percent, the largest annual expansion since data collection began in 1984 (Chart 9). Net interest income grew 12.9 percent for community banks, while full-year NIM rose 17 basis points to 3.45 percent, the largest annual expansion for community banks since 1992. In first quarter 2023, community banks continued to report higher NIMs than the overall banking industry.

Significant growth in net interest income also drove the reduction in the efficiency ratio for the banking industry to 53.02 in first quarter 2023, down from 57.71 in 2022 and 61.15 in 2021.[14] From a year earlier, the industry's NIM rose 77 basis points in the first quarter but fell 7 basis points from fourth quarter 2022. Despite the decline, the banking industry's NIM of 3.31 percent in first quarter 2023 remained above its pre-pandemic average of 3.25 percent. In first quarter 2023, NIM declined for banks of all asset size groups from the prior quarter, except banks with total assets less than $100 million. The decline in NIM reflects the cost of deposits (i.e., the interest banks pay on deposits) rising at a faster rate than yields on loans (i.e., the interest banks charge on loans), a reversal of the trend experienced in 2022 when yields on loans increased at a faster rate than cost of deposits. During first quarter 2023, banks reported increased competition for deposit funding from banks and other sources. There was also a shift in deposits from transaction and savings accounts, typically lower-yielding accounts, to time deposits, such as certificates of deposit, which historically pay higher interest rates than traditional savings accounts.

Total industry deposits declined for the fourth consecutive quarter through first quarter 2023. In 2022, deposits fell 2.5 percent, the largest year-end decline on record. While this reduction offset to some extent the unprecedented growth in deposits reported during the pandemic, total deposits remained elevated at the end of last year. The banking stress experienced in first quarter 2023 accelerated the outflow of deposits from the banking system, causing total deposits to decline at a record rate on a quarterly basis (down 2.5 percent) and on an annual basis (down 6.0 percent) early this year. Total deposits were $18.7 trillion in first quarter 2023, as the reduction in uninsured deposits (down 8.2 percent) outpaced the growth in insured deposits (up 2.5 percent). However, total deposits for community banks slightly increased 0.5 percent as growth in insured deposits (up 3.7 percent) outpaced the decline in uninsured deposits (down 6.3 percent). (See the Market Risk—Liquidity and Deposits section of this report for more analysis of deposit shifts across bank asset groupings.)

[11] The "pre-pandemic average" refers to the period first quarter 2015 through fourth quarter 2019.

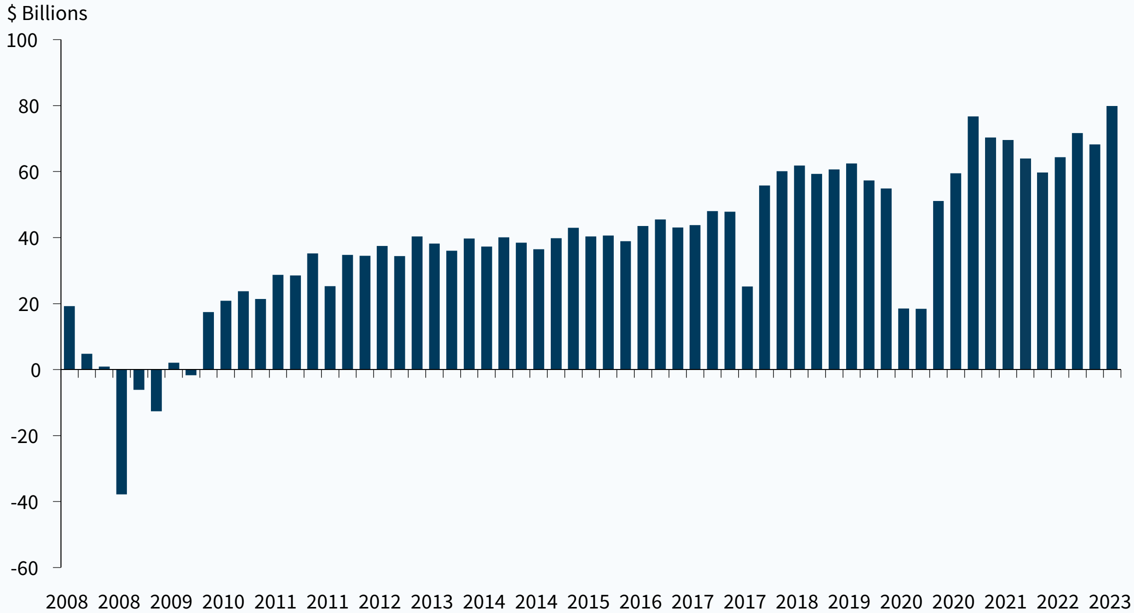
[12] Pre-provision net revenue is calculated as net interest income plus noninterest income minus noninterest expense; it excludes expenses related to goodwill.

[13] Noninterest income decreased 15.8 percent, while noninterest expense increased 5.3 percent.

[14] Efficiency ratio is noninterest expense as a percentage of net interest income plus noninterest income. The reduction in this ratio indicates that banks were more efficient in producing revenue.

CHART 8

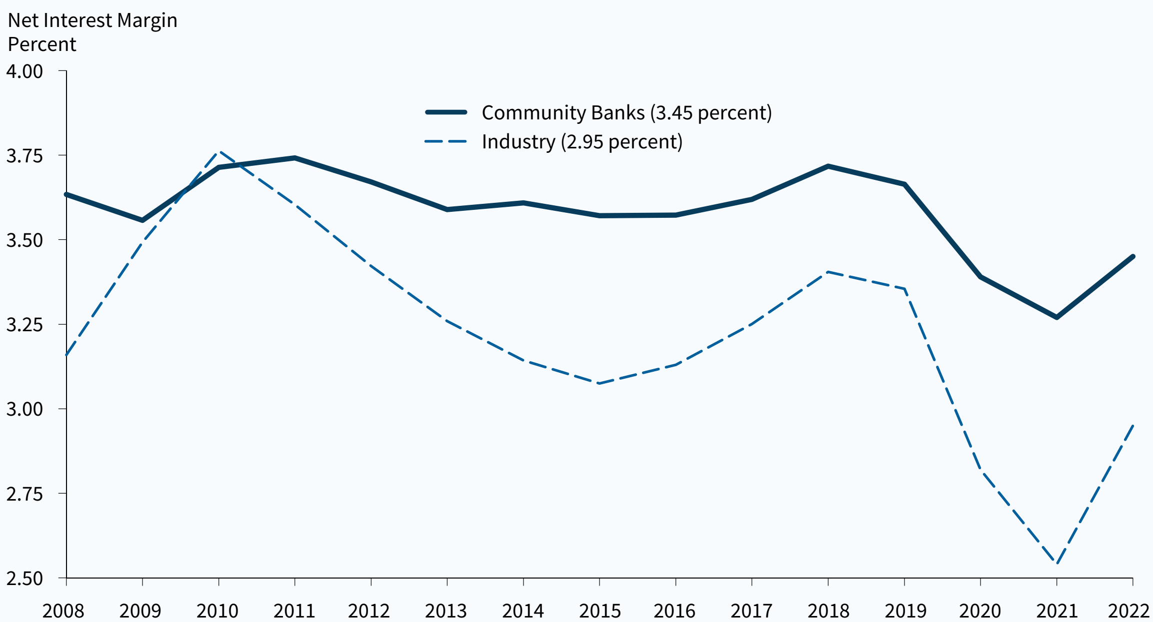
Quarterly Net Income Remained High in First Quarter 2023



Source: FDIC.
Note: Quarterly data as of first quarter 2023. Net income was roughly flat over the quarter after excluding acquisition gains.

CHART 9

Full-Year Net Interest Margins Rebounded and Significantly Widened in 2022



Source: FDIC.
Note: Annual data as of fourth quarter 2022.

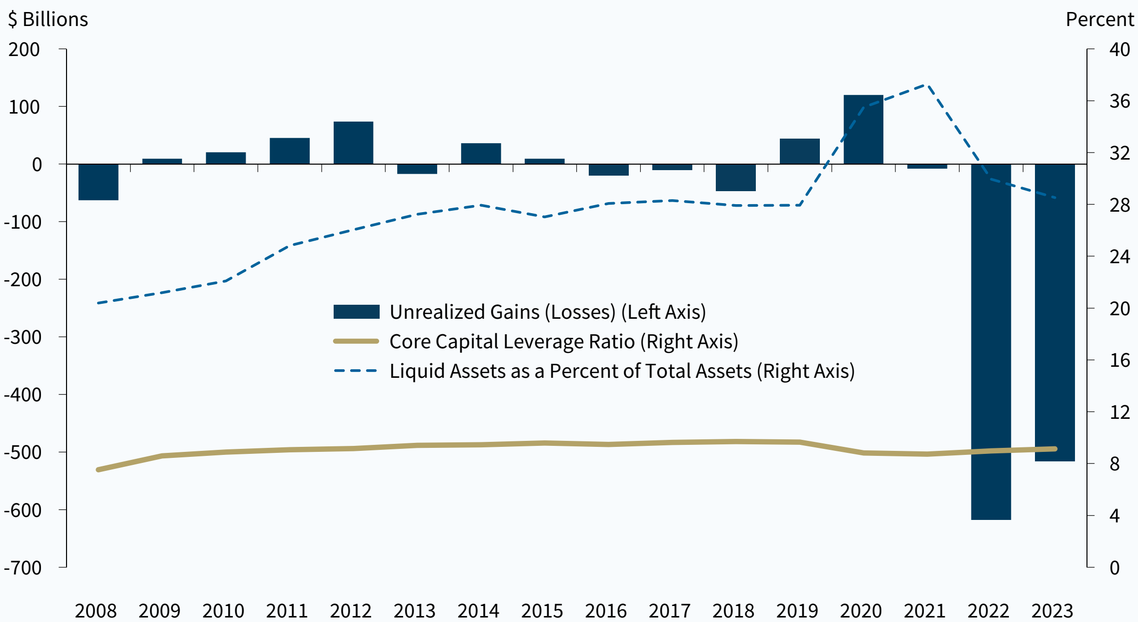
Higher interest rates coupled with longer asset maturities may present challenges to the banking industry. The banking industry's share of longer-term loans and securities relative to assets increased to 39.7 percent in 2022 before declining to 38.5 percent in first quarter 2023.[15] Community banks also reported a slight decline in first quarter from the prior quarter, from 54.7 percent of total assets, a recent high, to 53.9 percent of total assets. Despite the slight decline, both industry and community banks' share of longer-term assets to total assets remained above the pre-pandemic level in first quarter 2023. (See the Market Risk—Net Interest Margins and Interest Rate Risk section of this report for more information on the effects of long-term assets to total assets on bank NIM performance.)

Although the higher level of longer-term loans and securities helped preserve NIMs during a period of lower interest rates, unrealized losses remained high in the first quarter and could continue to pressure industry earnings (Chart 10). In first quarter 2023, unrealized losses on securities declined to $515.5 billion, down 16.5 percent from $617.8 billion in fourth quarter 2022.[16] The decline was primarily due to declines in medium- and long-term market interest rates in the first quarter. Unrealized losses present a significant risk should banks need to sell investments and realize losses to meet liquidity needs.

While the banking industry was well capitalized at year-end 2022 and in first quarter 2023, continued depreciation of bank investment portfolios may negatively affect capital if banks are forced to sell investments at a loss to meet liquidity needs. Depreciation of the investment portfolio could also adversely affect the ability of banks to pledge collateral or meet margin requirements when seeking access to wholesale or other sources of alternative funding. As noted at the outset of this report, liquidity

CHART 10

Unrealized Losses Remained Elevated Through First Quarter 2023



Source: FDIC.
Note: Data as of first quarter 2023. Data for 2008-2022 are annual and as of December 31. Data for 2023 is as of March 31. Unrealized losses on securities solely reflect the difference between the market value as of quarter-end and the book value of non-equity securities.

[15] Longer-term loans and securities have maturities greater than three years.

[16] Unrealized losses on securities reflect the difference between the market value as of quarter-end and the book value of non-equity securities.

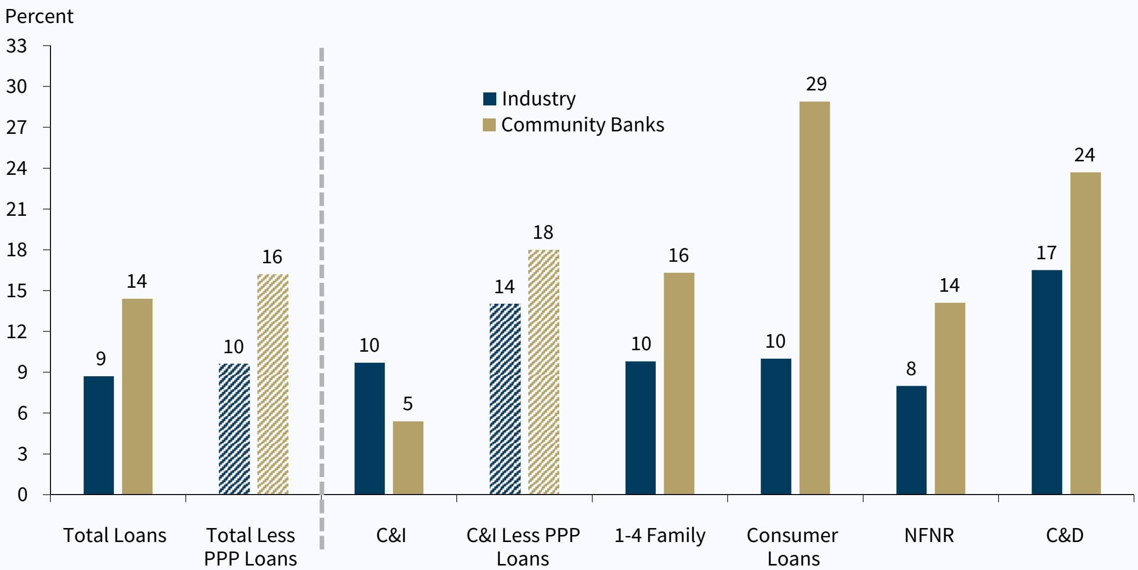
risks came to the fore for some banks in March 2023. In response, the FDIC, Federal Reserve, and Treasury took steps to protect the economy by strengthening public confidence in the banking system.[17] To address funding issues arising from lower collateral values, banks utilized the Federal Reserve's liquidity facilities, including the new Bank Term Funding Program (BTFP), with borrowing rising to $64.6 billion as of March 31, 2023.[18]

After reporting strong loan growth in 2022, banking industry loan balances declined slightly in first quarter 2023. Total loans for the industry grew 8.7 percent in 2022 and 9.6 percent net of Paycheck Protection Program (PPP) loans (Chart 11). The loan growth rate without PPP loans last year was double the industry's average annual growth rate for the five-year period preceding the pandemic. Commercial and industrial loans, 1–4 family residential mortgages, and consumer loans represented the largest share of loan growth in 2022. Construction and development loans increased for both community and noncommunity banks during 2022 but represented a smaller share of total industry loans. Community banks reported 14.4 percent total loan growth in 2022 and 16.2 percent net of PPP loans.

In first quarter 2023, banking industry loans declined modestly (down 0.1 percent), reflecting loans transferred to the FDIC as receiver and the seasonal decline in credit card loan balances (down 2.6 percent). Excluding the loans transferred out of the banking system to the FDIC, total loans increased modestly (up 0.4 percent) quarter over quarter, led by increased 1–4 family residential mortgages and loans to nondepository institutions. (See the Credit Risk—Housing and Nonbank Financial Institutions. Lending sections of this report for more information.) Community banks reported stronger loan growth than the banking industry as a whole in first quarter 2023,

CHART 11

Annual Change in Loan Balances Was Driven by C&I Loans



Source: FDIC.
Note: Data as of fourth quarter 2022. Loan portfolios are presented from left to right in descending order of annual dollar growth."PPP" is Paycheck Protection Program, "C&I" is commercial and industrial, "NFNR" is nonfarm nonresidential, and "C&D" is construction and development.

[17] See the remarks cited in footnote 3 of this report. Also see FDIC, "Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC," press release, March 12, 2023; and Board of Governors of the Federal Reserve System, "Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors," press release, March 12, 2023.

[18] The BTFP provides qualified institutions with eligible securities the ability to access longer-term (one year) funding at par, which should alleviate the need to sell those securities at a loss in times of stress, as happened at Silvergate Bank and SVB. For more information, see https://www.federalreserve.gov/monetarypolicy/bank-term-funding-program.htm.

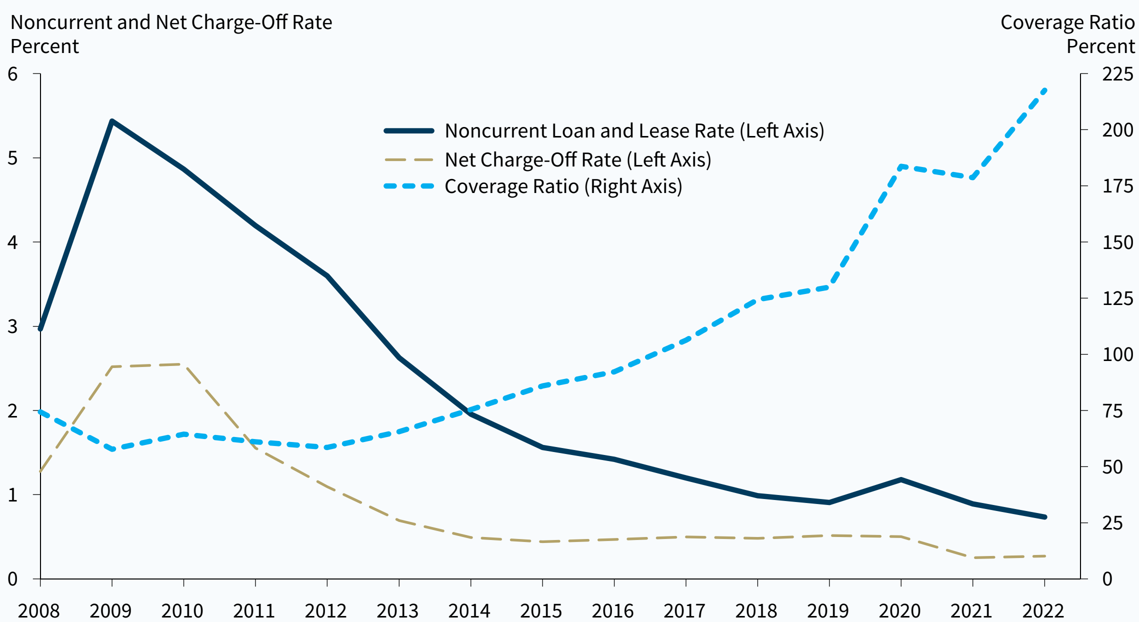
up 1.8 from the previous quarter and 15.0 percent from first quarter 2022. Growth in real estate loans, nonfarm nonresidential, and 1–4 residential mortgages fueled the growth. Recent surveys indicate that loan demand may be waning and underwriting standards are tightening, which may hinder loan growth rates in coming quarters.[19]

Despite a modest rise in noncurrent and net charge-off rates, asset quality indicators remained favorable through first quarter 2023. After rising slightly at the end of 2022, the early-stage past-due rate (loans and leases 30 to 89 days past due) declined slightly in first quarter 2023 to 0.52 percent, in part a reflection of seasonal improvement in auto loans and lower delinquencies on 1–4 family residential mortgages. The total early-stage past-due loan rate remained below the pre-pandemic average of 0.66 percent. The noncurrent loan rate for the banking industry increased 2 basis points in first quarter 2023 to 0.75 percent but was still well below the high of 5.44 percent at year-end 2009. The net charge-off rate increased to 0.41 percent from 0.36 percent at the end of 2022 (Chart 12). The coverage ratio for the industry, which compares the amount of loan-loss reserves to total noncurrent loans, increased to 219.5 percent in first quarter 2023, the highest level on record.[20] While aggregate delinquency measures remained low among banking industry through first quarter, commercial real estate lenders face challenges, particularly among loans backed by office properties in some large, urban markets should conditions continue to weaken this year. (See the Credit Risk—Commercial Real Estate section of this report for more information.)

In 2022, community banks also reported a modest increase in early-stage loan delinquencies as the early-stage past-due rate rose 3 basis points to 0.36 percent. The noncurrent loan rate decreased 14 basis points in 2022 to 0.44 percent, the lowest level for community

CHART 12

Asset Quality Indicators Remain Favorable



Source: FDIC.
Note: Annual data as of fourth quarter 2022.

[19] Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey on Bank Lending Practices, April 2023.

[20] Data collection began in 1984.

banks on record. In first quarter 2023, the early-stage past-due rate and noncurrent loan rate rose by 1 basis point. The net charge-off rate fell 2 basis points to 0.09 percent. Community banks also reported a coverage ratio of 272.9 percent in first quarter 2023, slightly lower than the record high of 274.2 percent in fourth quarter 2022.

While the banking industry was resilient through first quarter 2023, the industry continues to face significant downside risks in 2023. The banking industry continued to face considerable risks in early 2023 after several bank failures and industry stress. At year-end 2022, the FDIC's "Problem Bank List" was at a record low 39 institutions since data collection began in 1984. The number of problem banks increased to 43 in first quarter 2023, still low by historical standards.[21] Two banks failed in first quarter 2023, with a subsequent failure in May 2023. These were the first failures since October 2020.

As first quarter 2023 came to an end, risks to bank performance included the effects of inflation, rising market rates, slower economic growth, and geopolitical uncertainty. Collectively, these risks could pressure industry earnings, result in slower loan growth and deterioration in asset quality, and lead to a return to more normalized metrics from pre-pandemic periods. The FDIC is focused on monitoring banking industry conditions, including the effects of bank failures on overall banking conditions and stability.

[21] Banks on the FDIC's Problem Bank List have a CAMELS composite rating of "4" or "5" due to financial, operational, or managerial weaknesses, or a combination of such issues. The number of banks on the list increased by four from the previous quarter, reflecting movement from banks coming on and off the list.