Impact of Rising Rates on Certain Banks and Supervisory Approach Background Materials

What does this presentation cover?	Discuss the impact rising interest rates is having on certain banks' financial condition and our supervisory approach to address issues at these banks
Why is this being presented to the Board now and what should the Board takeaway from this presentation?	As rates rise more banks' unrealized losses on their investment holdings increase, this can cause low, declining or negative equity capital, earning pressures, and liquidity and interest rate risk concerns. We wish to discuss these increased financial and risk management challenges with the Board. Our objective is to 1) Highlight the risks of rising rates on banking institutions 2) Discuss our supervisory approach in addressing those risks
Who is presenting?	Redacted , Board, Cross Portfolio, Risk Group Redacted, Federal Reserve Bank of Kansas City

Impact of Rising Rates on Certain Banks and Supervisory Approach

S&R Quarterly Presentation

February 14, 2023

Redacted
Board Risk, Supervision and Regulation

Redacted
Federal Reserve Bank of Kansas City

Financial Risks Are Growing for Many Banks

Most banks are generally benefiting from rising interest rates; net interest margins are expanding, and credit quality performance continues to look favorable

However, rising interest rates are creating significant unrealized losses in investment securities and in some cases depressing tangible equity

As interest rates increase, banks with large market value losses could experience increased financial and risk management challenges

Objectives:

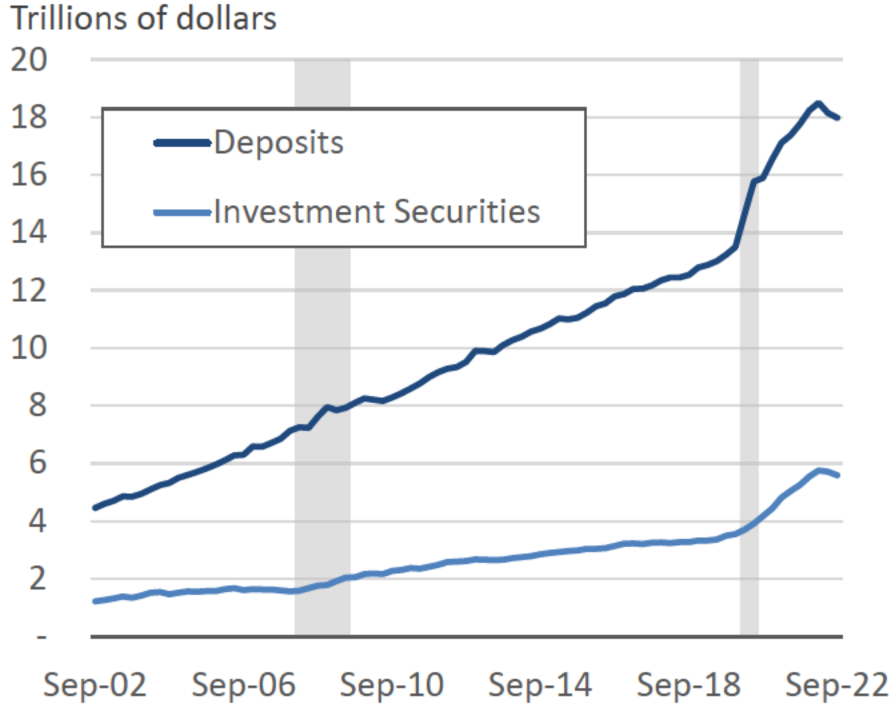
- Highlight the risks of rising rates on banking institutions
- Discuss our supervisory approach in addressing those risks

Deposits Surge and Securities Increase During Pandemic

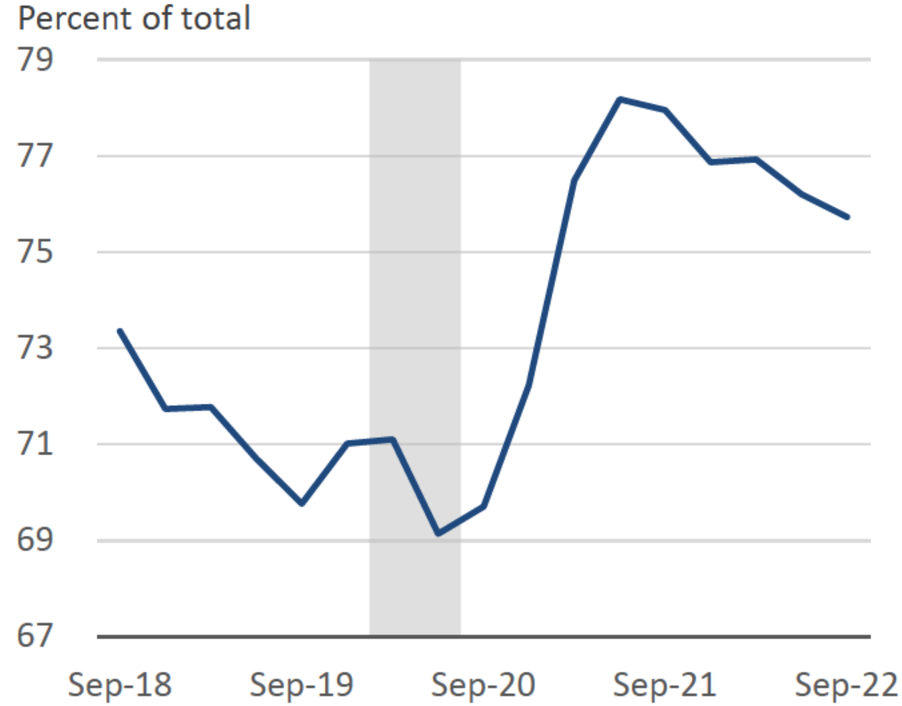
During the pandemic, deposit levels increased significantly

- Industry investment in securities grew to nearly $6 trillion in the first quarter of 2022. Since then, deposits have declined for two consecutive quarters, raising concerns about ongoing stability
- Many banks invested funds from record deposit growth in longer duration securities to boost earnings

Deposits and Investment Securities



Investment Securities Greater Than 3 Years



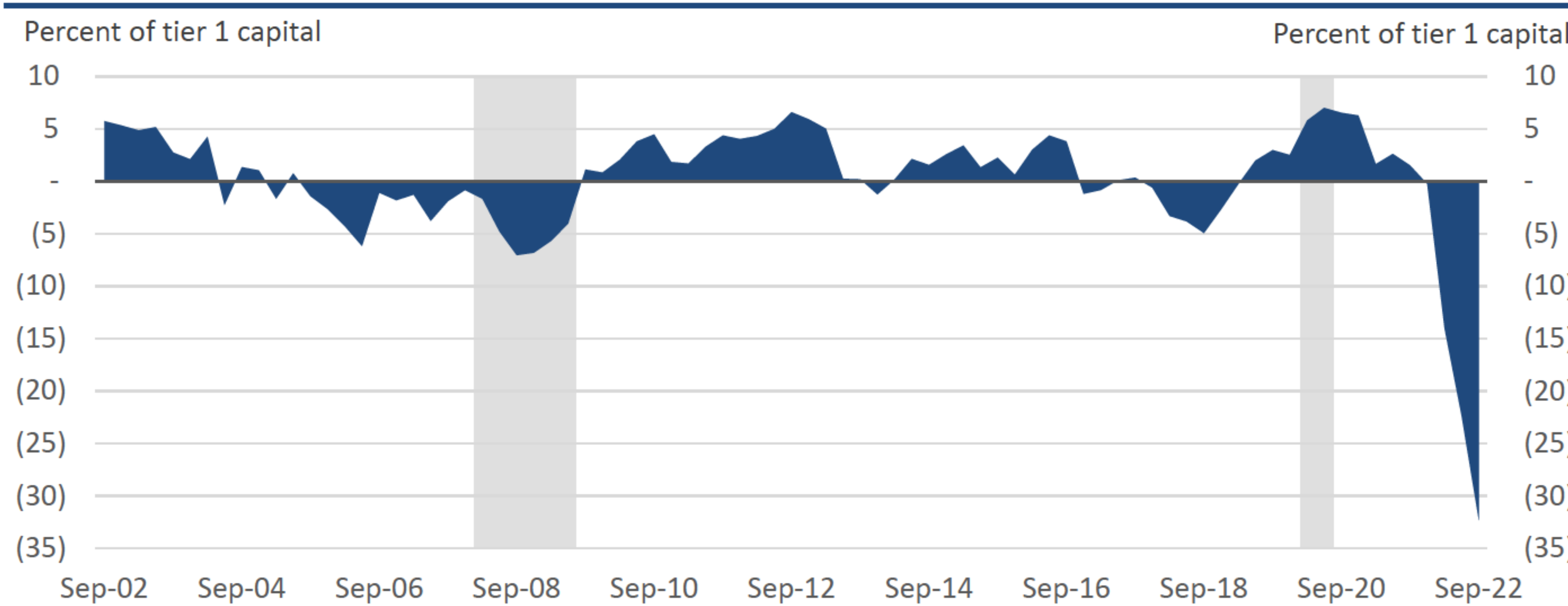
Note: Investment securities in the left chart are shown at amortized cost.
Source: Reports of Condition and Income.

Unrealized Losses Are at High Levels

As interest rates rose during 2022, the market value of banks' securities significantly declined creating unrealized losses

- Unrealized losses are highest at banks with long-duration securities and/or large securities portfolios
- Banks reporting large unrealized losses may have limited ability to sell securities to fund loan demand or support any unanticipated deposit withdrawals without recognizing losses

Unrealized Gain (Loss) on Investment Securities



Note: Net unrealized gains (losses) are computed as fair value less amortized cost as a percent of tier 1 capital.
Source: Reports of Condition and Income.

A Growing Number Report Unrealized Losses that Threaten Capital

At third quarter end, 722 banks reported unrealized losses exceeding 50% of capital

- 31 of these banks report negative tangible equity levels
  - Banks reporting negative tangible equity are currently not able to borrow new money from Federal Home Loan Banks and may lose the ability to sell loans to Government Sponsored Enterprises
  - Some banks are taking actions to shelter further market losses, including
    - Changing the accounting treatment of their securities, thus their intent to use securities for liquidity purposes,
    - Hedging their interest rate risk, and/ or
    - Retaining more tangible capital
  - The decisioning around such actions is complex, particularly at smaller banks where securities have always been used for liquidity purposes and expertise with hedging is limited

Risks

Banks with large unrealized losses face significant safety and soundness risks

Securities have traditionally been used for liquidity purposes; Today, the level of unrealized losses are causing some banks to face tough choices

- Liquidity concerns
  - Banks with higher levels of unrealized loss are funding loan growth and deposit withdrawal with other, more highly liquid assets and borrowings
    - As a result, many banks need to build and diversify contingent liquidity sources
  - Banks may need to curtail future lending activity due to limited funding options
- Earnings and Capital concerns
  - Banks will face difficulty in liquidating securities without realizing losses
  - Holding securities with below-market yields while funding costs increase negatively impacts net interest margins
  - Banks may need to sacrifice earnings to maintain liquidity

Supervisory Approach

Staff have increased bank risk identification, monitoring efforts, and interagency collaboration

- Increased supervisory activity at banks with significant risk

Banks less than $100 Billion:

- Enhanced monitoring of banks with low and declining levels of tangible equity
- Conduct targeted examinations at banks with negative tangible equity or when risk management practices are considered weak; Expand follow-up at banks that may become negative if rates rise
  - Focus on Sensitivity to Market Risk, Liquidity and Risk Management component ratings

Banks greater than $100 Billion:

- Utilize existing on-site and horizontal supervisory programs to monitor firms' exposure to interest rate increases and the impact on earnings, liquidity and capital
  - Reassess firm's ability to monetize securities under contingency funding plans (LFBO)[1]
  - Recently completed horizontal review of contingent and recovery actions; numerous supervisory findings to be issued (LISCC) [1]

1 Large and Foreign Bank Organization (LFBO); Large Institution Supervision Coordinating Committee (LISCC)

Example of Financial Risks – Silicon Valley Bank

SVB, the 18th largest U.S. banking organization, has significant interest rate risk

- The bank used significant deposit growth to purchase longer maturity securities
    - Since year-end 2019, the investment portfolio as a percent of total assets grew 17 percentage points to 56 percent
        - Yields on purchases were low due to the rate environment and portfolio duration increased
    - At third quarter-end 2022, total unrealized losses to capital totaled -110 percent
- Since rates began increasing, the bank has lost nearly 8 percent of its deposits and the company is executing on its contingency funding plan to maintain appropriate liquidity
- Interest rate risk measurement systems failed to estimate sensitivity to rising rates, resulting in higher funding costs

SVB's weaknesses in market risk management and high IRR exposure has resulted in

- Sensitivity to Market Risk component was **downgraded to 3, or "fair"**
- Supervisory matter requiring attention to improve reliability of interest rate risk modeling simulations
- Heightened supervisory attention to assess corrective action and ongoing rating accuracy

Training and Communication Strategy

To ensure examiners are aware of the issue and focused on addressing risks, Federal Reserve staff has conducted internal training

- "Rapid Response" – internal examiner training – November 2022
- Decision Tree for Assessing State Member Banks with Negative Tangible Equity Risk and Examiner Guide to Assessing CAMELS Ratings – December 2022
  - Documents created to ensure consistency of supervisory approach and guide examiners on appropriate risk considerations in developing supervisory ratings
- Interagency training is being considered

System staff are also reaching out to industry to raise awareness and encourage a dialog between affected banks and their supervisors

- "Ask the Fed" session with Governor Bowman – external dialog with bankers – December 2022
  - Provided information on our supervisory approach, guidance on managing exposures, and answered industry questions
- "Community Banking Connections" – external article in January 2023

Conclusion

The rising interest rate environment is increasing financial risks for many banks

- We are concerned with banks that have investment portfolios with large unrealized loss positions
- As rates rise, investment portfolios which have traditionally been a source of liquidity will be further limited
- Higher than anticipated deposit outflows and limited available contingency funding may cause banks to make difficult choices, including reliance on higher-cost wholesale funding or curtailing lending

Supervisory approach has been developed consistent with existing supervisory practices

- Monitoring programs and targeted examinations are being utilized to ensure full understanding of bank risk profiles and additional examiner training and banker outreach is being conducted

As banking conditions continue to evolve, we will update the Board on any developing trends