

SEMIANNUAL RISK PERSPECTIVE

.....
FROM THE NATIONAL RISK COMMITTEE

FALL 2023

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ABOUT THIS REPORT

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks and federal savings associations and licenses, regulates, and supervises the federal branches and agencies of foreign banking organizations.¹ The OCC supervises these banks to ensure they operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

The OCC's National Risk Committee (NRC) monitors the condition of the federal banking system and identifies key risks. The NRC also monitors emerging threats to the system's safety and soundness and ability to provide fair access to financial services and treat customers fairly. NRC members include senior agency officials who supervise banks of all sizes and develop bank supervisory policy. The NRC meets quarterly and issues guidance to examiners that provides perspective on industry trends and highlights issues requiring attention.

The OCC's Semiannual Risk Perspective addresses key issues facing banks, focusing on those that pose threats to the safety and soundness of banks and their compliance with applicable laws and regulations. This fall 2023 report presents data in five main areas: the operating environment, bank performance, special topics in emerging risks, trends in key risks, and supervisory actions. The report reflects data as of June 30, 2023, unless otherwise indicated.

The OCC welcomes feedback by email: NRCReport@occ.treas.gov.

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Throughout this report, the term "banks" refers collectively to national banks, federal savings associations, and federal branches and agencies.

EXECUTIVE SUMMARY

KEY TAKEAWAYS

- ▶ The overall strength of the federal banking system remains sound. The OCC expects banks to remain diligent and adhere to prudent risk management practices across all risk areas.
- ▶ Banks should continue to guard against complacency to ensure they maintain the ability to withstand potential future economic challenges.
- ▶ Recessionary pressures are easing with the U.S. economy having proved more resilient than anticipated. However, headwinds persist. Inflation remains elevated and above long-run goals. A slowing labor market, declining savings, and higher interest rates could cause financial stress to borrowers.
- ▶ Excess consumer savings from the pandemic assistance has been declining due to inflation and strong spending. Although job growth remains healthy, it has been slowing.

KEY RISK THEMES



CREDIT RISK is increasing due to higher interest rates, increasing risk in commercial real estate lending, prolonged inflation, declining corporate profitability, and potential for slower economic growth. Key performance indicators are beginning to show signs of borrower stress across asset classes.



RIISING DEPOSIT rates, broader market liquidity contraction, and increased reliance on wholesale funding started to impact net interest margins (NIM) through the first half of 2023. Competition for deposits and higher interest rates are raising deposit rates. Deposit and liquid asset trends stabilized in the latter half of 2023, but these levels were supported by increased reliance on wholesale funding. Increases in interest rates are negatively impacting investment portfolio values.



OPERATIONAL RISK is elevated. Cyber threats continue. Banks continue to leverage new technology to further digitalization efforts, offering innovative products and services to meet customer demands. Increasing digitalization efforts can also heighten risk of fraud and error, including fraud targeting peer-to-peer (P2P) and other faster payment platforms.



COMPLIANCE RISK remains elevated. This is due to the heightened focus on ensuring equal access to credit and fair treatment of consumers; the expanded use of innovative technologies for product and service delivery, and expanded partnerships with third parties, such as financial technology (fintech) firms; and increases in Bank Secrecy Act/ Anti-Money Laundering (BSA/AML) risk.

U.S. consumers continue to withstand costs associated with elevated levels of inflation and higher interest rates due to the strong labor market, rising wages, manageable debt levels, and elevated, but declining, cash reserves. While recessionary pressures are easing, the consensus among economists is that the U.S. economy will experience slowing growth in the future.

Elevated interest rates continue to have an adverse impact on some companies' profit margins and cash flow. The companies most affected are those firms with high leverage and marginal repayment capacity, smaller and lower-credit-rated firms with shorter debt maturities, firms with a higher level of floating debt, and firms with limited financial flexibility. Risk in the office market remains high and is expanding beyond urban business districts. Although risk remains highest in urban core markets, vacancy rates are rising for suburban submarkets.

Banks are facing significant deposit competition from competing higher-yielding investments as well as reduced market liquidity, which may further pressure banks' deposit retention and growth strategies. Higher interest rates and increased competition have pushed deposit rates higher. Banks' NIM could be further pressured from market liquidity contraction, high and steady or increasing short-term rates, and a continued trend in higher deposit rates and funding costs. Sound liquidity risk management, including processes that ensure sufficient committed capacity to meet contingent liquidity needs, remains critical.

Banks are operating in a dynamic banking environment due to heightened attention and focus on ensuring equal access to credit and fair and consistent treatment of consumers. Banks are also adapting to changing customer needs and preferences related to product, service, and delivery channel offerings. In response to the changes in customer needs and preferences, banks are offering new, modified, or expanded products, services, and operational structures.

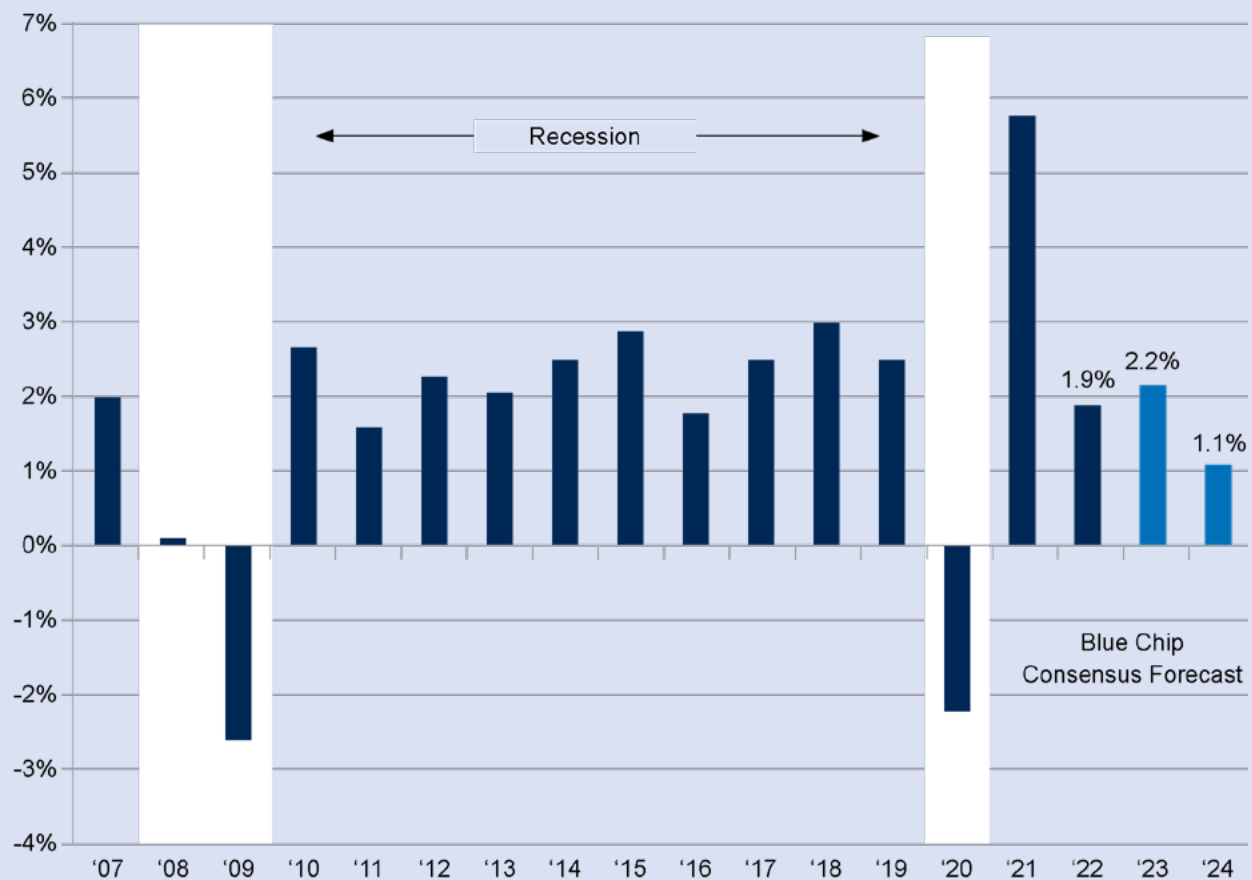
PART I

OPERATING ENVIRONMENT

U.S. ECONOMIC GROWTH REMAINS SOLID IN THE FIRST HALF OF 2023 DESPITE HIGHER INTEREST RATES

The U.S. economy proved more resilient than anticipated in the first half of 2023. Real gross domestic product (GDP) increased at an annual rate of 2.1 percent in the second quarter of 2023, easing just slightly from the first quarter's 2.2 percent pace. Many economists expected a decline in second quarter GDP. Consumer spending, which accounts for almost 70 percent of economic growth, continued to support real activity, contributing 0.6 percentage points to the second quarter's annualized rate. Second quarter GDP was also supported by an acceleration in nonresidential fixed investment. The Blue Chip Consensus expects real GDP growth to slow through early 2024 but avoid an outright decline. See figure 1.

FIGURE 1: REAL GDP, PERCENT CHANGE ANNUAL RATE



Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators (October 2023)

According to the latest monthly data released from the U.S. Department of Commerce, real consumer spending growth decelerated in August, but this came in the wake of a robust increase during the prior month. Real spending was up a solid 2.3 percent in August, holding slightly above its trend range over the past year. Consumers are being supported by the strong labor market and excess savings from pandemic assistance. Uncertainty about the economy earlier in the pandemic also prompted many households to sell securities in 2020 and 2021. This conversion to liquid deposits, plus excess savings inflow, increased household deposit and cash holdings. Although drawdowns of excess savings are well underway, enough savings could remain to support household outlays at least through the third quarter of 2023.²

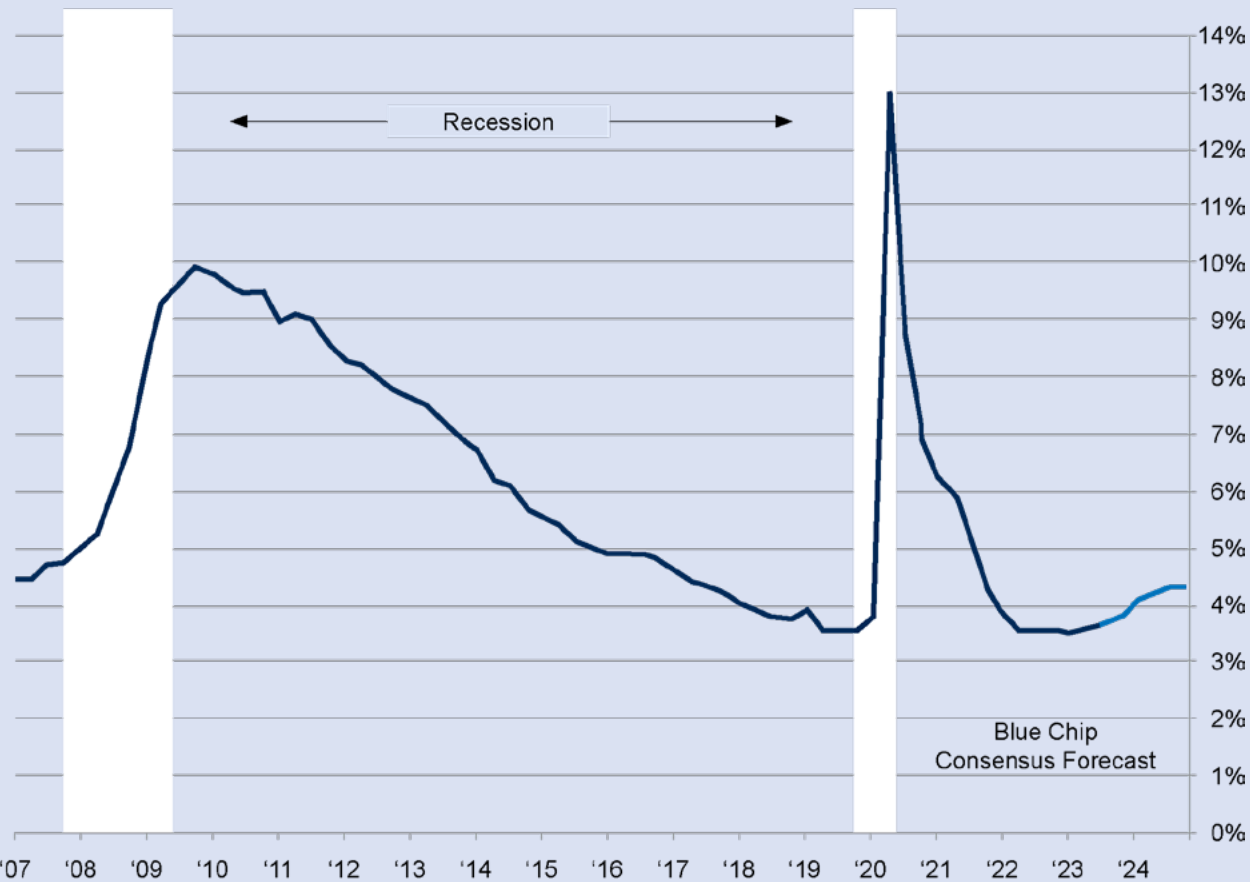
On top of the boost from tight labor markets and excess savings, economic growth is also bolstered by stronger than expected housing starts and auto sales compared with earlier Board of Governors of the Federal Reserve System (Federal Reserve) tightening cycles. These sectors are key channels through which tighter monetary policy slows the economy. Single-family housing construction has rebounded since bottoming out in November of last year due to a scarcity of existing homes for sale. Many households refinanced their mortgages during the pandemic and locked in historically low borrowing costs, making

2 Refer to the Federal Reserve's "[Excess No More? Dwindling Pandemic Savings](#)" (August 16, 2023).

them reluctant to sell. A global shortage of semiconductors restrained auto inventories and sales following the pandemic, resulting in heavy pent-up demand, which continues to support auto sales despite higher interest rates.

Job growth remained strong through the third quarter of 2023, though it slowed in the start of the fourth quarter. Nonfarm payrolls increased by 150,000 in October. Consumers are unlikely to cut back spending unless employment levels decline. The unemployment rate ticked up to 3.9 percent in October. See figure 2. This continued the longest stretch of below 4 percent unemployment since the late 1960s. Workers’ average hourly earnings increased 4.1 percent in October from a year earlier, down slightly from a 4.2 percent gain in September and well below the 4.9 percent pace in October of last year. This occurred in part as higher labor force participation, in conjunction with softening demand for workers, reduced worker confidence to change jobs, slowing wage growth. The labor force participation rate was 62.7 percent in October, up from 62.2 percent in October of last year. Wage gains remain well above the pre-pandemic trend. From 2017 to 2019, growth in hourly earnings over a 12-month period averaged 3 percent. The current rate of wage gains remains inconsistent with the Federal Reserve’s 2 percent inflation target.

FIGURE 2: QUARTERLY AVERAGE UNEMPLOYMENT RATE



Sources: Bureau of Labor Statistics (3Q:2023), Blue Chip Economic Indicators (October 2023)

FIGURE 3: CORE PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX, YEAR-OVER-YEAR PERCENT CHANGE



Sources: Bureau of Economic Analysis (3Q:2023), Blue Chip Economic Indicators (October 2023)

The Core Personal Consumption Expenditures (PCE) index, which is the Federal Reserve's preferred gauge of inflation, increased 4.6 percent in the second quarter of 2023 from a year earlier, down slightly from the first quarter's 4.8 percent pace. This was below the peak 5.5 percent rate of the first quarter of 2022, but still well above the Federal Reserve's 2 percent inflation target. The Blue Chip Consensus expects core inflation to continue to slow through the remainder of this year and next, reaching 2.4 percent by the end of 2024. See figure 3. Headline inflation, which was running at 3.6 percent year-over-year in the third quarter, is also expected to slow persistently, dropping to 2.4 percent by the end of next year. The outlook, however, is uncertain. Despite the recent rise in home prices, further easing in housing inflation is expected to continue to place downward pressure on core PCE. Wage-sensitive core services inflation remains elevated, and the prospect for slowing inflation continues to depend in part on further easing of the tight labor market, which will complicate the Federal Reserve's task.

The Federal Reserve raised the target range for the federal funds rate in July from 5.00-5.25 percent to 5.25-5.50 percent. Officials noted that while inflation has moderated, it has a “long way to go,” emphasizing the data-dependent approach on further rate hikes as well as the lag with which monetary policy affects economic activity and inflation. For these reasons, officials have retained the possibility for another rate hike before the end of the year if economic activity does not slow sufficiently to keep inflation on a downward trajectory. The Blue Chip Consensus expects the three-month Treasury yield to remain above 5 percent through the second quarter of 2024 as inflation continues to ease. By contrast, the 10-year Treasury yield is projected to average 4.2 percent or less. This implies that the yield curve will remain inverted throughout 2024.

In all but one Federal Reserve tightening cycle since the mid-1950s, an inverted yield curve has been followed by a recession. In the present cycle, however, the yield curve has already remained inverted for almost a year, but the economy has so far avoided a recession. While predictive, inverted yield curves do not typically cause recessions, and it is possible that post-pandemic effects may have lessened this inversion’s predictive power. Investors expect short-term rates to fall. Whether due to a recession or soft landing, predictions see inflation slowing to the Federal Reserve’s target and an easing in the policy rate, which would allow the yield curve to move toward a normal upward slope.

GLOBAL ECONOMIC OPERATING ENVIRONMENT

Global economic growth has been resilient despite monetary policy tightening by the major central banks. Consensus projections for global GDP growth are 2.4 percent for 2023 and 2.1 percent for 2024. Growth in advanced economies has been supported by household savings and rising corporate profits. Given inflation remains persistently above target in most countries, major central banks are not projected to loosen monetary policies until mid-2024, though some emerging market central banks, such as Brazil and China, have started to lower interest rates.

China’s economic rebound following its exit from zero-Covid restrictions was short and weighed down by weakness in the property sector and low consumer confidence. China’s slow economic growth, projected to be 4.4 percent in 2024, is expected to contribute to sluggish global trade and manufacturing activity. This could further depress growth in export-oriented economies, like Germany and Southeast Asian countries.

After appreciating strongly in 2022, the U.S. dollar is projected to remain roughly stable in 2023-2024 as the Federal Reserve holds off on interest rate reductions and the U.S. dollar maintains its safe-haven status. Geopolitical risks remain heightened given recent tensions and could rapidly change the global outlook.

Despite Rising Mortgage Rates, Residential Real Estate Prices Rebounded as Low Inventory Persists

After falling during the second half of 2022, the Black Knight national home price index rebounded during the first half of 2023 by more than 3 percent as home prices were supported by low inventory of homes for sale. In June 2023, the inventory would have covered three months of sales, more than one month below pre-pandemic levels, and home prices bounced back in most metropolitan areas. The limited inventory was sufficient to offset the decline in housing demand arising from tightening affordability. See figure 4.

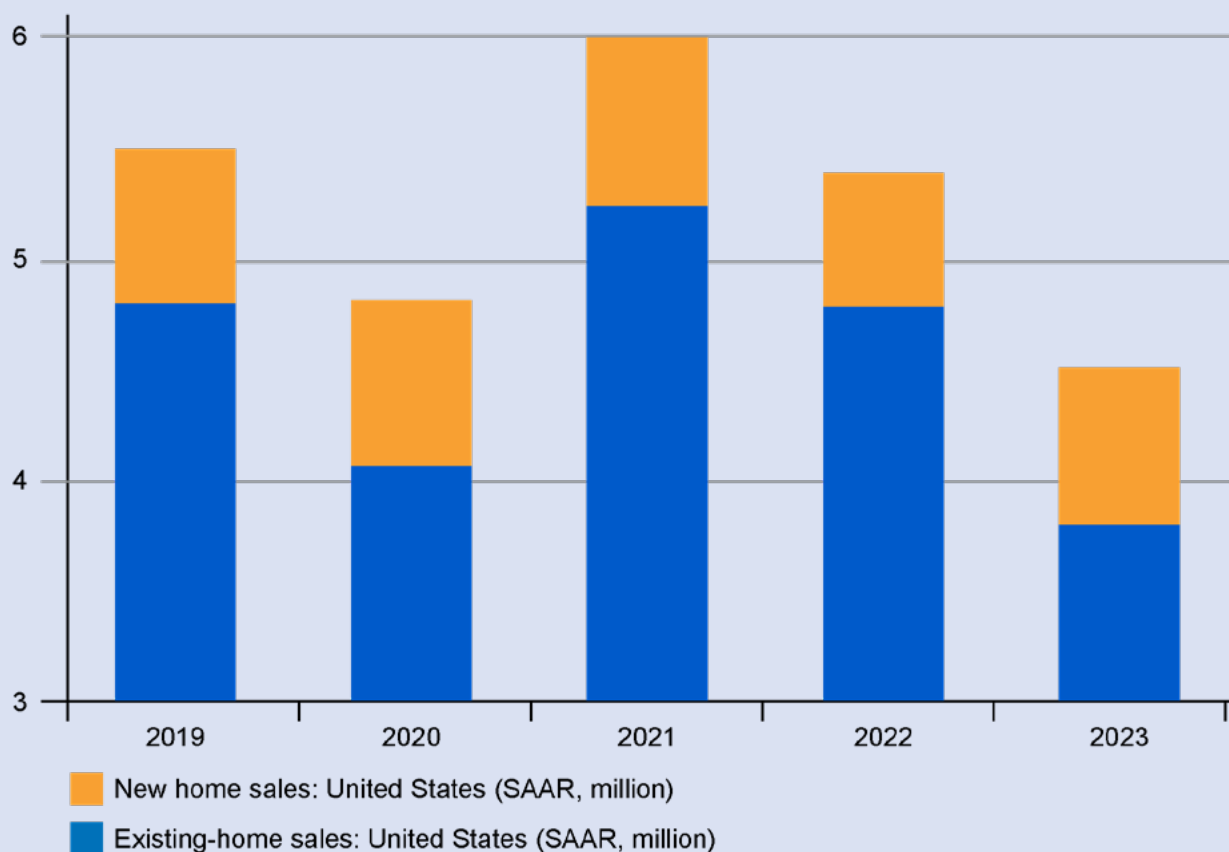
FIGURE 4: MONTHLY AVERAGE U.S. SINGLE-FAMILY HOME PRICES AND INVENTORY OF HOMES FOR SALE



Sources: Black Knight Financial, NAR, Moody's Analytics (August 2023)

Home sales continued to fall as both supply and demand were curtailed. See figure 5. As interest rates on most current homeowners' mortgages are more than 300 basis points lower than today's market rates, homeowners are less motivated to move and obtain a new mortgage. At the same time, demand softened as the share of median household income needed to finance the average-priced home almost doubled from 20 percent in December 2021 to 37.8 percent in June 2023.

FIGURE 5: U.S. HOME SALES (IN MILLIONS)



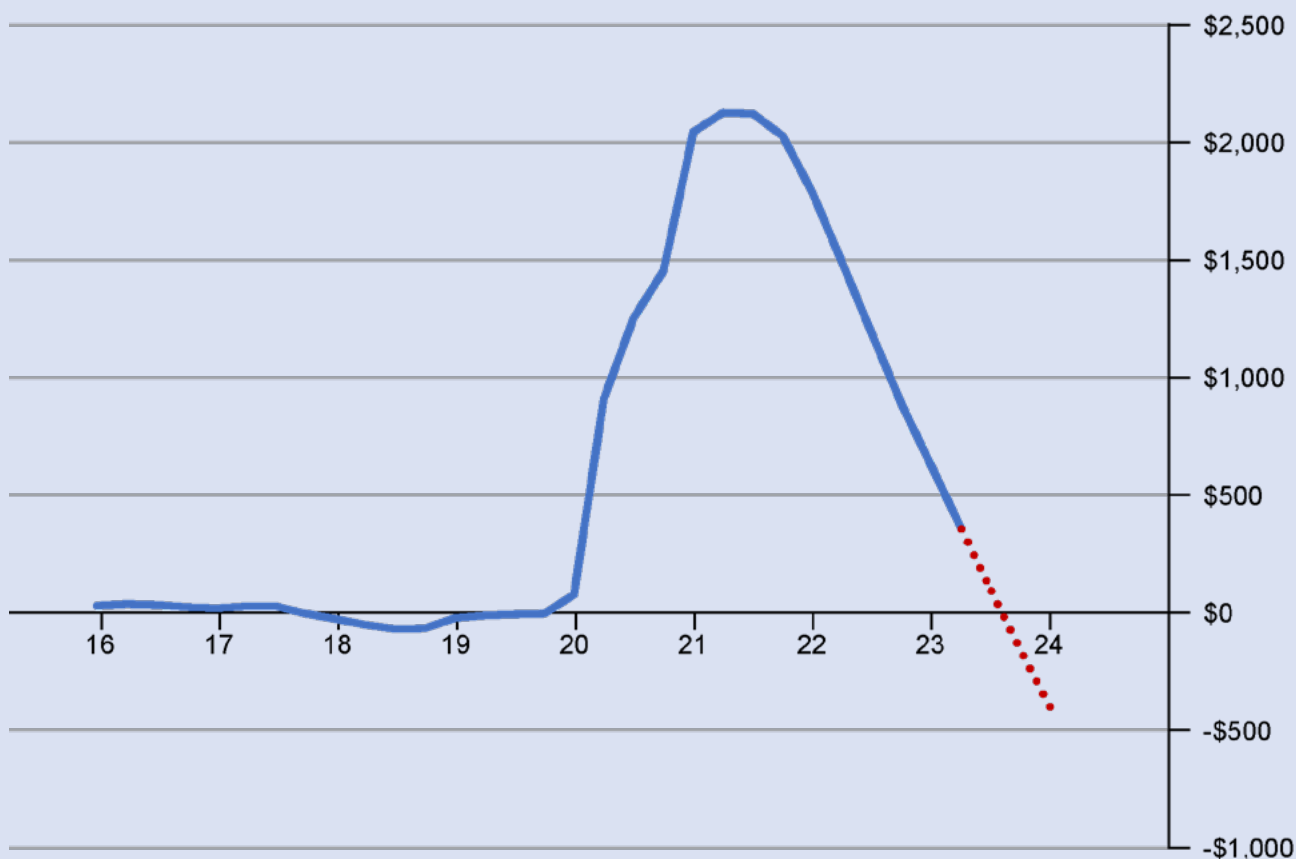
Sources: Census Bureau, NAR, Moody's Analytics (Updated August 2023)

Note: 2023 home sale numbers annualized based on the first two quarters of 2023.

THE CONSUMER IS HEALTHY, BUT HEADWINDS ARE BUILDING

The consumer has been a major driver of economic growth since the second half of 2020. Excess savings from pandemic assistance and a strong labor market have allowed consumers to pay down debt and increase consumption. Rising asset values have also supported consumer spending over the past few years. The maturing economic cycle, however, may cause headwinds for the consumer. Although job growth remains healthy, it has been slowing and the average employment growth over the past three months has returned to its 2017-2019 average. Job openings and quit rates have also been declining after peaking in April 2022. The cooling job market may start to negatively impact wage growth. In addition, the “excess” savings from the pandemic assistance has been declining due to inflation and strong consumer spending. See figure 6. The savings rate increased from 8.8 percent in 2019 to 20 percent during the pandemic but declined to 3.4 percent by September 2023. A slowing labor market, declining savings, higher interest rates, and sticky inflation could cause financial stress to consumers and slacken consumption.

FIGURE 6: CUMULATIVE EXCESS HOUSEHOLD SAVINGS (IN BILLIONS)



Sources: Bureau of Economic Analysis, Blue Chip Forecast, Economic and Policy Analysis Calculations

Note: Savings is equal to disposable personal income less personal consumption expenditures, personal interest payments and personal current transfer payments. Projection is based on Blue Chip forecast of disposable income, personal consumption expenditure, and core PCE price index. Trend line based on actuals from 2016:Q1 through 2019:Q4.

OFFICE SECTOR PROPERTY VALUES CONTINUED TO DECLINE AS THE VACANCY RATE REACHED A NEW HIGH

The office sector continues to be challenged by low levels of demand for rental space, causing the vacancy rate to hit a new record at 13 percent in the second quarter of 2023. See figure 7. Office net absorption remains negative, resulting in a large pool of total available office square footage. Hybrid and remote work schedules continue to be the major drivers keeping office occupancies low. While it appears that hybrid work

arrangements are here to stay, the number of fully remote workers has been declining since 2020,³ indicating that the market could stabilize in the future. Between looming lease expirations which portend shrinking office needs and an uptick in loan defaults, the office sector will likely face more challenges before reaching an equilibrium.

Despite the overall office outlook, certain office types have been more resilient. Medical office and life sciences offices have outperformed their office counterparts⁴ due to their lesser frequency of remote work. Moreover, the aging of the population has increased demand for healthcare services.

The multifamily sector continues to be under pressure with increasing expenses and rent growth slowing since 2021, driving down valuations. Net operating income (NOI) growth slowed as expenses, in particular property insurance, have increased significantly, outpacing revenues. The vacancy rate continued to increase in the first half of 2023, reaching almost 7 percent and surpassing its pre-pandemic level. Meanwhile, supply continues to come online. This is placing pressure on occupancy rates, which will likely weigh on rent growth in the short term. Sunbelt markets, which drove much of the rapid rent growth in the last couple of years, are expected to face greater pressure as new supply outpaces demand.

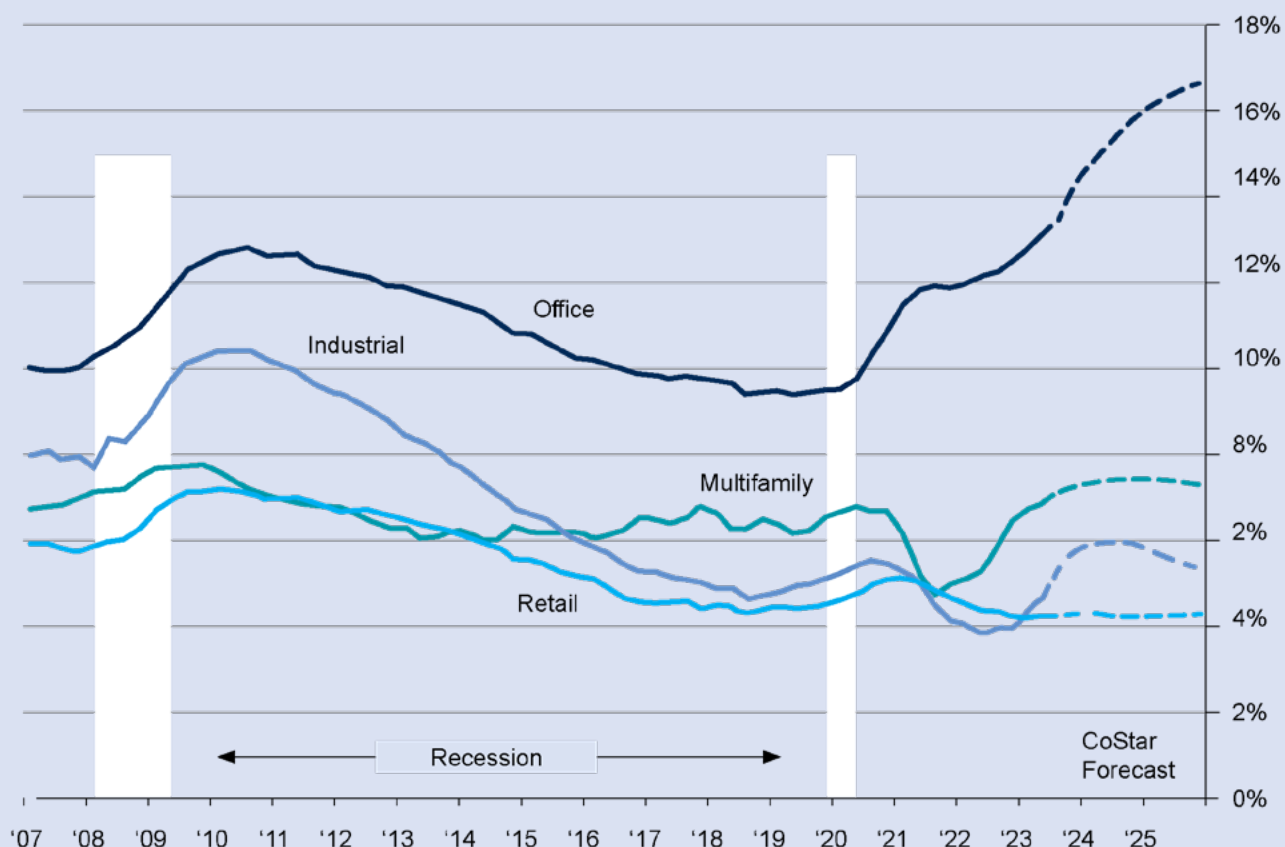
The industrial property sector remained strong throughout the pandemic, and even though it continued to show strength through the second quarter of 2023, there may be some signs of cooling. The vacancy rate continued to increase in the first half of 2023 but remains well below its pre-pandemic average. See figure 7. Vacancies are expected to increase over the next 12 months, as a wave of new supply that started in 2022 enters the market. Meanwhile, net absorption slowed as firms pulled back on inventory stockpiles, and this is expected to keep upward pressure on vacancies. Industrial rent growth remains above its pre-pandemic level but slowed and is expected to slow further into 2024 due to the continued delivery of new supply. Rising interest rates and a declining need to keep “just-in-time” levels of inventory should slow the rate of new projects and may mitigate the decline in rent growth and moderate rising vacancies in the industrial property sector.

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3 See [Survey of Working Arrangements and Attitudes \(SWAA\)](#).

4 See Forbes [“Medical Office Buildings as in Investment,”](#) August 23, 2023.

FIGURE 7: COMMERCIAL REAL ESTATE VACANCY RATES BY SECTOR



Source: CoStar Portfolio Strategy (historical data through the second quarter of 2023, baseline forecast updated July 2023)

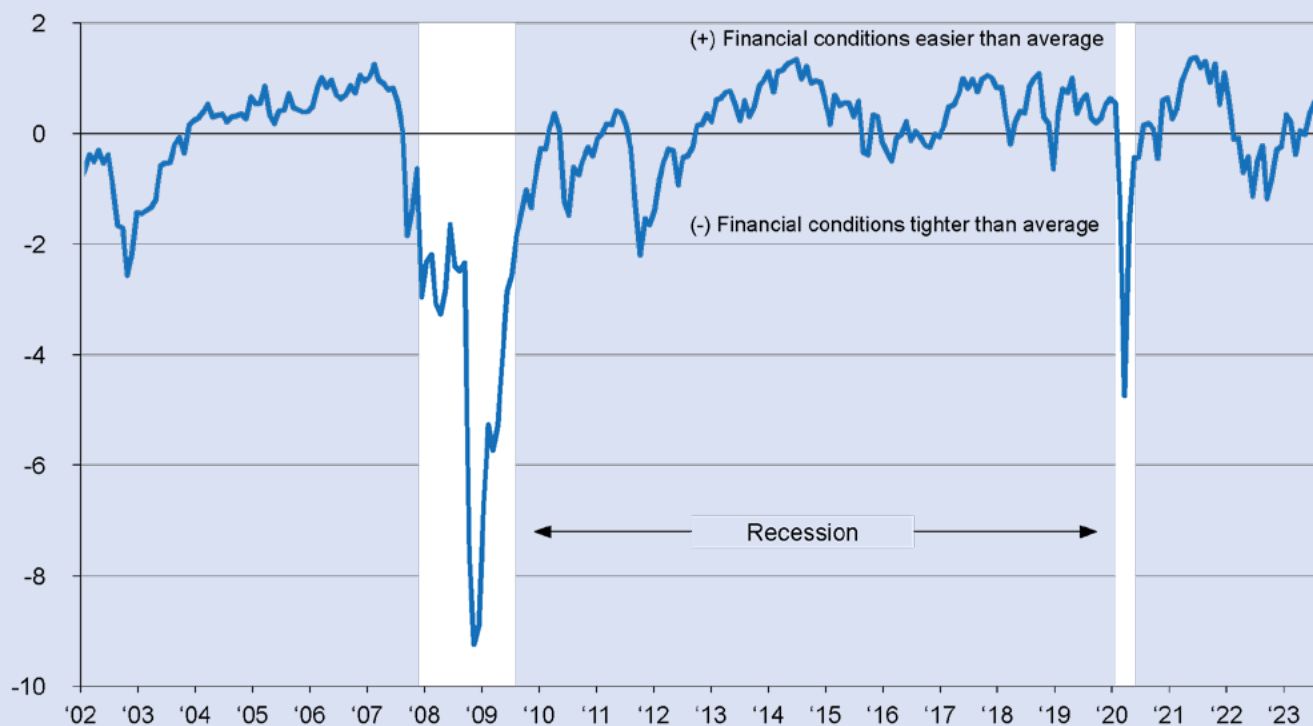
CORPORATE PROFITS DECLINED AGAIN DUE TO A WEAKER FINANCIAL SECTOR

Corporate profits before tax fell for the fourth consecutive quarter in the second quarter of 2023. Most of the pullback can be attributed to the financial sector, which saw pretax profits slide by nearly \$50 billion in the second quarter of 2023 while non-financial sector corporate profits, supported in part by a still resilient pace of consumer spending, increased by nearly \$25 billion. At the industry level, performance was mixed. According to earnings reports of publicly traded companies, the consumer discretionary and information technology industry saw the strongest year-over-year earnings growth of S&P 500 companies in the second quarter of 2023. On the other hand, the healthcare, materials, and energy industries reported a decrease in their year-over-year earnings growth. Looking ahead, high interest rates along with rising costs, particularly robust wage growth, are expected to weigh on firms' profit margins.

FINANCIAL CONDITIONS EASED

Financial conditions eased through September 2023. See figure 8. Acute financial stability risks related to the failure of midsize banks in mid-March 2023 have abated. Current and expected measures of inflation remain elevated. In response, interest rates continued to rise over the last two quarters to near two-decade highs. This raises the risk of a material slowdown in demand for credit-sensitive sectors of the economy.

FIGURE 8: U.S. FINANCIAL CONDITIONS INDEX



Source: Bloomberg (data through September 1, 2023)

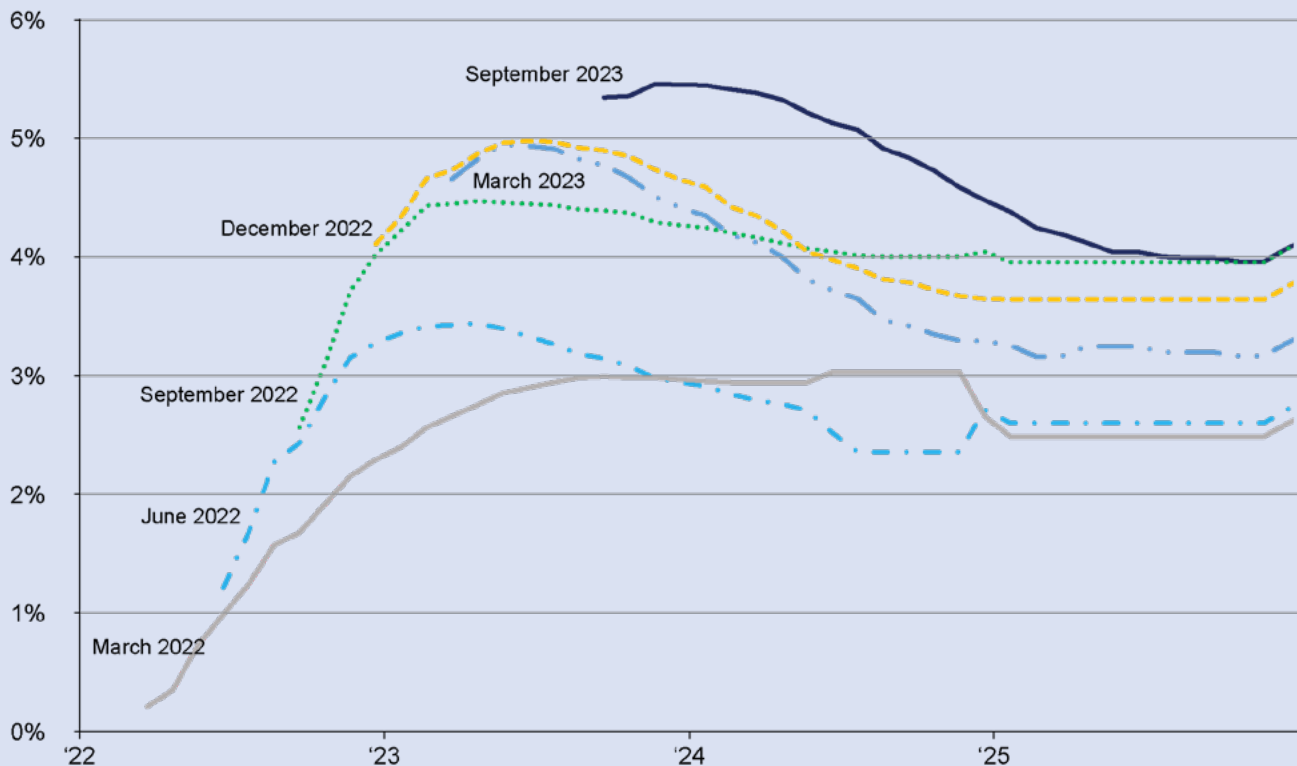
Note: The U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions while a negative value indicates tighter financial conditions relative to pre-2008 crisis norms.

Some risks to the U.S. financial market outlook faded in the second and third quarters of 2023. Stronger-than-expected measures of consumer spending, continued strength in the labor market, resilient corporate profits, and other signs of an economic soft landing have decreased the odds of a sudden downturn in markets consistent with a recession.

The Federal Reserve slowed the pace of interest rate hikes earlier this year but is open to increasing rates further should inflation dynamics remain unfavorable. Market expectations, implied through Fed funds futures, have consistently underestimated the pace and long-run level of policy rates. See figure 9. The central bank continued to reduce its holdings of Treasury and mortgage-backed securities (MBS) as financial stability risks faded. Funding through the Bank Term Funding Program (BTFP) expanded, while borrowing

through the Discount Window has returned to minimal levels.⁵ Banking system reserves briefly increased during March 2023 but have modestly declined in the last two quarters.

FIGURE 9: IMPLIED FEDERAL FUNDS RATE FROM FED FUNDS FUTURES



Source: Chicago Board of Trade, Bloomberg (data through September 1, 2023)

The pace of economic growth is forecast⁶ to remain lower over the next few quarters, but the odds of an imminent recession have diminished from earlier this year. As a result, rates on longer-maturity Treasury bonds rose more than shorter-maturity notes and, as of the third quarter of 2023, the 10Y-3M yield curve inversion (see figure 10) edged back from a 40-year low reached in the second quarter. While the implied probability of recession from shorter-dated term spreads⁷ signaled an elevated risk of recession over the next year, the implied probability of recession has somewhat declined since May.

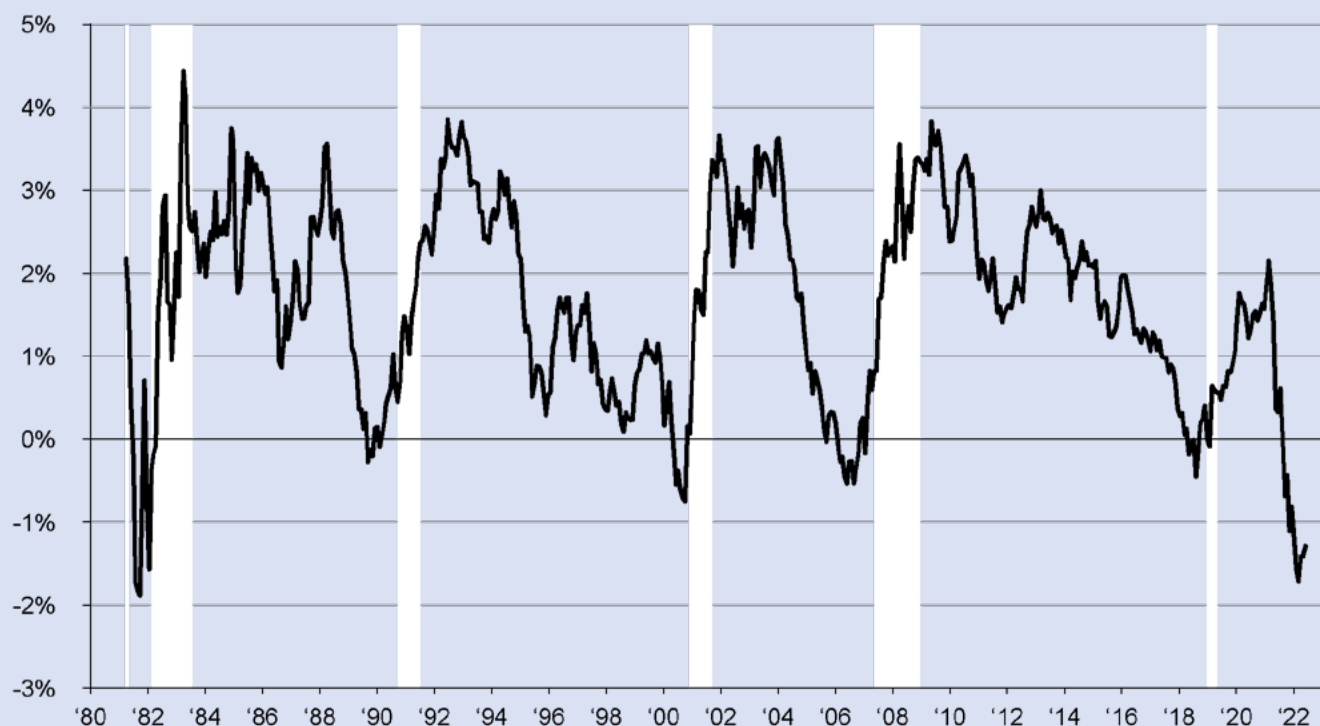
5 Excluding “other credit extensions” which include discount window loans to Federal Deposit Insurance Corporation (FDIC) bridge banks.

6 According to the October 2023 Blue Chip Consensus.

7 The near-term Treasury term spread (3-month Treasury forward rate 18 months ahead-3-month Treasury bill) and the 10-year note-3-month bill Treasury term spread are negative as of September 5, 2023.

FIGURE 10: U.S. TREASURY TERM SPREAD (10Y-3M), PERCENT

TREASURY TERM SPREAD MEASURED BY THE DIFFERENCE IN YIELDS BETWEEN THE 10-YEAR (Y) NOTE AND 3-MONTH (M) BILL RATE AT CONSTANT MATURITY INDICATES AN ELEVATED PROBABILITY OF RECESSION.



Source: Bloomberg (data through September 1, 2023)

U.S. Treasuries saw mixed funding conditions through the third quarter of 2023. Treasury market volatility, measured by the Bank of America Merrill Lynch MOVE index, settled at 107.93 at the end of August 2023 (well above its 20-year average of 85.71) as market participants priced in higher economic uncertainty. Bond market volatility declined after the suspension of the Treasury's statutory borrowing limit in June. Liquidity conditions improved, and issuance in the T-bill market has seen the largest announced increases in issuance across the curve. In the year leading up to the suspension of the debt limit, money market mutual funds saw an influx of assets under management as interest rate sensitive savers steadily moved their holdings from bank deposits to other higher-yielding alternatives. A large portion of money market fund assets were allocated to the Federal Reserve's overnight reserve repurchase agreement facility (O/N RRP), but recently money market funds have taken up the increased T-bill issuance—reallocating funds out of the Federal Reserve's O/N RRP to the Treasury market. This reallocation was due to many factors including the reduced uncertainty of the future path of policy rates and the yield advantage of T-bills to the O/N RRP rate. This has effectively facilitated an increase in liquidity conditions in Treasury and other wholesale markets.

Equity markets continue to recoup their losses from 2022 as market participants priced in higher odds of a soft landing. Survey-based and market-based inflation expectation measures remained elevated above the central bank target of 2 percent inflation over the longer run.⁸ Equity market volatility, measured by the S&P 500 VIX Index, settled in the quarter well below its year-to-date high. Despite the decline, equity volatility remains above pre-pandemic lows, as tightening credit conditions, a strong dollar, higher debt servicing costs (for floating rate obligations), uncertainty in the outlook for inflation, slowing economic activity measured by business surveys, and elevated odds of sudden economic slowdown increased the uncertainty for the outlook of corporate profits.

Credit spreads tightened through the third quarter of 2023. Investment-grade bond issuance was slightly lower than 2022 levels, but issuance for high-yield bond markets was running well above last year's depressed levels. Issuance trends in high-yield markets are likely reflective of the modestly higher investor demand for riskier debt at a higher yield and the prospect of a soft landing and lower recession odds. This has led to the outperformance of bonds by speculative grade companies over higher-rated peers this year.

There are several risks that may increase volatility in asset markets in the next few quarters, including an increase of financial stability risks, continued tightening of monetary policy, sticky inflation dynamics, further deterioration in commercial real estate (CRE) prices, and higher short-term interest rates for a longer period than currently anticipated by market participants ("higher for longer"). As of September 2023, most international equity indexes outperformed U.S. benchmarks this year. The U.S. dollar remained near a multi-decade high against developed market peers when measured in inflation-adjusted terms on a trade-weighted basis.

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8 As measured by the five-year forward breakeven rate.

PART II

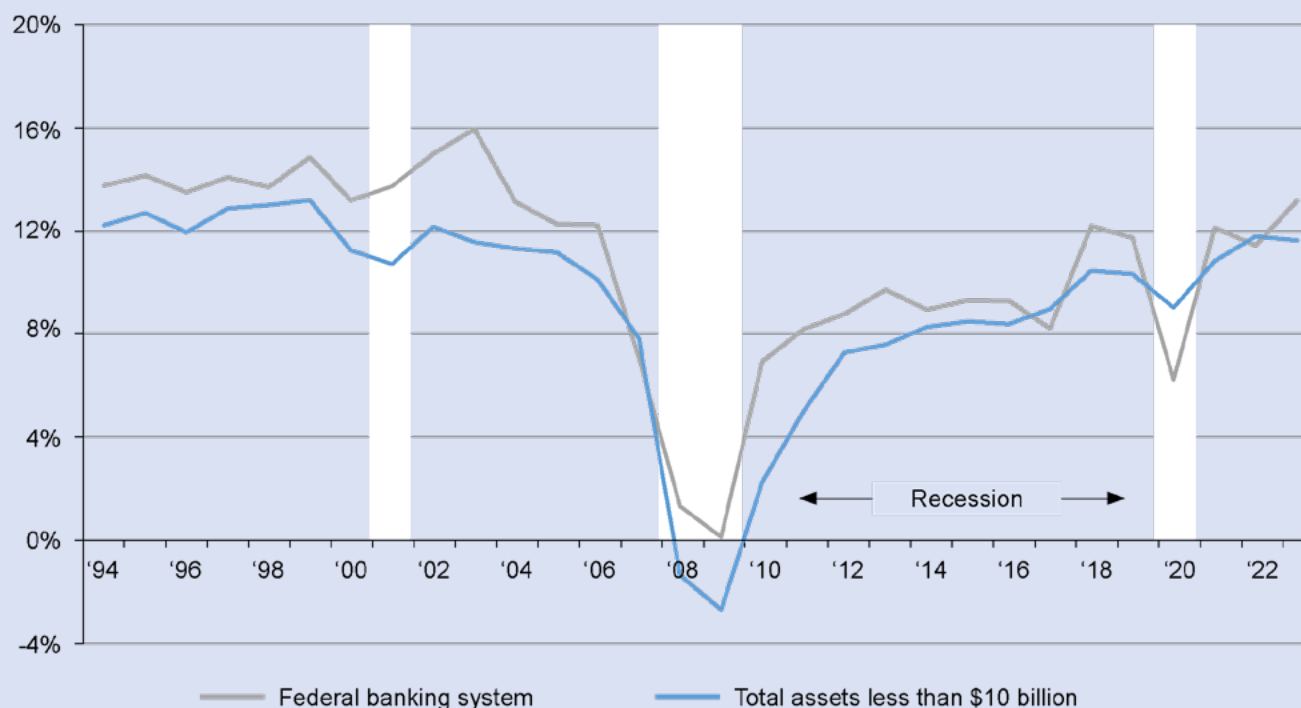
BANK PERFORMANCE

BANK PERFORMANCE REMAINED RESILIENT IN THE FIRST HALF OF 2023, AMID HIGHER INTEREST RATES

Profitability for the federal banking system improved in the first half of 2023, even as banks continued to navigate a higher interest rate environment, uncertain economic climate, and fallout from the failure of three regional banks in the spring.⁹ Return on equity for the system, driven by the largest institutions, increased to 13.3 percent from 11.6 percent in 2022 on strong growth in net interest income (NII). See figure 11. Performance trends among banks with assets less than \$10 billion (“community banks,” hereafter) were more mixed. While higher interest rates continued to provide a lift to loan yields and NII, funding costs, securities valuations, and liquidity have come under pressure in the higher rate environment. The outlook for the remainder of 2023 rests on banks’ ability to manage elevated interest rates, higher funding costs, potentially weaker demand for loans, and deteriorated credit quality.

9 See [FDIC: Bank Failures in Brief](#).

FIGURE 11: TREND IN BANK RETURN ON EQUITY



Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2022 and annualized for the first half of 2023. Banks with less than \$10 billion in total assets exclude credit card and trust institutions.

Banks continued to post NII growth in the first half of 2023, as margins benefited from higher interest rates. For the federal banking system, NII increased 24.2 percent in June from a year ago, an elevated number historically. For community banks, NII grew at about half this rate. See table 1.

Banks also continued to build reserves, and noninterest expense was higher than a year ago. For the system, provisions increased to \$31 billion in the first half of 2023, bringing the current pace of provisioning higher than it was pre-pandemic. The gains in spread revenues were enough to offset the reserve builds and higher operating costs. Year-to-date, overall net income for the system increased 21 percent in June from a year ago and 5 percent for community banks.¹⁰ In the second quarter, net income for community banks declined 0.3 percent compared with the same period a year earlier and slowed to 15 percent for the system, reflecting profitability pressures that intensified in the second quarter as margins came under pressure.

10 Excluding JPMorgan Chase, system net income increased 9.9 percent from a year ago. The bank had a gain of \$2.7 billion in the second quarter of 2023 associated with the acquisition of First Republic.

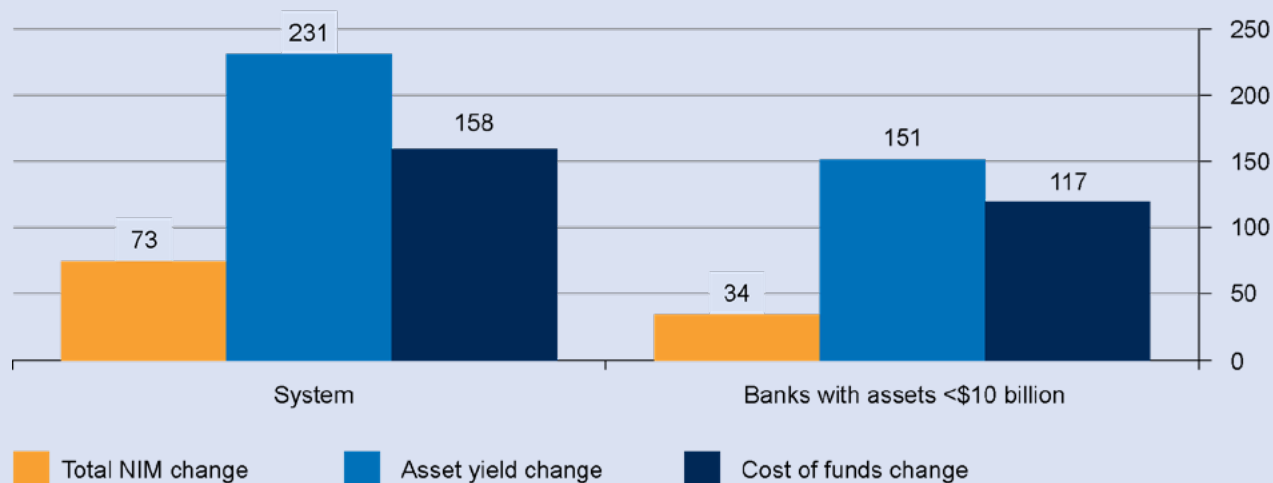
TABLE 1: TRENDS IN BANK NET INCOME (\$ BILLIONS)

	Federal banking system			Banks with total assets less than \$10 billion		
	6/30/2022	6/30/2023	Y/Y % change	6/30/2022	6/30/2023	Y/Y % change
Net interest income	184.6	229.5	24.2%	11.0	12.6	13.8%
Noninterest income	109.4	112.7	3.0%	4.9	4.4	-9.0%
Provisioning	10.2	31.0	202.4%	0.3	0.7	103.2%
Noninterest expense	182.5	188.6	3.4%	10.4	10.8	3.2%
Net income	80.2	97.2	21.2%	4.2	4.4	4.8%

Source: Integrated Banking Information System (OCC)

Note: Data are merger-adjusted and held constant for banks in continuous operation from the first quarter of 2015 to the second quarter of 2023. Banks with less than \$10 billion in total assets exclude credit card and trust institutions.

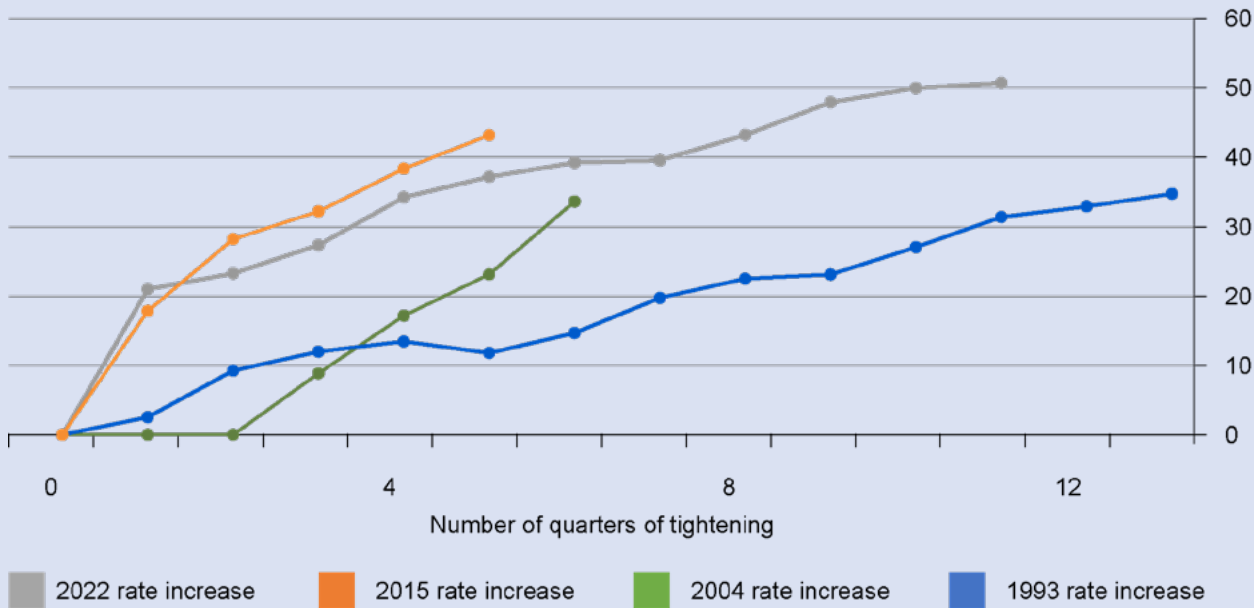
Figure 12 shows that NIM gains were more pronounced for the system, increasing by 73 basis points when comparing second quarter 2022 with second quarter 2023, while for banks with less than \$10 billion in assets, the NIM increased by less than half that amount. NIM improved on increases in yield across the loan portfolio and other interest-earning assets, while the cost of funds increased significantly across the industry. The largest banks were still able to grow NIM significantly on strong gains in asset yields. For community banks, the increase in asset yields was more muted.

FIGURE 12: BASIS POINT CHANGE IN NIM COMPONENT, SECOND QUARTER 2022 TO SECOND QUARTER 2023

Source: Integrated Banking Information System (OCC)

Note: Data are merger-adjusted and held constant for banks in continuous operation from the first quarter of 2015 to the second quarter of 2023. Banks with less than \$10 billion in total assets exclude credit card and trust institutions.

FIGURE 13: CUMULATIVE DEPOSIT BETA FOR THE FEDERAL BANKING SYSTEM



Source: Integrated Banking Information System (OCC)

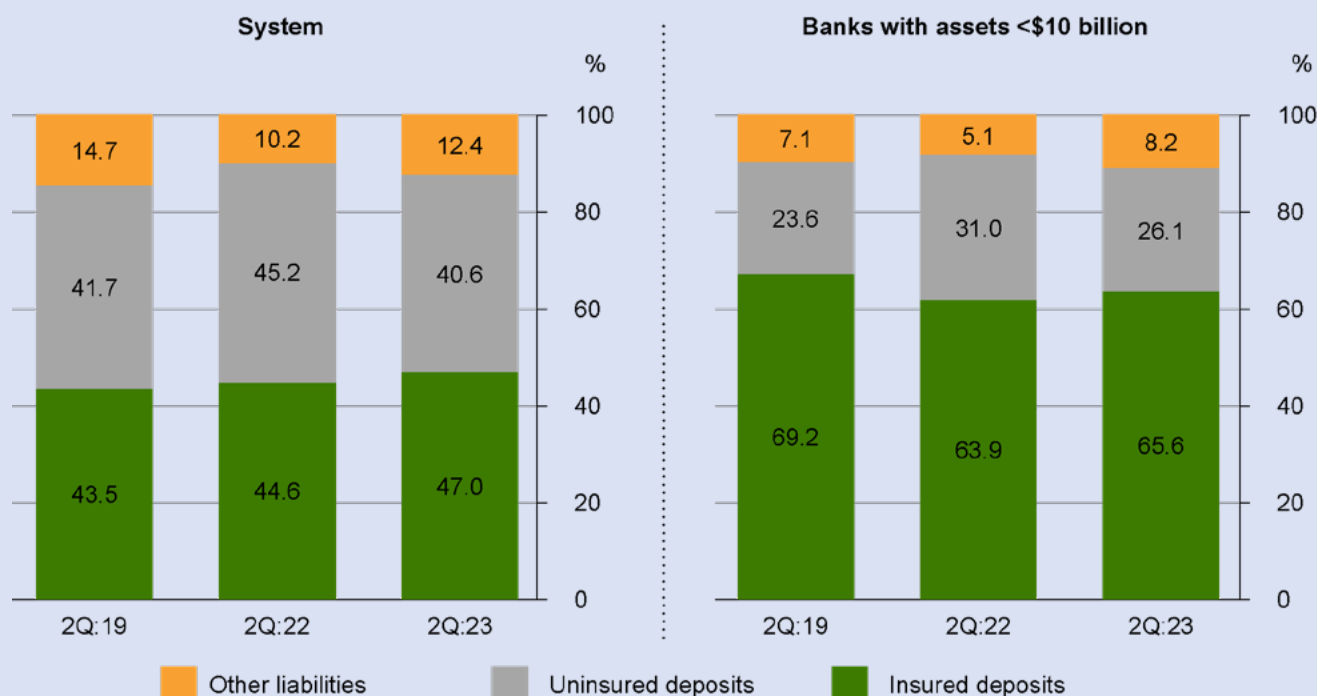
Note: Data are quarterly and merger adjusted for institutions in continuous operation within each respective cycle. The beta measures the cumulative change in the annualized deposit rate (deposit expense as a share of interest-bearing deposits) over the cumulative change in the average effective federal funds rate.

Funding costs accelerated significantly in 2023, catching up with the interest rate increases that began in 2022. The federal banking system’s cost of deposits rose in the second quarter of 2023, and as a result, deposit betas¹¹ were significantly higher in the period than a quarter earlier. Since the Federal Reserve began monetary tightening in March 2022, the cumulative five-quarter deposit beta of 43 percent for the system surpasses the cumulative beta at the comparable stages of the prior three rate tightening cycles. See figure 13. Elevated interest rates, if they persist, could further intensify funding pressures, putting margin pressure on additional institutions.

As deposit costs continued to rise in the first half of 2023, the composition of funding also changed. Over the last year, as deposit growth slowed and trended lower, banks increased their reliance on higher-cost sources of funding. For the federal banking system, uninsured deposits as a share of total liabilities fell, while non-deposit sources of funding increased to 12 percent of total liabilities. For community banks, this trend was more pronounced. See figure 14. Overall deposits for the system fell in June from a year ago, though at a slight improvement from the prior quarter, as deposit outflows slowed. For community banks, deposits in June were just slightly below the level of a year ago.

11 The deposit beta measures the change in deposit expense to the change in the federal funds rate and captures the percentage of the change in the federal funds rate passed on to depositors.

FIGURE 14: COMPOSITION OF LIABILITIES



Source: Integrated Banking Information System (OCC)

Note: Data are merger adjusted for institutions in continuous operation between the first quarter of 2015 and the second quarter of 2023. Data exclude specialists. Uninsured deposits are total deposits minus estimated insured deposits.

While deposit growth trended lower, loan growth also slowed. For the system, growth in total loans has slowed since peaking in mid-2022 and grew at 2.6 percent in June from a year earlier. For community banks, loan growth was more resilient, increasing over 10 percent from the previous year. As a result, community bank loan-to-deposit ratios have risen faster than that of the system, returning closer to pre-pandemic levels.

The slowdown in the system's loan growth was driven by commercial and industrial (C&I) loans, which make up 22 percent of total loans for the system. C&I loan growth was essentially flat from a year ago. Growth in CRE loans—particularly for nonfarm nonresidential and multifamily properties—and residential real estate also experienced a slowdown from a year ago. See figure 15. For community banks, loan growth was more resilient in the real estate sector, and nonfarm nonresidential CRE loans—which make up the largest portion of lending for community banks—grew at nearly 10 percent. A minority of these community banks also have CRE exposures that exceed 200 percent of their tier 1 capital, making them potentially more exposed to deteriorating CRE market conditions.

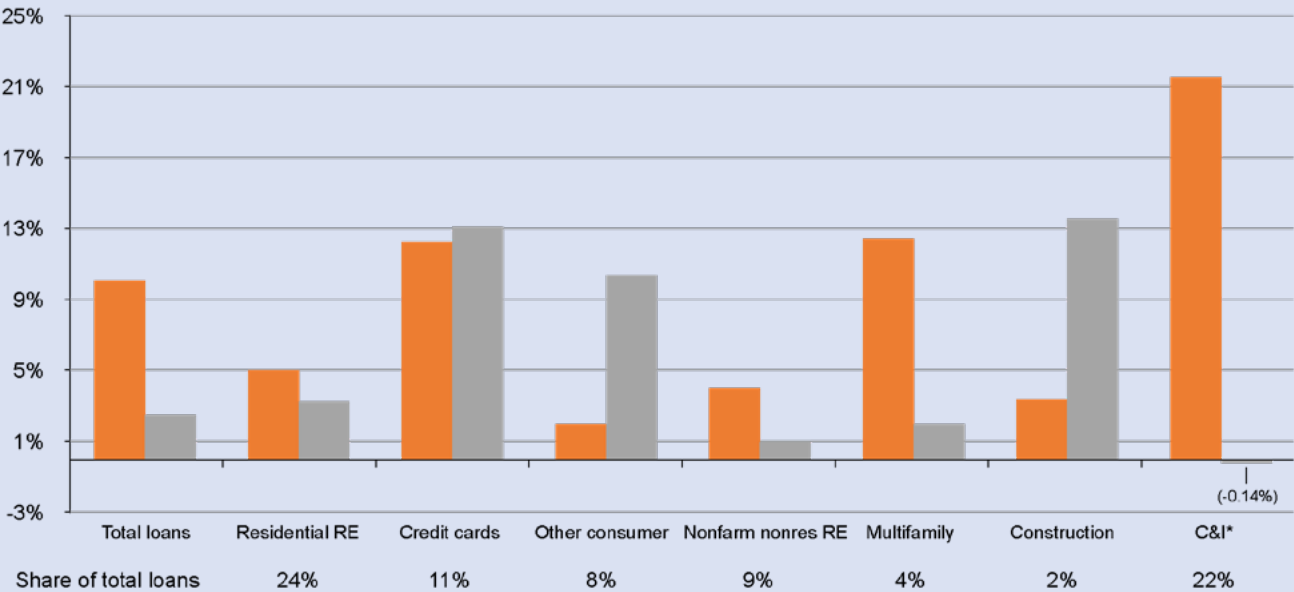
Loan growth could slow further this year, as banks continue to tighten credit to both businesses and households. According to the Federal Reserve's July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices,¹² banks expect to further tighten lending standards on all loan categories for the

12 Board of Governors of the Federal Reserve System, [Senior Loan Officer Opinion Survey on Bank Lending Practices](#) (July 2023).

remainder of the year. The net percentage of large and midsize banks reporting tightening and weaker demand for C&I loans was greater than 50 percent; for small banks, a smaller net share indicated tightening and weakening demand. For all CRE loan products, the net share of banks reporting tightening and weaker demand was also over 50 percent, though for some products these measures improved from the prior quarter. For consumer loans, smaller net shares of banks reported tightening and weaker demand. The most cited reasons for tightening were a more uncertain economic outlook, deterioration in collateral values, and expected deterioration in credit quality of CRE and other loans. Banks also cited concerns over funding costs and deposit outflows weighing on their decision to tighten further.

Overall credit stress remained mild, with the system nonperforming loan (NPL) rate for total loans essentially unchanged from a year ago and below the long-term average. Credit cards and nonresidential real estate NPL rates increased from a year ago, while other categories saw an improvement or were slightly changed from a year ago. Community bank loan performance was also stable, with low NPL rates across all products. The NPL rate for total loans was slightly changed from a year ago, while the rate for C&I and some consumer loan products increased slightly from a year ago.

FIGURE 15: YEAR-OVER-YEAR CHANGE IN LOAN BALANCES, EXCLUDING PAYCHECK PROTECTION PROGRAM (PPP) LOANS



Source: Integrated Banking Information System (OCC)

** C&I growth for the second quarter of 2023 was -0.14 percent and was not referenced on the chart.

Note: Data are merger-adjusted and held constant from banks in continuous operation from the first quarter of 2015 to the second quarter of 2023. RE is real estate and CRE is commercial real estate. CRE includes commercial mortgages and construction loans. Total and C&I loans exclude PPP loans from all time periods. “Other consumer” is consumer loans less credit card loans.

SPECIAL TOPIC IN EMERGING RISKS – ARTIFICIAL INTELLIGENCE

Advances in computing capacity, combined with greater availability of data and improvements in analytical techniques, continue to expand opportunities for banks to leverage AI for various risk management and operational purposes. AI use cases have varied widely and include customer chatbots, fraud detection, and credit scoring. Generative AI in particular has garnered significant attention over the past year following the commercial availability of large language model tools that have made the use of generative AI more widely accessible. Many risks can arise from all types of AI, such as lack of explainability, reliance on large volumes of data, potential bias, privacy concerns, third-party risk, cybersecurity risks, and consumer protection concerns. The use of generative AI may pose additional risks including providing inaccurate responses that appear credible.

The potential for further benefits as AI gains more widespread adoption could be significant. Developments in the technology may reduce costs and increase efficiencies; improve products, services, and performance; strengthen risk management and controls; and expand access to credit and other banking services. Widespread adoption of AI, however, may also present significant challenges relating to compliance risk, credit risk, reputation risk, and operational risk.

Consistent with existing supervisory guidance, it is important that banks manage AI use in a safe, sound, and fair manner, commensurate with the materiality and complexity of the particular risk of the activity or business process(es) supported by AI usage. It is important for banks to identify, measure, monitor, and control risks arising from AI use as they would for the use of any other technology. Advances in technology do not render existing safety and soundness standards and compliance requirements inapplicable. Although existing guidance may not expressly address AI use, the supervision risk management principles contained in OCC issuances provide a framework for banks that implement AI to operate in a safe, sound, and fair manner.

The OCC is technology neutral and supports continuing efforts by national banks and federal savings associations to explore safe and sound uses of new and emerging financial technology such as AI. While AI has the potential to provide many benefits, the OCC is also mindful of the associated challenges and risks. The OCC will continue to monitor this rapidly evolving area, including generative AI use.

TRENDS IN KEY RISKS

A. CREDIT RISK

COMMERCIAL CREDIT THEMES

Commercial credit risk remains moderate and increasing. While recessionary pressures are easing, the consensus among economists is that the U.S. economy will experience slowing growth, which will affect vulnerable borrowers. Inflation remains elevated, and many economists predict that interest rates will remain higher for longer. Wages remain a primary cost driver, and companies in the service industries are the most affected by higher labor costs. Operating margin deterioration is particularly evident in senior living and health care facilities, which are experiencing both wage inflation and staffing shortages.

Elevated interest rates also continue to have an adverse impact on some companies' profit margins and cash flow. The companies most affected are those with high leverage and marginal repayment capacity, smaller and lower-rated firms with shorter debt maturities, firms with a higher level of floating debt, and firms with limited financial flexibility. An obligor on a maturing loan with a balloon payment will likely need to demonstrate a higher repayment capacity at renewal or refinance due to higher debt costs and, for CRE loans, lower property values could also lead to the need for re-margining. Renewed loans should be appropriately risk-rated. The liberal use of extensions and renewals could mask credit weaknesses and obscure a borrower's inability to meet reasonable repayment terms. Generally, risk ratings are driven by the strength of the primary source of repayment rather than collateral value or strength of guarantor.

The Federal Reserve has not ruled out additional federal funds rate hikes if inflation remains elevated. Manufacturing production and new order indexes are declining. Further rate hikes would continue to increase the cost of business investment and consumer goods, placing downward pressure on demand. Demand-side shocks for industries and companies already under stress from high input costs or higher interest rates create the potential for a rapid and sustained decline in cash flow and profitability. The sustained period of price increases will likely serve as a drag on revenues for a wide range of industries, particularly growth-dependent borrowers and industries that are dependent on consumer discretionary spending, if consumers significantly curtail spending across the board.

Credit quality metrics for CRE in some markets show signs of deterioration as persistent headwinds threaten asset quality and loan performance. CRE concentrations increased steadily over the past 18 months, and refinance risk is heightened due to higher debt costs and increases in operating expenses. Expenses, including utilities, property insurance, and taxes, are rising. Increasing debt costs are driven by higher interest rates and lower valuations. In June 2023, the OCC, the Federal Reserve, Federal Deposit Insurance Corporation, and National Credit Union Administration published the “Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts.” The final interagency policy statement updates and builds on existing interagency guidance on CRE loan workouts calling for banks to work prudently and constructively with creditworthy borrowers during times of financial stress.

Risk in the office market remains high and is expanding beyond urban business districts. Although risk remains highest in urban core markets, vacancy rates are rising for suburban submarkets. Data suggest that the office sector is experiencing significant structural shifts that could take several years to fully materialize as new remote work practices normalize and office loans made before 2020 mature. Leases reflect smaller footprints for businesses as tenants seek less square footage per employee. There is some resiliency in 5-star and newer buildings, but these leases often include concessions and, because of low demand, could negatively affect less well-situated properties. Retail and other small business real estate in urban business districts that are reliant on office worker foot traffic have higher and rising vacancy rates than suburban submarket peers.

Risk in the multifamily market is increasing, with higher vacancy levels due to a combination of new inventory and slowing demand. Mortgage delinquencies for multifamily properties remain low but are starting to increase. Multifamily real estate risk varies by market, property type, and other factors. Senior housing continues to struggle as health care worker shortages exacerbate real estate risk factors. Some parts of the United States, such as Phoenix and Salt Lake City, are experiencing an overbuild in luxury properties, which leads to further devaluation for older properties.

Other CRE markets remain sound but show signs of softening. The industrial market, which has been the best performing CRE segment, is also starting to exhibit some signs of slowing. Overall industrial vacancy rates remain low, and it is uncertain whether the market is reaching an inflection point or reverting to a normalized level. Just as with other CRE property types, however, rising interest rates will have a negative impact on cash flows and valuations and will increase project financing costs. While some retail property types have stabilized, regional malls continue to struggle.

A heightened risk environment could strain the resources of credit risk review and loan workout functions. Retirements and other attrition, coupled with an extended benign credit period, have decreased the number of bankers with problem loan identification and mitigation experience. Credit risk review functions may need to adjust sampling methodologies to capture higher risk industries or segments, borrowers who become constrained under stress test scenarios, or borrowers who exhibited marginal repayment capacity at origination or during stronger economic conditions. Workout functions could experience quickly increasing workloads that warrant additional experienced staff. Regardless of whether problem loans are part of a formal loan workout, accurate and timely risk ratings are a key factor in successful credit risk management and are critical for problem loan mitigation.

RETAIL CREDIT THEMES

Retail credit performance remains satisfactory and has largely normalized across all asset classes. Lagging asset quality indicators have largely returned to pre-pandemic levels and remain in line with long-term averages. Portfolio growth moderated, with banks reported to have tightened underwriting standards earlier in 2023 in response to uncertain economic forecasts. Credit risk, including rising credit card and auto delinquencies, is moderate and remains manageable. Effective risk management practices, including stronger residential real estate underwriting since the Great Recession and the low rate refinancings done during the pandemic, will support homeowners' repayment ability and better position banks to manage through current economic challenges.

The strong labor market, rising wages, manageable debt levels, and elevated, but declining, cash reserves enabled U.S. consumers to withstand costs associated with the level of inflation and rising interest rates. Credit card and auto delinquencies, however, increased in most banks in 2023 and are increasing. More material credit deterioration is evident in banks with higher risk appetites and more nonprime strategies. Retail net charge-offs, primarily driven by credit cards, have increased steadily each quarter for the past year. The most vulnerable segments of households continue to be those in lower income brackets, on a fixed income, or more highly leveraged. Higher interest rates on new originations and upward adjustments on variable rate debt, along with the potential for declining asset values, could place additional pressure on certain consumer and mortgage borrower segments and loan vintages.

The resumption of federal student loan payments in October 2023 and the discontinuation of other government support programs pose uncertainty regarding the potential impacts on some borrowers' ability to pay. The new Saving on Valuable Education (SAVE) program is anticipated to reduce student loan payment shock by limiting payments to 5 percent of discretionary income, increasing the amount of income considered non-discretionary, and accelerating loan forgiveness. Banks should evaluate the risk that consumers' student loans payment resumption may impact repayment of their other bank loans. Additional considerations include the risk inherent in new loan applications where missed student loan payments will not be reported to the credit-reporting companies as delinquencies, and borrowers will not be considered in default for the next year.

Residential real estate loan portfolios demonstrate satisfactory performance. Consumer home loans reflect sound underwriting; and overall portfolio risk metrics reflect satisfactory support from the level of homeowner equity. Stress testing vulnerable vintages, segments, and geographies, on variables such as unemployment, declining collateral values, and inflation impacts on disposable income, is an effective tool to identify weaker portfolio segments. If identified, weaker segments warrant monitoring, incremental adjustments to underwriting, and an emphasis on safe and sound principles in the execution of loss mitigation programs to provide prudent, affordable, and sustainable borrower payment assistance.

Borrower payment assistance programs for retail loan products take many forms. Effective loss mitigation programs accurately address financial hardship and underwrite the loan to the borrower's willingness and ability to pay the debt. Prudent programs verify the borrower's sources of income, total debt, and contractual payments, which support affordability and should result in sustainability of the borrower's ability to repay their debt.

Loss mitigation programs based on unverified information and lacking sufficient repayment analysis are inappropriate, and reliance on extended amortization, extensions, and deferral of unpaid amounts reflect a borrower's lack of repayment capacity and may not be in the best interest of the borrower or the bank. Imprudent loss mitigation programs can result in less effective risk oversight and reporting. Bank management should remain focused on accurate and timely risk identification utilizing delinquency reporting, risk rating, loss recognition, and financial reporting.

B. MARKET RISK

The speed and magnitude of rising rates have materially influenced depositor behavior and rate sensitivity in direction and magnitude inconsistent with historic observations. Banks are facing significant deposit competition from higher-yielding choices as well as reduced broader market liquidity, which may further pressure banks' deposit retention and growth strategies. Deposit competition has pushed rates higher and resulted in increasing usage of higher cost CDs, brokered deposits, and borrowings. Banks' NIM could be further pressured from continued market liquidity contraction, high and steady or increasing short-term rates, and a continued increasing trend in deposit rates and funding costs.

Deposits as a percentage of assets in OCC-supervised institutions stabilized at 79 percent through the third quarter of 2023 after trending down from a peak of 82 percent at year-end 2021. This stabilization was supported by increased brokered deposit and wholesale funding usage. Between year-end 2022 and September 30, 2023, borrowings in OCC-supervised institutions increased \$172 billion (29 percent) and brokered deposits increased \$258 billion (55 percent). Rising deposit rates and increased reliance on wholesale funding significantly increased funding costs through the third quarter of 2023. Banks with assets under \$1 billion had a 91 basis point (131 percent) increase in funding costs while banks with assets over \$1 billion saw a 112 basis point (100 percent) increase. Increased funding costs observed in 2023 compressed NIMs in smaller institutions, despite rising asset yields, after significant NIM expansion in 2022. The median NIM (quarterly annualized) in banks with assets between \$10 billion and \$50 billion declined 35 basis points to 3.14 percent, while banks with assets less than \$10 billion saw a reduction of 22 basis points to 3.30 percent. Banks with assets greater than \$50 billion actually had a modest improvement of 6 basis points in the third quarter, bringing median NIM to 3.10 percent and nearly back to the 3.12 percent observed at year-end 2022.

Stress testing and sensitivity analyses of deposit assumptions remain critical given recent trends in deposit movement and rates as well as uncertainty regarding depositor behavior moving forward. Banks may experience continued pressure to raise deposit rates contemporaneously and at higher levels than forecasted relative to market rate changes to grow or retain deposits. These factors may continue to compress margins, elevate risk to earnings, and present new challenges for banks to model and project deposit rates and balances in both interest rate and liquidity risk stress testing scenarios. Inaccurate deposit assumptions will render model results unreliable and may mask banks' true interest rate risk and liquidity risk profiles. Unreliable model projections and stresses may result in higher-than-forecast funding costs, potentially unexpected liquidity shortfalls, and imprecision in balance sheet hedging.

Sound liquidity risk management, including processes that ensure sufficient committed capacity to meet contingent liquidity needs, remains critical. Asset liquidity stabilized in 2023 and has been buoyed by increased wholesale funding reliance. Unrealized losses in OCC-supervised institutions' investment portfolios were negatively impacted by continued increases in the 10-year U.S. Treasury rates and remain a concern. The current elevated levels of bank investment portfolio depreciation could exacerbate risk exposure, particularly if security sales are required to meet funding outflows. Unrealized losses (as a percentage of amortized cost) in OCC-supervised institutions' available for sale (AFS) portfolios increased in the third quarter of 2023 and remain elevated at 8 percent, while unrealized losses in held-to-maturity (HTM) portfolios increased to 16 percent. Unrealized investment portfolio losses highlight the importance of operational readiness to monetize securities in a timely manner in case liquidity needs arise, to avoid recognizing unrealized losses. Examples include repo lines, Federal Home Loan Bank (FHLB) capacity, and access to Federal Reserve facilities. Regular testing and capacity assessments will help ensure these sources remain accessible. This is particularly important for banks with large HTM holdings, as sale of these securities can taint the portfolio and lead to recognition of losses.

C. OPERATIONAL RISK

CYBERSECURITY

Operational risk continues to be elevated as cyberattacks evolve and become more sophisticated and pervasive to the U.S. economy. Continuing cyberattacks and current geopolitical tensions highlight the importance of heightened threat monitoring and safeguarding against disruptive attacks targeting the financial sector. Over the past year, there has been an observed increase in distributed denial of service (DDoS) attacks against the financial sector. Some of the increase may be attributed to politically motivated attacks while others are financially driven, coupled with extortion demands.

Ransomware actors continue to affect the sector by targeting banks and their third parties. These attacks have the potential to affect banks and market operations by rendering critical data inaccessible as well as by threatening the confidentiality of customer data through data leaks. Single cyber campaigns have demonstrated the ability to compromise hundreds of organizations and affect a significant number of consumers. Threat actors continue to leverage phishing emails and texts targeting employees and compromised credentials to gain access to networks through remote access solutions. Such unauthorized access would enable threat actors to conduct ransomware and other extortion campaigns that can affect bank customers. Malicious actors have also continued to use DDoS attacks to target the financial sector. Threat actors continue to exploit publicly known software vulnerabilities and weak authentication controls at targeted organizations, including banks and financial service providers. To mitigate against cyber risks, it is important for banks to adopt heightened threat and vulnerability monitoring processes and implement effective security measures, including the use of multifactor authentication (MFA), hardening of systems configurations, and timely patch management.

The OCC continues to see cybersecurity incidents that exploit weak or poorly configured authentication controls and practices. Recent attacks suggest that banks using single-factor authentication or relying on weak security methods may face increased risk of unauthorized access to information systems, potential

operational disruption, data compromise, or financial loss. The OCC encourages banks to conduct thorough risk assessments that include authentication practices. When consistently implemented, properly configured, and combined with other layered security controls, MFA can provide an enhanced level of protection and help prevent attacks on bank systems.

INNOVATION AND ADOPTION OF NEW PRODUCTS AND SERVICES

Banks continue to leverage new technology and innovative products and services to further their digitalization efforts and to meet evolving customer demand and expectations. Examples of innovations include faster and real-time payment products, increased use of mobile and digital technologies to deliver financial services, application programming interfaces, data aggregation services, AI, and contactless payment devices. While these products and services and their underlying technologies can offer many benefits to banks and their customers, they also contribute to a complex operating environment along with increasing compliance, reputational, strategic, and other risks. It is important to assess how technology can be leveraged to fuel rapid deposit outflows and how the use of social media and other digital channels may accelerate communications. Banks are also reminded to implement appropriate due diligence, change management, and risk management processes when considering changes to products, services, and operating environments.¹³

Banks have approached AI adoption cautiously, with a wide range of use cases. The use of AI has the potential to reduce costs and increase efficiencies; improve products, services, and performance; strengthen risk management; and expand access to credit and other banking products and services. AI systems may, however, present particular challenges related to bias and discrimination. For example, these systems may perpetuate or exacerbate the results of historical discrimination if they are improperly trained or used with data sets that reflect biases or past discrimination practices. Use of generative AI is becoming more accessible with the introduction of commercially available large language models. Like with all new or expanded products, services, and relationships, appropriate risk management processes, including due diligence and change management, are needed.

Banks and service providers continue to face challenges with maintaining legacy technology architectures while responding to increasing digitalization demands. It is important for banks to maintain appropriate operational resilience for on-premises and critical third-party technology architecture, commensurate with the size and complexity of products, services, and operations being supported. An effective operational resilience strategy can enhance a bank’s ability to mitigate disruption from all hazards, including cyber threats, and other technology and operational outages.

Sound risk management practices can help safeguard against fraud, financial crimes, and operational errors. While traditional payment channels, such as checks and wire transfers, continue to be targeted, increasing digitalization of products and services can also heighten risk of fraud and error, including fraud targeting P2P and other faster payment platforms. While P2P payment platforms can provide enhanced capabilities

13 Refer to OCC Bulletin 2017-43, “New, Modified, or Expanded Bank Products and Services: Risk Management Principles.”

and convenience to consumers for managing payments, the faster and streamlined payment capabilities and the irreversible and irrevocable nature of these payments have also been used to perpetuate consumer fraud. Banks can aid customers by strengthening controls, educating customers on potential scams, and enhancing internal fraud monitoring capabilities. Examiners will continue to assess how banks are managing these and other risks related to changes in operating environments driven by these innovations.

The OCC continues to approach crypto-asset products, services, and activities cautiously for a variety of reasons, including high volatility, high-risk lending, excessive leverage, interconnectedness, concentration within the crypto industry, and lack of comprehensive regulation. Banks are reminded to follow the process outlined in [OCC Interpretative Letter 1179](#) before engaging in permissible crypto-asset-related activities.¹⁴

THIRD-PARTY RISK MANAGEMENT AND OTHER OPERATIONAL RISKS

Digitalization and technological innovation continue to advance the trend of banks outsourcing technology operations and banks entering partnerships or other arrangements with third parties, including fintech firms, to deliver innovative financial products and services. For example, increasing adoption of cloud services in the financial sector, as noted in a recent U.S. Department of the Treasury report, is allowing banks to gain efficiencies, but also can present risk if not implemented properly.¹⁵ The complexity of bank-fintech partnerships is also increasing as the volume of new entrants within the fintech ecosystem continues to grow. Effective management and oversight are important for third-party relationships. Third-party risk management processes should be commensurate with the size, complexity, and risk profile of the bank and with the nature of the third-party relationship. It is also important for banks to engage in more rigorous oversight of third-party relationships that support higher-risk and critical activities. In addition, it is important for banks to maintain talent management strategies to ensure sufficient resources and subject matter expertise to implement critical controls. Given demand for staff with specialized experience and technical expertise, it may sometimes be necessary for banks to engage with a third party.

14 Refer to OCC Interpretive Letters [1170](#), [1172](#), and [1174](#) for permissible crypto-asset activities.

15 Refer to the Treasury Department's [The Financial Services Sector's Adoption of Cloud Services](#) (February 2023).

D. COMPLIANCE RISK

BANK SECRECY ACT/ANTI-MONEY LAUNDERING AND OFFICE OF FOREIGN ASSETS CONTROL COMPLIANCE RISKS

Banks continue to adopt or consider fintech relationships related to product and service offerings, and it is important that they effectively manage the resulting operational and compliance risks, including third-party risk management. It is important that banks understand the benefits and risks associated with each third-party relationship, with particular focus on relationships that involve higher-risk or critical activities, and that they enter into effective contracts addressing the potential for default and termination. It is also important for banks to identify potentially nested relationships where a fintech firm may be providing services to other fintech firms without appropriate controls. As the range of payment methods and their accessibility continue to expand and evolve, for example with the launch of instant payments via FedNow, it is important that banks continuously evaluate their BSA/AML risks and corresponding controls to keep pace with new or changing risk profiles.

While banks continue to expand their digital and electronic products, services, and capabilities, they should be aware of related risks, including a recent alert issued by the Financial Crimes Enforcement Network (FinCEN) highlighting a prominent virtual currency investment scam known as “pig butchering.” Banks also should remain vigilant against traditional financial crime risks. There have been significant increases in fraud, as highlighted in both a FinCEN alert on the nationwide surge in mail theft-related check fraud schemes, and a FinCEN analysis identifying threat patterns and trends related to business email compromise in the real estate sector. FinCEN also has noted increases in payroll tax evasion and worker’s compensation fraud in the construction sector.

Suspicious activity report (SAR) data trends reflect significant increases in SAR filings related to fraud. Effective processes to prevent, identify, and file SARs in a timely manner, including fraudulent activity, remain important to protect financial institutions, consumers, and the financial system, as indicated by the fact that fraud is one of FinCEN’s National AML/CFT Priorities. Banks’ responsibilities under the current Customer Due Diligence and Beneficial Ownership Rule and other existing BSA requirements remain unchanged, pending the issuance of changes to those regulatory requirements as required by the AML Act of 2020.

CONSUMER COMPLIANCE AND COMMUNITY REINVESTMENT ACT/FAIR LENDING (CRA/FL) RISKS

Banks continue to face heightened attention and focus on ensuring equal access to credit, and fair and consistent treatment of consumers as they adapt to changing customer needs and preferences related to product, service, and delivery channel offerings. Risks are compounded if changes are not delivered or implemented in a fair or equitable manner. Banks’ compliance risk management frameworks should be

commensurate with their existing risk profiles and capable of efficiently and effectively supporting risk profile changes. Additionally, as interest rates continue to rise, banks may experience an increase in relief requests under the Servicemembers Civil Relief Act on certain obligations or liabilities incurred before the servicemember entered military service. In particular, borrowers may seek relief for adjustable-rate credit products such as credit cards and for eligible auto payments.

On October 24, 2023, the OCC, the Federal Reserve, and the FDIC issued a final rule to strengthen and modernize regulations implementing the CRA. The effective date of the rule is April 1, 2024, with key provisions of the final rule going into effect on January 1, 2026, and January 1, 2027. It is important for banks to plan for changes that become effective on April 1, 2024, and to implement change management processes as appropriate to address the potential impact of the rule on bank systems and resources.

E. CLIMATE-RELATED FINANCIAL RISK

FINAL INTERAGENCY PRINCIPLES FOR CLIMATE-RELATED FINANCIAL RISK MANAGEMENT FOR LARGE FINANCIAL INSTITUTIONS

On October 24, 2023, the OCC, FDIC, and Federal Reserve issued final Interagency Principles for Climate-Related Financial Risk Management for Large Financial Institutions that provide a high-level framework for the safe and sound management of exposures to climate-related financial risk for financial institutions with total consolidated assets over \$100 billion. The principles support large financial institutions' efforts to focus on key aspects of climate-related financial risk management, providing a high-level framework for climate-related financial risk management consistent with the agencies' existing rules and guidance.

OBSERVATIONS OF LARGE BANKS' MANAGEMENT OF CLIMATE-RELATED FINANCIAL RISK

As noted in our Spring 2023 *Semiannual Risk Perspective*, the OCC has been conducting supervision activities at its largest banks (those with over \$100 billion in total assets) to understand the banks' climate-related financial risk management programs. This work is well underway and will continue in 2024. As we stated in the spring, the large banks have been making progress to incorporate climate-related financial risks in their risk management frameworks and policies. At the same time, the large banks overall have significant additional work to do to move those programs to maturity.

Observations to date include:

- Efforts to incorporate climate-related financial risk in strategic planning remain in the early stages of development.
- Most of these banks are also still in the early stages of integrating climate-related financial risk into their broader risk appetites, and some have developed quantitative risk appetite metrics.

- Banks are reporting on climate-related financial risk to senior management and the board and indicated that reporting will become more detailed moving forward.
- Banks continue to face challenges and limitations on obtaining granular data for their climate-related financial risk analysis.
- Banks have generally developed or are planning to implement climate-related credit risk assessments to evaluate borrowers' and clients' exposures to high-risk sectors and industries.
- Banks are in the very early stages of understanding the impacts of climate change and ways to mitigate climate-related financial risk on low- and moderate-income communities they serve. Bank management teams generally have focused their initial work on the physical risks (e.g., flooding) of residential real estate.

SUPERVISORY ACTIONS

The OCC communicates supervisory concerns to a bank's board and management in the form of matters requiring attention (MRA), which consist of one or more supervisory concerns. MRA concerns include practices that deviate from sound governance, internal control, or risk management principles. Such deviations, if not addressed appropriately, could adversely affect a bank's financial condition or risk profile, or result in violations of laws or regulations, leading to enforcement actions. The chart below shows the composition of outstanding MRA concerns.

FIGURE 16: OUTSTANDING MRA CONCERNS

OPEN CONCERNS - PRIMARY RISK

