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**.

Key Risks to Banks

Past banking crises have been frequently associated with economic activity related to a specific sector or geographic area. While the discussion of risks in this report is organized by topic, it is important to bear in mind that the confluence of risks facing institutions exposed to multiple sectors or geographies may present challenges that are difficult to foresee and therefore warrant attention.

Credit Risk: After ten years of economic growth, loan performance metrics at FDIC-insured banks remain strong. However, institutions with concentrations of credit have greater exposure to market sector changes. Competition among lenders has increased as loan growth has slowed, posing risk management challenges. Market demand for higher-yielding leveraged loan and corporate bond products has resulted in looser underwriting standards.

- **Agriculture: The agricultural economy is now in its sixth year of low commodity prices and farm incomes, and agricultural exports have reflected pressure from trade uncertainties and slowing global growth.** A slowdown in the agricultural economy is an important risk to the FDIC because farm banks are a large source of financing for the agriculture industry and represent about one-fourth of banks in the United States. Farmland values have been relatively resilient to the downturn in farm profits and have partially insulated borrowers and lenders from more serious credit quality deterioration. While asset quality metrics at farm banks are beginning to weaken, loan restructuring has helped keep credit problems at bay and loan delinquencies below levels experienced during the 1980s farm crisis. Farm bank liquidity has declined as farmers have shifted from being net depositors to net borrowers.

- **Commercial Real Estate: Commercial real estate (CRE) market fundamentals remain favorable as the economic cycle matures. However, outstanding CRE loan balances are rising, and competition among lenders to maintain market share in the face of slowing loan growth is increasing.** Vacancy rates are low, and property prices and rents continue to grow for CRE in general. But, overbuilding in some multifamily and industrial segments and oversupply of outdated retail properties may weigh on CRE fundamentals going forward. During the last crisis, banks considered to be CRE lending specialists failed more than twice as often as the average community bank.[4] In the current environment, CRE loan growth has slowed, and bank portfolios are more concentrated in existing property loans rather than historically vulnerable construction loans. Competition among banks for quality CRE loans poses challenges for institutions lending to the CRE sector as loan growth has slowed. FDIC examination findings since mid-2017 noted opportunities for improvement in risk management practices for CRE-concentrated institutions, particularly in the areas of board governance and oversight and portfolio stress testing. Despite the competitive pressures, CRE credit quality metrics at insured institutions remain satisfactory in early 2019.

- **Energy: U.S. oil production reached record highs in 2018, but the energy industry is susceptible to volatility that has produced past boom and bust cycles. Banks most exposed to this geographically concentrated industry are vulnerable to future downturns.** Banks in oil- and gas-concentrated areas were resilient to the 2014 to 2016 energy industry stress. Indeed, no banks in those areas failed during that period. However, asset quality deteriorated, particularly in the portfolios of large and regional banks, as reported in the 2015 to 2017 Shared National Credit reviews. Improved economic conditions in the energy sector in 2018 led to strengthened prospects for energy credits at banks, but energy sector high-yield debt remains elevated.

[4] FDIC Community Banking Study, December 2012, 5-13, https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf. The study covers the period from 1984 to 2011. The study defines CRE lending specialists as banks that hold construction and development loans greater than 10 percent of assets or total CRE loans (C&D, multifamily, and secured by other commercial properties) greater than 30 percent of total assets.

- **Housing: The housing market began to slow in 2018 as concerns about affordability intensified. Banks with concentrations in this portfolio could be vulnerable to the slowdown, but credit quality has been resilient so far.** Rising home prices, low inventory, and rising mortgage rates reduced affordability in many markets and led to a decline in home sales in 2018. While mortgage rates came down in 2019, the housing market continued to slow. Residential mortgage loan concentrations have declined from post-crisis peaks but remain elevated at community banks in some areas. Credit quality metrics for residential mortgage loans are relatively strong.

- **Leveraged Lending and Corporate Debt: Nonfinancial corporate debt as a share of gross domestic product (GDP) has reached a record high level. The increase has been driven by growth in corporate bonds and leveraged loans, which have become increasingly risky as the share of low-rated bonds has grown and lender protections in leveraged loans have deteriorated.** Partly in response to low interest rates, corporate debt levels reached a record high 46.9 percent of GDP in 2018.[5] Investors reaching for yield increasingly funded leveraged loans to highly indebted companies that lacked traditional lender protections. Direct bank exposure to corporate debt is concentrated in revolving leveraged loans, traditional commercial and industrial loans, and commercial mortgages. In contrast, indirect exposures are opaque and could transmit corporate sector stress into the banking system.

- **Nonbank Financial Institution Lending: By lending to nondepository financial institutions, banks are increasingly accruing direct and indirect exposures to these institutions and to the risks inherent in the activities and markets in which they engage.** Bank lending to nondepository financial institutions, which is primarily driven by noncommunity banks, has expanded seven-fold since 2010 and now exceeds $400 billion.

Market Risk: The current interest rate environment presents earnings and funding challenges to banks and could pressure liquidity at some institutions.

- **Interest Rate Risk and Deposit Competition: Banks have enjoyed several years of abundant low-cost deposit funding, but they could be challenged if deposit competition intensifies.** After a delayed response to the rising interest rate cycle that began in fourth quarter 2015, consumer preferences have shifted toward interest-bearing deposits, which are becoming increasingly expensive for both community and noncommunity banks. Community banks are especially vulnerable to this trend because of competitive pressures with noncommunity banks. The effects of increased competition on deposit costs have not yet affected aggregate net interest margins. However, nearly one-third of banks have seen a decline in their net interest margin since fourth quarter 2015, generally due to an increase in funding costs but also partly because of a decline in asset yields at some banks. Many rural community banks face added deposit retention challenges associated with long-term demographic shifts and the recent downturn in the agriculture industry.

- **Liquidity: Short-term liquidity at smaller banks has declined in recent years, potentially reducing these institutions' ability to manage a future downturn.** Steady loan growth has resulted in a decline in short-term liquid assets and increased reliance on wholesale funding sources for banks with total assets of less than $100 billion. Institutions with additional risk factors, such as higher loan concentrations, also generally have lower liquid assets and higher wholesale funding, sometimes significantly so. A turn in the credit cycle could be detrimental to institutions with low levels of liquidity or high levels of wholesale funding, particularly if a sale of securities is required to meet liquidity demands or if access to certain types of funding is limited.

[5]Nonfinancial business debt, including loans to both corporate and noncorporate borrowers, reached 73.2 percent of GDP in 2018, nearing the all-time high of 73.7 percent set in 2009.