SECTION 1
Executive Summary

Economic conditions remained strong in 2023, and financial market conditions improved toward the end of the year. Economic growth exceeded expectations in 2023 despite higher interest rates. Inflation moderated in 2023 but remained above the Federal Reserve's 2 percent target rate, keeping monetary policy tight and interest rates elevated. Labor market conditions slowed but remained tight, which supported consumer incomes. Financial markets were volatile in 2023, but conditions were more favorable toward the end of the year as equity markets rebounded and corporate bond market conditions improved. Treasury yields were volatile during the year and the yield curve remained inverted. Bank stocks underperformed in 2023.

The banking industry demonstrated resilience after a period of stress in early 2023 as full-year net income remained high, overall asset quality metrics were favorable, and liquidity stabilized. The banking industry's earnings remained high in 2023 as higher net interest income more than offset higher provision expense. For community banks, net income declined because of higher noninterest expense, lower net interest income, greater losses on the sale of securities, and increased provisions. Though unrealized losses on securities moderated substantially in the fourth quarter, they remained elevated in 2023. Deposit levels declined during the year, affecting liquidity positions, but increased in the fourth quarter for the first time in seven quarters. While bank lending slowed in 2023, growth remained positive and asset quality remained favorable. Capital levels increased in 2023. The number of problem banks at year-end represented 1.1 percent of total banks, which is near the low end of the typical range for non-crisis periods.

Key Risks to Banks

Market risks posed challenges for the banking industry in 2023 with higher interest rates, an inverted yield curve, declining deposits, higher cost of funding, and compressing net interest margins for some banks. The decline in bank deposits and a shift toward higher-yielding deposit accounts put upward pressure on bank cost of funds and interest expense. In response, many banks reduced securities to fund deposit outflows, pledged securities to ensure access to liquidity lines, and turned to higher-cost borrowings to cover anticipated liquidity needs. Community banks increased their reliance on wholesale funding to support strong loan growth, resulting in weakened liquidity positions to year-end levels not seen since 2009. The industry's net interest margin increased in 2023 despite rising funding costs and an inverted yield curve, but margin changes varied across the industry. Banks continued to hold an elevated share of long-term assets overall, putting pressure on margins in a higher-rate environment, but some banks began to sell off lower-yielding securities to reinvest at higher rates. Net interest margin compression contributed to a larger share of unprofitable community banks in 2023.

Credit risks varied by loan type in 2023, with greater asset quality deterioration occurring in commercial real estate and consumer loans.

- **Commercial Real Estate:** Most commercial real estate markets were resilient in 2023, but markets for office and retail malls were weak. While commercial real estate loan quality overall remained favorable at year-end 2023, weakness emerged, particularly among office properties in large bank portfolios. The ability to refinance commercial real estate loans remains a challenge to borrowers and the banking industry amid high interest rates, softening property values, and emerging credit weakness.

- **Residential Real Estate:** High mortgage rates contributed to a slowdown in housing activity in 2023, but housing prices increased during the year as the supply of homes for sale remained tight. Affordability of homes decreased, especially for first-time buyers. Credit quality remained sound, but early signs of stress emerged, particularly at community banks.

- **Consumer:** Consumer loan growth at banks slowed in 2023 as banks tightened lending standards and households reduced their demand for loans. Household balance sheets were solid in 2023 with higher net worth, but household savings declined despite higher incomes. Consumer loan performance weakened in 2023, led by credit card and auto loans.

- **Agriculture:** Agricultural conditions remained strong and supported agricultural lending, favorable asset quality, and higher loan concentrations at banks.

- **Small Business:** Small businesses reported challenges of high inflation and tight labor markets, but steady consumer spending helped support business conditions in 2023. Small business asset quality remained relatively sound.

- **Corporate Debt and Leveraged Lending:** Corporate debt increased in 2023 as market conditions improved, while bank lending to businesses continued to tighten. Leveraged loan default rates have increased but remain near the long-term average. Higher interest rates may continue to challenge some borrowers, but limited near-term corporate debt maturities should mitigate some risks in the short term.

- **Nonbanks:** Bank lending to nonbanks moderated in 2023. Despite favorable asset quality measures, sudden changes in market conditions may pose potential indirect and direct risks to nonbanks and their lenders.

- **Energy:** Economic conditions in energy-producing states were generally favorable in 2023, buoyed by higher U.S. oil production. Bank loan exposure to oil and gas firms continued to decline. Community bank asset quality in energy-producing states deteriorated slightly, but loan delinquency rates remained low by historical standards.

Operational and Cyber Risks: Ransomware and supply chain attacks continue to threaten banks and their third parties. Geopolitical events continued to increase the likelihood of cyber-attacks on banks. Check fraud continued to rise, despite a general decline in the use of checks. Adoption of quantum computing and artificial intelligence can pose new risks to critical infrastructure systems.

Climate-Related Financial Risks: In 2023, the number of billion-dollar climate events was the highest since 1980. While insurance policies may cover some or all of the loss associated with many severe climate and weather events, policies are becoming more expensive or unavailable, increasing risks to the banking industry.

Crypto-Asset Risks: While limited, crypto-asset-related activities can pose novel and complex risks to the U.S. banking system that are difficult to fully assess. The FDIC, in coordination with the other federal banking agencies, took steps in 2023 to closely monitor crypto-asset-related activities of banking organizations.