Office of the
Comptroller of the Currency

SEMIANNUAL RISK PERSPECTIVE

FROM THE NATIONAL RISK COMMITTEE

FALL 2024

occc.gov

CONTENTS

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 that 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.[2] 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 are 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* (SARP) 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 2024 SARP report presents data in four main areas: the special topic, trends in key risks, operating environment, and bank performance. The report reflects data as of June 30, 2024, unless otherwise indicated.

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

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

FEDERAL BANKING SYSTEM KEY THEMES

- The 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. Continuous assessments of and improvements to risk management practices support banks' efforts to guard against complacency and to build and enhance resiliency against potential future economic and operational challenges.
- The special topic focuses on an increasing trend of external fraud activity targeting the federal banking system.
- **Commercial credit risk** remains moderate and shows signs of stabilizing as risks are better identified, monitored, and controlled. Commercial credit risk drivers indicate the presence of pockets of risk specific to a lender's region and lending market. The commercial real estate (CRE) office sector remains stressed. Risks in multifamily CRE lending remain elevated, particularly in the luxury segment.
- Overall **retail credit risk** is stable. Delinquency and loss rates on residential real estate-secured loans held by banks remain historically low but are increasing. Delinquencies in other retail asset classes, namely credit cards and auto loans, reflects an increasing trend. However, banks' retail credit loan performance is consistent with many industry forecasts reflecting delinquency and seasonal loss patterns normalizing from atypical historically low levels.
- **Operational risk** is elevated. Banks continue to respond to an evolving and increasingly complex operating environment. Evolving cyber threats by sophisticated malicious actors target the financial services industry and their key service providers. Recent significant disruptions across many sectors, including the financial sector, highlight the importance of sound third-party risk management and operational resilience.
- From a **compliance risk** perspective, banks continue to operate in a dynamic banking environment as customers' needs and preferences related to products, services, and delivery channels evolve. It remains important for banks to maintain appropriate risk-based compliance risk management frameworks capable of growing and transforming as their risk profiles change. Banks should perform timely investigations of fraud and unauthorized transaction disputes and resolve them in accordance with applicable laws. Data governance gaps and customer or transaction exclusions in Bank Secrecy Act and Anti-Money Laundering (BSA/AML) transaction monitoring may result in increased noncompliance with requirements to report potentially suspicious activity.

- **Community Reinvestment Act (CRA)-related risks** remain stable as the OCC continues to assess banks' CRA performance under the 1995/2021 regulatory framework.

- Regarding **market risk**, banks' net interest margin (NIM) performance has varied across bank asset sizes. Bank funding costs trended higher throughout 2024 but at a slower pace compared with 2023. Funding cost trends have had mixed impacts on NIMs due to trends in earning asset yields. Deposit volumes, deposit mix, and wholesale funding usage have started to stabilize while banks build asset liquidity.

- Banks with over $100 billion in total assets continue their efforts to build out their risk management frameworks for **climate-related financial risks**.

GLOBAL AND DOMESTIC ECONOMIC OPERATING ENVIRONMENT

- Global economic growth has been supported by higher growth in the United States and large emerging market economies. However, there is persistent weakness in some of the world's largest economies. Ongoing geopolitical conflicts and tensions continue to affect the normal functioning of the global economy. These conflicts and tensions could disrupt global trade, supply chains, and commodity markets.

- The Blue Chip Consensus Forecast projects that headline inflation will ease through the remainder of this year and next, falling to 2.1 percent by year-end 2025.[3] U.S. economic expansion continues at a solid pace, but growth is expected to slow. The labor market rebounded in September 2024 as the unemployment rate fell slightly to 4.1 percent from 4.2 percent in August 2024. Although September's jobs report exceeded expectations, other recent indicators signaled a slightly less vigorous hiring picture. While consumers remain resilient, some headwinds exist. Job openings and quit rates have been declining, and the cooling job market may negatively affect wage growth. A slowing labor market, rising consumer delinquencies, and higher prices could cause financial stress to consumers and slacken consumption.

3 Developed by Wolters Kluwer.

PART I

SPECIAL TOPIC: INCREASED EXTERNAL FRAUD ACTIVITY TARGETING THE FEDERAL BANKING SYSTEM

The special topic focuses on the increasing trend in external fraud activity targeting consumers and the federal banking system. The frequency of both traditional and novel, more sophisticated fraud activities targeting customers and banks continues to increase. Banks should maintain sound fraud risk management practices through prudent controls and appropriate fraud monitoring capabilities to identify, investigate, mitigate, and report fraudulent activity.[4] Banks can also support their customers by providing educational information about trending fraud activities and ways to protect themselves.

Criminals continue to exploit traditional payment methods through check and wire transfer schemes. The Financial Crimes Enforcement Network (FinCEN) September 2024 "Financial Trend Analysis" analyzed threat patterns and trend information on mail theft-related check fraud incidents over a six-month period in mid-2023. The report noted that financial institutions filed 15,417 BSA reports on mail theft-related check fraud, 13,618 (88 percent) of which were filed by banks.[5] It described several types of check fraud such as bad actors altering stolen check payees and amounts, using the stolen check to create counterfeit checks, fraudulently signing the check, and selling the check or its identifying information on dark web marketplaces

4 OCC Bulletin 2019-37, "Fraud Risk Management Principles."

5 In this analysis, FinCEN report defined "financial institutions" as consisting primarily of banks, credit unions, and securities/futures firms, and banks consist of all U.S. commercial banks as regulated by the OCC, Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System.

or encrypted social media platforms. Furthermore, the OCC's Customer Assistance Group observed an increase in the number of check fraud-related complaints submitted by consumers over the past year. [6]

Federal banking system-related wire transfer complaints that consumers submitted to the Customer Assistance Group reflect an increasing trend. For wire transfer schemes, the fraudster often poses as a trusted business, government agency, or even a bank employee, fabricating scenarios that require immediate action and convincing, with urgency, victims to wire money to a fraudster's account. In most cases, once the wire transfer is complete, the funds cannot be retrieved.

While artificial intelligence (AI) can enhance fraud risk management capabilities, reduce costs, and improve efficiency, this and other new technologies are also being used to enable increasingly more sophisticated and frequent fraud tactics. Fraudsters could use AI to implement sophisticated frauds by digitally altering voices, biometric systems, or images (also known as "deepfakes"), or to facilitate social engineering schemes, identity theft, and impersonation of a trusted business or government agency. For example, deepfakes through voice replication have been used to perpetrate fraud by tricking voice biometric systems or by convincing a victim they are dealing with someone they know and trust, such as a family member.

Increasing product and service digitization can also heighten fraud risk, including fraud targeting peer-to-peer (P2P) and other fast payment platforms. P2P payment platforms can provide enhanced capabilities and convenience to consumers and other users for managing payments. However, criminals also have exploited the faster, more streamlined payment capabilities and the irreversible and irrevocable nature of these payments.

Effective fraud risk management includes appropriate internal controls, such as authentication, customer identification and verification processes, fraud monitoring, and open lines of communication between bank departments responsible for researching unusual activities.[7] It is critical for banks to promptly identify, investigate, and resolve suspicious activities and potential fraudulent concerns. Banks should also continue to promptly identify, investigate, report, and resolve fraud concerns in accordance with applicable laws and regulations, including the BSA, Expedited Funds Availability Act (Regulation CC) and Electronic Fund Transfer Act (Regulation E).

Recent increases in the volume of fraud cases have led to heightened unfair or deceptive acts or practices (UDAP) risk as some banks may take prolonged timeframes to complete investigations or implement broad account access limitations, preventing customers—including those who are not victims of fraud—from accessing their funds. If banks on either side of the transaction do not complete investigations expeditiously, customers may not have access to funds for extended periods of time, which may create financial hardship for them. Refer to Part II: "Trends in Key Risks – C. Compliance Risk – Consumer Compliance" for further discussion.

6 The OCC Customer Assistance Group seeks to ensure that national banks, federal savings associations, federal branches and agencies of foreign banks, and their customers receive fair and expeditious resolution of their complaints. Consumers can file complaints on About HelpWithMyBank.gov.

7 OCC News Release 2024-75, "Acting Comptroller Discusses Importance of Addressing Financial Fraud," July 10, 2024.

Banks can continue to support customers by providing information about scam and fraud trends and education of potential preventative measures. For example, to address the prevalence of text messaging and bank impostor scams, it can be beneficial to inform customers about how the bank will contact its customers regarding potential fraudulent transactions, as well as the strengths and limitations of various authentication methods and how to identify potential fraudulent schemes. Banks can also develop policies and procedures regarding what and how to communicate with customers when the bank determines that account access should be limited, taking care not to reveal the existence of any suspicious activity report (SAR) filing, and ensuring that the communication is otherwise consistent with safe and sound banking practices. Communications can provide critical information to customers seeking to access their funds.

In addition, staff can be trained to identify and respond to customers seeking to conduct unusual transactions that have signs of fraud, such as a large withdrawal or wire transfer that may be outside of a customer's usual transaction habits. Employee training may also include identifying red flags for different types of financial exploitation, providing proactive approaches to detecting and preventing elder financial exploitation, and detailing actions for employees to take when they have concerns.[8] When multiple departments are responsible for researching unusual account activities across functions such as BSA compliance, fraud prevention, consumer protection, and open lines of communication between the bank's departments are important and may result in enhanced coordination and expedited resolution.

8 OCC News Release 2024-130, "Agencies Issue Statement on Elder Financial Exploitation," December 4, 2024.

PART II

TRENDS IN KEY RISKS

A. CREDIT RISK

COMMERCIAL CREDIT THEMES

Commercial credit risk remains moderate and shows signs of stabilizing as risks are better identified, monitored, and controlled. Elevated but declining interest rates could continue to affect borrowers with loans that originated before 2022, especially those with variable rates, or borrowers seeking refinancing. Credit risk drivers indicate pockets of risk specific to a lender's region and lending market.

The current operating environment remains challenging, especially for companies 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. It is important that banks continue to use sound credit risk management practices such as stress testing at both the portfolio and facility levels, timely and accurate risk ratings, and effective concentration risk management.

The CRE office sector continues to experience stress, and there may be additional valuation declines and bank losses as a volume of office and multifamily loans—many with interest-only terms—are set to mature or reprice over the next two to three years. CRE borrowers seeking to refinance may need to re-margin through cash equity injections or by providing additional collateral because of higher debt costs and lower property values.

Generally, banks are appropriately identifying problem office CRE loans, and the OCC expects banks to continue to have credit risk management systems that produce accurate, timely risk ratings. Classified loan levels may increase but are expected to remain manageable. Risks in multifamily CRE lending remain elevated, particularly in the luxury segment. Nationwide, pressures from higher interest rates and increased expenses are slowing the growth in net operating income (NOI). Oversupply in some southern, southeastern, and western metro areas and changes in rent regulations in some markets have resulted in further narrowing of NOI. The hotel and industrial sectors continue to show signs of softening. While banks with CRE concentrations continue to present heightened risk, CRE loan growth has slowed overall.

Staffing continues to be challenging in the loan workout and credit risk review functions. During the most recent benign credit period, retirements and other attrition decreased the number of experienced professionals. It remains important for banks to ensure that experienced staffing is adequate.

The allowance for credit losses (ACL) should continue to reflect a forward-looking assessment of loan portfolio risks. This includes considerations for potential loss drivers from a bank's current business, economic, and overall operating environments. The ACL should include appropriate adjustments, such as qualitative factors, recalibration, or model redevelopment, to address potential modeling imprecision.

RETAIL CREDIT THEMES

Retail credit performance remains satisfactory, and overall retail credit risk is stable. In recent years, consumers benefitted from strong employment and wage growth, but those factors are beginning to slow. However, the labor market's rebalancing of supply and demand does not currently indicate systemic consumer stress. Consumer segments that are most susceptible to elevated prices are highly leveraged, lower income borrowers, but do not present systemic credit risk. Delinquency and loss rates on residential real estate-secured loans held by banks remain historically low but are increasing. Delinquencies in other retail asset classes, namely credit cards and auto loans, reflect an increasing trend. However, banks' retail credit loan performance is consistent with many industry forecasts reflecting delinquency and seasonal loss patterns normalizing from atypical historically low levels.

Portfolio growth was generally flat for the first half of 2024. Headline nominal growth in credit card outstandings continues, largely because of several years of high inflation. Credit risk drivers continue to include higher interest rates on newly originated loans with potentially higher loan-to-value ratios, upward adjustments on variable rate loans, and borrower segments with more limited repayment capacity.

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

Homeowners face mortgage payment increases. Home price appreciation is contributing to increased real estate taxes, and insurance costs are increasing because of 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. The increase in housing obligations may warrant enhanced risk identification, monitoring, and reporting. Despite increasing costs, the median monthly payment increase in taxes and insurance is not anticipated to have a systemic impact on retail credit. Collateral administration policies should outline standards, responsibilities, processes, and internal controls so banks maintain appropriate collateral protection. Such policies and procedures should facilitate timely identification, remediation, and reporting of expired insurance policies and inadequate insurance coverage.

B. OPERATIONAL RISK

CYBERSECURITY

Operational risk remains elevated as cyber threat actors continue to evolve and refine their tactics by using more advanced technology, such as AI. Simultaneously, banking services continue to engage with third parties, including fintech firms, expanding the cyberattack surface. Thus, the probability of occurrence and the potential impact of cyber incidents are increasing. This complex, interconnected operating environment amplifies the importance of third-party risk management, change management, and operational resilience measures.

A financial entity's exposure to cyber threats and operational disruptions extends beyond its own network. Threat actors are increasingly targeting vulnerabilities and deficient security practices at financial service providers and their third parties. The OCC continues to see compromised systems involving the exploitation of publicly known vulnerabilities on internet-accessible networks. This underscores the need for banks to maintain an inventory of assets and external connections and remediate vulnerabilities promptly.

It is important that banks maintain effective change management and third-party risk management, including ensuring that third parties throughout the bank's information technology supply chain are adhering to secure software development standards to reduce the risk of disruptions or compromises. Additionally, it is critical that banks and their service providers have effective threat and vulnerability monitoring processes and security measures, including the use of multi-factor authentication (MFA), hardening of systems configurations, testing software updates before implementation, phased rollouts of software updates, timely vulnerability patch management, and immutable backups.

The OCC continues to monitor the progress toward quantum computing capabilities and the associated risks to general encryption techniques. On August 13, 2024, the National Institute of Standards and Technology (NIST) finalized its principal set of encryption standards designed to withstand cyberattacks from a quantum computer. The new standards are designed for general encryption and digital signatures, which are critical to protect information and authentication. The process for transitioning to these new post-quantum computing (PQC) standards will likely take years to fully test and implement. Banks are encouraged to conduct inventories of where encryption is used within their operations and work with third parties to assess their PQC transition plans to ensure long-term security and interoperability. Institutions that develop their own software are also encouraged to begin the migration process.

OPERATIONAL RESILIENCE

An effective operational resilience strategy can enhance a bank's ability to mitigate disruption events, including cyber incidents, disruptions at third parties, change management issues, and other technology or operational outages. Operational resilience was highlighted in mid-2024 when a flawed software update at a large cybersecurity firm and weaknesses in change management programs caused global operating disruptions, shutting down systems across many sectors, including financial. Testing and validating operational resilience plans are appropriate to enable banks to respond to disruptions. Clear expectations should be in place for testing and certifying that a cyber event or other disruption at a third party has been effectively remediated. Validation and confidence are critical before reconnecting that third party's systems to appropriately mitigate contagion risk.

INNOVATION AND ADOPTION OF NEW PRODUCTS AND SERVICES

Banks continue to adopt new technology and innovative products and services to further their digitization efforts and meet evolving customer expectations. Banks' incorporation of new technologies, including cloud computing and engaging with fintechs, may help banks of all sizes gain efficiencies and provide products and services to customers, often at lower cost and with enhanced customer experience. In addition to benefits, new technology and innovative products and services may increase the complexity of banks' operating environments, pose new risks, or exacerbate existing risks. Banks' increasingly complex relationships with fintech firms may increase the complexity of the operating environment and expose banks to a wider range of risks than traditional third-party arrangements.

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

Banks generally have approached AI adoption cautiously. Although AI and machine learning (ML) have been around for years in banking, new capabilities such as those arising from generative AI can present greater compliance and operational risks. Training large language models requires effective data quality governance.

Many banks and service providers face challenges with maintaining legacy technology architectures while responding to these and other increasing digitization 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. Technology strategies should include processes for managing and mitigating risks from technology assets that have reached their end of life.

Banks considering or engaging in custody services for digital assets (including cryptocurrencies), holding stablecoin reserves, or participating in distributed ledger transaction verification should establish and maintain prudent, effective risk management practices. Some assets may present unique operational risks.

Banks are reminded to follow the process outlined in OCC Interpretative Letter 1179 before engaging in certain cryptocurrency, stablecoin, and distributed ledger activities.[9]

FRAUD RISK MANAGEMENT

As fraud targeting banks and their customers continues to increase, it is important for fraud risk management approaches to keep pace with a bank's evolving fraud risk profile. Effective fraud risk management includes reporting risk to senior management and the board on a timely, comprehensive basis. Additional considerations include confirming that control systems encompass both preventative controls to deter fraud and detective controls to identify and respond to fraud in a timely manner once it has occurred. Results of ongoing control testing should inform the redesign of existing controls, the implementation of new controls, and the addition of qualified staff, as needed.

Effective customer identification and verification processes at account opening and appropriate monitoring throughout a customer's banking relationship are critical. Confirming wire instructions, verifying identity, and effective authentication controls are critical to preventing scams that are perpetuated using wire transfers. Verifying the accuracy of the transaction has caught and thwarted efforts to wire funds to fraudsters. Similarly, alerts and other messages introducing small frictions in P2P and other transactions could help consumers pause before making a payment to an unknown party. Identifying SARs on fraudulent activity in a timely manner remain important to protect both banks and consumers. Technology can help to flag suspicious activity, support prudent authentication, and block suspicious transactions until further authentication has occurred. Refer to Part I: "Special Topic – Increased Fraud Activity Targeting the Federal Banking System" for prior discussion.

THIRD-PARTY RISK MANAGEMENT

Banks should guard against complacency and ensure that fundamental risk management practices, including third-party risk management, remain sound. Technological advances have continued the increasing trend of banks and trust companies outsourcing operations and entering relationships with third parties to deliver financial products and services. Effective management and oversight of third-party relationships are essential and generally follow a continuous life cycle. Third-party risk management processes should be commensurate with the bank's size, complexity, and risk profile, and the criticality of activities supported by the third-party. A third-party relationship may expand or grow throughout the banking relationship. Ongoing monitoring activities should remain commensurate with the changes in the level and type of risk and any expanded use of services. Banks should consider interagency guidance

9 Refer to OCC Interpretive Letters 1170, "Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers"; 1172, "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves"; 1174, "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities"; and 1179, "Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank."

describing sound risk management principles for all banks with third-party relationships when developing and implementing third-party risk management practices.[10]

C. COMPLIANCE RISK

BSA/AML AND OFFICE OF FOREIGN ASSETS CONTROL (OFAC) COMPLIANCE RISK

Data governance gaps and customer or transaction exclusions in BSA/AML transaction monitoring may result in increased noncompliance with requirements to report potentially suspicious activity. Effective data governance processes may include periodically revisiting decisions on monitoring or testing exclusions and exceptions and periodic verification to ensure that processes continue to be appropriate and are executed as intended.

Independent testing and other control functions, as applicable, are critical to an effective BSA compliance program. Processes should be effective with adequate scope and coverage. Banks should develop and apply effective compliance risk management practices in their implementation of innovative technology, including arrangements with fintechs designed to remotely deliver banking services, develop new products to make payments more ubiquitous, enhance product and service delivery, and improve financial crime detection and reporting.[11]

Risks may also increase when access to SAR data becomes necessary for numerous areas of the bank including the board, legal staff, audit staff, BSA/AML staff, and other employees. Expanded access to SAR data necessitates effective access controls and monitoring sensitive information. Challenges maintaining SAR confidentiality can increase in the context of outsourcing and remote work environments. Banks are reminded to monitor staffing and 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). Fraud is one of FinCEN's anti-money laundering and countering the financing of terrorism national priorities.[12] The types of fraud highlighted by FinCEN include an investment scam,[13] workers' compensation fraud, identity theft, and business email compromise.

Banks should continue to monitor geopolitical events that could introduce new or updated sanctions, including sanctions applicable to new categories of customers, sectors, or geographies that might affect a

10 Refer to OCC Bulletin 2023-17, "Third-Party Relationships: Interagency Guidance on Risk Management."

11 See, for example, OCC Bulletin 2024-20, "Third-Party Arrangements: Joint Statement on Banks' Arrangements With Third Parties to Deliver Bank Deposit Products and Services."

12 FinCEN, "Anti-Money Laundering and Countering the Financing of Terrorism National Priorities," June 30, 2021.

13 FinCEN, "FinCEN Alert on Prevalent Virtual Currency Investment Scam Commonly Known as 'Pig Butchering,'" September 8, 2021.

bank's risk profile. As banks adapt to increased sanctions complexity, they are reminded to also be vigilant of increased attempts to evade sanctions, which may require a SAR filing.

CONSUMER COMPLIANCE

Banks continue to operate in a dynamic environment as customers' needs and preferences related to products, services, and delivery channels evolve. In response to the changes in customer needs and preferences, banks may offer new, modified, or expanded products, services, and operational structures. Delivery of new or modified products and services often relies on partnerships with third parties for marketing, originating, or servicing. Compliance risks are heightened if banks fail to deliver or implement products and services, including changes, in a fair, equitable manner. Banks should maintain appropriate risk-based compliance risk management frameworks capable of growing and transforming as their risk profiles change.

With increasing occurrences of floods posing risks to borrowers,[14] banks should maintain effective internal controls to comply with the Flood Disaster Protection Act and its implementing regulations. Banks that service government-backed mortgages should also ensure that escrow programs and loss mitigation processes remain in compliance with the Real Estate Settlement Procedures Act (Regulation X).

Increasing volumes of attempted check, wire, and P2P fraud present heightened consumer compliance risks to banks as they work to process payments in a safe, fair, and efficient manner, which can contribute to reduced risk of consumer loss or harm. Banks should perform timely investigations of fraud and unauthorized transaction disputes and resolve them in accordance with applicable laws such as the Electronic Fund Transfer Act (Regulation E). Check holds, including the use of exception or extended check holds, must follow applicable Expedited Funds Availability Act (Regulation CC) requirements. Refer to Part I: "Special Topic – Increased Fraud Activity Within the Federal Banking System" for prior discussions.

Risk of prohibited unfair, deceptive, or abusive acts or practices (UDAAP) may arise from several areas, including those related to bank actions in response to increases in the volume of fraud incidents and changes in bank products, services, or processes. Appropriate UDAP/UDAAP risk management includes effective implementation of policy, procedure, and process changes (e.g., changes in fees and placement of transaction or account holds during investigations) and performing appropriate pre- and post-implementation compliance monitoring and testing. When customers have been harmed, banks should have effective processes to identify customers affected by UDAP/UDAAP, provide appropriate remediation in a timely manner, and implement effective corrective actions to prevent future harm.

COMMUNITY REINVESTMENT ACT/FAIR LENDING

Banks continue to increase their use of AI and ML in customer service, underwriting, and lending operations. Most banks recognize the need to monitor and adjust the models for credit risk. However,

14 U.S. Environmental Protection Agency, "Climate Change Indicators: Coastal Flooding" and "Climate Change Indicators: River Flooding."

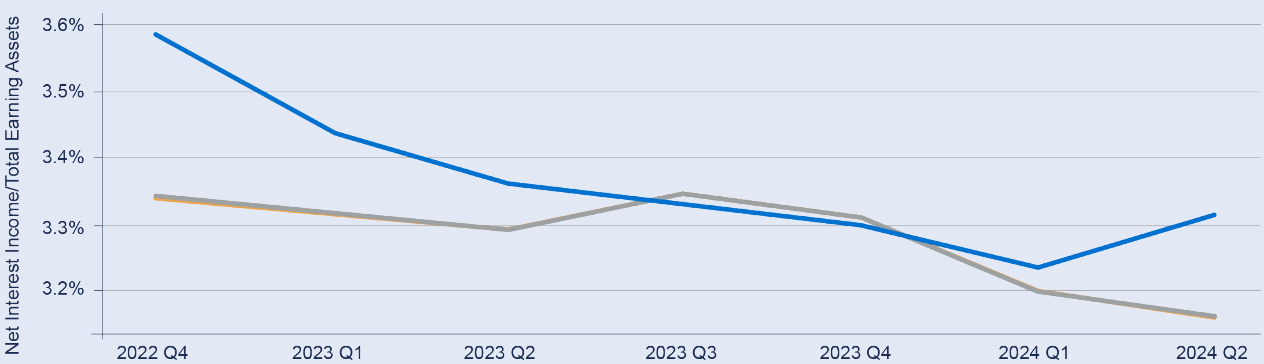
compliance risk may increase when banks fail to identify and appropriately manage the fair lending risk associated with these models. In addition, fair lending risk arises when banks do not have sufficient self-identification processes or fail to effectively implement corrective action plans to address fair lending program weaknesses.

CRA-related risks remain stable as 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 that assessment areas do not arbitrarily exclude low- and moderate-income (LMI) census tracts and the assessment areas do not reflect illegal discrimination. Banks should also monitor lending inside and outside bank assessment areas for appropriate levels of lending activity in both LMI areas (CRA) and majority-minority areas (fair lending).

D. MARKET RISK

OCC-supervised banks' NIM performance has varied among asset size segments in 2024, as shown in figure 1. But a slowing rate of rising funding costs may indicate some easing in deposit competition. Deposit volumes, deposit mix, and wholesale funding use have started to stabilize while banks build asset liquidity and monitor for changes to the federal funds target rate from the Federal Open Market Committee (FOMC).

FIGURE 1: OCC-SUPERVISED BANKS QUARTERLY NET INTEREST MARGIN TREND



	2022	2023				2024	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Assets <$1 Billion	3.58%	3.44%	3.36%	3.33%	3.30%	3.24%	3.31%
Assets >$1 Billion	3.34%	3.32%	3.29%	3.34%	3.31%	3.20%	3.16%
All Banks	**3.34%**	**3.32%**	**3.29%**	**3.34%**	**3.31%**	**3.20%**	**3.16%**

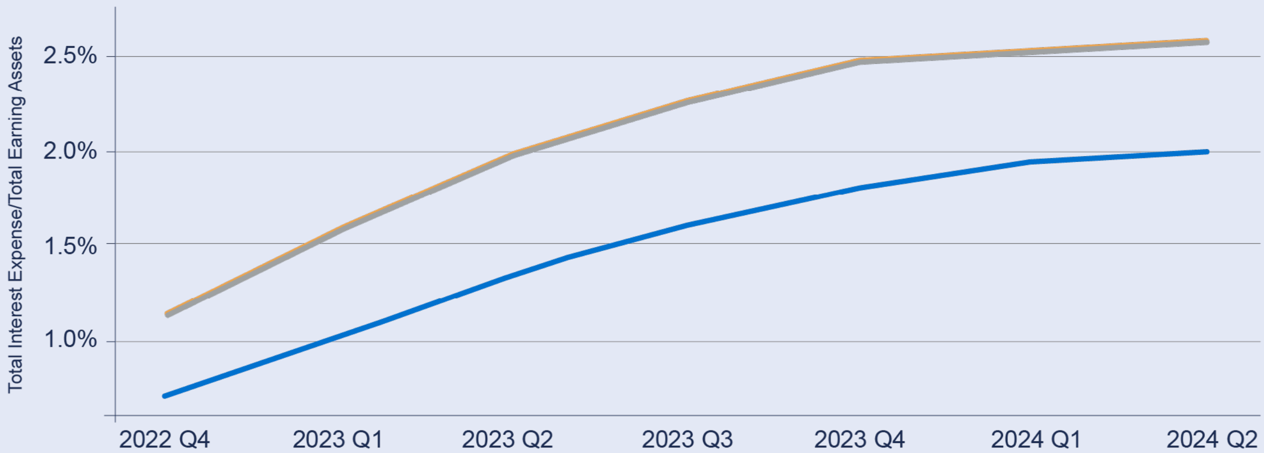
Assets < $1 Billion Assets > $1 Billion All Banks

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 net interest income (NII) divided by average earning assets. NIMs for all banks have declined by 18 basis points when comparing the fourth quarter of 2022 through the second quarter of 2024.

Cost of funding in OCC-supervised banks trended higher through the second quarter of 2024 but at a slower pace than 2023. The cost of funding in banks with less than $1 billion in total assets rose 111 basis points between year-end 2022 and year-end 2023 compared with a 20-basis point increase year-to-date 2024. Funding costs in banks with over $1 billion in total assets increased 134 basis points between year-end 2022 and year-end 2023 compared with a 10-basis point increase year-to-date 2024. See figure 2.

FIGURE 2: OCC-SUPERVISED BANKS QUARTERLY COST OF FUNDING TREND



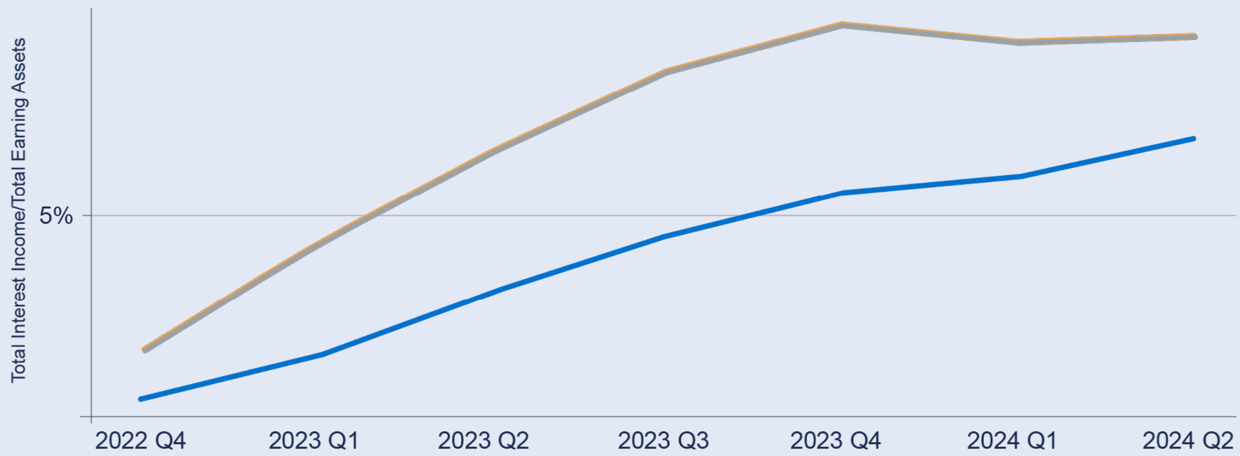
	2022	2023				2024	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Assets <$1 Billion	0.69%	1.01%	1.34%	1.60%	1.80%	1.93%	2.00%
Assets >$1 Billion	1.13%	1.58%	1.97%	2.25%	2.47%	2.51%	2.57%
All Banks	**1.12%**	**1.57%**	**1.97%**	**2.24%**	**2.46%**	**2.50%**	**2.56%**

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 cost of funding is defined as total interest expense divided by total earning assets. The cost of funding in all banks rose 134 basis points between year-end 2022 and year-end 2023 compared with a 10-basis point increase year-to-date 2024.

Funding cost trends have had mixed impacts on NIMs in 2024 due to trends in earning asset yields. NIMs for banks with less than $1 billion in total assets are in-line with year-end 2023 due to a 22-basis point increase in earning asset yields. See figure 3. Earning asset yields in banks with over $1 billion in total assets declined 5 basis points in the first half of 2024, helping to compress margins by 15 basis points.

FIGURE 3: OCC-SUPERVISED BANKS QUARTERLY YIELD ON EARNING ASSETS TRENDS



	2022	2023				2024	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Assets <$1 Billion	4.28%	4.95%	4.70%	4.93%	5.10%	5.16%	5.32%
Assets >$1 Billion	4.47%	4.90%	5.27%	5.59%	5.78%	5.70%	5.73%
All Banks	**4.47%**	**4.89%**	**5.26%**	**5.58%**	**5.77%**	**5.70%**	**5.72%**

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 yield on earning assets is defined as total interest income divided by total earning assets.

Deposit volumes and mix in OCC-supervised banks have been fairly stable year-to-date 2024 with a slight shift into insured time deposits. Deposits as a percentage of total assets declined from 79 percent to 78 percent in the second quarter of 2024 but remain well above a historical median of 72 percent dating back to the first quarter of 2000. Borrowings and brokered deposit usage materially slowed after considerable growth in 2022 and 2023. OCC-supervised banks continue to slowly build asset liquidity,[15] primarily driven by banks with over $50 billion in total assets. Liquid assets grew $152 billion or 2.8 percent between the second quarter of 2023 and the second quarter of 2024.

Unrealized losses in investment portfolios remain a concern. Banks with over $1 billion in assets reported depreciation of 13.66 percent in held-to-maturity securities and 4.93 percent in available-for-sale securities. Banks with less than $1 billion in total assets reported depreciation of 9.1 percent in held-to-maturity securities and 9.5 percent in available-for-sale securities. Concerns associated with investment portfolio unrealized loss may ease as the FOMC determines future federal funds target rate adjustments.

Market expectations are for downward federal funds target rate adjustments from the FOMC. However, significant uncertainty remains surrounding the timing and extent of future rate movements. Depositor

15 “Asset liquidity” is defined here as securities and cash and due from depository institutions.

behavior in a declining rate environment is also uncertain, particularly given elevated deposit competition compared with historical trends. The lack of clarity surrounding future rate movement and depositor behavior may present challenges for banks to model and project deposit rates and balances in both interest rate and liquidity risk stress scenarios.

Inaccurate deposit assumptions, including inaccurate funding cost forecasts, could render model results unreliable and may mask banks' true interest rate risk and liquidity risk profiles. Unreliable model projections and stress may result in unforeseen funding costs, potentially unexpected liquidity shortfalls, and imprecision in balance sheet hedging. Prudent risk management includes interest rate risk and liquidity stress-testing scenarios that assume higher than expected deposit competition and pricing, regardless of rate movement, as well as stress testing and sensitivity analysis of deposit assumptions. Liquidity contingency planning, with operationally ready contingent funding sources, remains critical.

E. CLIMATE-RELATED FINANCIAL RISK

According to the National Centers for Environmental Information, there have been 24 confirmed U.S. weather/climate disaster events with losses exceeding $1 billion each through November 1, 2024.[16] These physical risks have the potential to affect banks' operations and clients. For instance, 78 percent of the properties affected by Hurricane Debby were outside of Federal Emergency Management Agency Flood Zones,[17] hence less likely to be covered by a flood insurance policy.

From the first half of 2022 through the first half of 2024, investments in clean technologies and infrastructures in the United States totaled $493 billion, a 71 percent increase from the prior two-year period.[18] Global spending on clean energy technologies and infrastructure is expected to hit $2 trillion in 2024.[19] Given that banking clients are potentially exposed to these changing global trends, transition risks to banks can surface in a variety of ways. As noted in our *Spring 2024 Semiannual Risk Perspective*, the OCC has been conducting discussions with bank management at banks with over $100 billion in total assets to understand their climate-related financial risk management programs. This work continued through 2024. These banks continue their efforts to build out their risk management frameworks for climate-related financial risks.

16 National Centers for Environmental Information, "Billion-Dollar Weather and Climate Disasters."

17 First Street, "Review of Hurricane Debby: First Street Recreation Finds Majority of Damaged Homes Outside of FEMA Flood Zones," August 12, 2024.

18 Rhodium Group and MIT Center for Energy and Environmental Policy Research, *Clean Investment Monitor: Tallying the Impact of the Two-Year Inflation Reduction Act*, August 7, 2024.

19 International Energy Agency, "Investment in Clean Energy This Year Is Set to Be Twice the Amount Going to Fossil Fuels," June 6, 2024.

PART III

OPERATING ENVIRONMENT

GLOBAL OPERATING ENVIRONMENT

The global financial system continues to navigate multiple wars, geopolitical tensions, and divergent interest rates in a changing economic environment. Although global economic growth was supported by resilient growth in the United States and large emerging market economies, there is persistent weakness in some of the largest economies including Germany and China. Germany is vulnerable to further weakness in China's economy, as its trade with China grew from 5 percent of its total trade in 2000 to 20 percent in 2023. China's attempts to reach the government's 5 percent growth target involve redirecting credit from construction to the manufacturing and export sectors. The decrease in construction spending may result in reduced Chinese imports of industrial commodities, thus affecting major commodity exporters in Latin America and Africa.

Differences in the pace and direction of monetary policy adjustments can lead to movement in exchange rates and capital flows as investors rebalance portfolio holdings across countries. Many central banks have lowered policy interest rates from recent peaks. Even so, many governments and corporations will face higher interest rates when they refinance debt issued before the start of the post-pandemic tightening cycle. This was evident in the market volatility surrounding the rapid appreciation of the Japanese yen in August 2024. Such volatility can further tighten debt refinancing conditions across countries.

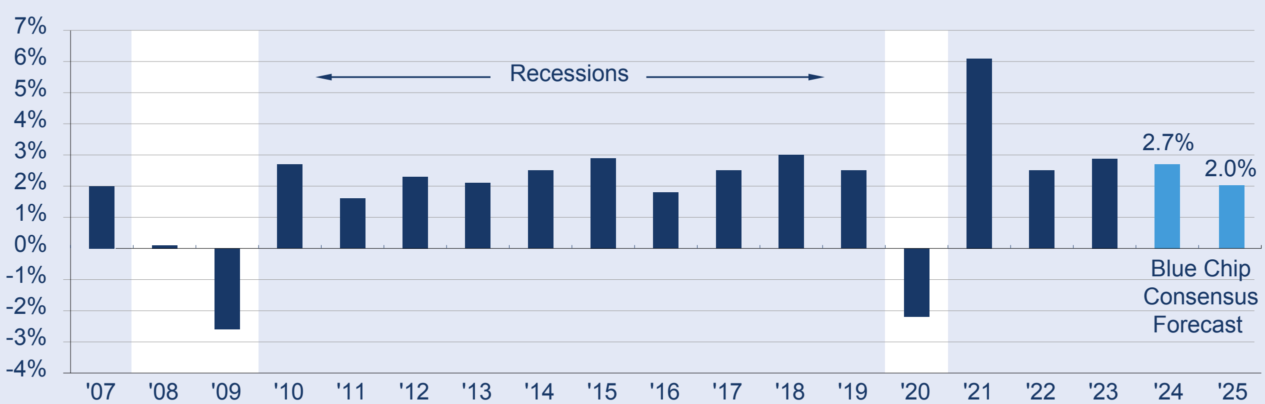
Ongoing geopolitical conflicts and tensions continue to affect the normal functioning of the global economy. Conflicts in Ukraine and the Middle East have broadened in scope. The United States has continued to issue new sanctions against Chinese entities, and China has enacted its own sanctions and the Anti-Foreign Sanctions Law. Tensions in the South China Sea remain elevated. These conflicts and tensions could disrupt global trade, supply chains, and commodity markets. Prices of commodities such as oil, natural gas, and metals could increase in response to these tensions and imposition of sanctions.

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

Real gross domestic product (GDP) increased at an annual rate of 3.0 percent in the second quarter of 2024, well above the 1.6 percent pace set in the first quarter. The acceleration largely reflected inventory building and a pickup in consumer spending fueled by a rebound in durable goods. These improvements were partially offset by a decrease in residential investment and a continuing drag from net exports. GDP has cooled appreciably from the robust 3.8 percent annualized growth in the second half of 2023. Moreover, the Blue Chip Consensus Forecast expects real GDP growth to slow to annualized rates of 2.3 percent in the third quarter and 1.8 percent in the fourth quarter of this year. Consumption is expected to downshift as the economy has yet to feel all the restraint from previous monetary tightening efforts.

In addition, the support to GDP growth from fiscal policy is fading. In 2023 the CHIPS and Science Act, the Infrastructure and Jobs Act, and other fiscal measures helped to power a surge in real business spending on structures and real federal nondefense spending on structures, equipment, and intellectual property. In the first quarter of 2023, these business and government spending components of GDP contributed almost a full percentage point to the quarter's 2.8 percent increase in total real GDP.[20] But growth in these areas made only a negligible contribution to GDP growth in the second quarter of this year. On a full year-over-year basis, the Blue Chip Consensus Forecast expects real GDP to be 2.7 percent in 2024 and 2.0 percent in 2025. See figure 4.

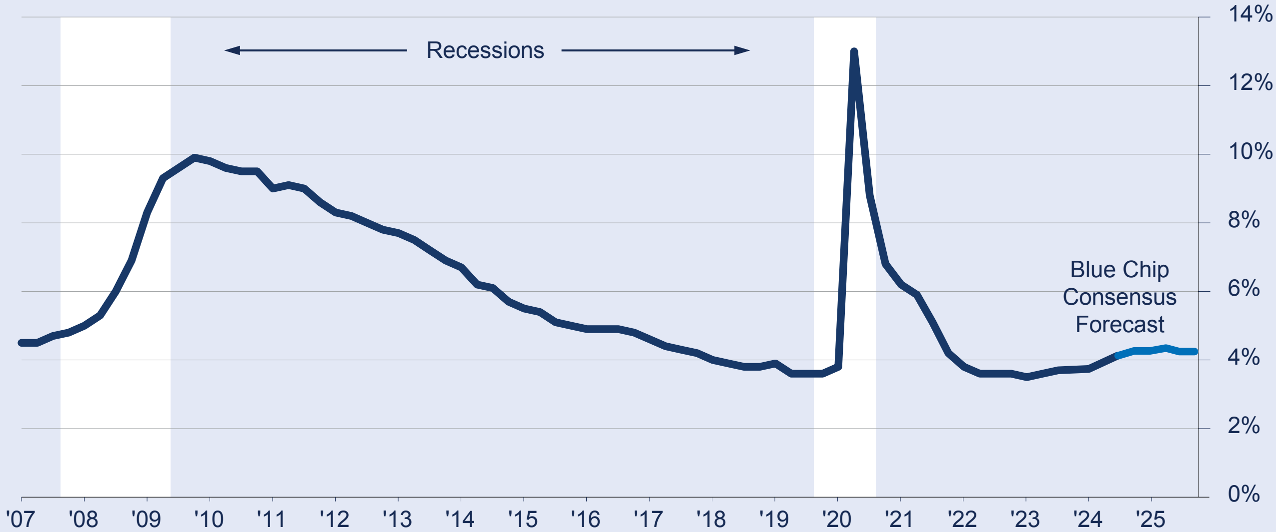
FIGURE 4: REAL GDP, PERCENT CHANGE ANNUAL RATE



Sources: Bureau of Economic Analysis (second quarter 2024), Blue Chip Economic Indicators, October 2024

20 U.S. Bureau of Economic Analysis, "Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product."

FIGURE 5: QUARTERLY AVERAGE UNEMPLOYMENT RATE, PERCENT



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

The labor market rebounded in September, adding 254,000 jobs, up from 159,000 the previous month.[21] The unemployment rate fell slightly to 4.1 percent. See figure 5. Although September's jobs report exceeded expectations, other recent indicators signaled a slightly less vigorous hiring picture. A Labor Department report showed that the percentage of workers quitting their jobs in August dropped to its lowest rate since 2020,[22] an indication that workers are becoming increasingly cautious about leaving their current jobs for new ones. In addition, the Bureau of Labor Statistics' preliminary estimate of the upcoming annual benchmark revision to its establishment survey suggests that 818,000 fewer jobs were created in the 12 months that ended in March of this year than initially reported. When distributed across the entire year, this indicates that employers added 173,500 jobs per month, down from 242,000 per month as published in the bureau's original survey. This suggests that the labor market was not as robust as originally believed although hiring was still solid by historical standards.

The headline PCE price index (the price index for personal consumption expenditures) increased 2.2 percent in August 2024 from a year earlier, down from a 2.5 percent pace the previous month. Inflation has declined steadily since peaking at 7.3 percent in June 2022 but remains somewhat above the Federal Reserve Board's 2.0 percent target. Food and energy price inflation has eased back sharply since peaking in mid-2022. But inflation in housing costs (shelter inflation) remains elevated, despite trending downward since March 2023. Inflation in transportation services also remains high. Both shelter and transportation services have impeded progress toward the Federal Reserve Board's target rate, although most economists expect price pressures in both areas to retreat significantly through 2025. Core-PCE (the personal consumption expenditure price index less food and energy) increased 2.7 percent in August 2024, roughly

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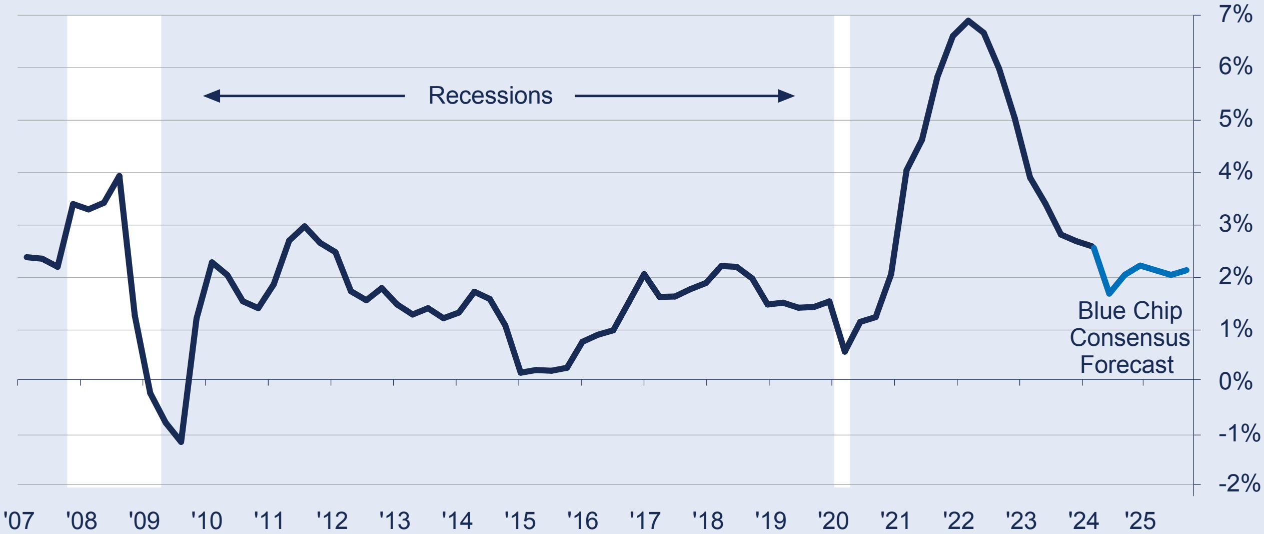
21 U.S. Bureau of Labor Statistics, "The Employment Situation – September 2024," October 4, 2024.

22 U.S. Bureau of Labor Statistics, "Job Openings and Labor Turnover – August 2024," October 1, 2024.

the same pace as July. The Blue Chip Consensus Forecast expects that core-PCE inflation will slow through the remainder of this year and next, falling to 2.1 percent by year-end 2025. See figure 6.

FIGURE 6: CORE PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX, YEAR-OVER-YEAR PERCENT CHANGE



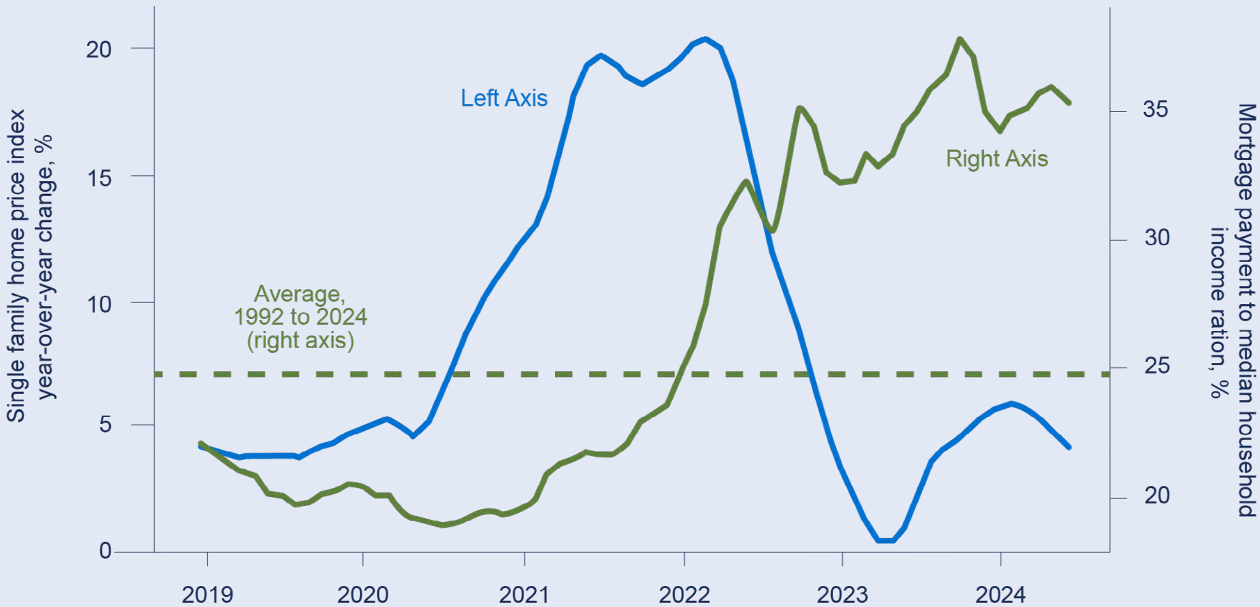
Sources: Bureau of Economic Analysis (second quarter 2024), Blue Chip Economic Indicators, October 2024

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

DESPITE LOW INVENTORY OF HOMES FOR SALE, HOME PRICE GROWTH SLOWED IN FIRST HALF OF 2024 AS AFFORDABILITY CHALLENGES CURTAILED DEMAND

After rebounding during the second half of 2023, the national home price appreciation slowed to around 4.0 percent during the first half of 2024. Relative to home prices in June 2023, in June 2024 home prices slowed or declined the most in metro areas in the Southeast and South. The largest declines were concentrated in Florida, Louisiana, and Texas metro areas. See figure 7.

FIGURE 7: U.S. SINGLE-FAMILY HOME PRICE INDEX YEAR-OVER-YEAR CHANGE, % AND MORTGAGE PAYMENT OVER MEDIAN HOUSEHOLD INCOME RATIO, %



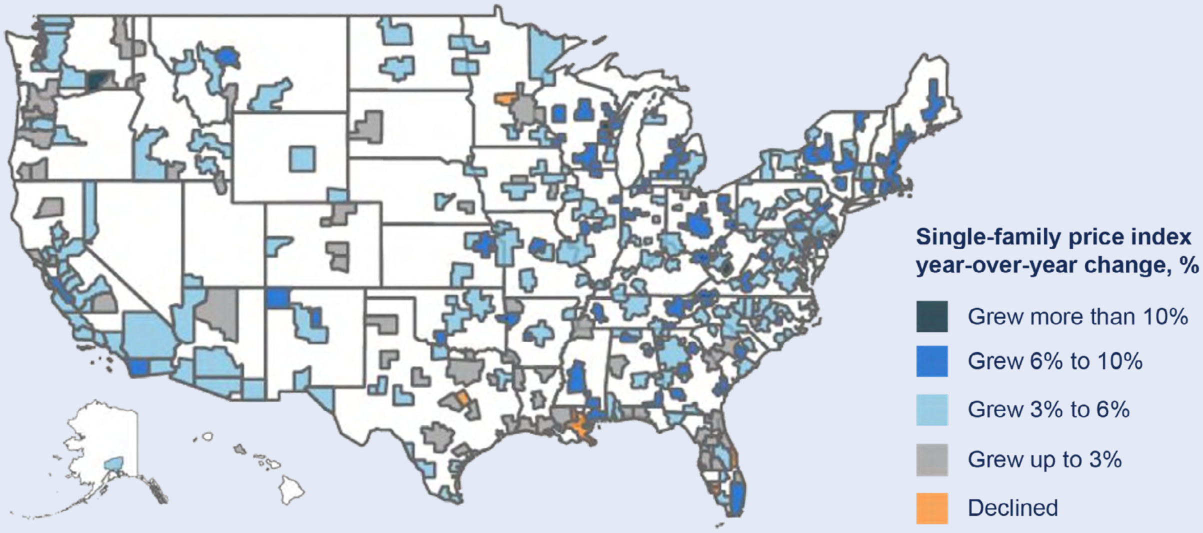
Sources: Intercontinental Exchange Inc. (ICE), Freddie Mac, Census Bureau, Moody's Analytics (updated September 2024)

Note: This figure 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. ICE HPI level is used as the base price for the market average property.

Affordability challenges have contributed to slowing home price growth. Homeownership affordability, as measured by the mortgage burden,[23] worsened during the first half of 2024. At the national level, mortgage burden peaked in October 2023 at a little less than 38.0 percent of the median household income or more than 13.0 percentage points above the historical average of 24.8 percent. See figure 8. Though affordability has slightly improved since, it stood above its historical average by more than 10.0 percentage points in May 2024. Continued affordability issues have limited housing demand especially from first-time homebuyers.

23 Mortgage burden is defined as the ratio of the mortgage payment (for an average-priced home) to median household income ratio.

FIGURE 8: CHANGES IN SINGLE FAMILY HOME PRICES BETWEEN JUNE 2023 AND JUNE 2024

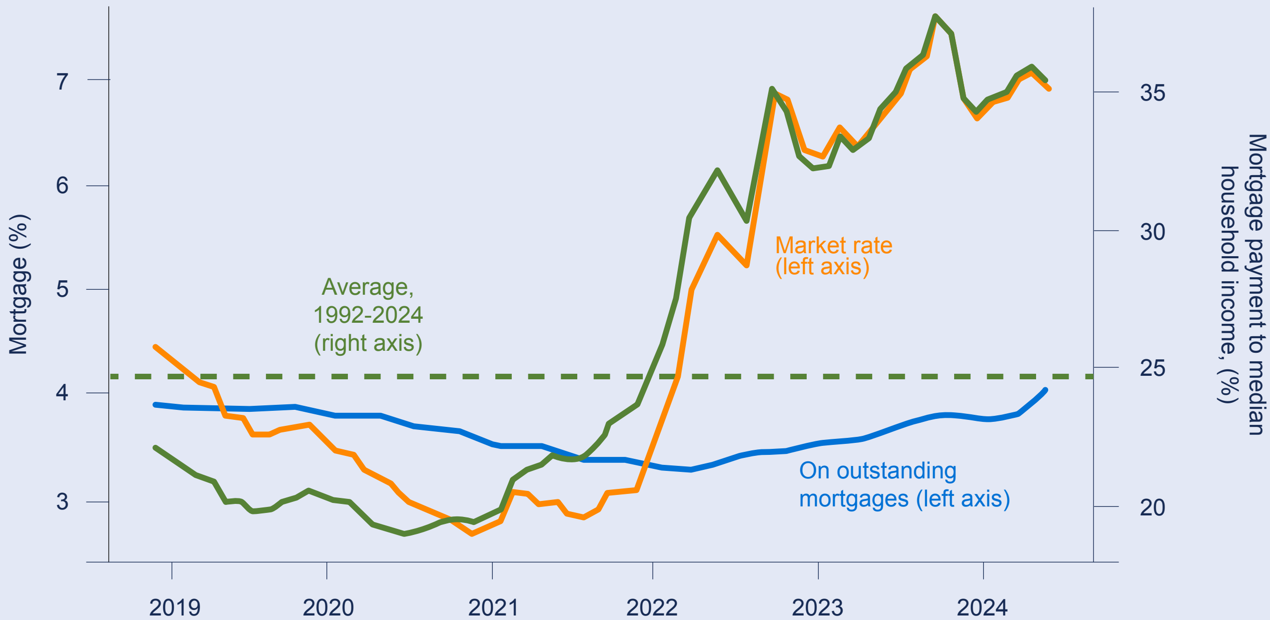


Sources: Intercontinental Exchange Inc. (ICE), Freddie Mac, Census Bureau, Moody's Analytics (updated September 2024)

Note: This figure 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. ICE HPI level is used as the base price for the market average property.

Home sales continued to fall as housing supply was limited alongside reduced demand. Many homeowners took advantage of the very low mortgage rates from mid-2020 to 2021 by either purchasing a new home or refinancing their existing mortgage. See figure 9. This has resulted in a "rate lock-in" effect keeping existing homes from the market.

FIGURE 9: U.S. 30-YEAR MORTGAGE RATE, AVERAGE MORTGAGE RATE ON OUTSTANDING DEBT AND MORTGAGE PAYMENT TO MEDIAN HOUSEHOLD INCOME RATIO (%)



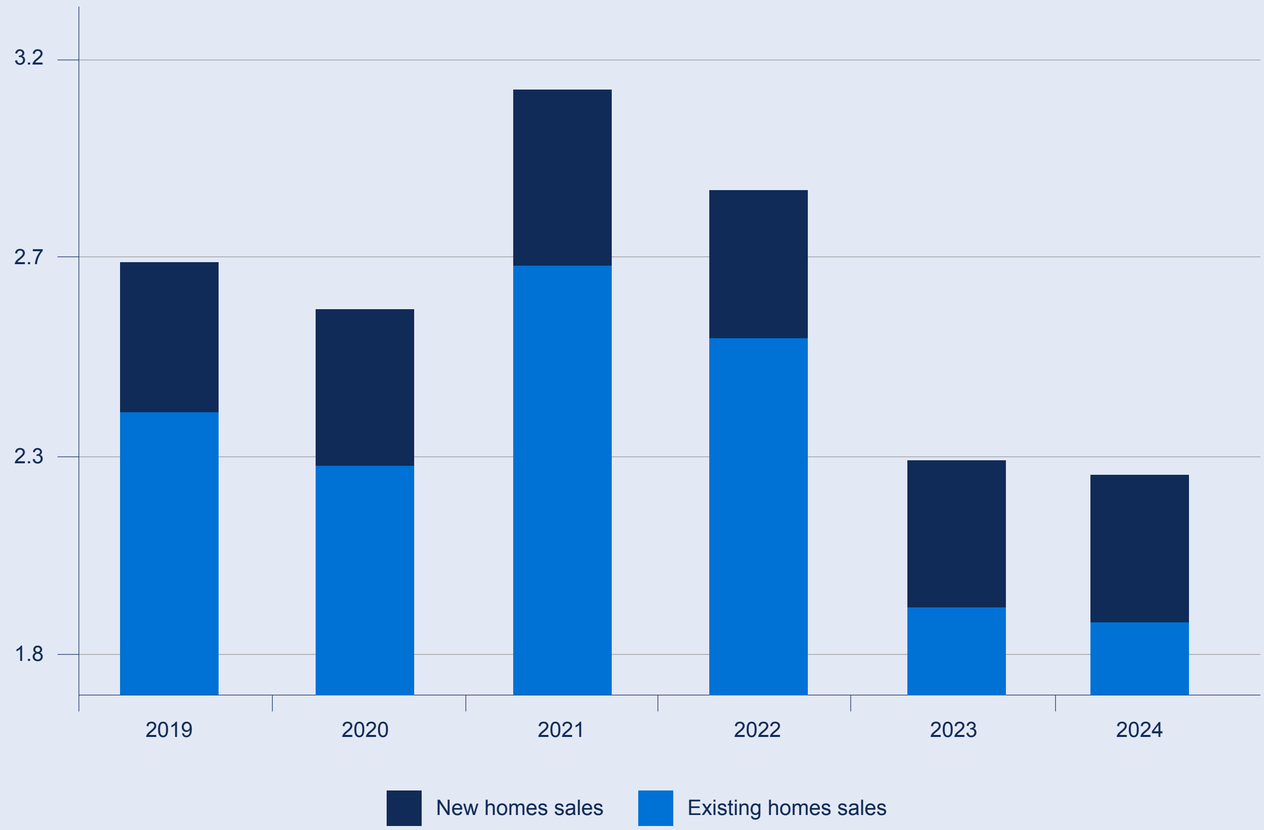
Sources: ICE, Freddie Mac, Census Bureau, Bureau of Economic Analysis, National Association of Realtors (NAR), Moody's Analytics (updated September 2024)

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. ICE HPI 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.

As interest rates on most homeowners' mortgages are nearly 300 basis points lower than currently offered market rates,[24] homeowners are less motivated to look for a new home. Home sales in the first half of 2024 were roughly at the same level as in the first half of 2023, but 15.0 percent below the average over the four prior years. See figure 10. Further, the share of new homes of all homes sold had increased from 12.4 percent in 2019 to 15.4 percent in 2024.

24 In June 2024 the average mortgage rate on outstanding mortgages was 4.04 percent and the market rate was 6.92 percent.

FIGURE 10: U.S. HOME SALES DURING 1Q AND 2Q (MILLIONS)



Sources: ICE, Freddie Mac, Census Bureau, Bureau of Economic Analysis, NAR, Moody's Analytics (updated September 2024)

CONSUMERS REMAIN RESILIENT, BUT HEADWINDS EXIST

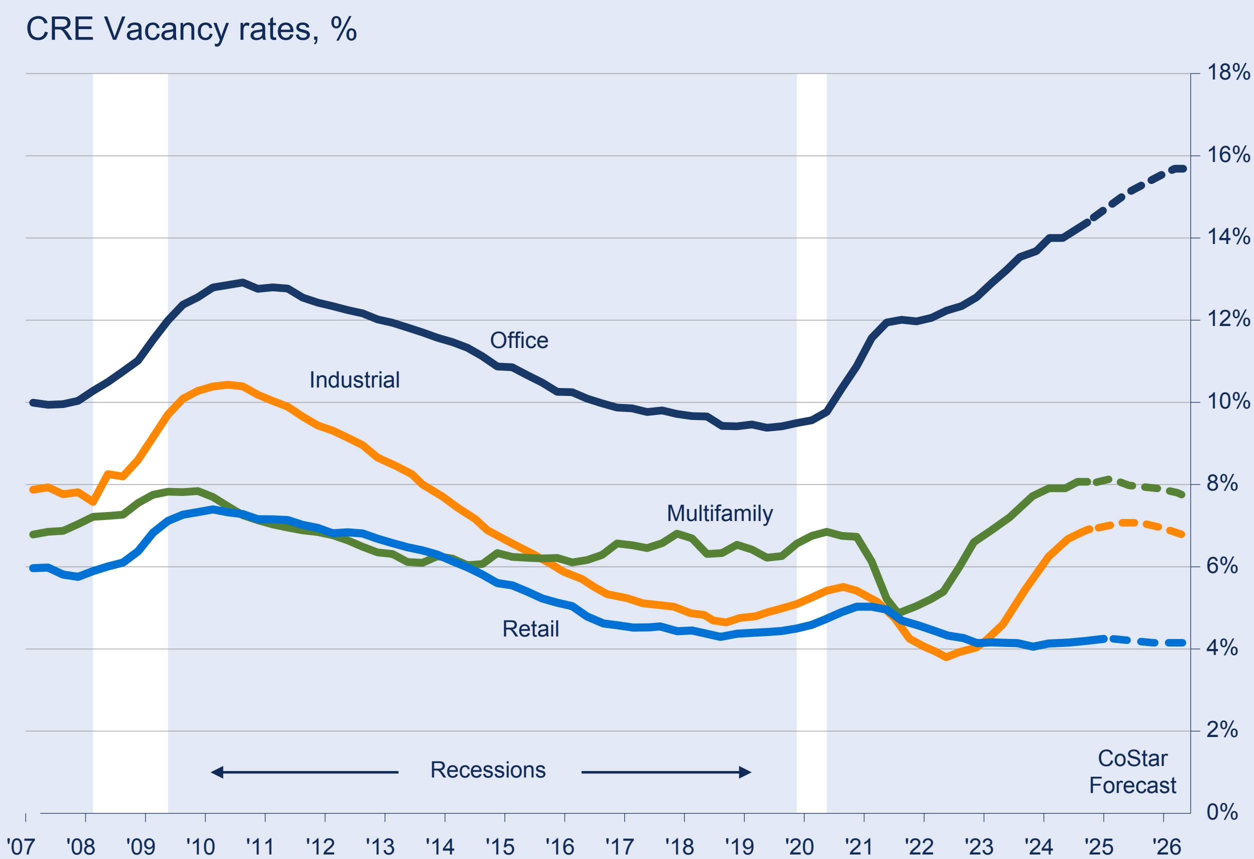
Despite a cooling labor market, consumers continued to spend in the first half of 2024. On a nominal basis, consumer spending was up 5.3 percent year-over-year in June 2024. The growth was led by services, which was up 6.9 percent, while spending on goods was up 2.2 percent year-over-year. On a price-adjusted basis, service spending was up 3.0 percent and spending on goods was up 2.5 percent. The strong growth in spending has pushed the savings rate down to 2.8 percent in the second quarter of 2024. The growth in asset prices increased the net worth of households and nonprofit organizations by 9.0 percent year-over-year, which supported the spending growth.

However, the maturing economic cycle may cause headwinds for the consumer. Job openings and quit rates have been declining, and the cooling job market may negatively affect wage growth. A slowing labor market, rising consumer delinquencies, and higher prices could cause financial stress to consumers and slacken consumption.

ONGOING CHALLENGES CONTINUE TO WEIGH ON THE CRE SECTOR

After shrinking for two years, demand for office space turned positive in the second quarter of 2024, but additional new supply pushed the national vacancy rate to a record high of 13.8 percent. See figure 11. Despite the vacancy rate being forecast to peak at 16.0 percent in late 2026, property prices and over-the-year asking rent growth are expected to reach bottom and start to rebound in the second half of 2025 as net completions slow considerably. The large drop in valuations, however, could translate into increased risk distressed sales, which could then push prices even lower.

FIGURE 11: OFFICE, MULTIFAMILY, INDUSTRIAL, AND RETAIL COMMERCIAL REAL ESTATE SECTORS



Source: CoStar Portfolio Strategy (historical data through second quarter 2024)

The multifamily sector is stabilizing following two years of rising vacancy rates. The national vacancy rate in the second quarter of 2024 remained unchanged from the last quarter at 7.8 percent. See figure 11. Rising net absorption significantly reduced the imbalance between multifamily demand and supply, easing pressure on the vacancy rate. Increased demand, alongside a stabilization in rent growth, contributed to the uptick in multifamily property prices that had been declining since the second quarter of 2022. However, some markets in the South and Southeast continue to face oversupply, resulting in double-digit vacancy rates. Higher expenses, including insurance and maintenance costs, along with recently enacted state-level rent regulations have contributed to a slowdown in NOI growth. The multifamily sector is forecast to rebound in early 2025, with an improvement in vacancy rates and stronger growth in ask rent and property prices.

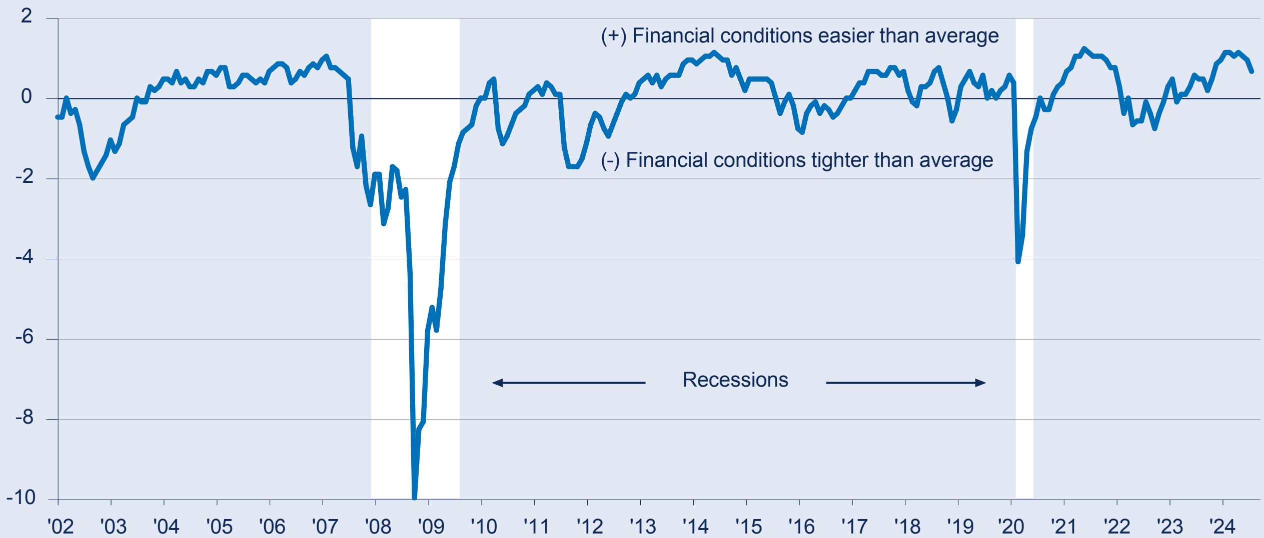
The industrial and retail sectors continue to outperform other commercial property types despite some expected softening in the near term. Industrial sector fundamentals softened further in the second quarter of 2024 from new supply continuing to outpace demand growth. The national industrial vacancy rate continued to increase, reaching 6.5 percent, which contributed to further deceleration in rent growth; see figure 11. Supply pressures are expected to ease in the second half of 2025, allowing the industrial vacancy rate to plateau, while rent and price growth start to rebound. For the retail sector, the reduction in store closures and tenant bankruptcies, along with tight supply, continue to support fundamentals. The national retail vacancy rate moved sideways in the second quarter to 4.0 percent, remaining below its pre-pandemic level; see figure 11. As consumer spending growth moderated, over-the-year asking rent growth has declined but remains above 2019 levels. However, there is significant variation in retail rent growth across the country. Markets in the South and Southwest, with strong population growth, have outperformed that national rate while Northeast and Midwest markets, with weak growth or even declining populations, have underperformed the national average.

The hotel sector is generally healthy as consumer and business travel spending held steady over the past year, although current results are bifurcated by property segment. The national hotel sector occupancy rate has remained slightly under pre-pandemic levels over the past year. Although occupancy rates softened for all properties, they improved in August among economy and midscale properties. The national inflation-adjusted revenue per available room (RevPar) has also remained somewhat below pre-pandemic levels, although performance was uneven at the low and top ends of the market. Real RevPar for luxury hotels was 1.0 percent higher in August compared with August 2019, as upper-income households continued to spend on leisure travel and corporate travelers have returned. For economy hotels, real RevPar was down nearly 6.0 percent in August compared with August 2019, as lower-income households facing higher expenses chose to travel less.

FINANCIAL CONDITIONS REMAINED EASED AS INTEREST RATES DECLINED

Financial conditions continued to ease relative to their long-run historical average over the past six months. See figure 12. The labor market came into better balance as supply shortages eased, but remained historically strong, alongside steady progress on disinflation. The Federal Reserve Board reduced interest rates by 0.5 percentage points during their September meeting. Futures markets and forecasts have benchmark policy rates declining by over 1.7 percentage points through the end of 2025.

FIGURE 12: U.S. FINANCIAL CONDITIONS INDEX



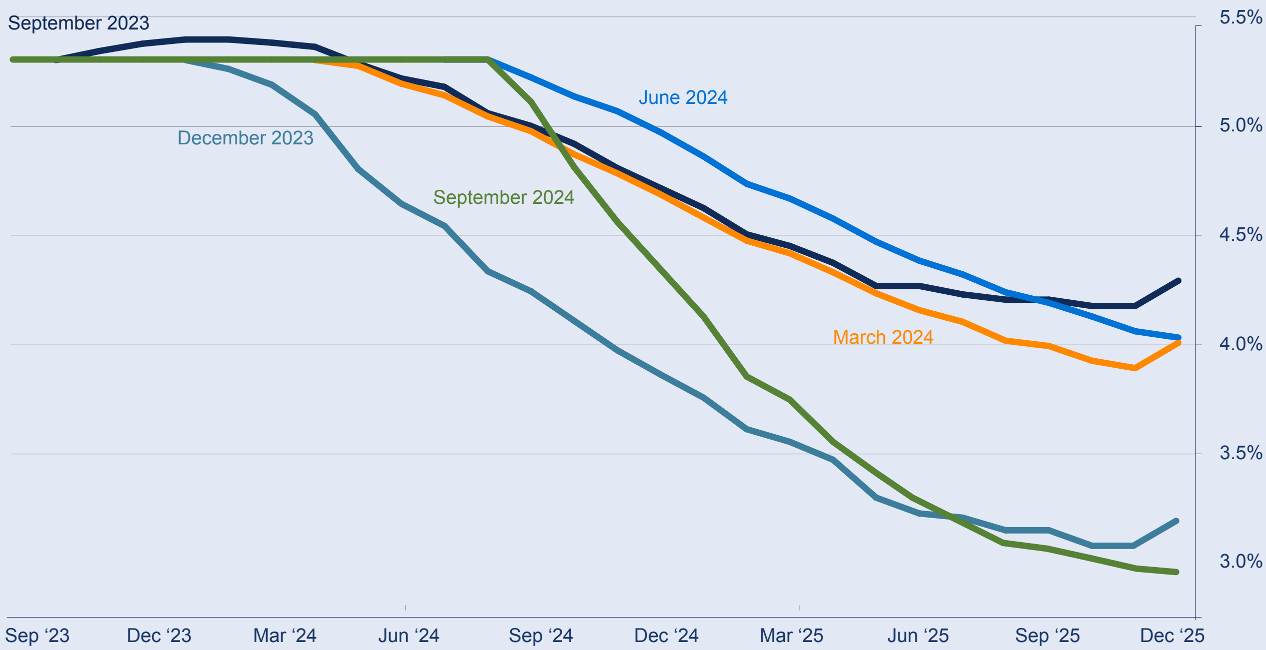
Source: Bloomberg (data are monthly average of daily data through September 30, 2024)

Note: The Bloomberg 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, and a negative value indicates tighter financial conditions relative to pre-2008 crisis norms.

Risks to the U.S. financial market outlook, however, were little changed through the third quarter of 2024. The Federal Reserve Board cut interest rates, though the continued pace and timing remain dependent on labor market and inflation dynamics. Market expectations, implied through federal funds futures, were more dovish than in the first quarter of 2024, suggesting a steep reduction of the federal funds rate through the end of next year. See figure 13. Meanwhile, the central bank reduced the reinvestment cap on Treasury reinvestments from $65.0 billion to $25.0 billion per month in July 2024, effectively reducing the pace of balance sheet reduction. Reinvestment caps on mortgage-backed securities holdings remained unchanged at $35.0 billion per month. Funding levels remain ample.

Banking system reserves declined by over $300.0 billion since March 2024 and are forecast to decline gradually through 2025.[25]

FIGURE 13: IMPLIED FEDERAL FUNDS RATE FROM FEDERAL FUNDS FUTURES



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

Treasury market yields declined, and prices rose since March 2024. The term spread, as measured as the difference between 10-year note and 3-month bill prices, remained deeply inverted. An inversion suggests an elevated risk of recession in the next 12 months.[26] There are reasons that this is not consistent with prior interest rate or economic cycles, but rather suggests a “soft landing” when short-term policy rates decline in response to a successful disinflation while measures of economic activity are consistent with an expansion. The forward Treasury term spread implies a significant steepening over the next 24 months. See figure 14.

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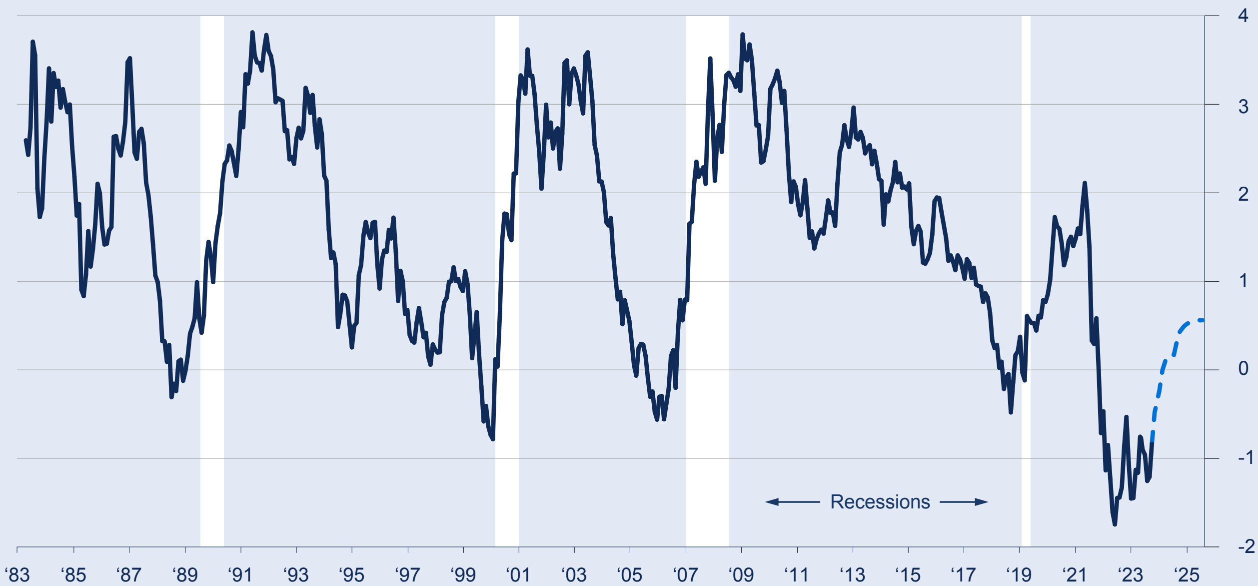
25 Federal Reserve Bank of New York, “Survey of Primary Dealers,” July 2024.

26 As of September 9, 2024, the probability of recession implied by the 10-year note minus 3-month bill spread is 62.40 percent.

FIGURE 14: TREASURY TERM SPREAD SPOT AND FORWARD SPREADS, PERCENT



Source: Bloomberg (October 4, 2024)

Note: The light blue dashed line is the 10-year note forward rate minus the 3-month bill rate at forward maturities by month.

Treasury market volatility, measured by the Bank of America Merrill Lynch MOVE index, increased modestly since the spring. Market participants priced in some higher economic uncertainty ahead of interest rate decisions and potential geopolitical risk events.[27] Market liquidity was robust over the two quarters despite record auction sizes, continued reduction of Federal Reserve Board holdings, and deep inversion along the yield curve. Money market funds have continued to hold and purchase T-bills with repos by continuing to decrease funds from the Federal Reserve Board's Overnight Reverse Repurchase Facility. The pace of this trend slowed in the past two quarters as modest uncertainty remained for the outlook in interest rate policy and asset managers' portfolio preferences.

Equity markets reached new highs at the beginning of the third quarter as economic activity surprised to the upside and the potential for lower rates outweighed concerns over modest weakening in labor market indicators. Equity market volatility, measured by the S&P 500 VIX Index, spiked in early August on a weaker than expected monthly employment report. Volatility readings remain elevated relative to levels in early 2024.

Credit spreads remain tight. See figure 15. Investment-grade and high yield bond issuance is significantly above calendar year levels year-to-date for 2024. Typically, this suggests ample liquidity in corporate capital markets and outlook for a "soft landing" scenario by market participants.

27 As of October 4, 2024.

FIGURE 15: INVESTMENT-GRADE AND HIGH YIELD BOND OPTION ADJUSTED SPREADS, BASIS POINTS

Source: Bloomberg (data through September 27, 2024)

A few economic and financial sector risks remain that, if realized, could present challenges to capital market performance over the coming year: a more rapid deterioration in labor markets, reacceleration in inflation, further stress in select CRE sectors, and a mismatch between the easing of short-term interest rates at a slower pace than currently anticipated by market participants. As of September 2024, most international equity indexes underperformed U.S. benchmarks for the calendar year. The U.S. dollar measured in inflation-adjusted terms on a trade-weighted average inched lower.

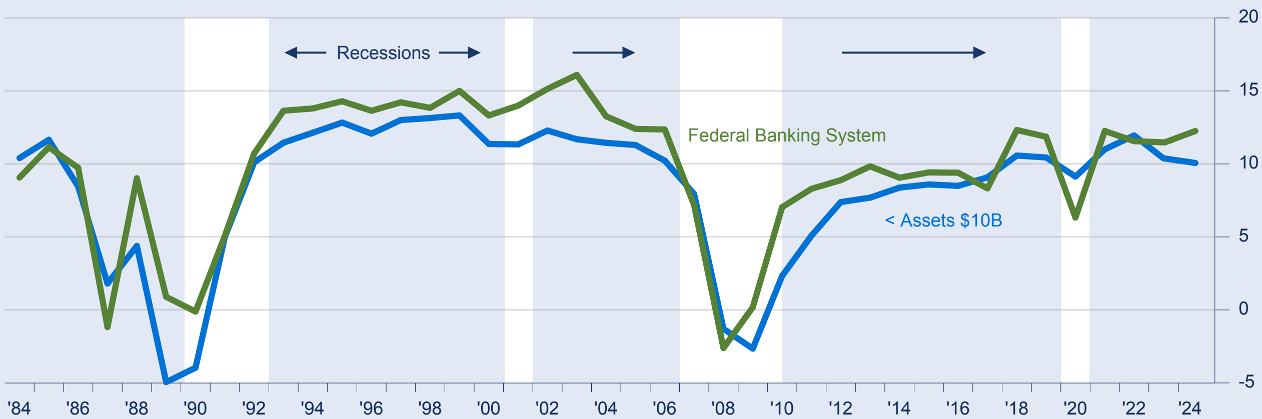
PART IV

BANK PERFORMANCE

BANK EARNINGS FACED CHALLENGES IN THE FIRST HALF OF 2024, AMID ELEVATED INTEREST RATES

Profitability for the federal banking system weakened in the first half of 2024, as interest rates remained high to tame inflation, pressuring banks on multiple fronts. Return on equity for the system, driven by the largest institutions, declined to 12.2 percent from 13.3 percent a year ago.[28] For banks with less than $10.0 billion (community banks) in assets, profitability also declined from a year ago by a similar amount. See figure 16. While higher interest rates continued to lift to asset yields, loan volumes and NIMs were lower, and limited revenue support pressured earnings. With the Federal Reserve Board's September 2024 rate cut, the outlook for the remainder of the year rests on how bank margins respond to lower interest rates, while facing potentially weaker loan growth and higher credit costs.

FIGURE 16: TREND IN BANK RETURN ON EQUITY



Source: Call reports from OCC Integrated Banking Information System

Note: Data are annual values 1984-2022 and year-to-date annualized for 2024. Banks with less than $10 billion in total assets exclude credit card and trust institutions.

28 On a year-to-date basis through the second quarter of each year.

While NII benefited from higher interest rates in 2023, those benefits normalized in 2024 as higher funding costs outstripped gains in asset yields. For the federal banking system, NII declined 1.0 percent from one year ago; for community banks, the decline in NII was about half as large.[29] Banks also continued to build reserves, and noninterest expense was higher than one year ago. Overall, this led to a decline in net income for the system and community banks, 5.7 percent and 6.6 percent, respectively. See table 1.

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

	Federal Banking System			Banks with total assets <$10 billion		
	6/30/2023	6/30/2024	Y/Y % change	6/30/2023	06/30/2024	Y/Y % change
Year-to-date **revenues** in billions of dollars						
Net interest income	229	227	-1.1%	12.4	12.3	-0.5%
Noninterest income	113	112	-1.0%	4.4	4.6	3.3%
Year-to-date **expenses** in billions of dollars						
Provisioning	31	33	7.1%	0.7	0.7	5.4%
Noninterest expense	189	197	4.4%	10.6	11.1	4.6%
Net income	97	92	-5.7%	4.4	4.1	-6.6%

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 2020 to the second quarter of 2024. Banks with less than $10 billion in total assets exclude credit card and trust institutions.

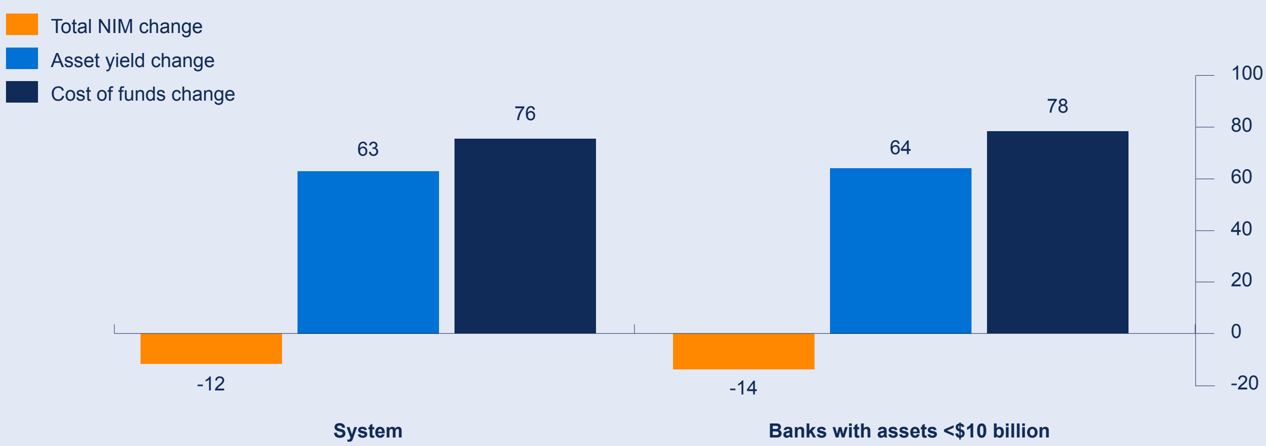
Behind the slowdown in NII, NIMs were lower than one year ago for both the system and community banks. See figure 17. Through the second quarter of 2024, the federal funds rate had remained flat since July 2023, deposit costs continued to rise as depositors switched to higher-yielding alternatives, and the delayed impacts of deposit repricing took hold. The overall cost of funds for the system increased from a year ago; for community banks, the increases were more pronounced, with funding pressures materializing later in this cycle among the smaller institutions. Since the beginning of the rate tightening cycle that began in March

29 In the second quarter of 2024, NII for community banks increased 1.8 percent from one year ago, reflecting margin pressures that began to ease from earlier in the year.

2022, the cumulative nine-quarter deposit beta for the system—54.0 percent through the second quarter of 2024—was higher than the cumulative beta at the same point in the prior three rate tightening cycles.

Although funding costs continued to rise, the pace of those increases eased in the second quarter, compared with the steeper rise in funding costs late last year, with some banks beginning to see NIM pressures mitigated. At the same time, elevated rates lifted yields on the loan portfolio and other interest-earning assets, but those gains moderated from the past year amid weaker loan volumes.

FIGURE 17: CHANGE IN NIM COMPONENT (BASIS POINTS), YEAR-TO-DATE 2023 TO 2024



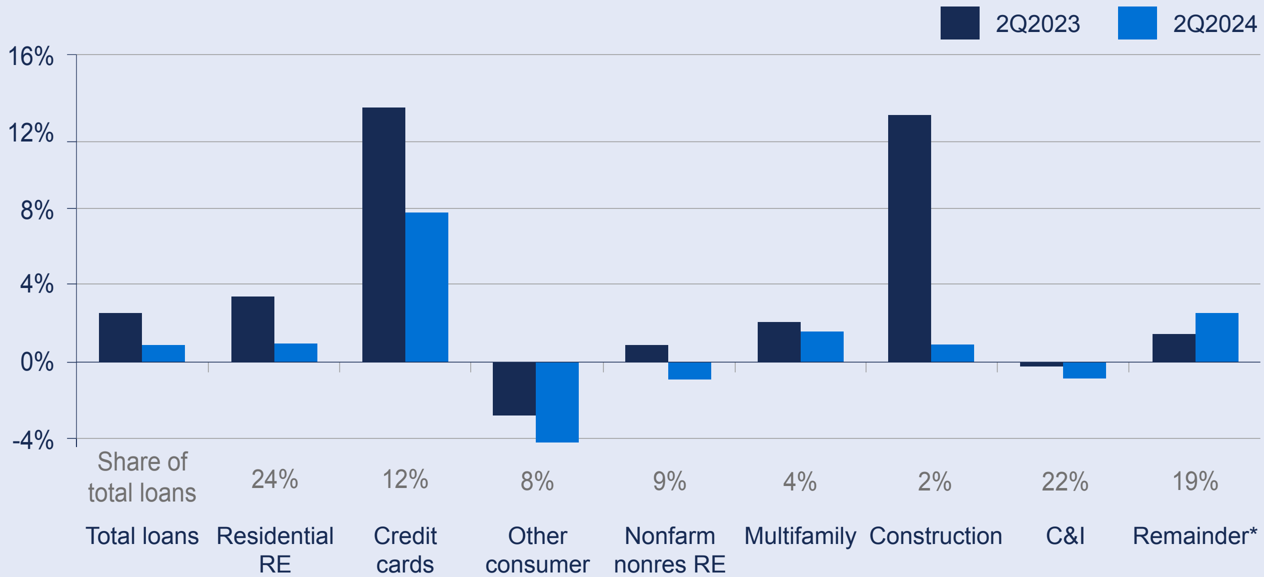
Source: Call reports from OCC Integrated Banking Information System

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 2023 and 2024 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 2023 and 2024 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 year-to-date and merger-adjusted and held constant for banks in continuous operation from the first quarter of 2020 to the second quarter of 2024.

Loan growth for the system slowed to 1.0 percent from a year ago. Deposits grew at a similar pace, nearly 1.0 percent, following several quarters of negative growth in 2023. With loan growth exceeding deposit growth for much of 2022–23, loan-to-deposit ratios returned to pre-pandemic levels in the second quarter, as excess liquidity dried up.

Behind the slowdown in loan growth for the system was a decline in commercial and industrial lending—which comprises nearly a quarter of total loans—as well as a decline in nonfarm nonresidential CRE. See figure 18. Growth in credit card lending was more robust, growing nearly 8.0 percent from a year ago, but lending in other types of consumer loans declined from a year ago. For community banks, loan growth was more resilient and increased 5.0 percent from a year ago, supported by property loans. Key loan segments for community banks, residential real estate, and nonfarm residential CRE—together accounting for nearly 60.0 percent of community bank lending—grew 7.0 percent and 6.0 percent, respectively.

FIGURE 18: YEAR-OVER-YEAR CHANGE IN LOAN BALANCES FOR THE FEDERAL BANKING SYSTEM, PERCENT



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 2020 to the second quarter of 2024. "Other consumer" is consumer loans less credit card loans. "Remainder" includes agricultural loans, loans to governments, banks, and municipalities.

Recent changes in banks' balance sheets have positioned institutions to potentially benefit more from a rate decline relative to prior periods when the Federal Reserve Board lowered interest rates. The proportion of banks with positive net short-term liabilities is at the highest in more than a decade, for example.[30] See figure 19. As of the second quarter of 2024, 60.0 percent of banks were net short-term liability sensitive, compared with 40.0 percent of banks at the beginning of 2019, the start of the previous rate lowering cycle. Since 2023, community banks are more likely to be net short-term liability-sensitive: among banks with less than $10 billion in assets, 63.0 percent had a positive ratio compared with 49.0 percent of banks with over $10.0 billion in assets.

At the same time, banks rebalanced or shifted balance sheets toward longer-maturity assets. As of the second quarter, for example, the long-term asset ratio was above the average share of long-term assets held from 2012–2019, suggesting that banks may retain the benefit on asset repricing if interest rates fall, more so than prior periods when interest rates declined. While it can be hard to predict the impact of changes in interest rates on bank earnings, these movements in the balance sheet suggest banks may be better positioned for a rate decline compared with prior periods.

30 "Net short-term liabilities" are defined as liabilities one year or less minus assets year or less, as a share of total assets.

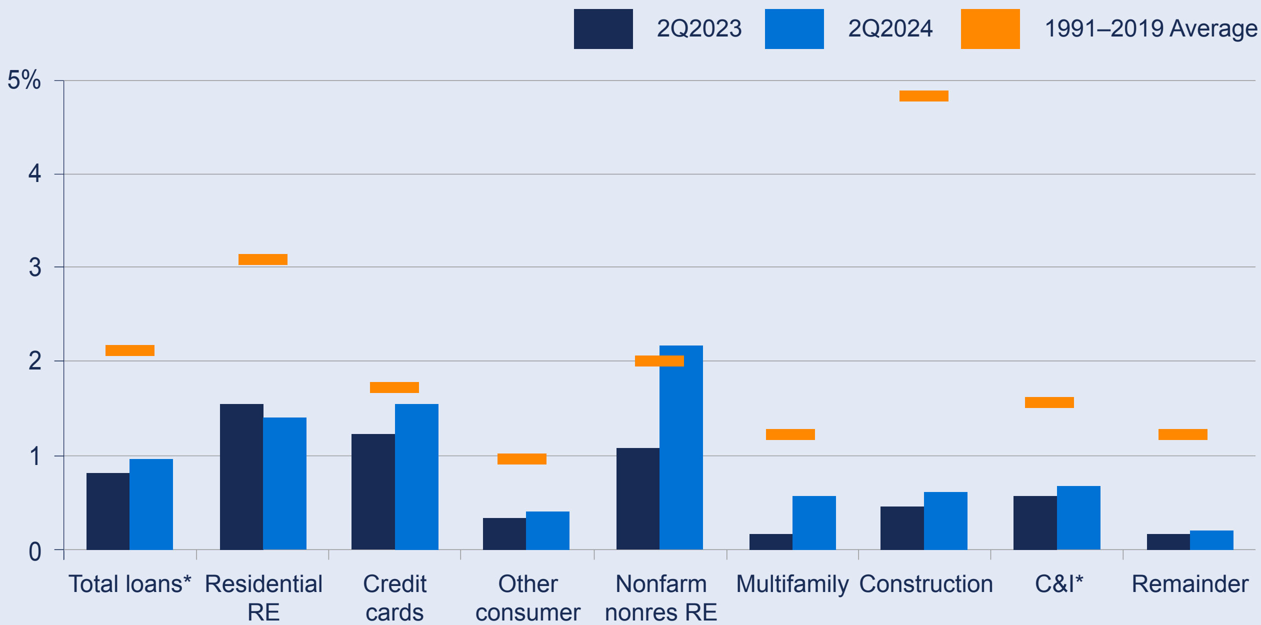
FIGURE 19: SHARE OF BANKS WITH NET SHORT-TERM LIABILITY SENSITIVITY, PERCENT

Source: Call reports from OCC Integrated Banking Information System

Note: Short-term liabilities defined as CDs and other borrowings one year or less plus federal funds purchased less assets with one year remaining maturity plus cash balances and federal funds sold.

In the first half of 2024, credit performance weakened from the year prior but remained strong relative to historic levels, with overall credit quality above the long-term average level of the system. See figure 20. The noncurrent loan rate for total loans increased to 1.0 percent, compared with 0.8 percent a year ago. Deterioration in credit quality was more evident in CRE loan products, particularly nonfarm nonresidential CRE, where the noncurrent rate rose slightly above the 1991–2019 average rate. Noncurrent loan rates for all other loan categories remained below their historical average. For community banks, noncurrent rates also rose slightly from historically low levels but remained below the 1991–2019 average in all loan categories.

FIGURE 20: NONCURRENT LOAN RATES FOR THE FEDERAL BANKING SYSTEM, PERCENT



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 2020 to the second quarter of 2024.

* Excludes Paycheck Protection Program loans. "Remainder" includes agricultural loans and loans to governments, banks, and municipalities.

LIST OF ABBREVIATIONS

ACL	allowance for credit loss
AI	artificial intelligence
BSA/AML	Bank Secrecy Act/Anti Money-Laundering
CRA	Community Reinvestment Act
CRE	commercial real estate
FinCEN	Financial Crimes Enforcement Network
FOMC	Federal Open Market Committee
ICE	Intercontinental Exchange Inc.
LMI	low- and moderate-income
ML	machine learning
NAR	National Association of Realtors
NII	net interest income
NIM	net interest margin
NOI	net operating income
NRC	National Risk Committee
OCC	Office of the Comptroller of the Currency
P2P	peer-to-peer
PCE	personal consumption expenditure
RevPAR	revenue per available room
SAR	suspicious activity report
UDAAP	unfair, deceptive, or abusive acts or practices
UDAP	unfair or deceptive acts or practices