Speech of Commissioner Katherine Bosken before the
NCBA/NCCOB Directors Assembly
March 4, 2024
State of Banking in North Carolina

Introduction

Good evening!

I'm glad you're all here and willing to allow me to sub in as your dinner speaker tonight. Unlike Peter and Harry, I usually feel a little uneasy about standing before a group such as this, and here on March 4, 2024, I have to say my discomfort is a little higher than normal. My team and I am continuing to watch a certain institution in New York, with my attention directed at making sure that whatever happens there does not spread to here. So, while I'm not expecting any urgent alerts to buzz through everyone's phones, please don't ask me about whatever news you catch right now, because I don't know any more about that situation than you do right now.

I should also say that if you missed the panel this morning and you aren't tired of me yet, I'll be happy to take your questions at the end.

Financial Outlook from My Perspective

Much as it was in 2022, our economy, our citizenry, and our financial services environment are healthy and robust. Could North Carolina stand to make a few improvements around the edges? Sure! We still don't have broadband access in all 100 counties, we keep adding more toll roads in Raleigh and Charlotte, and the green doom will be upon us any day now. All of which is to say, while I'm glad to live in the Old North State, I can still see some things that I might improve upon around the edges.

The thing of it is, as it relates to financial services, there's really only one specific area I'd like to improve upon. That is the number of independent state-chartered banks here (and by extension across the country). And here's why – the resilience in our financial system comes in large part from its diversity. Not from regulation, not from Washington, and not from hyper complex risk management systems.

And yet, because of increasing regulatory burden, shifting expectations after March 2023, and competition from other actors in the financial services space, plus a sprinkle of this philosophy I think of as "capitalism is unfair," we are seeing increasing homogenization and consolidation.

Let me take you through the numbers – our state has 35 state-chartered banks headquartered here, another handful of national banks and federal savings banks also headquartered here, plus another 57 out-of-state institutions that have branched into our state. That's less than 100 insured bank depositories to act as financial intermediaries, and with credit unions included, we get to around 130 insured institutions.

Perhaps in day-to-day operations, that feels like a lot of competition, but historically, that's a pretty limited number of organizations. That narrowing of the field, if you will, makes your job and my job all the more significant – your job is to supervise management, provide effective challenge, and prepare for whatever might come in 2024, so your bank doesn't make the evening news in a way that prompts your neighbors to call you. My job is to ensure that my staff is empowered to find material weaknesses, bring them to your attention, and partner with you to find a workable solution given the facts at hand.

We'll talk about what that regulatory partnership ought to look like in a little bit, but first, I'm going to review some of the background figures that inform my outlook here.

Assets and Deposits

The financial performance and condition of our banks remains stable year over year. Aggregate total assets for NC state-chartered banks started 2023 at $709 billion, increased to $830 billion with FCB's acquisition of SVB, and have gradually decreased to $793 billion as of year-end 2023.

Asset and deposit growth continued at most of our banks over last year, but the volume and pace of growth has slowed down year over year. Fifty four percent of North Carolina charters had net loan growth over 10 percent during 2023, and only 5 banks reported net decreases, all of which were less than 5% in magnitude. Excluding Surrey Bank & Trust (which as you know merged away to a Virginia-based bank), the aggregate total assets of community banks increased by $5.9 billion, and aggregate total deposits increased by $3.9 billion during 2023.

Asset quality is also doing well. The volume of delinquencies as a proportion of the loan portfolio stayed stable over the year, even though we're all still waiting on the most hotly anticipated recession of all time. The Delinquency Ratio for all banks in portfolio was 1.3% as of December 31, 2023, compared to 1.5% in 2022.

Aggregate troubled assets as a percentage of equity capital plus the allowance declined, going from 7.3% at year-end 2022 to 7.1% at year-end 2023. While I can spot a few outliers here, the numbers aren't anything like what a few of my sister states are dealing with. The aggregate ALLL/ACL as a percentage of total loans for all NC state-chartered community banks also decreased slightly, moving from 1.09% in 2022 to 1.04% in 2023. You can see, we're looking at increasingly smaller decimal places.

Return on Assets/Profitability

Those smaller decimal places also come into play with your returns and NIMs. Return on Assets dropped to .73% in 2023 from .85% at year-end 2022. And we had more institutions with declining net-interest-margins than those that didn't. That's not awful news though – that means that around half of our community banks were able to achieve positive net interest margins.

Plus, as you all know, cost of funds this past year increased dramatically, almost 3 to 4x depending on data set, as the yield on earning assets stayed steady and didn't move nearly at the same pace.

All that brings me to capital and liquidity levels.

Capital and Liquidity Levels

The average Tier 1 Leverage ratio in our portfolio remained stable since last year. We still see unrealized losses in bond portfolios, but it appears that management teams are working those down, after one of the most dramatic hiking cycles of most of our lifetimes. It's a testament to your management teams and their prudent judgment that, when last I looked, no NC bank was showing negative Tier 1 Leverage if they had to take those unrealized losses. That is not true nationwide. Liquidity levels also tightened up during 2023, with liquid assets as a percentage of average assets moving from 25% in 2022 to 21% in 2023. We saw bankers in North Carolina diversifying funding sources, raising deposit rates, and turning to brokered deposits and FHLB lines to shore up their positions.

Earnings

And finally, I'm going to say a word about earnings. Earnings were challenged in 2023, in part by the interest rate environment we're living through and in part because expenses just keep going up. Nationally, earnings component ratings have been the most downgraded, second only to liquidity.

Enough with the numbers – I'm a lawyer by training, and frankly, that's a lot of numbers for me! Let's get back to the regulatory partnership business.

Back to the Regulatory Partnership

With numbers this reasonable, my job really ought to be easy. So should yours. But they're not.

Non-bank Stressors and Ongoing Uncertainty

First, there's the news. National and international news has been terrible, lately, with regional violence in Ukraine and Israel. It's also an election year, and while I strongly believe in the democratic process and our unique political system, I get real tired real fast of the advertising, the road signs, and the occasional conversation that strays into "Can you believe that…." <Insert outrageous comment/action/logic here>.

Second, there's inflation and the potential for recession. CPI, CPE, Core, and Super Core inflation data provides only temporary reprieve from news of armed conflict.

Third, we are in a new era of continuous cyber assault from global superpowers plus some not-so-super-powers. Against that backdrop, artificial intelligence is the new EV super investment, and Elon Musk provides the entertainment each day, with neuralink chips and fantastic rocket launches.

Just in case I haven't really driven this point home, bitcoin prices and the equity markets are both reaching new highs, and the first couple of Bitcoin ETFs launched this year. If those things don't increase your anxiety, see me afterward so I can connect with your pharmacist!

Glimmers of Certainty

At least we have some certainty on a few things. We all know we can not control the national economy and neither, quite frankly, can the Federal Reserve. (For a scientific discipline, economists must play a fair amount of horseshoes – close is good enough, sometimes you can miss altogether and still be in the game.)

We should know what happens when negative growth starts, and how to deal with it. And we know how to do hard things, because we've done them before. We also kind of know that that the cycle is going to start during our working lives, and right now, we are fortunate to have a wealth of experience working here in North Carolina.

What we don't know is whether this go around will be different, where the first cracks will form, how big they'll get, or how long it's going to take. If you've heard the phrases "soft landing," hard landing, no-landing – that's what I'm talking about here.

Regulators feel this uncertainty too, and here's why, despite all the positive numbers and favorable reports of good risk management practices, my day job feels more challenging than ever.

Federal Regulatory Onslaught

My federal regulatory friends continue to react to March Madness 2023, but what they (and certain politicians) appear unable or unwilling to absorb is that no bank can withstand an extended run. That's what it means to have a fractional reserve system! That fractional reserve system works really well in the absence of panic, and when there is significant diversity in the system. It's also why we preach sound risk management practices, why we tailor our expectations to the size and complexity of the institution at hand, and why we stay out of managing your banks. We regulators are eternal pessimists, and we aren't especially adept at taking business risks.

I suspect you're all probably thinking that you have the solution to my difficulties - I should stop watching the news, lean into AI, and step back from March Madness. But I have kids, and I don't like where all this is headed.

The Core Issues We're Tracking

My staff and I are currently tracking no less than 15 federal regulatory issues, on which the NCCOB is likely to have an opinion. Specifically, we're looking at:

Regulation on a curve – by which I mean, regulation by being "relative to peer." Some outliers here are meaningful, but unless you understand the "why" of those numbers, they're just statistics. Gene delights in telling me to wringing my hands over red/yellow/green dashboards from CSBS until I understand the story behind them.

Escalation of findings and the velocity of remediation. This refers to the idea that you may no longer have a full exam cycle to fix a finding or execute on your plan to fix it, before you see more criticism on the way.

An ancillary problem here is that, while you won't have the full cycle, your supervisors don't yet feel constrained to that same timeline, or when they do, they have been unable to obtain the manpower to achieve the same velocity they expect out of you.

Enforcement actions for vendor management issues. These are rocking and rolling, particularly in the banking as a service space. Don't get me wrong, some of these are completely and fully deserved, but honestly, if the playing field were actually leveled, these options for revenue growth would not be as appealing as they are right now.

And finally, federal preemption. If we continue on this trajectory, the rules will be written exclusively in Washington. Take as a prime example the FDIC's corporate governance proposal. If you missed this one, it's a rule that proposes several changes to the way bank boards operate, with a proposed asset threshold of $10 billion and up. In a rare instance of a blatant trickle down effect, the proposal explicitly reserves the right to apply the governance standard to banks under $10bn based on "complexity." If your blood hasn't boiled yet, then you aren't paying attention – this one in particular ticked me off so badly, that I wrote my own comment letter urging recission, independent of the Conference of State Bank Supervisors.

The fact that folks in Washington DC felt comfortable explicitly stating that they know how to do corporate governance better than the state frameworks is about as repugnant to me as it gets.

I could go on but I want you all to be able to digest your meal. I didn't even really dive into cybersecurity, BSA compliance, using artificial intelligence in your bank, commercial real estate concentrations, reliance on brokered deposits, the new CRA rulemaking, ESG initiatives or turnabouts, or anything having to do with marijuana, sports betting, or guns.

Those are the things making my job challenging, and I can only imagine what they're doing to your ability to continue managing your institutions. These are the items driving increased homogenization.

These things are also indicative of that philosophy I mentioned earlier that seems to pervade Washington leadership, which is "capitalism is unfair."

A corollary to that philosophy appears to "make all banks the same!" Folks in Washington seem especially bent on eliminating volatility in the banking sector, at the expense of diversity in the system. They're going to do that by eliminating all risk at all times, a feat that is not possible to do. To have the hubris to believe you can achieve that effectively is pretty bold.

The biggest risk I see building right now is that in 10 years time, we're going to be down to 8-9 actual banks and they're going to be run by the federal government. If you thought the government was involved in the economy before, just wait. To come full circle, the one thing I would change about financial services in our state is that we need more rational competition, and a greater focus on the diversity of our system.

Closing Thoughts

Let me leave you with this – remember that partnership. Push back if you think your examiners are not getting the whole story, or don't understand the numbers. Examiners aren't any more perfect than you are, and they have a job to do too. Most of the time, their criticisms are designed to help you. But occasionally, you're going to run into some directions that came straight out of Washington, and that poor gal across the desk, is probably following orders. You might have to be diplomatic at times, but use your resources. I can not emphasize that enough! If you don't know what your resources are in the supervisory arena, call us.

Remember that context matters, too. Dare I say that many of us regulators continue to experience something akin to PTSD, and the situation with that bank in New York is poking at it, for sure. My regulatory PTSD causes me to ask Gene all the time about CRE, unrealized losses, accounting guidance, and the status of AML compliance. But a little context really helps here – we've been through cycles before, and we're going to get through them again.

Finally, try not to get discouraged. At times, this regulatory onslaught feels like death by a thousand papercuts. Some of these painful little buggers are necessary, but some of them are just reactionary to March.

At those times, I try to think on the gentleman that swings by the teller line every Friday, or the YouTube star that launched because a community bank extended him a loan. Or the myriad other buildings built, community centers funded, and houses purchased. I personally like to think about the grandma who will not ever go to a crypto ATM, because she knows her banker and she won't believe the sweet young man who called her out of the blue, pretending to be something he's not, walking her through a crypto scam.

Thank you for your time. I'm happy to answer any questions you might have.