SECTION 2
Overview of Conditions and Banking Performance

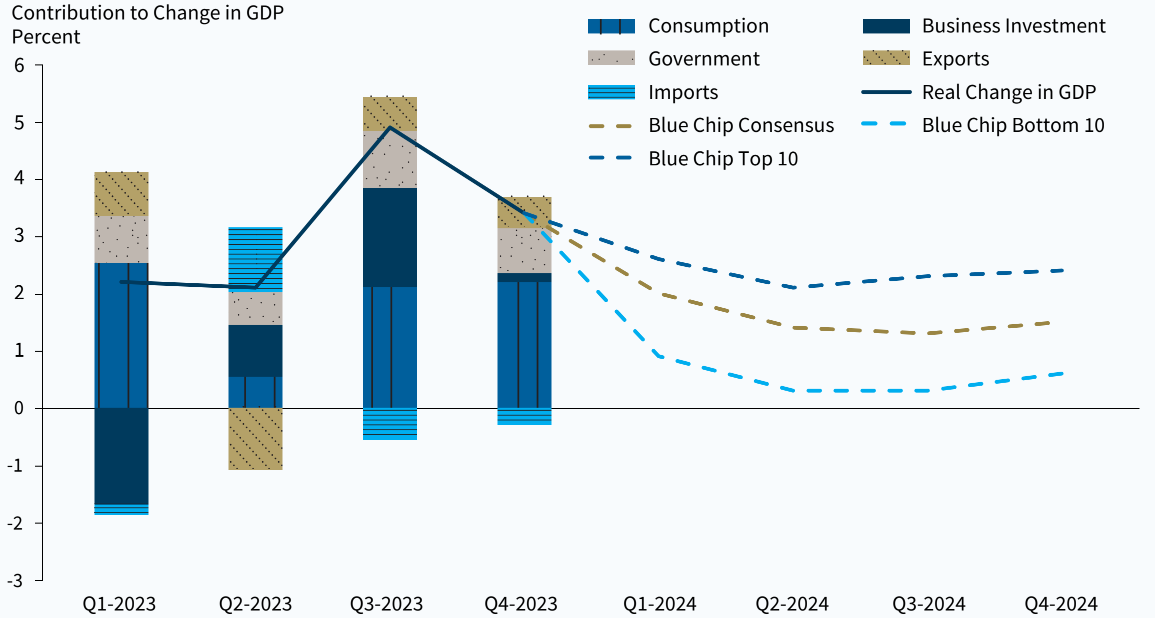
Economic and Financial Markets Conditions

- **Economic growth exceeded expectations in 2023 despite higher interest rates.**
- **Labor market growth slowed during the year but remained historically tight.**
- **Inflation fell in 2023 but remained above the Federal Reserve's 2 percent target rate, keeping monetary policy tight and interest rates high.**
- **Financial markets were volatile in 2023 but ended the year optimistic about the outlook for the economy. Equity markets rebounded, though bank stocks underperformed.**
- **Treasury yields rose and the yield curve remained inverted. Corporate bond market conditions improved.**

Economic growth exceeded expectations for much of 2023. Bolstered by resilient consumer spending, the U.S. economy expanded in all four quarters of 2023, defying analyst expectations for slower growth or even a recession (Chart 1). Consumer spending (consumption) was the primary driver of economic growth, followed by government spending. **Labor market growth slowed during 2023, but conditions remained historically tight, supporting consumer spending and economic conditions overall.** Monthly

CHART 1

The Economy Continued to Grow Throughout 2023



Sources: Bureau of Economic Analysis and February Blue Chip Indicators (Haver Analytics).
Note: Data are quarterly through fourth quarter 2023. The Blue Chip Economic Forecast is as of March 2024.

payroll employment gains slowed in 2023, and the unemployment rate edged up but was still near historical lows. Labor shortages eased in 2023, as the labor force participation rate increased from the lows reported since 2020. Still, job openings were elevated relative to unemployed workers at year-end 2023 and above the pre-pandemic level (Chart 2).[2] Wage gains remained strong in nominal terms, and real wage gains strengthened as inflation declined.

Labor market conditions varied by state. The unemployment rate increased in 29 states and declined in 16 states in 2023. The largest increase was in New Jersey (10 percentage points) and the largest decline was in Wyoming (0.5 percentage points).

Consumer spending moderated in 2023 but remained resilient amid overall favorable labor market conditions. The moderation occurred as the effects of pandemic-related support programs waned. These programs not only supported consumer finances in previous years but also contributed to excess consumer savings, which declined in 2023 according to various estimates.[3] Despite this decline, strong labor market conditions and moderating inflation supported consumer spending overall.

Inflation declined in 2023 but remained above the 2 percent Federal Reserve target, keeping monetary policy tight. After peaking in 2022, inflation moderated in 2023 as supply chain pressures eased, demand for goods and services normalized, and food and energy prices declined. While prices for many components eased, the price of shelter, which makes up a large portion of household budgets, remained high (Chart 3). As inflation moderated, the Federal Reserve Federal Open Market Committee (FOMC) slowed the pace of interest rate increases and eventually paused rate hikes in the second half of the year.

Financial markets were volatile in 2023, but market sentiment and conditions were generally favorable by year-end. Markets began 2023 optimistic that inflation was trending downward, but concerns remained about the prospect of a recession. Bank failures in March initially compounded the market's concerns that tighter credit conditions could lead to a weakening economy. In the second half of 2023, positive signs on inflation and strong economic growth allayed concerns and buoyed market optimism. Improvement in financial market conditions accelerated in the fourth quarter after the FOMC signaled that it was likely finished raising interest rates.

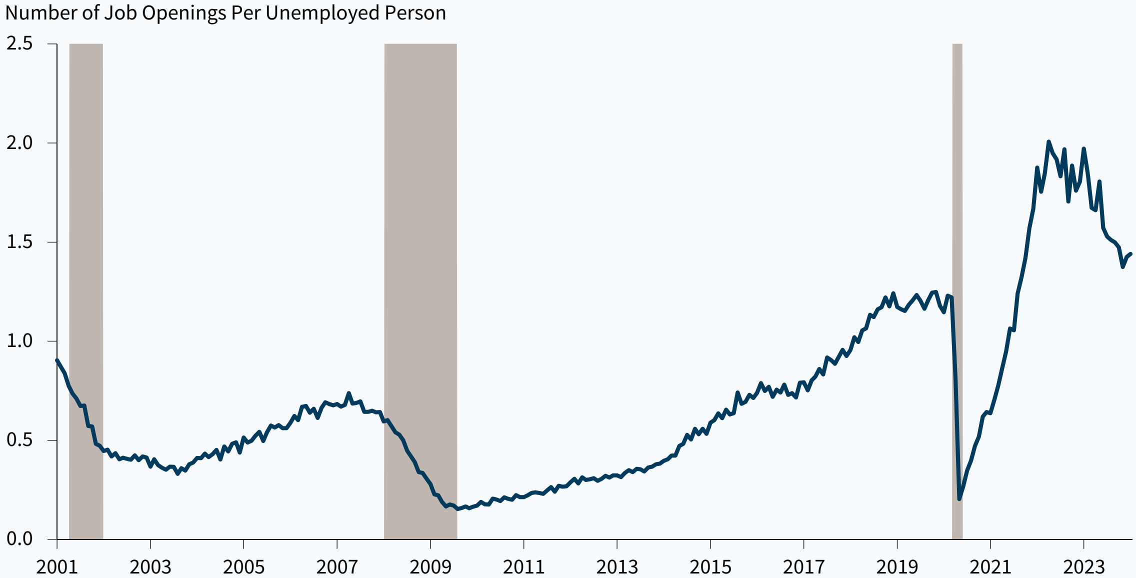
Stocks rebounded in 2023, reversing significant declines in 2022. Corporate earnings largely surpassed expectations in 2023, helping drive stock price appreciation throughout the year. Bank stocks underperformed the broader stock market in 2023 due to large price declines in early 2023 after the failures of Silicon Valley Bank and Signature Bank fueled concerns about overall bank liquidity and funding. Though liquidity and funding concerns gradually subsided in 2023, the KBW Bank Index, which consists of 24 large U.S. banks, ended 2023 with a total return of negative 1 percent, while the S&P Financials Sector Index reported a total return of 12 percent.

[2] Unless otherwise noted, "pre-pandemic" refers to the period first quarter 2015 through fourth quarter 2019.

[3] See, for example, François de Soyres, Dylan Moore, and Julio Ortiz, "An Update on Excess Savings in Selected Advanced Economies," Board of Governors of the Federal Reserve System, FEDS Notes, December 15, 2023.

CHART 2

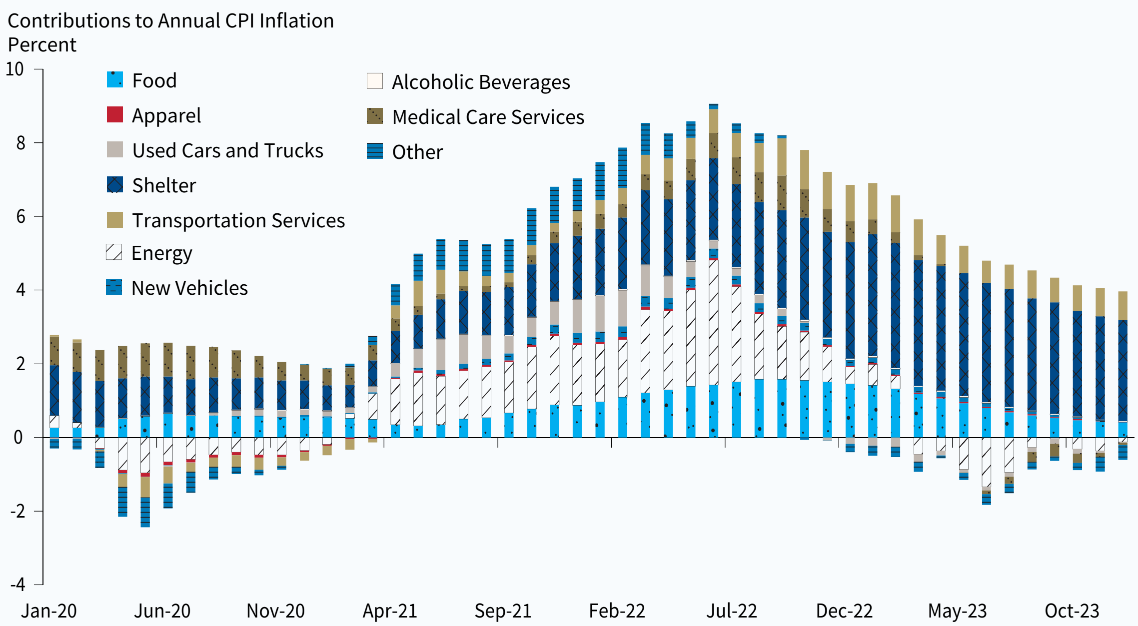
Labor Markets Remained Tight in 2023 as the Number of Job Openings Per Unemployed Person Was Elevated



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

CHART 3

Inflation Declined in 2023 but Shelter Costs Remained Elevated

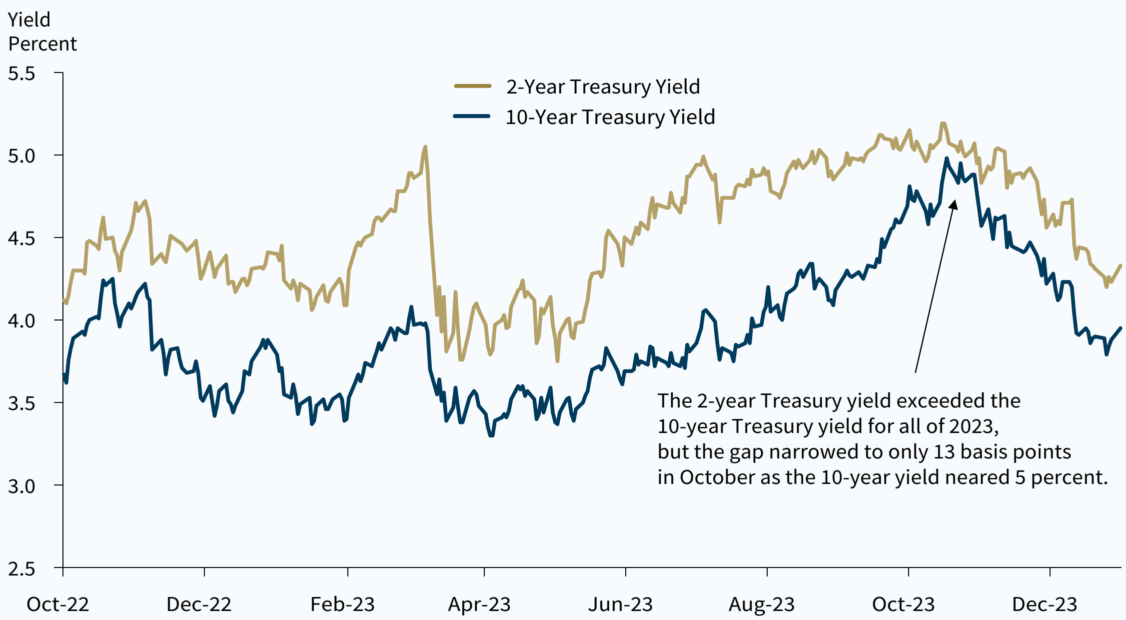


Sources: Bureau of Labor Statistics and FDIC calculations (Haver Analytics).

Treasury bond yields increased and declined in 2023, and the yield curve remained inverted throughout the year. U.S. Treasury yields trended higher for most of 2023, aside from a drop in March and a fourth quarter bond rally that reversed the earlier increases (Chart 4). Overall, the ten-year Treasury yield ended 2023 at the same level as at the start of the year, while the two-year Treasury yield declined 18 basis points during the year. The yield curve remained deeply inverted; in June 2023, the difference between the ten-year and the two-year Treasury yield reached the highest point since 1981 but flattened a bit toward the end of the year. The path of longer-term yields reflected investors' recalibrated views of the future path of interest rates in response to policymaker statements and news about the economic outlook. The reduction in Federal Reserve asset holdings also affected bond markets as the Federal Reserve's securities holdings declined $920 billion to about $7.2 trillion in 2023.

CHART 4

U.S. Treasury Yields Trended Higher for Most of 2023, but a Drop in March and a Fourth Quarter Bond Rally Offset the Increases

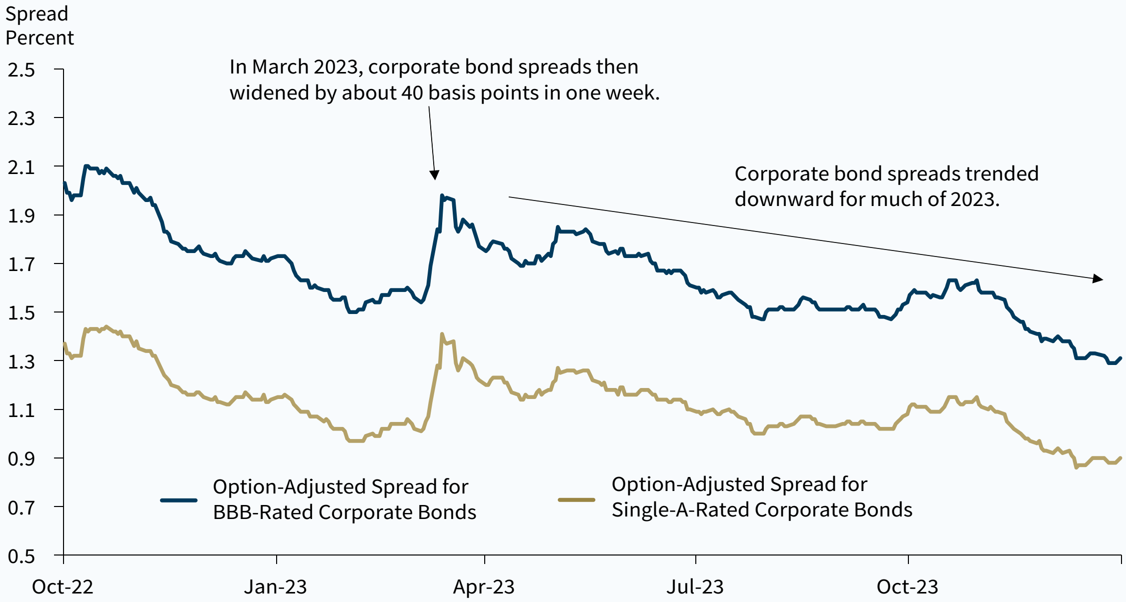


Source: Federal Reserve Board (Federal Reserve Economic Data).

The corporate bond market recovered in 2023 as interest rates peaked and bond market volatility tapered. Corporate debt and leveraged loan prices increased with stronger price increases for lower-rated borrowers. Loan prices stabilized and trended higher in late 2023 but remained below the robust levels of 2021.[4] Investment-grade bonds produced a total return of 9.4 percent in 2023, and high-yield bonds produced a total return of 11.5 percent. Corporate bond spreads declined from year-end 2022 to year-end 2023 despite widening by about 40 basis points in one week in March following the bank failures that increased market volatility (Chart 5).

CHART 5

The Spread Between Corporate Bond Yields and Benchmark Interest Rates Trended Downward for Much of 2023



Source: Federal Reserve Board (Federal Reserve Economic Data).

[4] PitchBook LCD.

Banking Performance Overview

- **The banking industry's earnings remained high in 2023.**
- **Net income for community banks declined because of lower net interest margins, higher noninterest expense, higher provisions, and greater losses on the sale of securities.**
- **Banks reported substantial changes in deposit composition, liquidity positions, and loan growth in 2023.**
- **Unrealized losses on securities remained elevated in 2023.**
- **Bank lending slowed in 2023 but remained positive, and asset quality metrics remained favorable overall.**
- **Capital ratios increased in 2023.**
- **The number of problem banks at year-end 2023 represented 1.1 percent of all banks.**

Overall, the banking industry was resilient in 2023, recovering well from the stress of bank failures and a self-liquidation in the spring.[5] The industry's full-year net income was well above pre-pandemic levels, asset quality metrics remained favorable overall, and capital levels increased. Concerns entering 2024 center on deterioration in office property loans, elevated levels of unrealized losses on securities, and continued funding pressures.

The banking industry's earnings remained high in 2023. The banking industry's net income of $256.9 billion in 2023 was down $6.0 billion (2.3 percent) from 2022, but it remained well above the levels reported before the pandemic (Chart 6). The industry's net operating revenue crossed the $1 trillion mark for the first time since data collection began in 1985, and the full-year net interest margin (NIM) was 3.30 percent, the highest reported margin since 2019. But these positive results were mitigated by higher noninterest expense, provision expense, and realized losses on securities.

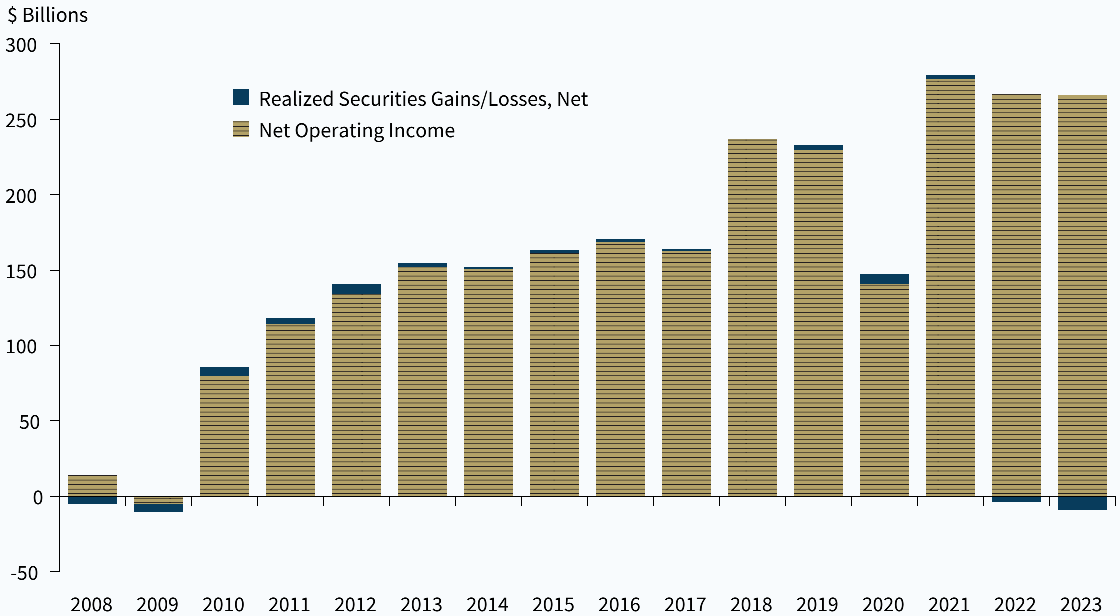
The industry's net income in 2023 was driven in part by higher net interest income, up $64.9 billion, or 10.2 percent from 2022. Banks benefited from a NIM that was 35 basis points higher than the full-year NIM reported in 2022. Noninterest income was also higher by $14.5 billion (10.2 percent), driven by higher trading revenue and accounting gains on failed-bank acquisitions in the spring. Offsetting these positive results was provision expense, the amount set aside by institutions to protect against future credit losses; at $86.3 billion, the industry's 2023 provision expense was 67.2 percent higher than the amount set aside in 2022. Provision expense increased because of higher credit card balances and charge-offs, greater risk in office properties, and increasing delinquency levels across loan portfolios. With the exception of 2020, provision expense was at the highest level since 2010.

Net income for community banks declined because of compressed NIMs, higher noninterest expense, higher provision expenses, and greater losses on the sale of securities. In 2023, community bank net income declined $2.0 billion, or 7.1 percent, from 2022's level. Community bank NIM was 3.39 percent in 2023, down from 3.44 in 2022. NIM declined as deposit costs rose faster than loan yields. This is in contrast to 2022 when higher interest rates benefited community bank earnings through higher loan yields for most of the year without a commensurate increase in funding costs. Noninterest expenses rose in 2023 due to higher "all other" noninterest expenses and higher compensation expenses. Losses on the sale of securities were also higher as some banks sold securities at a loss to reinvest the proceeds at higher market interest rates.

[5] 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.

CHART 6

Full-Year 2023 Net Income Remained Well Above the Pre-Pandemic Level



Source: FDIC.
Note: Data are annual through 2023.

Deposit compositions and liquidity positions at banks changed substantially in 2023. Domestic deposits declined 2.1 percent during the year as nonbank alternatives, such as money market funds, reported large inflows. In addition, banks reported a substantial shift from lower-yielding deposit accounts, such as transaction and savings accounts, into higher-yielding time deposits. On-balance-sheet liquidity fell in 2023 as the industry reduced securities holdings and pledged securities to secure liquidity lines of credit. See Section III: Market Risks – Liquidity, Funding, and Interest Rate Risk for a more in-depth discussion of deposit trends and liquidity levels.

Total deposits for community banks increased 2.3 percent in 2023 as growth in insured deposits (up 5.7 percent) outpaced the decline in uninsured deposits (down 4.2 percent).

Unrealized losses on securities remained elevated in 2023. The banking industry's share of longer-term loans and securities relative to assets increased to 39.7 percent at year-end 2022 before declining to 37.0 percent in fourth quarter 2023.[6] Community banks also reported a decline in fourth quarter from the prior year, from 54.7 percent of total assets, a recent high, to 50.9 percent of total assets. Despite the decline, both industry and community banks' share of longer-term assets to total assets remained above their pre-pandemic level in fourth quarter 2023. See Chapter 2: Liquidity, Funding, and Interest Rate Risk for more information on the effects of long-term assets on bank NIM performance.

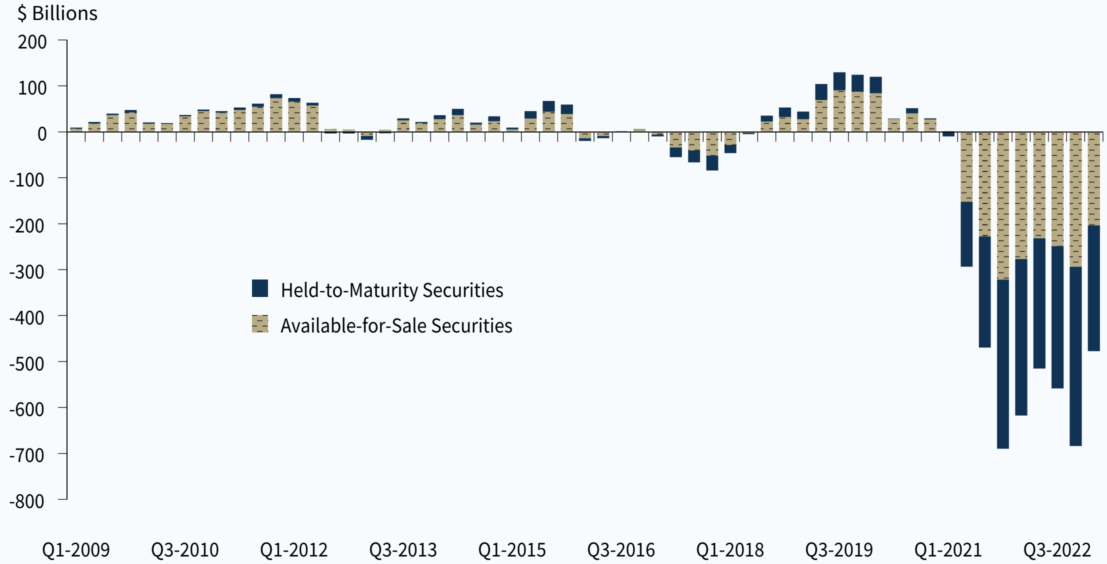
Although the higher level of longer-term loans and securities helped preserve NIMs during the period of lower interest rates, higher interest rates in 2022 and 2023 caused the market values of bonds to decline. At year-end 2023, unrealized losses for available-for-sale and held-to-maturity securities were $477.6 billion, 22.7 percent lower than the $617.7 billion reported at year-end 2022 but elevated compared to typical levels (Chart 7).[7] As of fourth quarter 2023, the industry's unrealized losses on securities made up 8.5 percent of

[6] Longer-term loans and securities have maturities greater than three years. Some of the decline is attributable to the lower fair value of available-for-sale securities.

[7] Unrealized losses on securities reflect the difference between the market value as of quarter-end and the book value of non-equity securities. This calculation does not account for any unrealized gains or losses in "accumulated other comprehensive income" because unrealized gains and losses cannot be derived from Consolidated Reports of Condition and Income (Call Reports) for the industry.

CHART 7

Unrealized Losses on Investment Securities Remained Elevated at Year-End 2023



Source: FDIC.
Note: Data are quarterly through fourth quarter 2023. Insured Call Report filers only. Unrealized losses on securities solely reflect the difference between the market value and book value of non-equity securities as of quarter end.

the book value of securities, down from 10.0 percent the previous year. Similarly, community bank unrealized losses on securities made up 9.1 percent of their book value, down from 10.4 percent the previous year.

Unrealized losses on securities present a significant risk should banks need to sell investments to meet liquidity needs, in which case they would have to realize the depreciation into earnings and capital. Even in the absence of liquidity concerns, unrealized losses represent a drag on future earnings as these securities tend to be longer term and fixed rate when interest rates are much higher than when banks purchased the bonds.

Bank lending slowed in 2023 but remained positive, and asset quality metrics remained favorable overall. Bank lending slowed in 2023 as higher interest rates reduced demand and tighter underwriting standards constricted supply.[8] During 2023, total loans grew $225.1 billion, or 1.8 percent, down from 8.7 percent growth in 2022. Growth was driven by credit card loans (up $107.4 billion, or 10.6 percent), 1–4 family residential mortgages (up $85.4 billion, or 3.4 percent), and loans to nonbank financial institutions (up $55.4 billion, or 7.5 percent) (Chart 8).

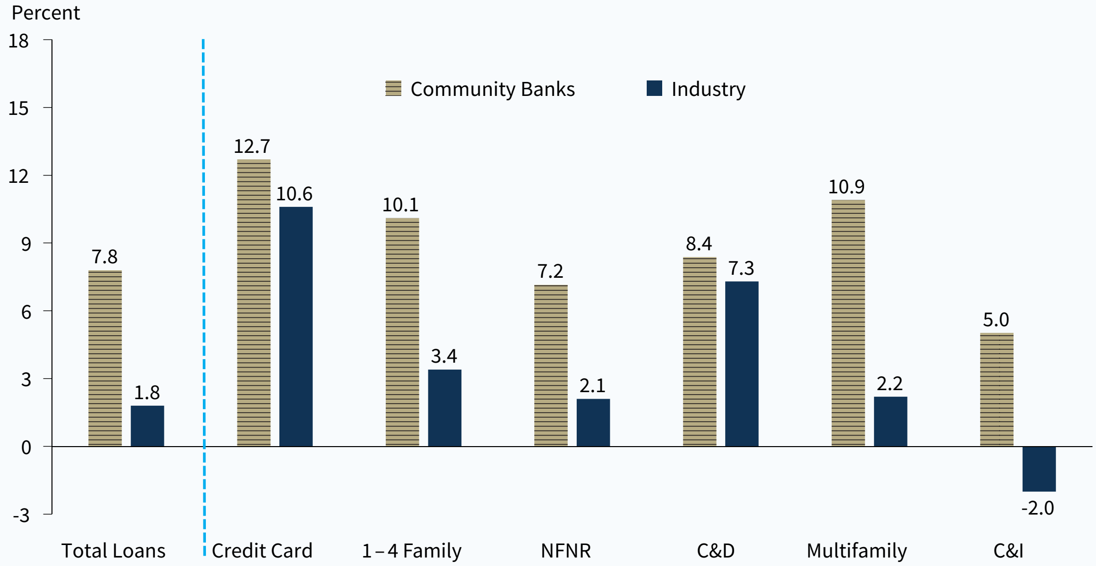
Community banks reported more robust loan growth than the industry, though their aggregate 7.8 percent loan growth reported in 2023 was down from 14.4 percent reported in 2022. Community bank loan growth was driven by 1–4 family residential loans (up $41.7 billion, or 10.1 percent), nonfarm, nonresidential loans (up $38.2 billion, or 7.2 percent), and construction and development (C&D) loans (up $12.1 billion, or 8.4 percent).

The industry's asset quality metrics remained favorable overall, though noncurrent and net charge-off rates increased in 2023. The industry's noncurrent rate increased 13 basis points to 0.86 percent at year-end, a level still well below the pre-pandemic average rate of 1.28 percent. But the industry's net charge-off rate almost doubled year over year to 0.65 percent in fourth quarter 2023, higher than its pre-pandemic rate

[8] Board of Governors of the Federal Reserve System, Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, January 2024.

CHART 8

Annual Change in Loan Balances Was Driven by Credit Card Portfolios



Source: FDIC.
Note: Data are as of fourth quarter 2023. Loan portfolios are presented from left to right in descending order of annual dollar growth for the industry. "NFNR" is nonfarm nonresidential, "C&D" is construction and development, and "C&I" is commercial and industrial.

of 0.54 percent. Higher credit card and auto loan net charge-offs drove the annual increase in the industry's charge-off rate.

Commercial real estate loans, particularly those backed by non-owner-occupied properties such as offices, deteriorated in 2023. Most of this deterioration was evident in the loan portfolios of banks with more than $100 billion in total assets. This issue is discussed further in Section IV: Credit Risks, Commercial Real Estate.

The community bank noncurrent rate increased 10 basis points from the previous year to 0.54 percent, and the net charge-off rate rose 6 basis points to 0.18 percent. These ratios remained near historical low levels and were much better than pre-pandemic levels.

Capital ratios increased in 2023. The industry's equity capital increased $90.1 billion (4.1 percent) from the level at year-end 2022. The industry's leverage capital ratio increased 16 basis points from 2022 to 9.14 percent, and its tier 1 risk-based capital ratio increased 28 basis points to 13.92 percent. The average community bank leverage ratio (CBLR) for the 1,618 community banks that elected to use the CBLR framework was 12.18 percent, up 28 basis points from 2022.

The number of problem banks at year-end 2023 represented 1.1 percent of all banks. The number of banks on the FDIC's "Problem Bank List" increased from 39 at year-end 2022 to 52 at year-end 2023.[9] Despite the increase, problem banks represented 1.1 percent of all banks, near the low end of the typical range of 1 to 2 percent of all banks during non-crisis periods. Total assets held by problem banks increased from $47.5 billion at year-end 2022 to $66.3 billion at year-end 2023. Five banks failed in 2023, the first failures since October 2020.

[9] 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.