

SEMIANNUAL RISK PERSPECTIVE

.....
FROM THE NATIONAL RISK COMMITTEE

SPRING 2024

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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 system² 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 spring 2024 SARP report presents data in four main areas: the special topic, operating environment, bank performance, and trends in key risks.

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

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- 1 Throughout this report, the term “banks” refers collectively to national banks, federal savings associations, and federal branches and agencies.
- 2 Refer to footnote one as this term collectively refers to national banks, federal savings associations, and federal branches and agencies. This represents all OCC supervised banks.

EXECUTIVE SUMMARY

KEY TAKEAWAYS

- ▶ The condition of the federal banking system remains sound. It is important for banks to continue identifying material risks and their interconnected impacts. Continuous risk management improvement remains appropriate as this allows banks to guard against complacency.
- ▶ The economy outperformed forecasts in 2023. Consumers, supported by a robust labor market and record wealth, continued to support economic activity.
- ▶ However, the maturing economic cycle may cause consumer headwinds. Job openings and quit rates have been declining and the cooling job market may negatively affect wage growth. A slowing labor market, high interest rates, and sticky inflation could cause consumer financial stress and reduce consumption.
- ▶ Despite the Blue Chip Consensus projecting a “soft landing” for the U.S. economy and core inflation to slow, the persistence of an inverted yield curve and possibility of prolonged elevated rates highlight the continued importance of prudent interest rate risk management.
- ▶ While higher interest rates provided a lift to loan yields and margins earlier in the year, funding pressures also took hold in the higher rate environment. The outlook for the remainder of 2024 relies on banks’ ability to manage funding costs, weaker loan growth, and higher credit costs.

KEY RISK THEMES



CREDIT RISK is increasing. Commercial real estate (CRE) sectors, primarily the office sector and some multifamily property types, are experiencing stress due to a higher-rate environment and structural changes. Office and multifamily loans, particularly those with interest-only terms, set to refinance over the next three years pose additional risk. Sticky inflation and elevated interest rates may increase financial stress in some households and weigh on overall consumption growth.



From a **MARKET RISK** perspective, net interest margins (NIMs) are under pressure due to strong deposit competition. However, trends observed indicate that pressure on funding costs and NIMs may be nearing a peak. The future direction, timing, and extent of rate movements and uncharted depositor behavior present risk management challenges. Wholesale funding usage continued to grow, albeit at a slower pace going into 2024. Investment portfolio depreciation improved, but unrealized losses remain elevated as banks continue to increase asset liquidity and interest rates remain elevated.



OPERATIONAL RISK is elevated. The financial industry is responding to an evolving and increasingly complex operating environment. Cyber threats continue as malicious actors target the financial services industry and their key service providers with ransomware and other attacks. Increasing digitalization, new and innovative product and service adoption, and third-party use increase bank operating environment complexity, creating both opportunities and risks. Continued check and wire transfer fraud and increased payment fraud incidents both underscore the importance of fraud risk management.



Banks are operating in a dynamic banking environment because of changing customer needs and preferences related to products, services, and delivery channels. Risks are compounded if products and services, including changes, are not delivered or implemented in a fair and equitable manner. It remains important for banks to maintain a compliance risk management framework that is commensurate with their risk profiles and capable of growing and evolving as their risk profiles change. Fraud continues to be a significant risk for banks. Effective processes to prevent, identify, and file suspicious activity reports (SARs) on fraudulent activity in a timely manner remain important to protect both banks and consumers. As banks work to process checks and other payments in a safe, fair, and efficient manner, check and wire fraud and P2P transaction scams have become more prevalent. The OCC continues to assess banks' Community Reinvestment Act (CRA) performance under the 1995/2021 regulatory framework.



The OCC has been conducting discussions with banks with more than \$100 billion in total assets to understand climate-related financial risk management programs. A current observation from these reviews notes that banks are at an early stage in analyzing the effects of insurance affordability and availability challenges.

SPECIAL TOPIC – FIRMWIDE RESILIENCE EFFORTS

The 2024 Spring SARP special topic highlights the importance for banks to prioritize firmwide resilience³ efforts as risks may be interconnected and events could simultaneously affect multiple risk categories. It is crucial that banks establish an appropriate risk culture that identifies potential risk,⁴ particularly before times of stress. A stress event could manifest through operational and/or financial events and have institution-specific or sector-wide impacts. These stress events could manifest from a regional catastrophic weather-related event (i.e., major hurricane), sudden or sustained loss of investor confidence due to asset quality concerns, cyber incidents, or any number of other events. Each stress event may vary (e.g., operational, liquidity, credit, compliance, and other) and resiliency implications need to be proactively considered. Prudent planning from a firmwide perspective can enhance a bank’s ability to maintain operations, remain financially sound, and service customers in times of stress.

PROACTIVELY RESPONDING TO CREDIT RISK

The ability to proactively understand and respond to potential increased credit risk during times of stress remains a prudent resilience-planning component. Recognizing concentrations early and developing effective strategies for managing concentration risk enhance financial resilience. Developing an allowance for credit loss (ACL) methodology that results in an appropriate reserve balance also adds to financial

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3 Resilience recognizes the bank’s ability to withstand periods of stress. [Comptroller’s Handbook, “Bank Supervision Process.”](#)

4 From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank’s current or projected “financial condition” and resilience. Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity. Comptroller’s Handbook, “Bank Supervision Process.”

resilience. The ACL process should reflect a forward-looking assessment of the risks in the loan portfolio that considers the current operating environment and includes appropriate adjustments, such as changes to qualitative factors, recalibration, or model redevelopment, to address potential modeling underprediction.

FINANCIAL RESILIENCE THROUGH CONTINGENCY PLANNING: LIQUIDITY RISK MANAGEMENT AND CAPITAL PLANNING

A significant liquidity risk management component includes contingency funding planning. Prudent contingency funding planning bolsters financial resiliency during times of stress and market volatility. Operationally ready contingency funding sources, as part of effective contingency funding planning, are essential to mitigate potentially unexpected liquidity shortfalls. Establishing contingent funding sources prior to liquidity stress events is important given the time requirements to establish and operationalize funding sources and pledge collateral. It is also critical that management have the operational capability to monitor, mobilize, and monetize collateral in the event certain contingent sources are reduced or no longer available. Ongoing operational testing of processes necessary to access each contingent funding source is critical to ensure the ability to access sources timely and efficiently.⁵

Effective contingency planning includes robust capital planning. Capital planning is a dynamic and ongoing process that, to be effective, generally is forward looking in incorporating changes in a bank’s strategic focus, risk tolerance levels, business plans, operating environment, and other factors that materially affect capital adequacy. Prudent capital planning should include developing a strategy to maintain capital adequacy and build capital during times of stress. This includes identification of credible mechanisms and strategies for capital preservation and enhancements to remain financially resilient.

OPERATIONAL RESILIENCE AND BUSINESS CONTINUITY PLAN

Banks are exposed to a wide range of potential disruptive events, including technology-based failures, cyber incidents, pandemic outbreaks, and natural disasters. While advances in technology have improved banks’ ability to identify and recover from various types of disruptions, cyber threats are increasingly sophisticated and interdependencies with counterparties and service providers are growing. These operational risks highlight the importance for banks to ensure continued maintenance of effective operational resilience.

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5 [OCC Bulletin 2023-25, “Liquidity: Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management.”](#)

Sound operational resilience includes identifying critical operations and core business lines and mapping interdependencies within a bank’s organization and with significant third parties. Increased interconnectedness and interdependencies across the financial industry elevate the threat of a single participant’s outage, creating broader sector disruption.⁶ This underscores the importance of banks and service providers maintaining sound operational resilience plans. For banks with more than \$100 billion in total assets, management should consider how climate-related financial risk exposures may affect a bank’s operations, control environment, and operational resilience.⁷

Business continuity plans addressing resilience of critical operations and core business lines should assess the risk and impact of different disruption scenarios, including severe but plausible scenarios. Business continuity plans address response, recovery, and resumption of critical operations under different scenarios to meet recovery expectations within board-approved risk appetites. Business continuity plans address backup and recovery of critical data and are tested on a regular basis, including testing significant third-party dependencies.

ENSURING COMPLIANCE DURING A DISRUPTIVE EVENT

Compliance risk management programs should consider operational resilience and the bank’s ability to deliver products and services during disruptions, while ensuring compliance with consumer protection laws and regulations. The identification and management of compliance risks related to third-party relationships are vital to operational resilience. It is important that banks implement secure and resilient information systems that can enhance their ability to withstand disruptions or failures, including those that can adversely affect compliance management.

6 OCC Bulletin 2020-94, [“Operational Risk: Sound Practices to Strengthen Operational Resilience.”](#)

7 OCC Bulletin 2023-33, [“Risk Management: Principles for Climate-Related Financial Risk Management for Large Financial Institutions.”](#)

OPERATING ENVIRONMENT

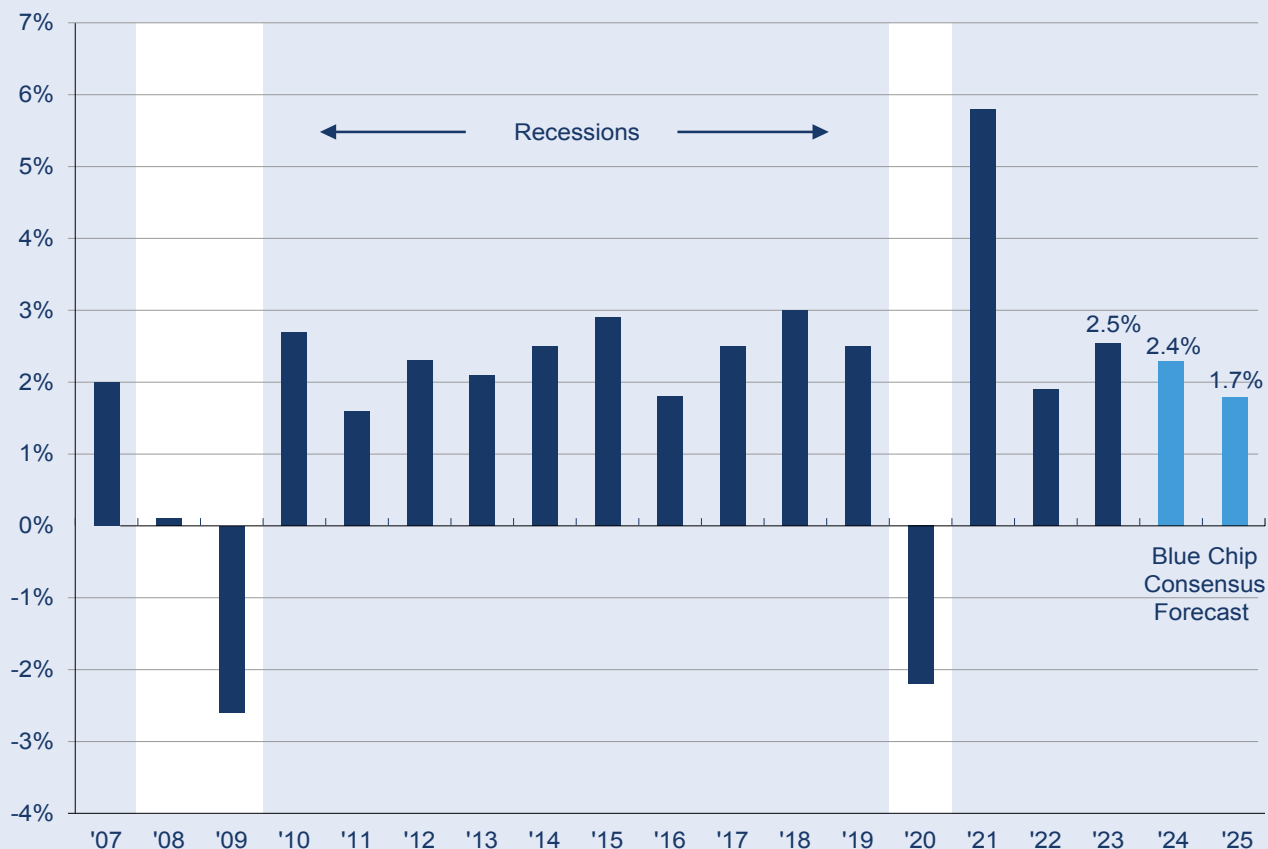
U.S. ECONOMIC EXPANSION CONTINUES AT A SOLID PACE, BUT GROWTH IS EXPECTED TO SLOW

In the fourth quarter of 2023, real gross domestic product (GDP) growth slowed to a 3.4 percent annual pace from 4.9 percent the previous quarter. The fourth-quarter GDP slowdown, however, was far less of a pullback than expected. The resilient economy consistently outperformed forecasts in 2023. Consumers, supported by a strong labor market and record wealth, continued to support economic activity. Government support also assisted growth.

Despite the strong fourth quarter, growth is expected to cool in 2024, although there is a high degree of uncertainty surrounding the GDP outlook. Both consumption and investment growth are expected to downshift as the economy likely has yet to feel all the restraint from previous monetary tightening efforts. Stimulative fiscal policy also contributed to the unexpected strength in real activity in 2023, but policy is likely to be significantly less expansionary in 2024.

The Blue Chip Consensus currently forecasts that real GDP will decrease to 2.4 percent in 2024 on a full year-to-year basis, down from 2.5 percent in 2023. Growth is then expected to slow further, to 1.7 percent in 2025. See figure 1.

FIGURE 1: REAL GDP, PERCENT CHANGE ANNUAL RATE

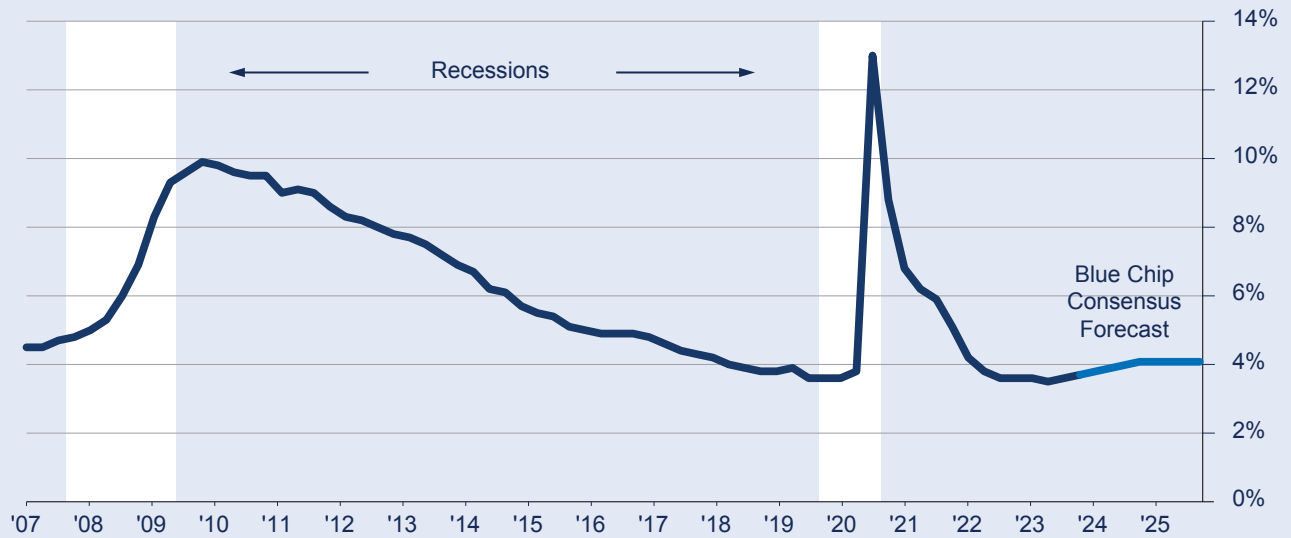


Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators (April 2024)

Interest rate-sensitive activity in the household sector has held up better than in earlier tightening cycles, which helped the economy consistently beat expectations. These sectors are key channels through which tighter monetary policy restrains the economy. For example, housing starts rebounded in the fourth quarter due to a scarcity of existing homes for sale; as many homeowners locked in low borrowing costs in recent years, they are reluctant to sell. In the auto markets, a shortage of semiconductors held down vehicle inventories and sales after the COVID-19 pandemic, resulting in pent-up demand that has supported car sales. In addition, the share of household debt that adjusts with market rates has fallen and is at its lowest point in decades. Furthermore, interest expense as a share of nonfinancial corporate profits has also trended downward. This helped to support a solid 4.2 percent gain in real capital spending over the past year despite higher interest rates.

The labor market remains robust as the hiring pace continues to exceed expectations. The economy added a monthly average of 276,000 nonfarm payroll jobs in the first quarter of 2024, a noticeable acceleration from the pace seen in the last half of 2023. However, there are indications that the labor market may be cooling. For example, the unemployment rate averaged 3.8 percent in the first quarter of 2024, up from 3.5 percent in the same period a year earlier. The Blue Chip Consensus expects the unemployment rate to rise to 4.1 percent by the close of 2024 and to remain there through 2025. See figure 2.

FIGURE 2: QUARTERLY AVERAGE UNEMPLOYMENT RATE



Sources: Bureau of Labor Statistics (4Q 2023), Blue Chip Economic Indicators (April 2024)

In March 2024, average hourly earnings were running 4.1 percent over March 2023 levels, versus a far higher 5.9 percent in March 2022. Inflation has cooled from its peak in 2022, but it is running higher than the Federal Reserve Board’s target of 2 percent. In the first quarter of 2024, inflation as measured by the personal consumption expenditures (PCE) price index was running at 2.6 percent. The increase in the core PCE price index, which excludes the volatile components of food and energy, came in slightly higher at 2.9 percent. The Blue Chip Consensus forecast is for moderating inflation, with the core PCE index falling to 2.2 percent by the end of 2024 and to 2.1 percent by the end of 2025. See figure 3.

FIGURE 3: CORE PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX, QUARTERLY PERCENT CHANGE



Sources: Bureau of Labor Statistics (4Q 2023), Blue Chip Economic Indicators (April 2024)

Note: Historical data are shown as quarterly year-on-year percent changes. Forecast data are shown as seasonally adjusted annualized quarterly rates.

The Federal Reserve Board held interest rates steady in December 2023 for the fourth consecutive meeting, maintaining the target range for the federal funds rate at 5.25 percent to 5.5 percent. Officials noted they did not expect a reduction in the target range until they had “greater confidence that inflation was moving sustainably towards 2 percent.” The Blue Chip Consensus expects the three-month Treasury yield to come down steadily, falling to around 3.4 percent by the close of 2025 as inflation continues to ease. The 10-year Treasury yield is also projected to edge down, settling at 3.7 percent by the end of 2025. The yield curve is currently inverted (as of April 22, 2024, the three-month Treasury bill yield was 5.4 percent, well above the 10-year Treasury note yield of 4.6 percent). And based on the trajectory of the Blue Chip Consensus forecast, the yield curve will remain inverted through the middle of next year, at which point it is projected to resume a normal, though fairly flat, shape.

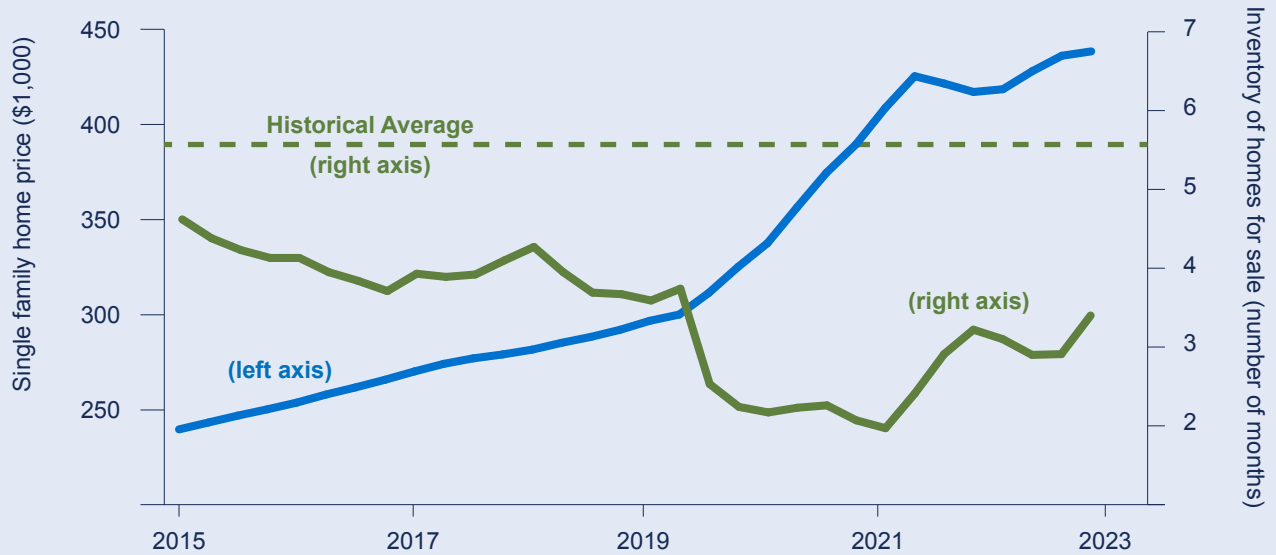
Inverted yield curves have long been considered a signal of a recession, and in all but one Federal Reserve Board tightening cycle since the mid-1950s, an inverted yield curve has been followed by a recession within 13 months on average. Despite the persistence of the current inverted yield curve, the Blue Chip Consensus continues to project a “soft landing” for the U.S. economy. It is possible that post-pandemic effects may have lessened this inversion’s predictive power. Nevertheless, investors expect short rates to fall, whether due to a recession or a “soft landing.” In either scenario, inflation would slow to the Federal Reserve Board’s target and the policy rate would ease, which would allow the yield curve to move toward a normal upward slope.

DESPITE AFFORDABILITY CHALLENGES, RESIDENTIAL REAL ESTATE PRICE GROWTH CONTINUED DURING 2023 AS LOW INVENTORY OF HOMES FOR SALE PERSISTED

National home prices continued their growth trajectory in the second half of 2023, increasing by more than 5 percent, mainly due to a low inventory of homes for sale. Home inventory, measured as months of supply, grew in late 2023 and exceeded three months by December 2023; it was still more than 2 months below the historical average level. This constrained home supply helped support prices even when demand declined as home buyers grappled with affordability challenges.

FIGURE 4: U.S. SINGLE-FAMILY HOME MARKET: PRICES, INVENTORY, AND PRICE CHANGES

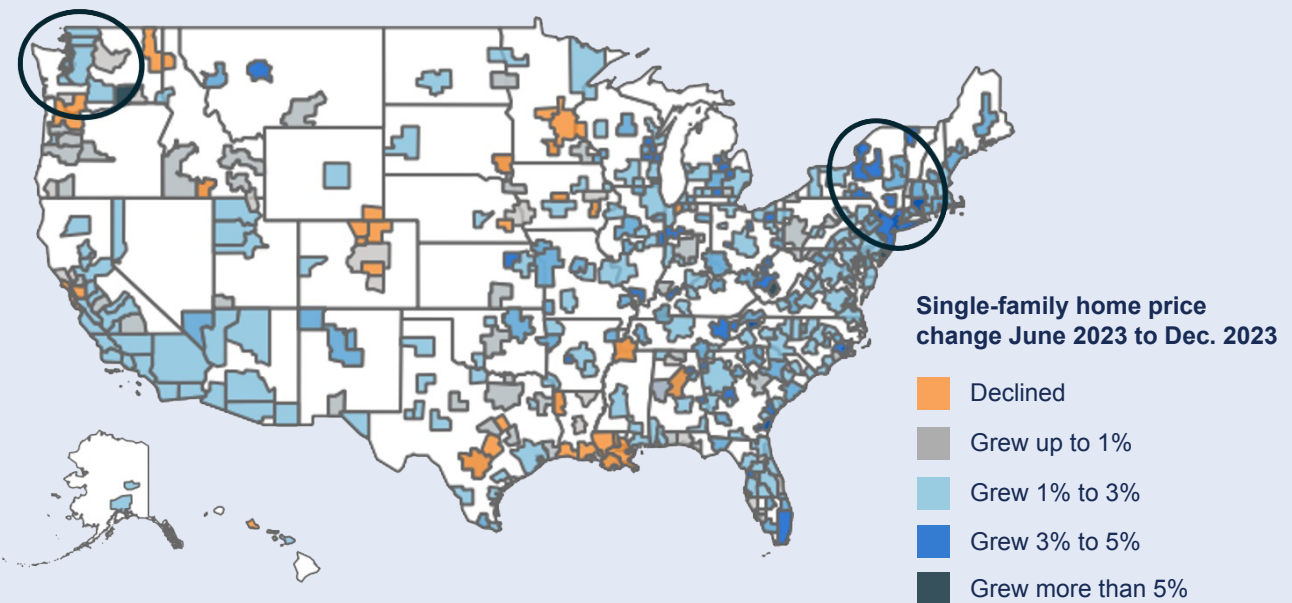
MONTHLY AVERAGE U.S. SINGLE-FAMILY HOME PRICES IN \$000S AND NUMBER OF MONTHS OF INVENTORY OF HOMES FOR SALE



Sources: ICE, NAR, Moody's Analytics (August 2023)

Most metropolitan areas saw home price growth between June 2023 and December 2023, with the largest home price growth concentrated in Washington state, New Jersey, and New York metros. See figure 5.

FIGURE 5: CHANGES IN SINGLE-FAMILY HOME PRICES BETWEEN JUNE 2023 AND DECEMBER 2023

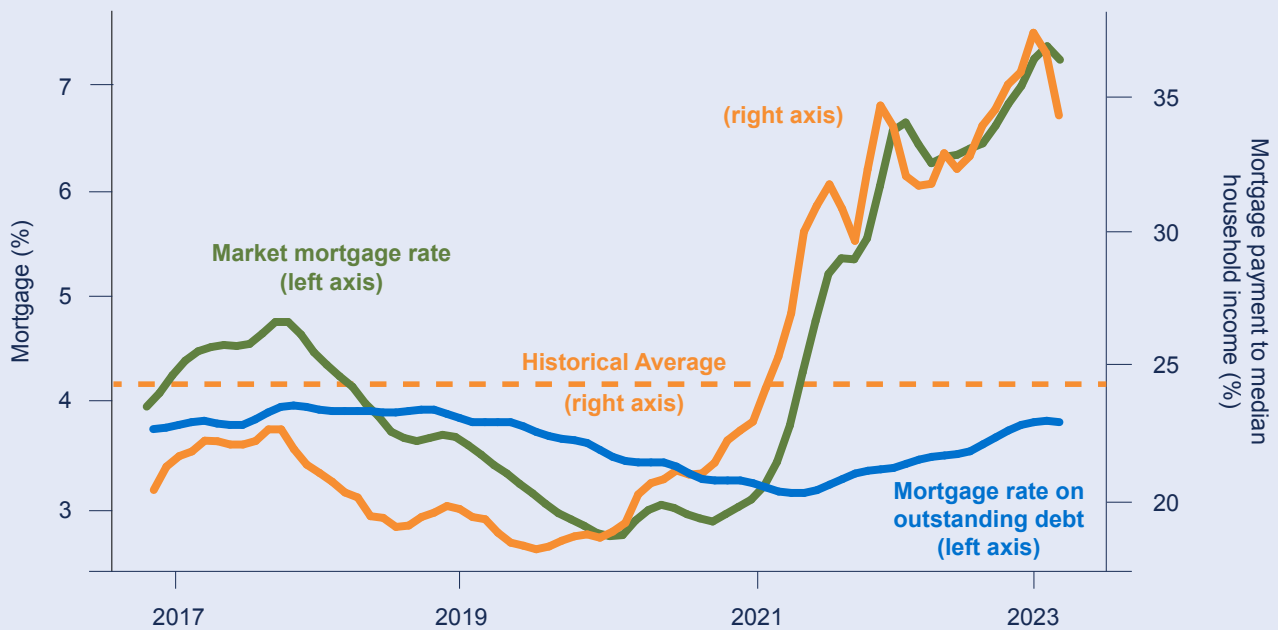


Sources: ICE, NAR, Moody's Analytics (August 2023)

Home sales declined as supply and demand waned. See figure 6. When interest rates on most homeowners' mortgages are more than 300 basis points lower than market rates, as they were in December 2023,⁸ homeowners are less motivated to put their houses on the market, which curtails the supply. At the same time, higher interest rates and higher home prices priced some prospective home buyers out of the market, tempering demand. The share of the median household income needed for the mortgage payment of an average priced home peaked at 37 percent in October 2023. Though mortgage rates have declined slightly since, this share remained more than 10 percentage points above its historical average.

FIGURE 6: U.S. HOUSING MARKET TRENDS: HOME SALES AND MORTGAGE RATES

U.S. 30-YEAR MORTGAGE RATE, AVERAGE MORTGAGE RATE ON OUTSTANDING DEBT, AND MORTGAGE PAYMENT TO MEDIAN HOUSEHOLD INCOME RATIO (%)

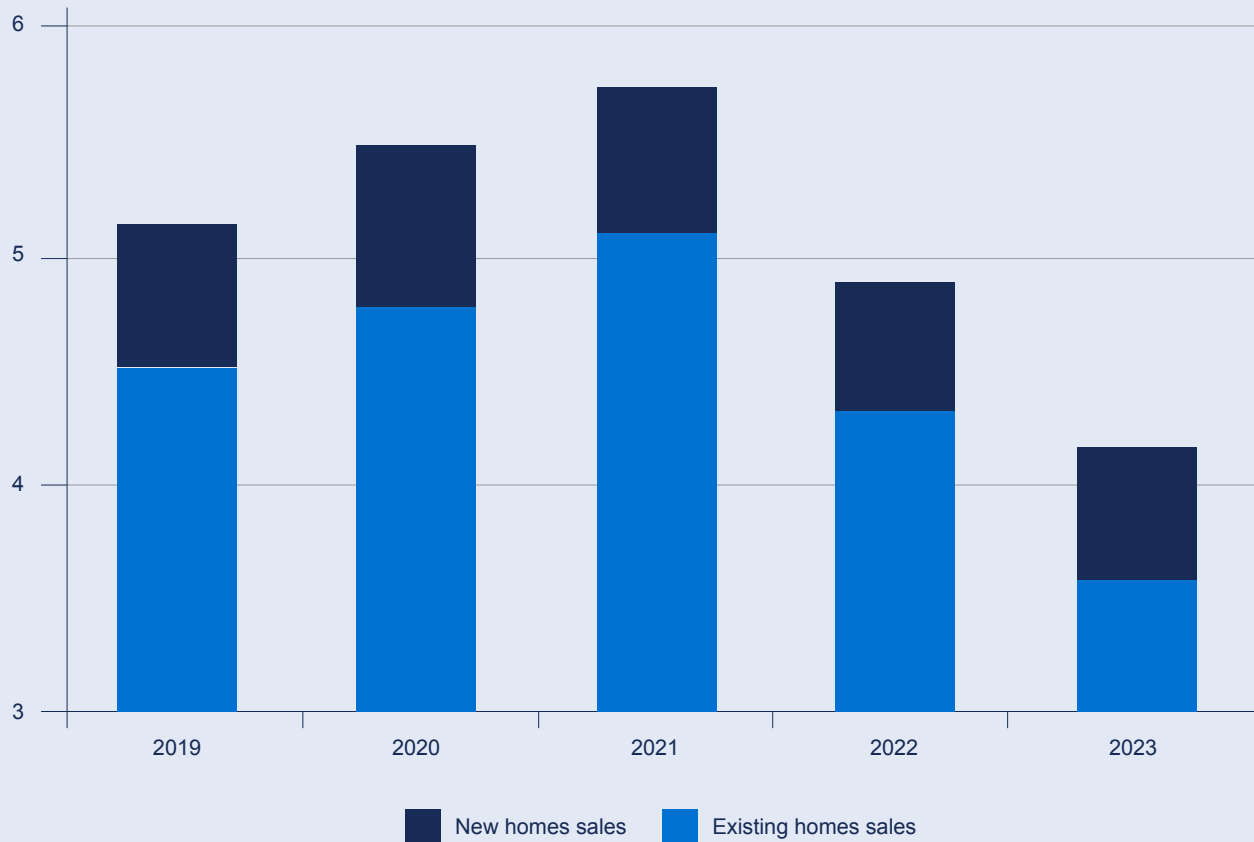


Sources: ICE, Freddie Mac, Census Bureau, NAR, Moody's Analytics (updated August 2023)

Note: Represents prices of nondistressed transactions; ICE computes discount-corrected real estate-owned and short-sale prices and combines them with nondistressed sale prices. Mortgage payment is based on a 30-year fixed-rate fully amortized mortgage with a 20 percent down payment. The mortgage payment only included contributions toward mortgage principal and interest. The ICE Home Price Index level is used as the base price for the market average property. The conventional mortgage rates for all loans from the U.S. Federal Housing Finance Board is the rate used for the mortgage calculation.

8 In December 2023, the average mortgage rate on outstanding mortgages was 3.77 percent and the market-offered mortgage rate was 7.23 percent.

FIGURE 7: U.S. HOME SALES (IN MILLIONS)



Sources: ICE, Freddie Mac, Census Bureau, NAR, Moody’s Analytics (updated August 2023)

THE CONSUMER REMAINS RESILIENT

Buoyed by solid employment and wage growth, consumers continued to spend in 2023. On a nominal basis, spending on services was up 6.5 percent year-over-year growth versus 3.5 percent growth on goods spending. Most of the growth in service spending was due to increases in housing costs. On a price-adjusted basis, service spending was up only 2.3 percent in 2023 and spending on goods was up 3.4 percent. The robust labor market has also allowed the consumer to increase their savings rate from 5.5 percent in 2022 to 6.3 percent in 2023.

Strong growth in asset prices helped increase the net worth of households and nonprofit organizations by 8 percent last year. However, the maturing economic cycle may cause consumer headwinds. Job openings and quit rates have been declining, and there are some early signs of softening in the job market, which may ultimately have a negative impact on wage growth. A slowing labor market, high interest rates, and sticky inflation could cause consumer financial stress and reduce consumption.

ECONOMIC INDICATORS ARE MIXED FOR THE OFFICE, MULTIFAMILY, AND INDUSTRIAL CRE SECTORS

Remote and hybrid work arrangements showed little change in 2023, continuing to weigh on office occupancies.⁹ The office sector incurred seven consecutive quarters of negative net absorption, pushing the vacancy rate to a new high of 13.5 percent. See figure 8. On the supply side, higher interest rates and construction costs contributed to a drop in new office building starts in 2023, which is likely to restrict deliveries once the properties currently under construction are completed. The imbalance between demand and supply has weighed on office sector rent and net operating income (NOI) growth. Investors continue to pull back from the sector, causing the national average office property price to drop by about 13 percent from its late 2021 peak, with an additional 15 percent decline expected by year-end 2025. Office properties in urban business districts have experienced the most deterioration in fundamentals, but market stress spread to suburban locations over the past year. The deterioration in economic indicators has also affected property values in certain markets.

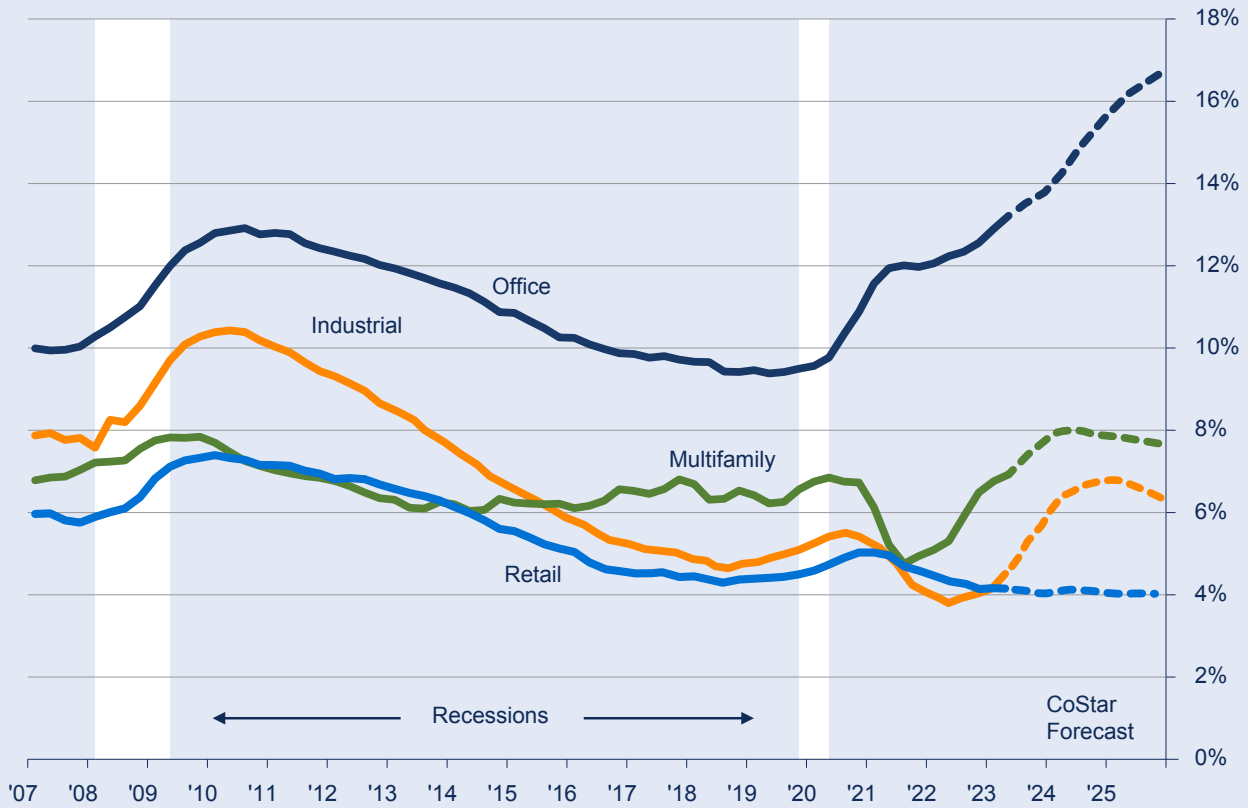
The multifamily sector experienced deteriorating fundamentals in 2023. The national average vacancy rate increased in the fourth quarter of 2023, reaching 7.6 percent from 6.5 percent a year ago, driven largely by a supply surge in the south, southeastern, and mountain markets. See figure 8. Rising vacancies were not the only headwind, as higher interest rates and operating expenses weighed on NOI growth, especially in markets with rent control regulations (e.g., New York City) that limit landlords' ability to quickly raise rents. Multifamily fundamentals are forecast to improve in late 2024 as population growth and fewer construction starts will help bring demand and supply into better balance.

The industrial property sector normalized in 2023. The boom in e-commerce sales pushed demand for industrial properties to a historic high in 2021 and 2022, but net absorption quickly returned to normal levels last year. Net completions, however, climbed throughout 2023 and reached the highest level ever recorded in the fourth quarter. This imbalance pushed up the national average vacancy rate to 5.7 percent from 4.3 percent a year ago. Fundamentals are forecast to stabilize in early 2025 as resilient consumer spending and new manufacturing facilities boost net absorption. Higher interest rates and construction costs have contributed to a sharp decline in industrial property starts, which should ease supply pressure in 2025.

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

FIGURE 8: COMMERCIAL REAL ESTATE VACANCY RATES BY SECTOR

CRE Vacancy rates, %



Source: CoStar Group (historical data through 4Q 2023, baseline forecast updated in January 2024)

CORPORATE PROFITS STRENGTHENED IN THE SECOND HALF OF 2023, BUT EARNINGS WERE CONCENTRATED IN A FEW LARGE TECHNOLOGY COMPANIES

After declining in the first quarter of 2023, corporate profits before tax stabilized in the second quarter and increased in the second half of the year.¹⁰ Most of the fourth-quarter gain can be attributed to the nonfinancial sector, which saw corporate profits before tax increase by \$137 billion, the largest increase since the second quarter of 2022.

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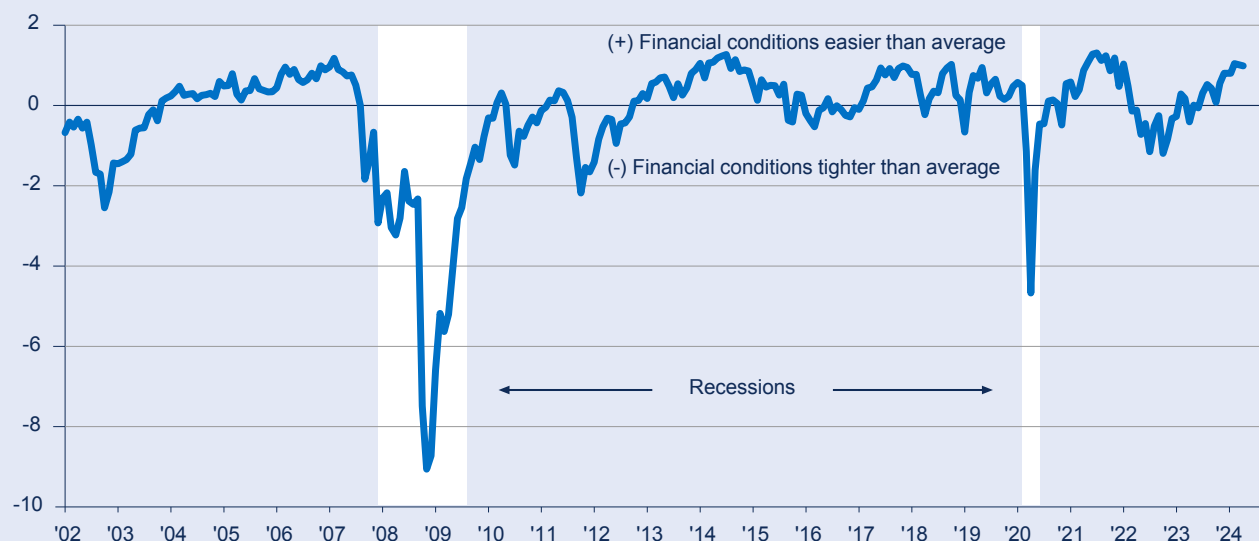
10 U.S. Bureau of Economic Analysis (corporate profits before tax with inventory and capital consumption adjustments; data through 3Q 2023).

For the fourth quarter, total earnings of publicly traded companies in the S&P 500 grew by 8 percent on a year-over-year basis.¹¹ However, earnings strength was concentrated among the “Magnificent 7” large technology companies.¹² Excluding these companies, total earnings growth among the remaining S&P 500 companies was negative in the fourth quarter compared with a year ago, although 60 percent of the S&P 500 firms had positive over-the-year growth. The industries with the largest over-the-year growth in the fourth quarter were communication services, utilities, and consumer discretionary while the energy, materials, and healthcare industries reported the largest losses.¹³ Looking ahead, anticipated interest rate cuts and softening wage growth are expected to support firms’ profit margins.

FINANCIAL CONDITIONS EASED

Financial conditions eased over the past two quarters. See figure 9. Given the stronger than expected growth and moderating year-over-year inflation, interest rates held steady near two-decade highs. Futures markets and forecasts have benchmark policy rates modestly declining this year, which may help support interest rate–sensitive sectors.

FIGURE 9: U.S. FINANCIAL CONDITIONS INDEX



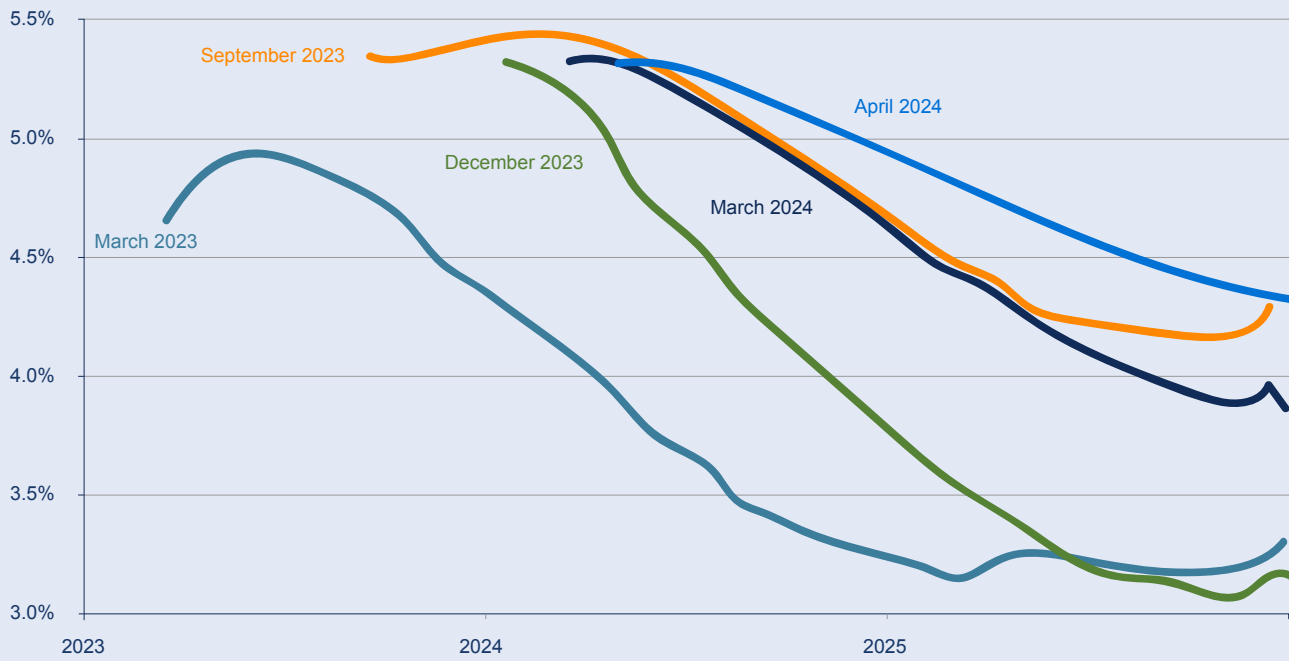
Sources: Bloomberg (data through April 24, 2024)

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.

11 Bloomberg (February 29, 2024).
 12 The “Magnificent 7” companies are Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.
 13 Bloomberg (February 29, 2024).

Risks to the U.S. financial market outlook remained muted in the first quarter of 2024. The Federal Reserve Board may decrease benchmark interest rates later in 2024, though the pace and timing are dependent on inflation dynamics. Market expectations, implied through federal funds futures, pared back estimates of interest rate cuts in 2024 as inflation readings in January, February, and March came in above expectations. See figure 10. Meanwhile, the central bank continued to reduce its holdings of Treasury and mortgage-backed securities. Funding through the Bank Term Funding Program ended on March 11, 2024, and minimal discount window borrowing has been observed. Banking system reserves have climbed since September 2023 but are forecast to slowly decline through 2025.¹⁴

FIGURE 10: IMPLIED FEDERAL FUNDS RATE FROM FEDERAL FUNDS FUTURES



Sources: Chicago Board of Trade, Bloomberg (data through April 24, 2024)

Treasury market yields modestly increased and prices declined since September 2023. The term spread, measured as the difference between 10-year note and three-month bill prices, steepened modestly in the last two quarters but remains negative. The deep inversion is historically associated with an elevated risk of recession over the next year,¹⁵ but it is also consistent with a decrease in benchmark interest rates due to achieving 2 percent inflation. Treasury market volatility, measured by the Bank of America Merrill Lynch MOVE index, was little changed at 110.21 as market participants priced in continued uncertainty about

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14 Federal Reserve Bank of New York’s Survey of Primary Dealers (March 2024).

15 As of April 24, 2024, the probability of recession implied by the 10-year note minus 3-month bill spread is 47.8 percent.

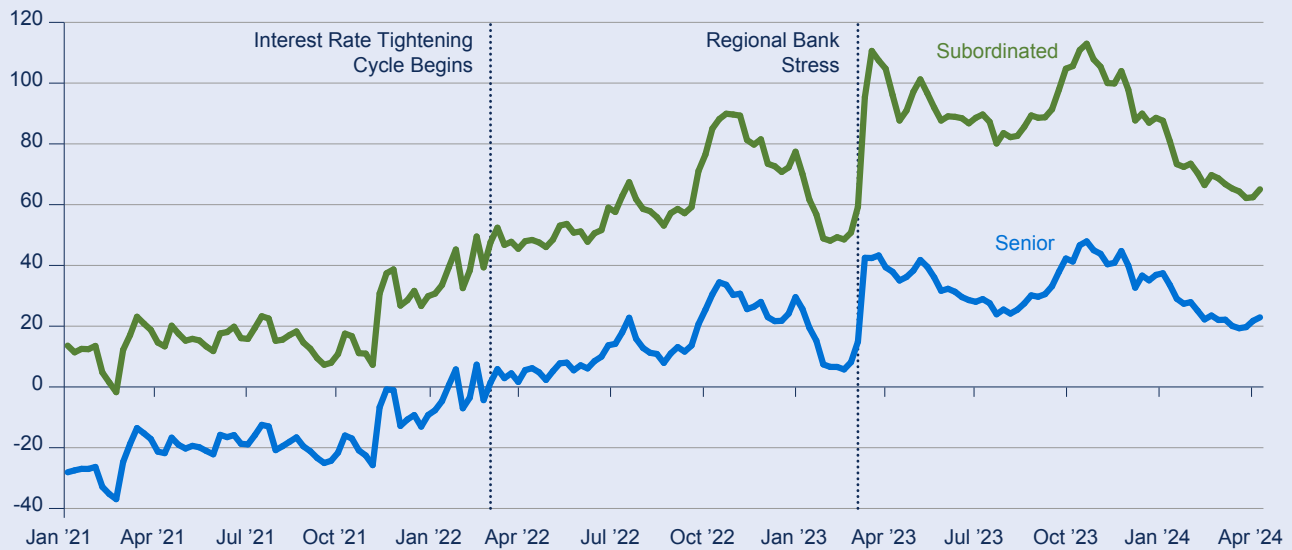
the path for interest rates and inflation dynamics.¹⁶ Money market funds have continued to shift assets into Treasury bills by partially drawing down funds from the Federal Reserve Board’s Overnight Reverse Repurchase Facility.

Equity markets rose to all-time highs as the potential for productivity gains from technological advancement and the potential for lower rates outweighed concerns over bumpy inflation readings in the first few months of 2024. Equity market volatility, measured by the S&P 500 VIX Index, fell significantly from year-ago levels but remained range-bound over the past six months.

Credit spreads tightened to two-year lows through the first quarter of 2024. Investment-grade and high-yield bond issuances increased through the first months of 2024 at a faster pace than in the first quarter of last year. Improved issuance trends likely reflect a strong economic outlook. This has resulted in a broad outperformance of speculative-grade companies’ bond securities over higher-rated peers this year. Option-adjusted spreads on both financial sector senior and subordinated bonds compared with their nonfinancial corporate peers declined over the past quarter, though remained wider since the beginning of the tightening cycle. See figure 11.

FIGURE 11: CORPORATE BOND MARKETS CONTINUE TO PRICE FINANCIAL SECTOR ISSUERS AS RISKIER THAN NONFINANCIAL PEERS

DIFFERENCE BETWEEN INVESTMENT-GRADE FINANCIAL AND NONFINANCIAL CORPORATE OPTION ADJUSTED SPREAD, BASIS POINTS



Source: Bloomberg (data through April 19, 2024)

Note: Series are calculated as the difference between the U.S. investment-grade corporate bond index excluding the financials option adjusted spread and the U.S. corporate bond financial senior or subordinated sector corporate option adjusted spread.

16 As of April 24, 2024.

There are several risks that may increase market risks in the next few quarters, including an increase of financial stability risks, reacceleration in inflation, further stress in select CRE sectors, and higher short-term interest rates for a longer period than currently anticipated by market participants. As of April 2024, most international equity indexes outperformed U.S. benchmarks this year. The U.S. dollar edged higher and remains historically strong against developed market peers when measured in inflation-adjusted terms on a trade-weighted basis.

GLOBAL OPERATING ENVIRONMENT

The global financial system continues to navigate multiple wars and geopolitical unrest in a changing economic environment. Although global economic growth in 2023 was supported by higher growth in the U.S. and large emerging market economies, there is persistent weakness in some of the largest economies including the United Kingdom, Germany, and China. Germany is vulnerable to economic weaknesses in China as trade has grown from 5 percent of GDP in 2000 to 20 percent in 2023. For China to reach the government's 5 percent growth target for 2024, growth would likely have to come from higher exports to offset declining activity in the property sector and falling infrastructure spending. The decrease in China's construction spending has reduced its imports of industrial commodities, affecting major commodity exporters in Latin America and Africa. Countries that manage their currencies against the U.S. dollar, or those whose domestic residents have borrowed in dollars, may be affected by the expected continued strength of the dollar in 2024.

Global inflation rates are declining and expected to fall further as the impact of pandemic-era monetary and fiscal policy stimulus continues to fade, commodity prices decline, and the pressure for wage growth weakens. Lower inflation rates should permit central banks to ease monetary policies. However, changes in monetary policies are very unlikely to perfectly align, and policy interest rates reduction differences may lead to capital flow shifts as investors rebalance investments from one country to another.

Although inflation is easing in the United States, this is not true across all countries, including those that are more susceptible to higher oil prices and shipping costs, which have risen due to reduced shipping via the Panama Canal and attacks in the Gulf of Aden. Some countries are experiencing double-digit inflation rates brought on by domestic policy choices. In these countries, risks from high inflation rates include sudden implementation of exchange rate restrictions and capital controls to stem capital outflows and currency depreciation.

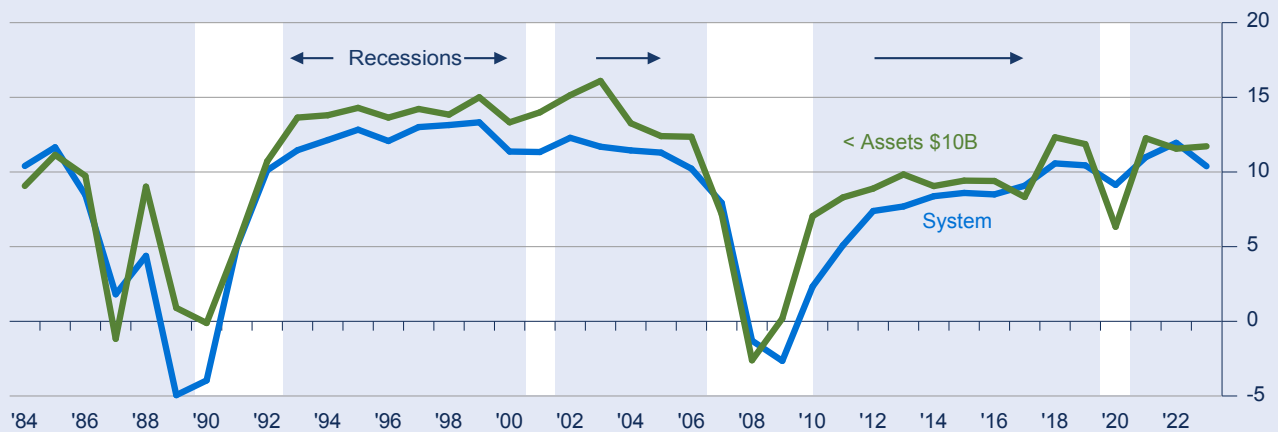
Foreign governments are also at risk from rising debt levels and an elevated interest rate environment. If higher interest rates continue to persist, governments and corporations will face higher debt servicing costs and pose greater credit risks as prior bond issuances are refinanced at higher interest rates.

BANK PERFORMANCE

BANK PERFORMANCE REMAINED RESILIENT IN 2023 AMID CHALLENGES

Profitability for the federal banking system, while showing signs of moderation, was resilient in 2023 as banks navigated an elevated interest rate environment, uncertain economic climate, and fallout from the failure of three regional banks in the spring.¹⁷ Return on equity for the federal banking system, driven by the largest banks, was slightly higher in 2023 at 11.7 percent, compared with 11.6 percent in 2022. For banks with assets of less than \$10 billion (hereafter, “community banks”), profitability was less robust and declined from 2022. See figure 12. While higher interest rates provided a lift to loan yields and margins earlier in 2023, funding pressures also took hold in the higher rate environment as the year progressed. The outlook for 2024 relies on banks’ ability to manage funding costs that could remain elevated, weaker loan growth, and higher credit costs.

FIGURE 12: TREND IN BANK RETURN ON EQUITY



Source: Call Reports from the OCC Integrated Banking Information System

Note: Annual data through year-end 2023. Banks with less than \$10 billion in total assets exclude credit card and trust institutions.

17 See [FDIC: Bank Failures in Brief \(2023\)](#).

While banks posted strong growth in net interest income (NII) in the first half of 2023, as margins benefited from higher interest rates, these benefits moderated in the latter half of the year. For the federal banking system, NII increased 13.8 percent in 2023 from a year ago; for community banks, NII advanced at a much slower pace of 4.9 percent. See table 1. In the fourth quarter, NII for the federal banking system declined slightly compared with the same period a year ago, -0.4 percent, reflecting margin pressures that intensified as funding costs rose.

Banks also continued to build reserves, and noninterest expense was higher than a year ago. For the federal banking system, provisions increased to \$62 billion in 2023, bringing the current pace of provisioning higher than it was pre-pandemic. The gains in asset–liability spread revenues for the federal banking system were enough to offset the reserve builds, higher operating costs, and moderating growth in NII. Overall, net income for the federal banking system increased 1.4 percent in 2023, while for community banks, net income declined 10.7 percent.

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

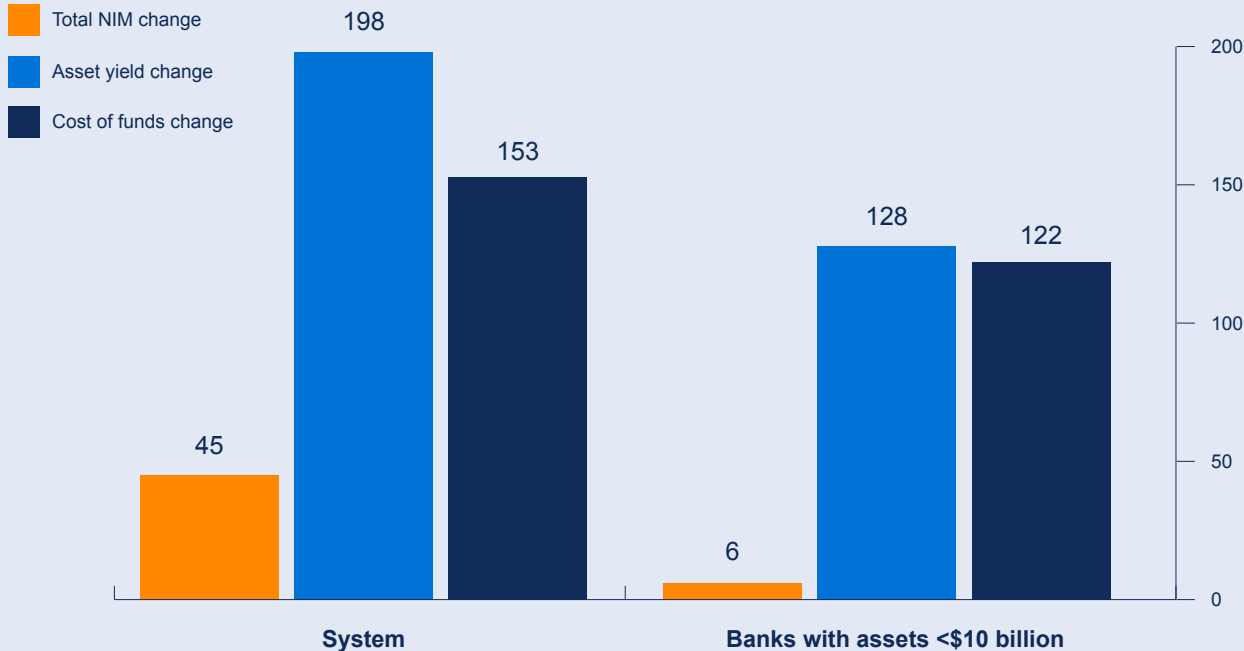
	Federal Banking System			Banks with total assets less than \$10B		
	2022	2023	Y/Y % change	2022	2023	Y/Y % change
Net interest income	405.35	461.14	13.8%	23.21	24.36	4.9%
Noninterest income	205.11	211.85	3.3%	9.14	8.52	-6.8%
Noninterest expense	361.64	393.15	8.7%	20.47	21.28	4.0%
Provisioning	34.53	61.80	79.0%	1.05	1.5	42.7%
Net income	169.76	172.12	1.4%	8.74	7.81	-10.7%

Source: Call Reports from OCC Integrated Banking Information System

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

The cost of funds increased significantly across the industry in 2023. When comparing the difference with year-to-date 2022 to 2023 NIM, the largest banks were still able to grow NIM from higher yields within the loan portfolio and other interest-earning assets. For banks with less than \$10 billion in assets, gains in asset yields were more muted, thus limiting year-to-date NIM growth. See figure 13.

FIGURE 13: CHANGE IN NIM COMPONENT, YEAR-TO-DATE 2022 TO 2023

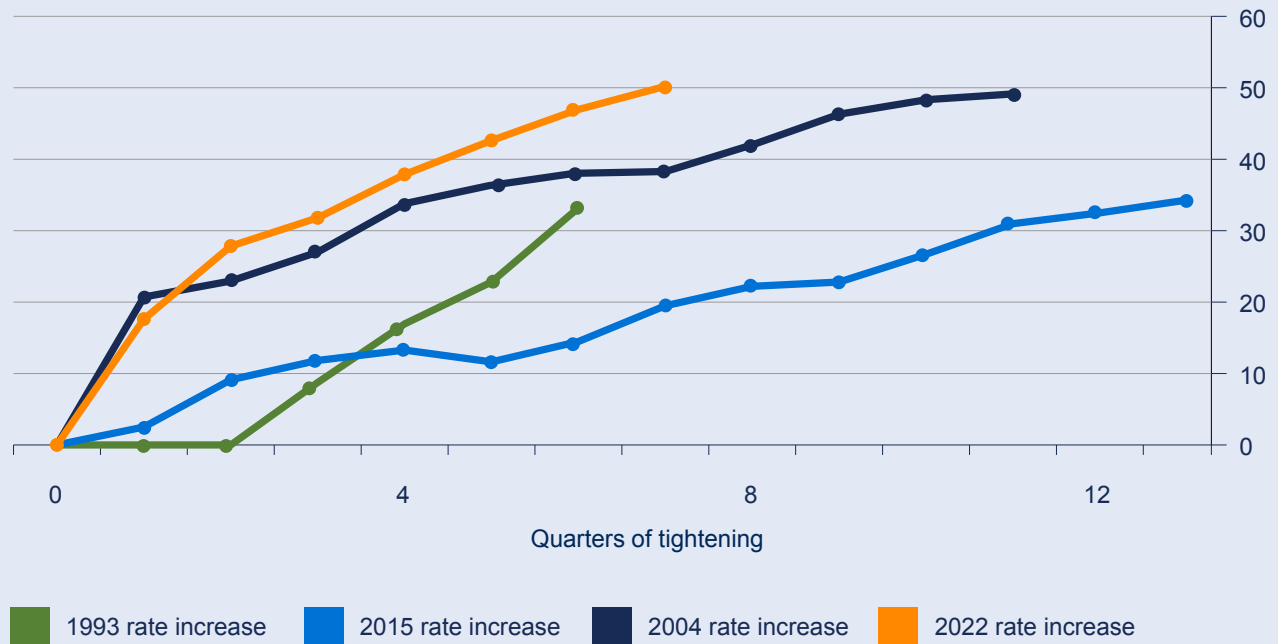


Source: Call Reports from OCC Integrated Banking Information System

Note: This chart represents the entire federal banking system and banks with less than \$10 billion in total assets excluding credit card and trust banks. The asset yield represents the difference in 2022 and 2023 year-to-date total interest income as a share of total earning assets expressed in basis points. The cost of funds change represents the difference in 2022 and 2023 year-to-date total interest expense as a share of total earning assets expressed in basis points. The charts express the year-over-year change in each NIM component. Data are merger-adjusted and held constant for banks in continuous operation from the first quarter of 2015 to the fourth quarter of 2023.

Funding costs accelerated significantly in 2023, catching up with the interest rate increases that began in 2022. Since the Federal Reserve Board began monetary tightening in March 2022, the cumulative seven-quarter deposit beta for the federal banking system, 51 percent, surpassed the cumulative beta at the same stage in the previous three rate tightening cycles. See figure 14. Even with interest rates expected to fall later in 2024, funding pressures could persist through 2024 as depositors shift into higher-yielding products.

FIGURE 14: CUMULATIVE DEPOSIT BETA FOR THE FEDERAL BANKING SYSTEM



Source: Call Reports from OCC Integrated Banking Information System

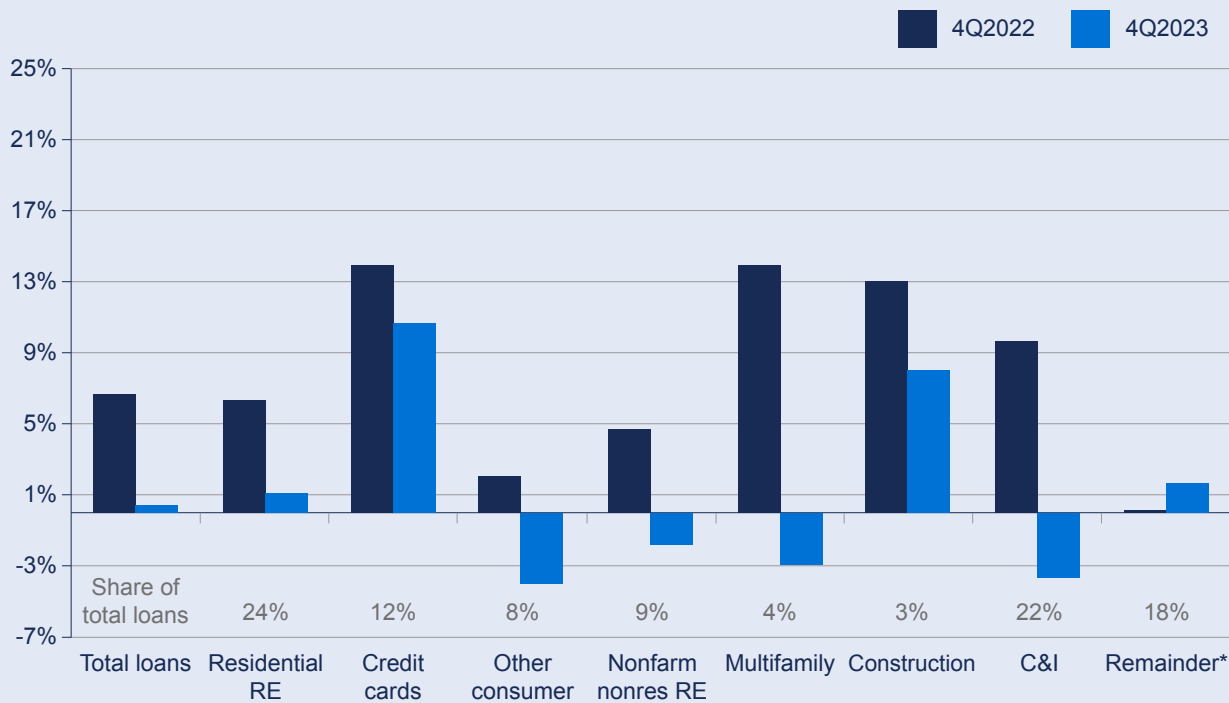
Note: Data are quarterly and merger-adjusted for institutions in continuous operation within each cycle. The beta measures the cumulative change in the annualized deposit rate (deposit expense as a share of interest-bearing deposits) over the cumulative change in the average effective federal funds rate.

As deposit costs rose in 2023, the composition of funding also changed with banks increasing their reliance on higher-cost sources of funding. For the federal banking system, uninsured deposits as a share of total liabilities fell, while nondeposit sources of funding increased. Deposit growth for the federal banking system was still slightly negative at the end of 2023 but has trended upward since the deposit outflows that occurred in the spring. For community banks, deposits were above the level of a year ago, increasing 1.4 percent.

For the federal banking system, growth in total loans has slowed since peaking in mid-2022 and was almost flat in 2023 from a year ago, increasing only 0.5 percent. For community banks, loan growth was more resilient, growing nearly 7 percent in 2023. As a result, community bank loan-to-deposit ratios have risen faster than those of the federal banking system, returning closer to pre-pandemic levels. The slowdown in loan growth for the federal banking system was due in large part to commercial and industrial (C&I) lending, which comprises 22 percent of total loans for the federal banking system and declined in 2023. See figure 15.

Growth in CRE loans—in particular, nonfarm nonresidential and multifamily properties—also experienced a slowdown from a year ago. Credit card lending was more resilient, increasing over 10 percent from a year ago, while growth in other types of consumer loans slowed. For community banks, loan growth was supported by residential real estate loans, which comprise 30 percent of total loans for community banks and grew over 12 percent.

FIGURE 15: YEAR-OVER-YEAR CHANGE IN LOAN BALANCES



Source: Call Reports from OCC Integrated Banking Information System

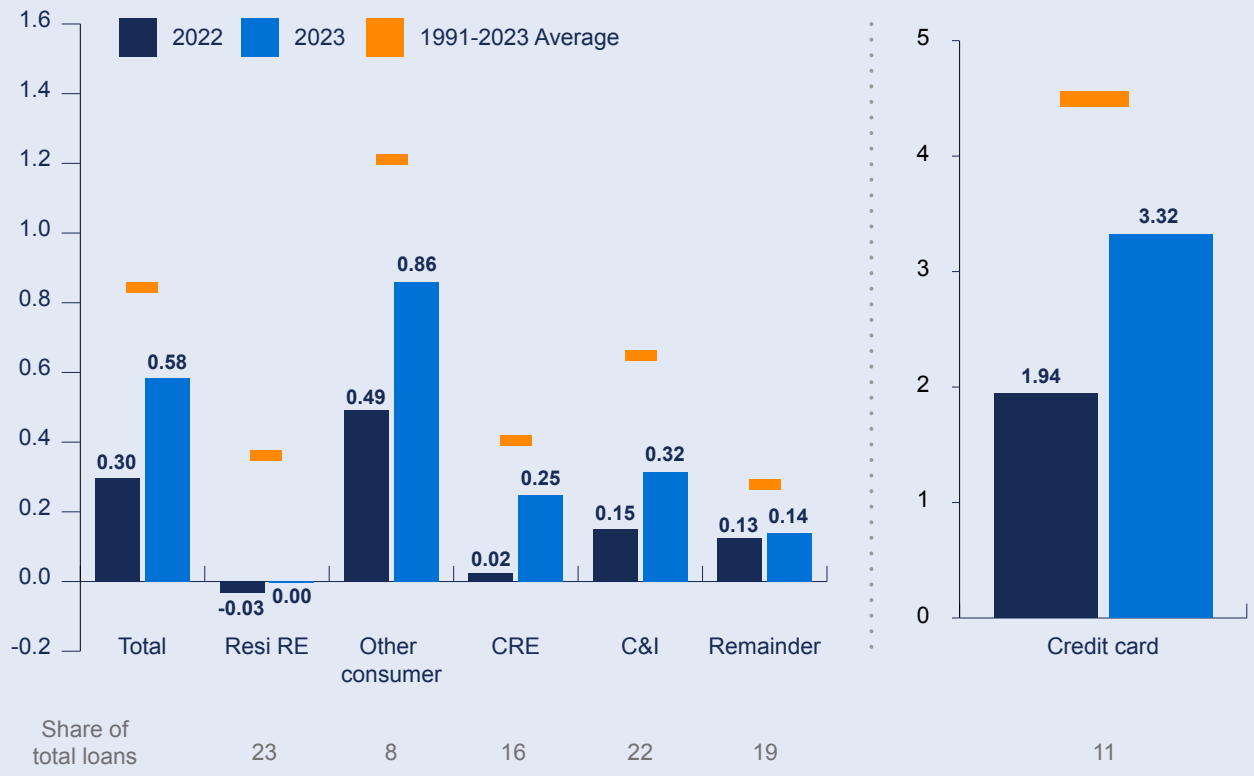
Note: Data are merger-adjusted and held constant from banks in continuous operation from the first quarter of 2015 to the fourth quarter of 2023. “Other consumer” is consumer loans less credit card loans. “Remainder” includes agriculture loans and loans to governments, banks, municipalities, etc.

According to the Federal Reserve Board’s January 2024 Senior Loan Officer Opinion Survey on Bank Lending Practices,¹⁸ banks reported tighter standards and weaker demand for C&I and all CRE loan categories in the fourth quarter of 2023. Banks also reported tighter lending standards and weaker demand across most categories of residential real estate lending, as well as credit card, auto, and other consumer loans. Regarding the outlook for 2024, banks reported expected lending standards to further tighten for CRE, credit card, and auto loans, while keeping lending standards essentially unchanged for C&I and residential real estate loans. In addition, banks reported expected demand to strengthen across all loan categories and a deterioration in loan quality across most loan types for 2024.

In 2023, credit performance deteriorated from historically low levels, but losses remain below the long-run averages. For the federal banking system, the net charge-off rate for total loans increased to 0.60 percent, compared with 0.30 percent in 2022. Increases in loan losses were most evident in CRE loan products, C&I, credit cards, and other types of consumer loans. For community banks, charge-offs also began to rise from historically low levels. Losses were most evident in consumer loans and C&I, while loan losses in CRE portfolios remained immaterial. See figure 16.

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

FIGURE 16: NET CHARGE-OFF RATES FOR THE FEDERAL BANKING SYSTEM



Source: Call Reports from OCC Integrated Banking Information System

Note: Data are merger-adjusted and held constant from banks in continuous operation from the first quarter of 2015 to the fourth quarter of 2023.

TRENDS IN KEY RISKS

A. CREDIT RISK

COMMERCIAL CREDIT THEMES

Commercial credit risk remains moderate and increasing. Some sectors of CRE, primarily the office sector and some multifamily property types, continue to experience stress due to increased expenses and property owners' limited ability to increase rents to offset rising costs. Elevated interest rates could have an adverse impact on some borrowers' cash flow and, while inflationary pressures are subsiding, many economists predict that interest rates will remain elevated over the next two years. CRE borrowers seeking to refinance maturing loans may need to re-margin through cash equity injections or by providing additional collateral due to higher debt costs and lower property values. Certain industries (including healthcare, publishing, textiles, and plastics manufacturing) are showing signs of strain. The companies most affected are those with higher leverage and marginal repayment capacity, smaller and lower-rated firms with near-term debt maturities, firms with a higher level of floating debt, and firms with limited financial flexibility.

CRE loan growth slowed, but concentrations continue to present heightened risk. Expenses, including utilities, property insurance, and taxes, are rising. Risk in the office market remains high and has expanded beyond urban business districts. The office sector is experiencing significant structural shifts that could take several years to fully materialize as remote work practices normalize and office loans made before 2020 mature. Although risk remains highest in urban business districts, classified and nonperforming loans are also increasing in other markets. New leases generally reflect smaller square footage and often include concessions as tenants seek less square footage per employee.

Risk in multifamily is increasing due to a variety of stressors. Broadly, rising interest rates, insurance costs, and other expenses are resulting in increased operating costs for many multifamily property owners; however, other risk drivers can vary by market, property type, and other factors. For example, in areas with rent control regulations, such as New York City and California, buildings with rent-regulated units might experience greater NOI compression due to a limited ability to offset rising costs. Some parts of the

southern and western United States, such as Nashville and Salt Lake City, are experiencing overbuilding in luxury properties, which leads to further devaluation for older properties. Office and multifamily loans, particularly those with interest-only terms, set to refinance over the next three years pose additional risk. This risk can be compounded in banks with concentrations in these exposures.

Other CRE property types remain sound but show signs of softening. In general, retail properties have stabilized, but regional malls and retail shops that depend on in-office workers continue to struggle. Warehouse loans are also starting to exhibit some signs of strain. Warehouse vacancy rates remain relatively low but have increased above the historically low levels experienced in 2022 and are expected to stabilize at a somewhat higher rate than before the COVID-19 pandemic.

The current operating environment remains challenging and 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 credit risk professionals with problem loan identification and mitigation experience. It is important for banks to ensure that staffing plans for workout functions are adequate. In addition, the allowance for credit costs drivers should continue to reflect a forward-looking assessment of loan portfolio risks that considers the current operating environment and includes appropriate adjustments, such as changes to qualitative factors, recalibration, or model redevelopment, to address potential modeling underprediction.

RETAIL CREDIT THEMES

Mortgage and retail credit performance remains satisfactory. While the direction of retail credit risk is increasing, loss forecasts indicate that delinquency and loss rates should moderate to longer-term averages. The persistent levels of inflation and interest rates plateauing at higher levels continue as key risk drivers. Mortgage loan delinquency and loss rates on loans held by national banks and federal savings associations are at historically low levels. Other retail credit performance, namely credit cards and auto loans, reflect delinquencies trending upward while many industry forecasts reflect delinquency and loss seasonal patterns reverting to longer-term averages.

Portfolio growth rate is contracting in the first part of 2024, coinciding with lower borrower demand and banks tightening underwriting standards in response to economic uncertainty. Headline nominal growth in credit card outstanding continues largely due to several years of high inflation. However, there are no signs consumers are systemically using credit cards to stretch borrowing, with total credit card debt as a share of disposable income remaining well below pre–Great Recession averages.

The robust labor market, rising real wages, and elevated savings have generally enabled consumers to withstand costs associated with the higher level of inflation and interest rates. Although several economic forecasts have reduced the probability of a 2024 recession, core inflation continues to exceed the target levels discussed by federal monetary policymakers and interest rates will likely plateau for an extended period. Credit risk drivers continue to include persistent inflation levels, higher interest rates on newly

originated loans with potentially weaker loan-to-value ratios, upward adjustments on variable rate loans, and borrower segments with more limited repayment capacity.

Due to continued economic and geopolitical uncertainty, management across the industry have reported tighter lending standards across most categories of residential real estate lending, as well as credit card, auto, and other consumer loans. As lending risk profiles change, increased portfolio monitoring may be warranted as well as appropriate allocation for risk within the ACL. Sound governance, transparency, and documentation of assumptions and judgments, including those for scenario selection and weighting, are critical to an adequate ACL.

Homeowners are facing payment increases. Home price appreciation is resulting in increased real estate taxes, while insurance costs are increasing due to appreciating home values, rising construction costs, and insurability issues related to climate-related events. Affordability pressures in some geographies are more material and may adversely affect borrowers' ability to repay debts. Based on the severity of the increase in homeowner obligations, payment increases may result in elevated credit risk that warrants enhanced risk identification, monitoring, and reporting. The resumption of federal student loan payments in October 2023 does not appear to have resulted in a far-reaching impact on federal student loan borrowers' ability to pay.

It is important for bank management to be vigilant in identifying, monitoring, and managing portfolio segments. Specific actions may include stress testing potentially vulnerable segments, vintages, and geographies, then adjusting underwriting standards and using loss mitigation and collection strategies based on stress-testing results. This would include monitoring the potential impacts on credit quality from changing vintage risk, plateauing interest rates, and the resumption of federal student loan debt payments.

B. MARKET RISK

Deposit competition remained strong through 2023 and exerted increased pressure on NIMs. Deposit repricing rates continue to catch up to the rapid effective federal funds rate increases in 2022 and 2023. Lower cost deposits are moving toward higher-yielding deposits or higher-yielding alternatives, resulting in certificate of deposit (CD) growth, higher wholesale funding usage, and NIM compression in 2023.¹⁹ CD growth and increased brokered deposit²⁰ usage helped to keep deposit levels stable in 2023 but at increased costs to banks. Funding costs and margin trends observed in the second half of 2023 indicate that deposit rate acceleration and NIM pressure may be nearing a peak. Banks continue to build asset liquidity, but investment portfolio depreciation remains a liquidity concern.

19 NIM in the "Market Risk" section of this report is referencing quarterly annualized NII divided by average earning assets. NIM compression was observed in 2023 when comparing quarterly annualized NII/average earnings assets between December 31, 2022, and December 31, 2023. This trend was more pronounced in banks with less than \$1 billion in total assets. See figure 17.

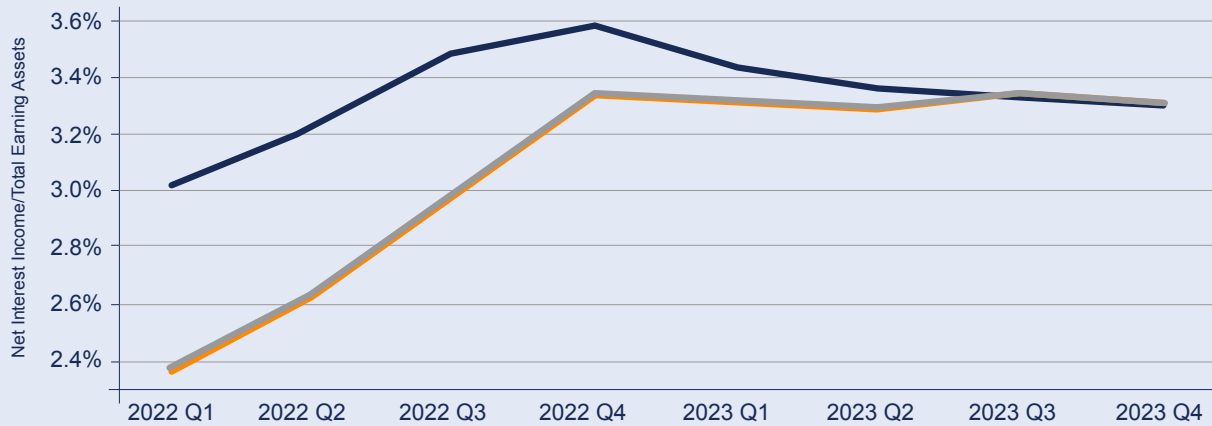
20 As defined in [12 CFR 303.243](#), "Brokered Deposits," and [12 CFR 337.6](#), "Brokered Deposits."

After a 2 percent decline to 79 percent of total assets in the first quarter of 2023, deposits in OCC-supervised banks remained stable for the remainder of 2023 due, in part, to increased brokered deposit usage. In addition to the modest overall decline in deposits in 2023, shifts in deposit mix to CDs and increased usage of brokered deposits pushed funding costs higher and pressured margins.

The increasing trends in CD funding and wholesale funding usage started to slow in the second half of 2023. CD funding in banks with assets less than \$1 billion increased from 22 percent to 24 percent between June 30 and year-end 2023, compared with 18 percent to 24 percent year over year. Banks with assets greater than \$1 billion increased from 8 percent to 10 percent compared with 5 percent to 10 percent year over year. Brokered deposit usage increased 17 percent in the second half of 2023 compared with 62 percent year over year, with a growth rate of 11 percent in banks with assets less than \$10 billion compared with 50 percent year over year. Borrowings increased 19 percent compared with 39 percent year over year, with an 8 percent decline in borrowings observed in banks with less than \$10 billion in assets compared with 23 percent growth year over year.

Funding shifts and rising rates materially raised bank funding costs in 2023, although this trend slowed in the second half of the year. Costs of funds increased 134 basis points in OCC-supervised banks year over year, with a slightly lower runup in deposit costs observed in banks with less than \$1 billion in assets. Quarterly annualized NIMs fluctuated between the fourth quarter of 2022 and the fourth quarter of 2023 but the net result was a three-basis-point decline to 3.31 percent. NIMs only modestly declined since year-end 2022 due to offsetting rises in asset yields. Banks with assets less than \$1 billion experienced 28 basis points in NIM compression during this time, but this trend showed signs of slowing in the second half of 2023, with NIM compression of three basis points in both the third and fourth quarters. See figure 17.

FIGURE 17: OCC-SUPERVISED BANKS YEAR-OVER-YEAR NIM TREND



	2022				2023			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Assets <\$1 Billion	3.02%	3.22%	3.49%	3.58%	3.44%	3.36%	3.33%	3.30%
Assets >\$1 Billion	2.36%	2.62%	2.98%	3.34%	3.31%	3.29%	3.34%	3.31%
All Banks	2.37%	2.63%	2.99%	3.34%	3.32%	3.29%	3.34%	3.31%

■ Assets < \$1 Billion ■ Assets > \$1 Billion ■ All Banks

Source: Consolidated Report of Condition and Income, Schedules RI-INC and RC-BAL

Note: This chart represents the entire federal banking system bifurcated by asset size of \$1 billion. The NIM ratio is calculated as quarterly annualized NII divided by average earning assets. NIMs have only slightly declined by three bps when comparing the fourth quarter of 2022 through the fourth quarter of 2023. Rising asset yields have assisted by limiting significant NIM compression.

Significant uncertainty surrounds the direction, timing, and extent of interest rate movements. Rate uncertainty, combined with depositor behavior during the recent increasing rate cycle, may present new challenges for banks to model and project deposit rates and balances in both interest rate and liquidity risk stress scenarios. Inaccurate deposit assumptions could 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-forecasted funding costs, potentially unexpected liquidity shortfalls, and imprecision in balance sheet hedging.

Uncertainty regarding the rate environment and depositor behavior over the next 12 to 24 months increases the importance of stress testing and sensitivity analysis of deposit assumptions. Given uncharted depositor behavior and rate sensitivity observed during the recent increasing rate environment, prudent risk management would include interest rate risk and liquidity stress-testing scenarios that assume higher than expected deposit competition, resulting in higher-than-expected deposit pricing regardless of rate movement direction.

Asset liquidity as a percentage of total assets was stable in OCC-supervised banks year over year in 2023. 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 improved due to a decline in U.S. Treasury yields in the fourth quarter. Unrealized losses (as a percent of amortized cost) in OCC-supervised banks' available-for-sale portfolios declined to 5.2 percent in the fourth quarter of 2023. Unrealized losses in held-to-maturity portfolios also declined in the fourth quarter but remained elevated at 11.5 percent.

Banks continue to slowly increase investment cash and equivalents, helped in part by higher investment portfolio cash flows. Liquidity risk management remains critical, particularly contingency planning with operationally ready contingent funding sources, as noted previously in this report. In addition to potential concerns from deposit competition and stability, the Federal Reserve Bank's Bank Term Funding Program ended March 11, 2024, and the Federal Housing Finance Agency's (FHFA) November 2023 *FHLBank System at 100: Focusing on the Future* report highlighted various FHFA proposals. FHFA initiatives include potential changes to Federal Home Loan Bank (FHLB) credit evaluation and underwriting processes and practices that could affect borrowing capacity for some banks. The timing of these initiatives is uncertain as some may be met through issuing guidance or proposed rulemaking while others could require congressional changes to statutory requirements.

C. OPERATIONAL RISK

CYBERSECURITY

Operational risk remains elevated as continuing cyberattacks and current geopolitical tensions contribute to a heightened risk environment. Cyberattacks continue to evolve and become more sophisticated and pervasive throughout the financial sector. Cyber risks pose significant financial sector and broader U.S. economy threats. It is essential that OCC banks maintain heightened threat monitoring and effective controls to safeguard against disruptive financial sector attacks.

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. Effective backup of critical data that are both physically and logically segmented from production systems is essential for response and recovery from cyber threats.

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.

OPERATIONAL RESILIENCE

An effective operational resilience strategy can enhance a bank’s ability to mitigate disruption from hazards, including cyber threats, and other technology and operational outages. Testing and validation of operational resilience plans are critical to enable banks to respond to disruptions in a manner consistent with their risk appetite. To ensure contagion risk from third parties is appropriately mitigated, clear expectations should be in place for testing and certification that a cyber event at a third party has been remediated to establish confidence in reconnecting that third party’s systems. Refer to Part I: “Special Topic – Firmwide Resilience Efforts” for further discussion.

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 expectations. 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. Effective adoption of new and modified services includes appropriate due diligence, enterprise change management, and risk management processes when considering changes to products, services, and operating environments. Where operational changes or increased complexity occur, assurance functions, such as audits, should be considered as part of planning, implementation, and ongoing monitoring.

Many banks and service providers face challenges with maintaining legacy technology architectures while responding to increasing digitalization demands. It is important for banks to maintain an effective technology architecture strategy, commensurate with the size and complexity of products, services,

and operations being supported. This should include processes for managing and mitigating risks from technology assets that have reached their end of life.

Banks have generally approached artificial intelligence (AI) adoption cautiously. AI types and uses vary widely, resulting in a wide range of potential benefits and risks. 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 and increase fairness in credit and other banking products and services. AI can also present challenges, including compliance and operational risks (e.g., fraud). Banks may partner with one or more fintechs to distribute banking products or services to end users, which can lead to increased risks, including increased complexity in the operational environment.

Banks should maintain prudent risk management practices when considering crypto-asset products, services, and activities given the characteristics of the crypto-asset market, including high volatility, high-risk lending, excessive leverage, interconnectedness, concentration within major players, and lack of comprehensive regulation. Banks are reminded to follow the process outlined in [OCC Interpretative Letter 1179](#) before engaging in certain cryptocurrency, distributed ledger, and stablecoin activities.²¹

FRAUD RISK MANAGEMENT

Fraud targeted against banks and their customers continues to grow. 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 peer-to-peer (P2P) and other faster payment platforms. While P2P payment platforms can provide enhanced capabilities and convenience to consumers and other users for managing payments, the faster and more streamlined payment capabilities and the irreversible and irrevocable nature of these payments have also been used to perpetuate fraud. Banks can support customers by strengthening controls, educating customers on potential scams, and enhancing internal fraud monitoring capabilities.²² Additional fraud risk discussion is also noted in the “Consumer Compliance” section herein.

THIRD-PARTY RISK MANAGEMENT AND OTHER OPERATIONAL RISKS

It is important that banks remain vigilant in managing third-party and other operational risks. Digitalization and technological innovation continue to advance the trend of banks and trust companies outsourcing technology operations and entering partnerships or other arrangements with third parties, including fintechs, related to the delivery of financial products and services.

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

22 Refer to OCC Bulletin 2019-37, “Operational Risk: Fraud Risk Management Principles.”

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. Implementing an appropriate governance framework and establishing an effective system of controls will help guard against complacency and ensure fundamental risk management practices remain sound. The OCC, along with the Federal Reserve System and the Federal Deposit Insurance Corporation, issued guidance to assist community banks in developing and implementing third-party risk management practices.²³ Although the guide is designed for community banks and discusses community bank relationships, it may be useful for all banks.

D. COMPLIANCE RISK

BSA/AML AND OFAC COMPLIANCE RISK

In January 2024, FinCEN issued a [Financial Trend Analysis](#) on identity-related suspicious activity in BSA reports filed in 2021. The analysis found that 42 percent, or 1.6 million, of the BSA reports filed that year related to identity exploitation including fraud, false records, identity theft, third-party money laundering, and circumvention of identity verification standards. The report noted that the perpetrators of identity-related suspicious activity used at least 14 typologies, the most reported of which was general fraud. Additionally, attackers most frequently use impersonation tactics and compromised credentials during authentication. These findings emphasize the critical importance of effective customer identification and verification processes, at account opening and throughout the banking relationship.

Current Customer Due Diligence Rule and other existing BSA requirements for banks remain unchanged pending the issuance of changes to those regulatory requirements required by the Anti-Money Laundering Act of 2020. The December 2023 [Interagency Statement for Banks on the Issuance of the Beneficial Ownership Information Access Rule](#) highlights that banks that access the FinCEN Beneficial Ownership Information (BOI) database are not required to incorporate BOI obtained from the database into their risk-based BSA compliance programs at this time. FinCEN’s recently issued Access Rule does not create new regulatory requirements or supervisory expectations for banks. However, any access to and use of BOI obtained from the BO IT System must comply with the requirements of the Corporate Transparency Act (CTA) and the Access Rule.

Fraud continues to be a significant risk for banks. Effective processes to prevent, identify, and file SARs on fraudulent activity in a timely manner remain important to protect both banks and consumers, especially since fraud is one of FinCEN’s national priorities. Banks are reminded to monitor staffing and

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23 OCC Bulletin 2024-11, [“Third-Party Relationships: A Guide for Community Banks.”](#)

expertise levels in response to potentially elevated fraud risk while maintaining effective BSA/AML risk management controls (e.g., customer due diligence updates, timely investigations, and SAR filings).

Banks are implementing innovative technology, often through fintech partnerships, in order to remotely deliver banking services, develop new products designed to make payments faster and easier, enhance product and service delivery, and improve financial crime detection and reporting. Banks must effectively manage the resulting operational and compliance risks, including third-party risk management.

Banks must continue to monitor world events that could introduce new or updated financial sanctions programs, including new sanctions applicable to customers, sectors, or geographies that might alter a bank's risk profile. Additionally, banks must remain vigilant of increased attempts to evade sanctions, which may require SAR filings.

CONSUMER COMPLIANCE AND COMMUNITY REINVESTMENT ACT AND FAIR LENDING

Banks are operating in a dynamic banking environment because of changing customer needs and preferences related to products, services, and delivery channels. In response to the changes in customer needs and preferences, banks offer new, modified, or expanded products, services, and operational structures. Risks are compounded if products and services, including changes, are not delivered or implemented in a fair and equitable manner. It remains important for banks to maintain compliance risk management frameworks that are commensurate with their risk profiles and capable of growing and evolving as their risk profiles change. Banks should maintain effective internal controls to ensure compliance with the Flood Disaster Protection Act and its implementing regulations. Banks that service federally related mortgage loans should ensure escrow programs and loss mitigation processes remain in compliance with the Real Estate Settlement Procedures Act (Regulation X).

As banks work to process checks and other payments in a safe, fair, and efficient manner, check and wire fraud and P2P transaction scams have become more prevalent. Banks should continue to timely investigate and resolve, in accordance with applicable laws, such as the Electronic Fund Transfer Act/Regulation E and the Expedited Funds Availability Act/Regulation CC as this could assist with mitigating scams.

Banks may face elevated Unfair or Deceptive Acts or Practices (UDAP) risk from multiple areas, including related to bank actions in response to increases in the volume of fraud incidents and to changes in overdraft practices. It is important for banks to appropriately manage UDAP risk in connection with implementation of policy and procedures changes (e.g., fees, customer disclosures and other communications) and to engage in appropriate pre- and/or post-implementation testing.

Banks continue to increase their use of AI and machine learning in customer service, underwriting, and lending operations. While most banks recognize the need to monitor and adjust the models for credit risk, compliance risk increases when banks fail to recognize and appropriately manage the fair lending risk associated with these models. An effective fair lending risk management program includes understanding fair lending laws and regulations and maintaining effective processes, procedures, testing, and monitoring systems to identify, manage, and mitigate potential fair lending risks.

The OCC continues to assess banks' CRA performance under the 1995/2021 regulatory framework. Banks should continue to evaluate the appropriateness of their delineated CRA assessment areas based on those requirements and adjust, if necessary, to ensure low- and moderate-income census tracts are not arbitrarily excluded and the assessment area does not reflect illegal discrimination. Banks should also monitor lending performance inside and outside bank assessment areas to ensure they support an appropriate level of performance under the CRA rule.

E. CLIMATE-RELATED FINANCIAL RISK

The United States experienced, on average, a billion-dollar weather and climate-related disaster every three weeks in 2023 versus every four months in the 1980s (adjusting for consumer price index).²⁴ Natural disasters can create indirect effects such as infrastructure damages, supply chain disruption, drops in crop yields, and labor productivity loss, which could lead to revenue reduction or increased costs for bank borrowers and inflationary pressure. Intensified natural disasters and chronic weather pattern shifts coupled with insurers withdrawing from higher-risk markets and/or raising insurance costs could pose increased risks to banks. Local government policies to reduce greenhouse gas emissions from large commercial buildings can lead to higher costs from retrofits or fines for noncompliance, compounding the effects of other rising costs.

As noted in our fall 2023 Semiannual Risk Perspective, the OCC has been conducting discussions with the largest banks (those with more than \$100 billion in total assets) to understand the banks' climate-related financial risk management programs. This work continues in 2024. A current observation from these reviews notes that banks are at an early stage in analyzing the effects of insurance affordability and availability challenges. Some of the bank practices observed include the following:

- » Considering impacts of changes in insured limits or deductibles, premium increases, or lack of coverage availability in climate scenario analysis and credit risk assessments for commercial and residential real estate portfolios
- » Exploring the use of granular insurance coverage data in climate-related scenario analysis
- » Monitoring lender-placed insurance policies as a percentage of overall policies in the mortgage portfolios
- » Identifying consumer lending geographies that could experience higher flood insurance premiums

24 NOAA Climate.gov, [2023: A Historic Year of U.S. Billion-Dollar Weather and Climate Disasters](#) (January 2024).