FEDERAL RESERVE SYSTEM

COMMUNITY BANKING
CONNECTIONS®

A SUPERVISION AND REGULATION PUBLICATION

A Message from Governor Bowman*

First Issue 2023

by Governor Michelle W. Bowman

Governor Michelle W. Bowman

The recent failures of three large banks continue to be a focal point in the news and of interest to community bankers. Therefore, I would like to focus my *Community Banking Connections* message on the events leading up to and following the failures of Silicon Valley Bank, Signature Bank, and First Republic. At the time of their failures, Silicon Valley Bank had approximately $218 billion in assets, Signature Bank held approximately $110 billion, and First Republic had approximately $229 billion in assets. The Federal Deposit Insurance Corporation (FDIC) estimates that the failure of Silicon Valley Bank will cost the Deposit Insurance Fund approximately $20 billion and that the failure of Signature Bank will cost $2.5 billion.[1] The FDIC estimates the cost to the Deposit Insurance Fund of the First Republic failure to be $13 billion.[2] Ultimately, the failures of Silicon Valley Bank and Signature Bank were largely due to their inability to fund the rapid outflow of deposits. More precisely, customers with deposits above the FDIC-insured amount of $250,000 per depositor, per account type, withdrew or tried to withdraw their deposits over the course of a few days, resulting in these banks having insufficient liquidity to meet their deposit outflows.

In March 2023, the U.S. Treasury, the Federal Reserve, and the FDIC announced that all depositors at Silicon Valley Bank and Signature Bank will be made whole.[3] On May 1, 2023, the FDIC entered into a purchase and assumption agreement with JPMorgan Chase Bank, N.A. to assume all of the deposits (including uninsured deposits) and substantially all of the assets of First Republic Bank.

The Federal Reserve Board created the Bank Term Funding Program (BTFP) to provide additional funding support to financial institutions beyond the Fed's discount window.[4] The BTFP, which expires on March 11, 2024, offers one-year loans to institutions that are collateralized by U.S.

* The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee or the Board of Governors.

[1] See the FDIC's press releases at www.fdic.gov/news/press-releases/2023/pr23023.html and www.fdic.gov/news/press-releases/2023/pr23021.html.

[2] See the FDIC's press release at www.fdic.gov/news/press-releases/2023/pr23034.html.

[3] See the joint press release at www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm.

[4] The Federal Reserve presented an Ask the Fed webinar on this topic: The Bank Term Funding Program — Overview and Important Details for Depository Institutions; see page 24 of this issue for more information.

Treasury securities, agency debt and mortgage-backed securities, and other qualifying assets.[5]

It is imperative that we understand these bank failures and market events, and the lessons we can draw from them.[6] Such information will help to guide discussions among policymakers about the gaps in current bank supervision and regulation, and the potential for effective improvements to both.

These events also highlight the importance of supervisors' continued focus on assessing core banking risks. I believe that the U.S. banking system remains resilient and is on a solid foundation. The relationship banking model employed by the vast majority of community banks represents a source of strength and resilience for the banking system. I am concerned that the disparate treatment of larger firms in comparison with the treatment of smaller firms in times of crisis can itself be a source of instability in the banking system, by reinforcing the notion that certain institutions are too big to fail.

5 See www.federalreserve.gov/monetarypolicy/bank-term-funding-program.htm.

6 For more information, see the April 28, 2023, report *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, available at www.federalreserve.gov/publications/files/svb-review-20230428.pdf, and its accompanying press release, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20230428a.htm.

Community Bank Resilience

After the recent bank failures, the deposits held by community banks were generally more stable than those at larger regional banks. In comparison with larger banks, traditional community banks generally hold fewer uninsured deposits and often leverage private sources of supplemental deposit insurance to protect their uninsured deposits. Community bank deposits remained relatively stable because their deposit base is closely tied to established customer relationships in their communities.

As we saw over the past three years, community banks continue to play an important economic function in their communities by using deposits to extend credit and financial support to families and small businesses. Small banks have a deep commitment to their communities and understand their unique customers. In turn, community bank customers, even those with uninsured deposits, are more closely tied to the institution.

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Unintended Effects of the Disparate Treatment of Depositors at Large Banks Versus Smaller Banks

The follow-on effects of these recent bank failures have had broader financial stability implications for the banking system. A question many are now asking is whether uninsured depositors at a future failed bank will be afforded the same treatment as depositors at Silicon Valley, Signature, and First Republic banks. Under federal law, deposit insurance is capped at the FDIC-insured account limit of $250,000. However, some depositors and market participants believe that deposits at the largest banks have an implicit government guarantee, including those deposits above the $250,000 cap. Affording larger and systemically important banks with this implicit government guarantee could harm the ability of community banks to compete for depositors. Further, uncertainty in the treatment of uninsured depositors contributed to the contagion risk in the banking system and resulted in uninsured depositors withdrawing their funds from regional banks and placing them at larger or systemically important banks.

In addition to implementing appropriate changes to the supervisory and regulatory framework to mitigate future bank runs, policymakers need to consider the competitive environment for community banks. At the heart of this work, policymakers need to address whether an implicit government guarantee on uninsured depositors will be afforded only to large banks that are viewed to be too big to fail. I support a level playing field.

There are certainly other areas of supervision that warrant further study about our supervisory approach for assessing the liquidity risk associated with uninsured deposits. These include refining the analysis of depositor and asset concentration risks, determining the risks associated with a bank's growth strategy, and understanding the effect of social media on depositor behavior.

As we take this opportunity to learn from the recent bank failures, the Federal Reserve will continue to promote a safe and sound banking system and safeguard the stability of the U.S. financial system. To attain these goals, the Federal Reserve will continue to hold supervised institutions to high regulatory standards, commensurate with their asset size and risks.

> **"The relationship banking model employed by the vast majority of community banks represents a source of strength and resilience for the banking system.**

In determining a way forward, I expect to support regulatory and supervisory changes that are efficient.[7] In other words, any incremental changes to regulation should consider the costs to comply with a rule and the risks to the bank's safety and soundness. We need to tailor any new regulatory requirements and changes to our supervisory approach based on the size, complexity, risk profile, and business activities of banks. Furthermore, changes to regulations promoting a safe and sound financial system need to be consistent, transparent, and fair.

Focus on Key Banking Risks

In my previous *Community Banking Connections* message about economic conditions and the Federal Reserve's supervisory posture under a rising interest rate environment, I highlighted the liquidity risks associated with declining tangible common equity and unrealized securities losses. This very issue played out, in part, at Silicon Valley Bank. Between 2019 and 2022, Silicon Valley Bank experienced significant deposit growth, and the bank invested these deposits in longer-term securities to boost yield and increase its profits. The rising interest rate environment presented challenges in managing Silicon Valley Bank's unrealized losses and the associated risks to liquidity.

Continued on page 18

7 See Governor Michelle W. Bowman's May 12, 2023, speech, titled "The Evolving Nature of Banking, Bank Culture, and Bank Runs," at the 21st Annual Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States, European Central Bank, Frankfurt, Germany, available at www.federalreserve.gov/newsevents/speech/bowman20230512a.htm.

View from the District

First District Perspective — Boston

New England Mutual Banks — The Pandemic and Beyond

by Chris Haley, Executive Vice President, Supervision, Regulation & Credit, Federal Reserve Bank of Boston, and Brett Oppel, Supervisory Examiner, Supervision, Regulation & Credit, Federal Reserve Bank of Boston

Chris Haley

Since the chartering of Provident Institution for Savings in Boston in 1816, mutually owned financial institutions, or mutual banks, have played a critical role in supporting the New England economy. Mutual banks opened for business in the early 19th century with the twin goals of encouraging household savings and providing residential loans to their members. Although present in other parts of the nation, mutual banks have historically made up a much larger proportion of financial institutions in New England given their popularity as an organizational structure in the mid-19th century when many New England banks were founded.

Two centuries after the first mutual bank opened its doors, there are currently over 400 mutual financial institutions operating nationwide, with nearly a third located within the six New England states.[1] Massachusetts alone has 84 such banks, which is the most in any state (see Figure). In September 2022, the Federal Deposit Insurance Corporation (FDIC) approved a new mutual bank application, the first in five decades; perhaps not surprisingly, it is located right in the center of New England.

General Activities and Operations of Mutual Banks

While mutual banks can engage in a wide array of banking services and product offerings, they have historically focused on local deposit-taking and residential lending. As of September 30, 2022, median one- to four-family residential lending totaled 65 percent of average gross loans at mutual institutions[2] compared with 46 percent at their stock-owned peers.[3] The mutual bank business model is similar to that of other community banks. Mutual banks face strong competition from national peers and newer nonbank and online-oriented entrants into the financial services landscape. Additionally, the median net interest margin for mutual banks tends to be lower than that for stock-owned peers, in large part because mutual banks

[1] Data obtained from the December 31, 2020, FDIC analysis, available at www.fdic.gov/resources/bankers/mutual-institutions/index.html.

[2] *Mutual institution* refers to the national median mutually owned insured savings bank having assets between $300 million and $1 billion using Call Report data as of September 30, 2022.

[3] *Stock-owned institution* refers to the national median stock-owned insured savings bank having assets between $300 million and $1 billion using Call Report data as of September 30, 2022.

have larger residential loan portfolios, which are lower yielding. In response, many mutual banks have focused on diversifying loan portfolios and product offerings as well as seeking out operational efficiencies. In particular, commercial real estate lending at mutual banks has been increasing in recent years; non-owner-occupied commercial real estate lending grew more than 43 percent over the past three years.[4]

Mutual Banks During the Pandemic

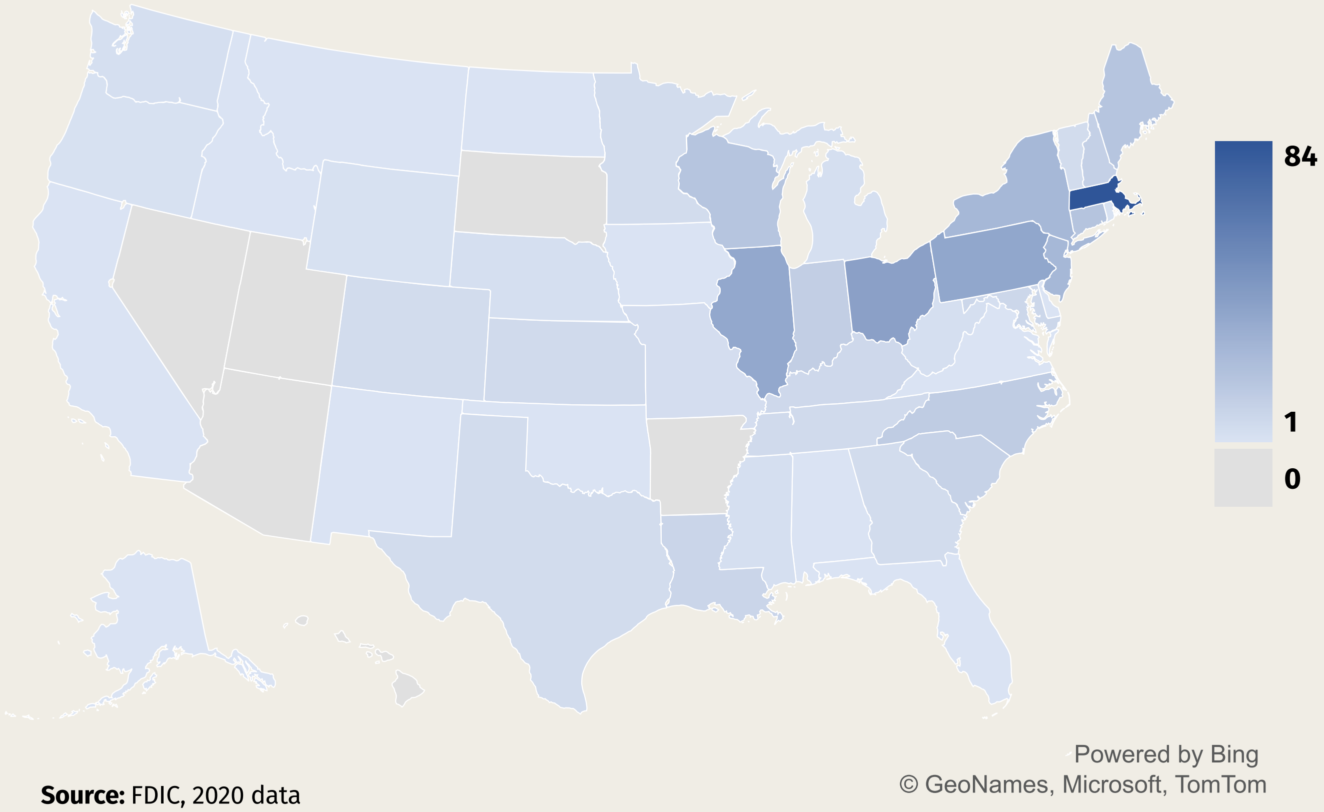
Since the onset of the pandemic, mutual banks have continued to support their members and communities by sustaining their lending and deposit-taking activities, resulting in substantial balance sheet growth at many banks. Similar to their community bank counterparts, mutual banks participated in pandemic assistance programs such as the Paycheck Protection Program (PPP)[5] and worked with their customers to mitigate the impact of business disruptions through deferrals or modifications. These actions were significant in helping communities in the First District navigate the pandemic and contributed toward regional economic stability. Also like their peers, mutual banks experienced significant deposit growth as a result of governmental stimulus measures and increased savings rates. While PPP-related activity led to an increase in commercial lending, banks that experienced pandemic-related growth in deposit balances placed those funds into short-term investments and cash equivalents due to what could be the shorter-term nature of the new deposits.

In a mutual structure, there are no shareholders or common stock; rather, depositors share ownership interest of the institution. In effect, retained earnings are the sole category of capital. Historically, mutual banks have had

[4] This is based on Call Report data as of September 30, 2022.

[5] The PPP was a Small Business Administration–backed loan program designed to help businesses keep their workforces employed during the COVID-19 crisis.

Figure: Geographic Dispersion of Mutual Banks Nationwide



Source: FDIC, 2020 data

Increased competition for consumers from online banks and other nonbank financial players is causing many mutual banks to reconsider the long-term implications of these competitors to their business strategy.

capital levels that are higher than those of their stock counterparts. The more conservative position is due in large part to the inability to raise capital via public offerings. This also is one of the reasons for the larger residential mortgage portfolios, which historically present less risk than commercial loans and therefore help to preserve capital. Other mutual banks are structured with a holding company owned by the depositors. In this type of structure, the mutual holding company can issue subordinated debt. This form of capital can be raised by mutual holding companies, with the proceeds flowing downstream to the bank. Over the course of the pandemic, mutual banks did see some reduction in their comparatively high capital levels stemming from balance sheet growth. As mutual banks emerge from the pandemic, the appropriate level of capital in light of larger balance sheets and more diversified loan portfolios is becoming an area of increased focus.

Strategy in Light of an Evolving World

Management teams at mutual banks and other community banks face the immediate challenges of how to strategically navigate an upward interest rate environment. Many of these institutions have a liability-sensitive balance sheet structure and face margin pressure in a prolonged rising rate environment. The current economic environment could also result in potential asset quality issues, which, together with margin pressure, can degrade capital.

Careful consideration of the loan portfolio and the inherent risk that it presents to capital will likely continue to drive how much credit risk is appropriate as well as the type of credit risk in the portfolio. On the deposit side, strong ties to the community given mutual banks' organizational makeup have led to historically stable core deposits fostered by strong long-term relationships. Increased competition for consumers from online banks and other nonbank financial players is causing many mutual banks to reconsider the long-term implications of these competitors to their business strategy. In response to this competition, many mutual banks are starting to partner with third-party technology providers in activities related to deposit gathering and concurrently implementing appropriate third-party risk management practices. Mutual banks are reassessing the required skill sets and accompanying staffing to better use third-party products, including the addition of board trustees with more technology-based backgrounds.

Like their stock counterparts, management teams at mutual banks realize that the banking world is dynamic, and they must keep up to compete. While they historically have had strong, loyal customer bases, mutual banks recognize that offering a competitive product suite is key to retaining this customer base. Their unique ownership structure provides one advantage in this regard: They lack shareholder return pressure, possibly allowing for a more patient and long-term view of necessary investments.

For the past two centuries, the mutual bank structure has served New England communities well. As the region and the nation transition out of the pandemic, fundamental risk management practices remain important. Boards of trustees and management at mutual banks, just like their counterparts at other community banks, who develop strong capital planning activities, employ prudent business strategies and risk management processes, and position their balance sheet appropriately will be well positioned to serve their customers well into the future. ■

Big Data in Small Banks — Maintaining Effective Data Management in Community Banks

by Carla Thomas, Senior Examiner, Supervision + Credit, Federal Reserve Bank of San Francisco

Because of the widespread adoption of digital banking services, the amount of data that community banks are able to collect is quickly expanding. According to the National Institute of Standards and Technology (NIST), the growth of data is outpacing the abilities of current scientific and technical advances to analyze the data.[1] This exponential growth of data produces larger and more varied pools of data, also known as big data.[2] While this data explosion can give banks new opportunities to combine and use data to support their business strategies and operations, banks can encounter significant challenges in managing and analyzing the large volume of data.[3]

Banks, large and small, are starting to fully recognize the advantages and capabilities of effectively capturing, managing, and using data. In fact, of 300 senior executive bankers surveyed in 2021 and 2022, many indicated that data analysis and business intelligence rank as increasingly top priorities in new or replacement system application capabilities.[4] As banks continue to amass large amounts of data, it is becoming increasingly important for bankers to understand the need for appropriate data governance processes and to establish the foundations of sound data management practices in order to fully reap the benefits as well as control the risks involved.

[1] See NIST Special Publication 1500-1r2, NIST Big Data Interoperability Framework: Volume 1, Definitions, available at https://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.1500-1r2.pdf.

[2] See the FFIEC IT Examination Handbook Infobase, Architecture, Infrastructure, and Operations Booklet, available at https://ithandbook.ffiec.gov/it-booklets/architecture-infrastructure-and-operations/iii-common-aio-risk-management-topics/iiia-data-governance-and-data-management.

[3] See NIST Special Publication 1500-1r2, NIST Big Data Interoperability Framework: Volume 1, Definitions, available at https://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.1500-1r2.pdf.

[4] Cornerstone Advisors, What's Going On in Banking 2023: Fighting the Headwinds, Riding the Tailwinds, available at www.crnrstone.com/whats-going-on-in-banking-2023.

A Bank's Most Valuable Asset

Community banks have long used data to assist in decision-making. Critical risk management functions such as loan loss reserve methodologies, capital and liquidity planning, interest rate risk sensitivity modeling, money laundering detection, and fraud monitoring rely on data to measure, monitor, and control a bank's risks. However, as technology evolves with the development of tools such as artificial intelligence and machine learning, the opportunities for banks to benefit from advanced analytics have grown considerably. From risk management to targeted marketing, data can shape a bank's strategies and business plans, reflecting the type of information and the story derived from the data.

What Makes "Big Data" Big? Look for the Four V's

Volume — size of the data set, usually in petabytes or exabytes. A typical data set would be equivalent to all the information contained within every research library in the United States.

Variety — types of data. This could include anything from business transactions, emails, photos, and activity logs to social media postings.

Velocity — speed at which data are accumulated. In 1998, Google received 10,000 searches per day; now, there are over 3.5 billion per day.

Variability — change in velocity or structure. This shows the need for data analysis to be dynamically scalable to efficiently handle additional processing loads.

Sources: NIST Special Publication 1500-1r2, available at https://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.1500-1r2.pdf (Four V's); www.internetlivestats.com/google-search-statistics/ (Google statistics)

Risks to Consider: **While improved data utilization can provide a variety of benefits to a bank, its directors and senior management should also evaluate the following risks while ensuring that sound risk management processes and controls are in place before implementing new data strategies.**

Operational Risk

Establishing new data systems may be especially challenging if the existing infrastructure is outdated or the new system is incompatible with existing systems. Data pools obtained through mergers and acquisitions can also be difficult to access, integrate, and manage with prevailing frameworks. As data become more accessible and available, the risk of data breaches and cyberattacks increases, resulting in a greater need for robust information technology systems.

Legal/Reputational Risk

Failure to comply with applicable regulations or industry standards could lead to a heightened risk of litigation for a bank. Lawsuits and data breaches can result in negative public sentiment that can damage a bank's reputation and potentially lead to other financial risks.

Compliance Risk

There are many complex regulatory requirements related to data handling and privacy, established to protect customers, consumers, and businesses. Bankers need to be fully aware of applicable state and federal laws and regulations, including the Gramm–Leach–Bliley Act, the Fair Credit Reporting Act, Section 1033 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, state laws (for example, the California Consumer Privacy Act), and the Electronic Fund Transfer Regulation (12 C.F.R. part 1005).

Third-Party Risk

Many community banks will opt to manage data through third-party relationships. Therefore, management should comprehensively assess the risks involved with each vendor and establish policies and procedures related to due diligence, onboarding, contract provisions, business continuity and contingency planning, and ongoing oversight.

External data from sources such as industry trends, peer metrics, and economic indicators can help bankers identify current and potential risk exposures on a macro level. Further, banks have a seemingly endless pool of internal data, which allows management to draw more institutional-specific conclusions about risks and understand customer behavior. Key sources of internal data include transactions involving payment cards, loans, and deposits. This information can assist management in pinpointing areas of heightened risk. Additionally, historical financial data may help predict future performance as well as identify areas in which improvements are needed in a bank's control framework to better plan for challenges ahead.

Remove the Rubbish

Of course, a bank's management information systems and reporting functions are only as good as the quality of the input — the principle of "garbage in, garbage out."

The key to ensuring that data are useful and reliable is the adequacy of a bank's data management processes. Data management is the development and execution of policies, standards, and procedures to acquire, validate, store, protect, and process data.[5] In other words, effective data management ensures that data are accurate, accessible, secure, and timely to meet user needs.

The way in which a bank builds a data management program can vary depending on its size, complexity, strategic goals, and available resources. For some banks, a first step may be to modify current practices to capture more data within unused data fields or expand the data points collected. Enriching data based on changing risks and industry conditions allows management to fully

[5] See FFIEC IT Examination Handbook Infobase, Architecture, Infrastructure, and Operations Booklet, available at https://ithandbook.ffiec.gov/it-booklets/architecture-infrastructure-and-operations/iii-common-aio-risk-management-topics/iiia-data-governance-and-data-management.

utilize the analytical capabilities of its existing systems. Other banks may opt to invest more resources in complex third-party services such as modernized core systems, data aggregators, cloud service providers, or advanced customer relationship management systems. Regardless of the approach, the keystone of data management is a continual assurance that information gathered is correct, relevant, available, and protected.

Data Governance Rules

As the business of banking becomes increasingly data driven, the management and oversight of data are no longer buried within information technology (IT) departments at community banks. Moreover, the availability of data is taking center stage in executive-level strategic discussions and decision-making. Bank directors and senior management are placing greater emphasis on the need for an effective data management framework through data governance, or a set of processes for formally managing data assets across all of a bank's activities and operations. Data governance establishes authority, management, and decision-making parameters related to the data that a bank produces or manages. Additionally, data governance involves the process for setting and executing the business and IT priorities for managing data.[6] Effective data governance allows bank management to make sound strategic decisions, maintain compliance with applicable laws and regulations, improve data security, and streamline planning processes.

Typically, data governance starts with establishing a data management hierarchy. Corresponding policies and procedures are typically developed to assign roles and responsibilities, outline the purpose and objectives for data use, and describe regulatory requirements and industry standards. Data governance practices can be applied to a wide range of activities and business lines within a bank and include the full "life cycle" of data, that is, from initial gathering of data, through usage and analysis, to retention or destruction.

[6] See FFIEC IT Examination Handbook Infobase, Architecture, Infrastructure, and Operations Booklet, available at https://ithandbook.ffiec.gov/it-booklets/architecture-infrastructure-and-operations/iii-common-aio-risk-management-topics/iiia-data-governance-and-data-management.

Resources

- ☑ "Community Bank Access to Innovation Through Partnerships," Federal Reserve System paper, September 2021: www.federalreserve.gov/publications/files/community-bank-access-to-innovation-through-partnerships-202109.pdf
- ☑ FFIEC IT Information Security Booklet: https://ithandbook.ffiec.gov/it-booklets/information-security.aspx
- ☑ NIST Big Data Public Working Group: https://bigdatawg.nist.gov/home.php
- ☑ "The Importance of Third-Party Vendor Risk Management Programs," *Community Banking Connections*, First Issue 2017: www.cbcfrs.org/Articles/2017/I1/third-party
- ☑ "Use of Artificial Intelligence and Machine Learning (AI/ML) at Supervised Financial Institutions," Ask the Regulators webinar, December 16, 2020: https://bsr.stlouisfed.org/askthefed/Home/DisplayCall/295

The Road Ahead

The banking industry continues to evolve. As customers demand a more tailored banking experience, data analysis allows banks to grow and stay competitive by understanding their customers' needs and preferences. The access to and management of high-quality data can be the driving force that facilitates growth at community banks by maintaining strong customer relationships and modernizing products and services. Whether the goal is to gain operational efficiencies, improve risk management processes, or make better strategic decisions, robust data management and governance processes are key to a bank being able to fully leverage its data. ■

Commercial Real Estate: Key Trends and Risk Management in a New Era

*by Jessica Olayvar, Senior Manager, Supervision, Regulation, and Credit, Federal Reserve Bank of Richmond, and Mina Oldham, Senior Supervision Analyst, Risk and Surveillance Team, Supervision, Regulation, and Credit, Federal Reserve Bank of Richmond**

While the banking industry is widely viewed as more resilient today than it was heading into the financial crisis of 2007–2009,[1] the commercial real estate (CRE) landscape has changed significantly since the onset of the COVID-19 pandemic. This new landscape, one characterized by a higher interest rate environment and hybrid work, will influence CRE market conditions. Given that community and regional banks tend to have higher CRE concentrations than large firms (Figure 1), smaller banks should stay abreast of current trends, emerging risk factors, and opportunities to modernize CRE concentration risk management.[2, 3]

Several recent industry forums conducted by the Federal Reserve System and individual Reserve Banks have touched on various aspects of CRE. This article aims to aggregate key takeaways from these various forums, as well as from our recent supervisory experiences, and to share noteworthy trends in the CRE market and relevant risk factors. Further, this article addresses the importance of proactively managing concentration risk in a highly dynamic credit environment and provides several best practices that illustrate how risk managers can think about Supervision and Regulation (SR) letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate,"[4] in today's landscape.

Market Conditions and Trends

Context

Let's put all of this into perspective. As of December 31, 2022, 31 percent of the insured depository institutions reported a concentration in CRE loans.[5] Most of these financial institutions were community and regional banks, making them a critical funding source for CRE credit.[6] This figure is lower than it was during the financial crisis of 2007–2009, but it has been increasing over the past year (the November 2022 *Supervision and Regulation Report* stated that it was 28 percent on June 30, 2022). Throughout 2022, CRE performance metrics held up well, and lending activity remained robust. However, there were signs of credit deterioration, as CRE loans 30–89 days past due increased year over year for CRE-concentrated banks (Figure 2). That said, past due metrics are lagging

* The authors thank Bryson Alexander, research analyst, Federal Reserve Bank of Richmond; Brian Bailey, commercial real estate subject matter expert and senior policy advisor, Federal Reserve Bank of Atlanta; and Kevin Brown, advanced examiner, Federal Reserve Bank of Richmond, for their contributions to this article.

[1] The November 2022 *Financial Stability Report* released by the Board of Governors highlighted several key actions taken by the Federal Reserve following the 2007–2009 financial crisis that have promoted the resilience of financial institutions. This report is available at www.federalreserve.gov/publications/files/financial-stability-report-20221104.pdf.

[2] See Kyle Binder, Emily Greenwald, Sam Schulhofer-Wohl, and Alejandro H. Drexler, "Bank Exposure to Commercial Real Estate and the COVID-19 Pandemic," Federal Reserve Bank of Chicago, 2021, available at www.chicagofed.org/publications/chicago-fed-letter/2021/463.

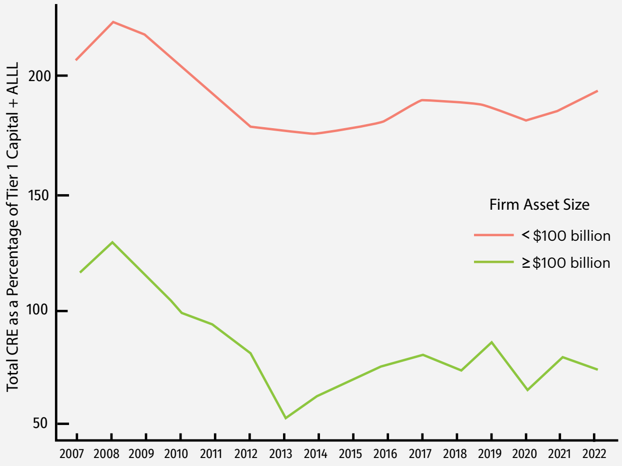
[3] The November 2022 *Supervision and Regulation Report* released by the Board of Governors defines concentrations as follows: *"A bank is considered concentrated if its construction and land development loans to tier 1 capital plus reserves is greater than or equal to 100 percent or if its total CRE loans (including owner-occupied loans) to tier 1 capital plus reserves is greater than or equal to 300 percent."* Note that this method of measurement is more conservative than what is outlined in Supervision and Regulation (SR) letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate," because it includes owner-occupied loans and does not consider the 50 percent growth rate during the prior 36 months. SR letter 07-1 is available at www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm, and the November 2022 *Supervision and Regulation Report* is available at www.federalreserve.gov/publications/files/202211-supervision-and-regulation-report.pdf.

[4] See SR letter 07-1, available at www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

[5] Using Call Report data, we found that, as of December 31, 2022, 31 percent of all financial institutions had construction and land development loans to tier 1 capital plus reserves greater than or equal to 100 percent and/or total CRE loans (including owner-occupied loans) to tier 1 capital plus reserves greater than 300 percent. As noted in footnote 3, this is a more conservative measure than the SR letter 07-1 measure because it includes owner-occupied loans and does not consider the 50 percent growth rate during the prior 36 months.

[6] See the November 2022 *Supervision and Regulation Report*.

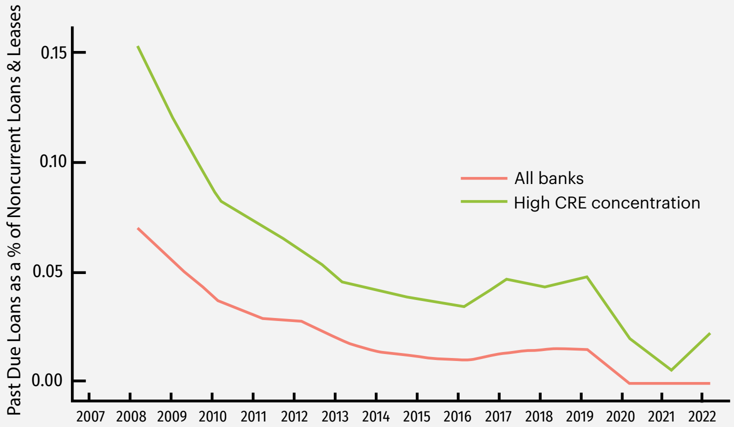
Figure 1: Median CRE Concentrations by Firm Size



Source: Call Report, Q4 2022 data, using the median for each bank group

ALLL = allowance for loan and lease losses

Figure 2: CRE Loans 30–89 Days Past Due



Source: Call Report, Q4 2022 data, using the median for each bank group

indicators of a borrower's financial hardship. Therefore, it is critical for banks to implement and maintain proactive risk management practices — discussed in more detail later in this article — that can alert bank management to deteriorating performance.

Noteworthy Trends

Most of the buzz in the CRE space coming out of the pandemic has been around the office sector, and for good reason. A recent study from business professors at Columbia University and New York University found that the value of U.S. office buildings could plunge 39 percent, or $454 billion, in the coming years.[7] This may be caused by recent trends, such as tenants not renewing their leases as workers go fully remote or tenants renewing their leases for less space. In some extreme examples, companies are giving up space that they leased only months earlier — a clear sign of how quickly the market can turn in some places. The struggle to fill empty office space is a national trend. The national vacancy rate is at a record 19.1 percent — Chicago, Houston, and San Francisco are all above 20 percent — and the amount of office space leased in the United States in the third quarter of 2022 was nearly a third below the quarterly average for 2018 and 2019.

Despite record vacancies, banks have benefited thus far from office loans supported by lengthy leases that insulate them from sudden deterioration in their portfolios. Recently, some large banks have begun to sell their office loans to limit their exposure.[8] The sizable amount of office debt maturing in the next one to three years could create maturity and refinance risks for banks, depending on the financial stability and health of their borrowers.[9]

In addition to recent actions taken by large firms, trends in the CRE bond market are another important indicator of market sentiment related to CRE and, specifically, to the office sector. For instance, the stock prices of large publicly traded landlords and developers are close to or below their pandemic lows, underperforming the broader stock market by a huge margin. Some bonds backed by office loans are also showing signs of stress. The *Wall Street Journal* published an article highlighting this trend and the pressure on real estate values, noting that this activity in

[7] See Arpit Gupta, Vrinda Mittal, and Stijn Van Nieuwerburgh, "Work from Home and the Office Real Estate Apocalypse," November 26, 2022, available at https://dx.doi.org/10.2139/ssrn.4124698.

[8] See Natalie Wong and John Gittelsohn, "Wall Street Banks Are Exploring Sales of Office Loans in the U.S.," *American Banker,* November 11, 2022, available at www.americanbanker.com/articles/wall-street-banks-are-exploring-sales-of-office-loans-in-the-u-s.

[9] An Ask the Fed session presented by Brian Bailey on November 16, 2022, highlighted the significant volume of office loans at fixed and floating rates set to mature in the coming years. In 2023 alone, nearly $30.2 billion in floating rate and $32.3 billion in fixed rate office loans will mature. This Ask the Fed session is available at https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/329.

the CRE bond market is the latest sign that the increasing interest rates are impacting the commercial property sector.[10] Real estate funds typically base their valuations on appraisals, which can be slow to reflect evolving market conditions. This has kept fund valuations high, even as the real estate market has deteriorated, underscoring the challenges that many community banks face in determining the current market value of CRE properties.

In addition, the CRE outlook is being affected by greater reliance on remote work, which is subsequently impacting the use case for large office buildings. Many commercial office developers are viewing the shifts in how and where people work — and the accompanying trends in the office sector — as opportunities to consider alternate uses for office properties. Therefore, banks should consider the potential implications of this remote work trend on the demand for office space and, in turn, the asset quality of their office loans.

Key Risk Factors to Watch

A confluence of factors has led to several key risks impacting the CRE sector that are worth highlighting.

- **Maturity/refinance risk:** Many fixed-rate office loans will be maturing in the next couple of years. Borrowers that were locked into low interest rates may face payment challenges when their loans reprice at much higher rates — in some cases, double the original rate. Also, future refinance activity may require an additional equity contribution, potentially creating more financial strain for borrowers. Some banks have begun offering bridge financing to tide over certain borrowers until rates reverse course.

- **Increasing risk to net operating income (NOI):** Market participants are citing increasing costs for items such as utilities, property taxes, maintenance, insurance, and labor as a concern because of heightened inflation levels. Inflation could cause a building's operating costs to rise faster than rental income, putting pressure on NOI.

- **Declining asset value**: CRE properties have recently experienced significant price changes relative to pre-pandemic times. An Ask the Fed session on CRE noted that valuations (industrial/office) are down from peak pricing by as much as 30 percent in some sectors.[11] This causes a concern for the loan-to-value (LTV) ratio at origination and can easily put banks over their policy limits or risk appetite. Another factor impacting asset values is low and lagging capitalization (cap) rates. Industry participants are having a hard time determining cap rates in the current environment because of poor data, fewer transactions, rapid rate movements, and the uncertain interest rate path. If cap rates remain low and interest rates exceed them, it could lead to a negative leverage scenario for borrowers. However, investors expect to see increases in cap rates, which will negatively impact valuations, according to the CRE services and investment firm Coldwell Banker Richard Ellis (CBRE).[12]

Modernizing Concentration Risk Management

Background

In early 2007, after observing the trend of increasing concentrations in CRE for several years, the federal banking agencies released SR letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate."[13] While the guidance did not set limits on bank CRE concentration levels, it encouraged banks to enhance their risk management in order to manage and control CRE concentration risks.

Key Elements to a Robust CRE Risk Management Program

Many banks have since taken steps to align their CRE risk management framework with the key elements from the guidance:

- Board and management oversight
- Portfolio management

[10] See Konrad Putzier and Peter Grant, "Investors Yank Money from Commercial-Property Funds, Pressuring Real-Estate Values," *Wall Street Journal*, December 6, 2022, available at www.wsj.com/articles/investors-yank-money-from-commercial-property-funds-pressuring-real-estate-values-11670293325.

[11] See the November 16, 2022, Ask the Fed session, which was presented by Brian Bailey and is available at https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/329.

[12] See "U.S. Cap Rate Survey H1 2022," CBRE, 2022, available at www.cbre.com/insights/reports/us-cap-rate-survey-h1-2022.

[13] See SR letter 07-1, available at www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.

- Management information system (MIS)
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

Over 15 years later, these foundational elements still form the basis of a robust CRE risk management program. An effective risk management program evolves with the changing risk profile of an institution. The following subsections expand on five of the seven elements noted in SR letter 07-1 and aim to highlight some best practices worth considering in this dynamic market environment that may modernize and strengthen a bank's existing framework.

Management Information System

A robust MIS provides a bank's board of directors and management with the tools needed to proactively monitor and manage CRE concentration risk. While many banks already have an MIS that stratifies the CRE portfolio by industry, property, and location, management may want to consider additional ways to segment the CRE loan portfolio. For example, management may consider reporting borrowers facing increased refinance risk due to interest rate fluctuations. This information would aid a bank in identifying potential refinance risk, could help ensure the accuracy of risk ratings, and would facilitate proactive discussions with potential problem borrowers.

Similarly, management may want to review transactions financed during the real estate valuation peak to identify properties that may currently be more sensitive to near-term valuation pressure or stabilization. Additionally, incorporating data points, such as cap rates, into existing MIS could provide useful information to the bank management and bank lenders.

Some banks have implemented an enhanced MIS by using centralized lease monitoring systems that track lease expirations. This type of data (especially relevant for office and retail spaces) provides information that allows lenders to take a proactive approach to monitoring for potential issues for a particular CRE loan.

Market Analysis

As noted previously, market conditions, and the resulting credit risk, vary across geographies and property types. To the extent that data and information are available to an institution, bank management may consider further segmenting market analysis data to best identify trends and risk factors. In large markets, such as Washington, D.C., or Atlanta, a more granular breakdown by submarkets (e.g., central business district or suburban) may be relevant.

However, in more rural counties, where available data are limited, banks may consider engaging with their local appraisal firms, contractors, or other community development groups for trend data or anecdotes. Additionally, the Federal Reserve Bank of St. Louis maintains the Federal Reserve Economic Data (FRED), a public database with time series information at the county and national levels.[14]

The best market analysis is not done in a vacuum. If meaningful trends are identified, they might inform a bank's lending strategy or be incorporated into stress testing and capital planning.

Credit Underwriting Standards

During periods of market duress, it becomes increasingly important for lenders to fully understand the financial condition of borrowers. Performing global cash flow analyses can ensure that banks know about commitments their borrowers may have to other financial institutions to minimize the risk of loss. Lenders should also consider whether low cap rates are inflating property valuations, and they should thoroughly review appraisals to understand assumptions and growth projections. An effective loan underwriting process considers stress/sensitivity analyses to better capture the potential changes in market conditions that could affect the ability of CRE properties to generate sufficient cash flow to cover debt service. For example, in addition to the usual criteria (debt service coverage ratio and LTV ratio), a stress test might include a breakeven analysis for a property's net operating income by increasing operating expenses or decreasing rents.

A sound risk management process should identify and monitor exceptions to a bank's lending policies, such as loans with longer interest-only periods on stabilized

[14] The FRED database is available at https://fred.stlouisfed.org/.

CRE properties, a greater reliance on guarantor support, nonrecourse loans, or other deviations from internal loan policies. In addition, a bank's MIS should provide sufficient information for a bank's board of directors and senior management to assess risks in CRE loan portfolios and identify the volume and trend of exceptions to loan policies.

Additionally, as property conversions (think office space to multifamily) continue to crop up in major markets, bankers could have proactive discussions with real estate investors, owners, and operators about alternative uses of real estate space. Identifying alternative plans for a property early could help banks get ahead of the curve and minimize the risk of loss.

Portfolio Stress Testing and Sensitivity Analysis

Since the onset of the pandemic, many banks have revamped their stress tests to focus more heavily on the CRE properties most negatively affected, such as hotels, office space, and retail. While this focus may still be relevant in some geographic areas, effective stress tests need to evolve to consider new types of post-pandemic scenarios. As discussed in the CRE-related Ask the Fed webinar mentioned earlier, 54 percent of the respondents noted that the top CRE concern for their bank was maturity/refinance risk, followed by negative leverage (18 percent) and the inability to accurately establish CRE values (14 percent). Adjusting current stress tests to capture the worst of these concerns could provide insightful information to inform capital planning. This process could also offer loan officers information about borrowers who are especially vulnerable to interest rate increases and, thus, proactively inform workout strategies for these borrowers.

Board and Management Oversight

As with any risk stripe, a bank's board of directors is ultimately responsible for setting the risk appetite for the institution. For CRE concentration risk management, this means establishing policies, procedures, risk limits, and lending strategies. Further, directors and management need relevant MIS that provides sufficient information to assess a bank's CRE risk exposure. While all of the items mentioned earlier have the potential to strengthen a bank's concentration risk management framework, the bank's board of directors is responsible for establishing the risk profile of the institution. Further, an effective board approves policies, such as the strategic plan and capital plan, that align with the risk profile of the institution by considering concentration limits and sublimits, as well as underwriting standards.

Conclusion

Community banks continue to hold significant concentrations of CRE, while numerous market indicators and emerging trends point to a mixed performance that is dependent on property types and geography. As market players adapt to today's evolving environment, bankers need to remain alert to changes in CRE market conditions and the risk profiles of their CRE loan portfolios. Adapting concentration risk management practices in this changing landscape will ensure that banks are ready to weather any potential storms on the horizon. ■

Correction

In the Fourth Quarter 2022 issue of *Community Banking Connections*, in the Ask the Fed piece that appeared on page 10, the last sentence of the text — "Presenters also discussed the accounting rules for bank holding companies, which are slightly different than the accounting rules applicable to banks." — should have read "Presenters also pointed out that there are differences between GAAP accounting and regulatory capital." We regret this error.

Transitioning to Regional Supervision

by Miles Green, Advanced Examiner, Community and Regional Safety and Soundness, Supervision, Regulation, and Credit, Federal Reserve Bank of Richmond

In the Federal Reserve System, financial institutions that have less than $10 billion in consolidated assets generally fall under the community bank organization (CBO) supervision program, while those that have between $10 billion and $100 billion are included in the regional bank organization (RBO) supervision program. As of June 30, 2022, the Federal Reserve supervised 99 RBOs (most of which are holding companies) with aggregate assets approximating $2.7 trillion.[1] From June 30, 2021, to June 30, 2022, the RBO supervision program experienced a net increase of 12 organizations, making it the fastest-growing portfolio of institutions supervised by the Federal Reserve.[2] CBOs transitioning to the RBO supervision program will encounter a new supervisory process, increased audit function expectations, and an expanding scope of risk management and governance considerations. To aid CBOs in transitioning to the RBO supervision program, the Federal Reserve established the Regional Banking Supervision Outreach Group to highlight guidance and industry best practices that RBOs should consider. This article provides an overview of the RBO supervisory program to aid CBOs that are experiencing asset growth and may soon become a regional institution.

The RBO Supervisory Process

The transition to the Federal Reserve's regional supervision is often a significant change for a CBO management team. Each Reserve Bank assigns a dedicated central point of contact (CPC) to both serve as a resource to the institution and oversee the execution of the Federal Reserve's supervisory plan for the institution. While community banks in satisfactory condition can expect a full-scope, risk-focused examination every 12 to 18 months, regional supervision involves more frequent touchpoints between the Reserve Bank and the supervised institution. Federal Reserve examiners develop a detailed supervisory risk assessment and tailored supervisory plan for each RBO. The supervisory plan weighs the complexity and financial condition of an RBO holding company and its subsidiary banks and nonbank subsidiaries. Further, the plan serves to establish the annual supervisory objectives and schedule for targeted and full-scope supervisory events, considering the primary bank regulator's examination schedule and results.

Because the bank subsidiary of the holding company generally contains most of the assets of the consolidated organization, the extent of supervisory activities at an RBO depends on its lead bank subsidiary. In scenarios in which the lead bank subsidiary of the RBO holding company is a state member bank, an annual supervisory cycle typically contains two asset quality targets, specialty target examinations such as information technology and Bank Secrecy Act compliance, and a full-scope holding company inspection. When the lead bank is not a state member bank — for example, a national bank, nonmember bank, or savings bank — the Federal Reserve's CPC coordinates with the primary bank regulator to leverage pertinent information about the lead bank to streamline the examination process. The Federal Reserve may participate in target supervisory events with the primary federal bank regulator when the bank's material business functions and activities are related to activities conducted at the holding company.

Beyond a more robust examination schedule, Federal Reserve examiners perform continuous monitoring of the institution throughout the year, which increases the interaction between the institution's management and the designated CPC. To aid in these monitoring efforts, an RBO provides Federal Reserve examiners with information such as the institution's board of directors and committee

[1] See Board of Governors of the Federal Reserve System, *Supervision and Regulation Report*, November 2022, available at www.federalreserve.gov/publications/files/202211-supervision-and-regulation-report.pdf.

[2] See Board of Governors of the Federal Reserve System, *Supervision and Regulation Report*, November 2021, available at www.federalreserve.gov/publications/files/202111-supervision-and-regulation-report.pdf.

meeting packages. The sharing of information is handled by the Federal Reserve's Supervision Central platform. Other examples of continuous supervisory monitoring activities include examiners conducting quarterly meetings with management and other regulators, analyzing the Federal Reserve's internal risk monitoring reports, and reviewing the institution's audit committee meeting packages and reports.

These supervisory activities may identify changes in the institution's risk profile, resulting in examiners contacting the institution's management outside of a scheduled supervisory event to discuss the institution's ability to manage and control risks. Therefore, the Federal Reserve suggests that an RBO institution assign an individual to manage this process and direct potential ad hoc inquiries from examiners to the correct stakeholders. Usually, this individual is also responsible for coordinating the process for delivering continuous document submissions to the Federal Reserve.

Asset Quality Reviews

Another key difference between CBO and RBO examinations is the loan coverage expectations for supervisory asset quality reviews. For CBOs, examiner loan coverage is generally a sample ranging from 20 percent to 40 percent coverage of total commercial and industrial and commercial real estate loans. Loan file review is normally performed at one full-scope supervisory event. In contrast, the Federal Reserve regional supervision program includes two asset quality targets per annual supervisory cycle for holding companies with lead bank subsidiaries that are state member banks. Further, Federal Reserve examiners are expected to perform loan sampling that includes at least 10 percent coverage of the four largest commercial loan segments. Therefore, each credit target examination will often focus on one or two material commercial loan segments, as well as a material retail loan segment of the RBO's loan portfolio or areas of emerging credit risk. In performing their loan reviews, Federal Reserve examiners expect that an RBO has a comprehensive internal loan review program to aid in assessing the accuracy of the institution's credit risk rating process and the adequacy

> **"As an institution grows and its risk profile changes, a strong chief audit executive becomes even more critical for an effective internal audit function.**

of its risk management practices. For institutions with a satisfactory to strong internal loan review function, examiners will typically leverage the RBO's internal loan review work and conclusions to perform the supervisory asset quality review. Supervision and Regulation (SR) letter 14-4, "Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Bank Holding Companies in the Regional Organization Supervision Portfolio," outlines expectations for an RBO's asset quality review.[3]

Heightened Internal Audit Expectations

Once an organization is assigned to the RBO supervision program, the policies outlined in SR letter 13-1/ Consumer Affairs (CA) letter 13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing," become applicable.[4] This policy statement sets the supervisory expectation for several enhanced audit practices. These practices include additional risk analysis, thematic control issues identification, a process for challenging management and policy actions, infrastructure change reviews, assessment of the firm's established risk tolerance, and evaluation of governance and strategic objectives. Institutions commonly experience challenges with adjusting to these internal audit expectations when transitioning to the RBO portfolio.

[3] SR letter 14-4 is available at www.federalreserve.gov/supervisionreg/srletters/sr1404.htm.

[4] SR letter 13-1/CA letter 13-1 is available at www.federalreserve.gov/supervisionreg/srletters/sr1301.htm.

As an institution grows and its risk profile changes, a strong chief audit executive becomes even more critical for an effective internal audit function. The chief audit executive conventionally discontinues direct audit work and instead focuses on developing and overseeing a framework and processes that enable audit work to be delegated across the internal audit function's staff. Further, the chief audit executive should have the knowledge and expertise to determine which audit work should be conducted in-house versus co-sourced with an outside audit firm. In making this determination, the chief audit executive should balance the benefits and challenges of both approaches to identify the mix that best meets the institution's needs.

Many institutions have found value in employing a gap assessment of their internal audit function, as discussed in SR letter 13-1/CA 13-1, that provides an objective and robust assessment of existing practices against the guidance. Once gaps in the function have been identified, audit management should develop plans and timelines for addressing each of the identified gaps, share the remediation plan with the institution's audit committee, and provide regular process updates to the audit committee. This gap assessment often identifies the need for the RBO to enhance the skill and training of its internal audit department's staff. Common gaps include technical expertise in areas such as information technology and compliance, as well as soft skills like leadership and communication. A skilled audit staff will enable the audit function to promote effective control functions across the entire organization and to raise concerns and control weaknesses to the RBO's audit committee when necessary.

Risk Management and Corporate Governance

In the RBO supervision program, examination work focuses on the quality of the institution's risk management, control functions, and governance structure. When transitioning to the regional portfolio, a bank needs to consider a variety of governance and management considerations such as organizational structure, the corporate risk management program, the qualifications and skills of the board of directors and senior management, and strategic planning.

Organic asset growth may drive a CBO's transition into the RBO supervision program, but the transition is often accelerated by acquisition or merger activity that involves a significant jump in asset size. In such scenarios, an institution's management needs to consider whether the organization's management structure is appropriate for achieving its strategic goals and business plans. The institution's revenue and risk functions need to share a clear overall strategic direction, maintain effective cross-functional communication, and collectively cultivate a strong risk management culture. The corporate risk management program will benefit from clear distinctions between first and second lines of defense that uphold effective challenge practices and hold management accountable for its actions.

The skills and expertise of the board of directors and senior management should keep pace with the institution's strategic direction and growth. As organizations grow, executive management may have less bandwidth to directly oversee certain elements of the bank's activities and risk management functions. Therefore, an institution's executives need to develop another layer of management, delegate responsibility, and implement accountability for corporate goals and effective risk management. Further, new business functions can become necessary as a bank expands its size and complexity. Examples include data governance, model risk management, and enterprise risk management. Executives need to carefully consider whether these functions need to be implemented or expanded and plan and budget for these resources accordingly.

Lastly, an institution's strategic plan is an important steering and governance tool for complex organizations, setting forth common objectives and aligning management expectations across business lines. Further, the strategic plan enables an institution's board of directors to develop and communicate its risk appetite to senior management. Senior management should develop business line action plans that reflect the board of directors' risk appetite and communicate these risk expectations throughout the organization.

Supervisory Outreach and Support

The transition of a CBO to the RBO supervision program represents a significant change in supervisory expectations for the institution's governance and risk management. The Federal Reserve is committed to supporting supervised firms going through this transition by providing technical assistance, spotlighting common challenges, and sharing industry best practices. Supervised institutions are encouraged to reach out to their local Federal Reserve Bank's examination staff for answers to questions regarding the possibility of a CBO moving to the RBO supervision program.

For up-to-date information and support on this topic, register with Ask the Fed[5] and follow the industry outreach series titled "Regional Banking: Beyond Examinations." The April 27, 2022, episode of this series includes coverage of a variety of common RBO transition pitfalls and corresponding keys to success.[6] The most recent episode in this series, "Maturing Your IT Risk Management and Governance Framework," addresses data management and managing third-party vendors.[7] ■

[5] Ask the Fed is available at https://bsr.stlouisfed.org/askthefed/Auth/Logon.

[6] See the Ask the Fed session "Regional Banking: Beyond Examinations – Transitioning to RBO Supervision," which was presented by Matthew Turner, Elizabeth Keenan, and Richard Perisie on April 27, 2022, and is available at https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/319.

[7] This Ask the Fed session is available at https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/335.

A Message from Governor Bowman

Continued from page 3

Starting in the summer of 2022, the Federal Reserve began closely monitoring banks with less than $100 billion in assets for unrealized losses in their available-for-sale securities portfolios and for a reduction in their tangible common equity ratios. As part of this effort, the Federal Reserve provided examiners with supplemental instructions and training to assist them in supervising community and regional banks with large unrealized losses relative to capital.

The Federal Reserve expects bank management to engage in proactive risk management to mitigate potential risks, including interest rate risks. In general, examiners will criticize banks with ineffective interest rate risk management practices and, in a letter or report of examination, communicate their supervisory findings and required corrective actions. Further, bankers should expect that examiners will base the assignment of a bank's supervisory ratings on the bank's current condition, considering the impact of unrealized losses on securities.

A Resilient Path Forward

The effects of the recent bank failures will not soon be forgotten. These bank failures highlight the interconnectivity of the banking system and that bank runs are not a relic of the past. As a result, there will undoubtedly be changes to regulation, policies, and supervisory practices. I will endeavor to work toward clear and appropriate changes for all supervised institutions based on lessons learned. Fortunately, most community banks are weathering the recent events. This is no accident. The community bank business model helps to mitigate the deposit-flight risks of the recent bank failures because the relationship banking model offers deposit stability. Furthermore, proactive supervision of community banks, focusing on the risks associated with unrealized losses and negative tangible equity, has elevated the importance of appropriate risk management processes for liquidity and interest rate risk.

In my industry outreach activities and meetings with bankers, I ask that you continue to provide me with your feedback on Federal Reserve supervision and your views on the risks faced by community banks and the broader economy. Your thoughtful comments will help in advancing an effective supervisory program and any potential policy changes. ■

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Ask the Regulators: Supervisory Update on Funding & Liquidity Risk Management

On May 24, 2023, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Conference of State Bank Supervisors held an Ask the Regulators webinar on funding and liquidity risk management. The presenters addressed:

- The impact that a rising interest rate environment may have on a bank's balance sheet strategy and liquidity
- Principles for sound funding and liquidity risk management practices as described in the 2010 Interagency Policy Statement on Funding and Liquidity Risk Management (see Supervision and Regulation letter 10-6, available at www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm)
- The importance of liquidity stress testing and the use of appropriate assumptions and effective contingency funding plans
- A bank's use of the Federal Reserve's discount window and Bank Term Funding Program (BTFP)
- What bankers should expect during upcoming safety and soundness examinations

If you missed the live session, a recording is available on the Federal Reserve's Ask the Fed site at https://bsr.stlouisfed.org/askthefed/Home/DisplayCall/341.

The Ask the Fed site also has a prerecorded presentation on "Discount Window Preparedness" from the Federal Reserve Board's Monetary Affairs Division. Community bankers may find this session helpful in understanding the process for borrowing from the discount window and the BTFP, including legal lending agreements and the pledging of collateral. The presentation is available at https://bsr.stlouisfed.org/askthefed/Home/DisplayCall/342.

D.C. UPDATES

D.C. Updates features highlights of regulatory and policy actions taken by the Federal Reserve since the last issue as well as a listing of speeches and congressional testimonies of the Federal Reserve Board members that may be of interest to community bankers. All the Federal Reserve Board's rulemakings, press releases, testimonies, speeches, and policy statements can be found on the Board's website.

Visit www.federalreserve.gov.

ACTIONS

Actions Related to Safety and Soundness and Consumer Policy

On April 28, 2023, the Federal Reserve Board announced the results from the review of the supervision and regulation of Silicon Valley Bank, led by Vice Chair for Supervision Michael S. Barr. Refer to the Board's press release, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20230428a.htm.

On April 26, 2023, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration, and the Consumer Financial Protection Bureau issued a statement to remind supervised institutions that U.S. dollar (USD) LIBOR panels will end on June 30, 2023. Refer to Supervision and Regulation (SR) letter 23-2/Consumer Affairs (CA) letter 23-1, available at www.federalreserve.gov/supervisionreg/srletters/SR2302.htm.

On March 12, 2023, the Board, the FDIC, and the U.S. Department of the Treasury issued a joint statement on actions taken to protect the U.S. economy by strengthening public confidence in our banking system. After receiving a recommendation from the boards of the FDIC and the Federal Reserve and consulting with the President, Secretary of the Treasury Janet L. Yellen approved actions enabling the FDIC to complete its resolution of Silicon Valley Bank, Santa Clara, CA, in a manner that fully protects all depositors. Refer to the Board's press release at www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm.

On March 12, 2023, the Federal Reserve Board announced the creation of the Bank Term Funding Program (BTFP). The BTFP offers loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions pledging U.S. Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral. For more information about the BTFP, as well as frequently asked questions about the program, see the Board's press release, available at www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.

On February 23, 2023, the Board and the other federal banking agencies issued a joint statement on liquidity risks resulting from crypto-asset market vulnerabilities. The Board's press release is available at www.federalreserve.gov/newsevents/pressreleases/bcreg20230223a.htm.

On January 31, 2023, the Federal Reserve issued changes to the Home Mortgage Disclosure Act loan volume reporting threshold for closed-end mortgage loans. Refer to CA letter 23-1, available at www.federalreserve.gov/supervisionreg/caletters/caltr2301.htm.

On January 27, 2023, the Federal Reserve Board issued a policy statement to promote a level playing field for all banks with a federal supervisor, regardless of deposit insurance status. The statement makes clear that uninsured and insured banks supervised by the Board will be subject to the same limitations on activities, including novel banking activities, such as crypto-asset-related activities and to the limitations on certain activities imposed on national banks, which are overseen by the OCC. Refer to the Board's press release, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20230127a.htm.

On January 3, 2023, the Federal Reserve and the other federal bank regulatory agencies issued a joint statement on crypto-asset risks to banking organizations. The statement describes several key risks associated with crypto-assets and the crypto-asset sector, as demonstrated by the significant volatility and vulnerabilities over the past year. Refer to the Board's press release, available at www.federalreserve.gov/newsevents/pressreleases/bcreg20230103a.htm.

On December 22, 2022, the Federal Reserve and the other federal banking agencies issued guidance on the status of certain investment funds and their portfolio investments for purposes of Regulation O and reporting requirements under Part 363 of FDIC Regulations. SR letter 22-11 is available at www.federalreserve.gov/supervisionreg/srletters/sr2211.htm.

SPEECHES

Speeches Related to Banking Supervision and Regulation and the U.S. Economy

Governor Lisa D. Cook gave a speech at the Carroll Round Keynote Speech, Georgetown University McDonough School of Business, Washington, D.C., on April 21, 2023. Her speech, titled "Important Questions for Economic Research," is available at www.federalreserve.gov/newsevents/speech/cook20230421a.htm.

Governor Michelle W. Bowman gave brief remarks at the Fed Listens Event hosted by the Federal Reserve Bank of Dallas, Odessa, TX, on April 20, 2023. Her remarks are available at www.federalreserve.gov/newsevents/speech/bowman20230420a.htm.

Governor Christopher J. Waller gave a speech at Cryptocurrency and the Future of Global Finance, Sarasota, FL, on April 20, 2023. His speech, titled "Innovation and the Future of Finance," is available at www.federalreserve.gov/newsevents/speech/waller20230420a.htm.

Governor Michelle W. Bowman gave a speech at the Georgetown University McDonough School of Business Psaros Center for Financial Markets and Policy, Washington D.C., on April 18, 2023. Her speech, titled "Considerations for a Central Bank Digital Currency," is available at www.federalreserve.gov/newsevents/speech/bowman20230418a.htm.

Governor Michelle W. Bowman gave a speech at the Wharton Financial Regulation Conference, Philadelphia, on April 14, 2023. Her speech, titled "The Consequences of Fewer Banks in the U.S. Banking System," is available at www.federalreserve.gov/newsevents/speech/bowman20230414a.htm.

Governor Lisa D. Cook gave a speech at the 2023 Midwest Economics Association 87th Annual Meeting, Cleveland, OH, on March 31, 2023. Her speech, titled "The U.S. Economic Outlook and Monetary Policy," is available at www.federalreserve.gov/newsevents/speech/cook20230331a.htm.

Vice Chair for Supervision Michael S. Barr gave brief remarks at the National Community Reinvestment Coalition Just Economy Conference, Washington, D.C., (via prerecorded video), on March 29, 2023. His remarks are available at www.federalreserve.gov/newsevents/speech/barr20230329a.htm.

Governor Philip N. Jefferson gave a speech at the H. Parker Willis Lecture, Washington and Lee University, Lexington, VA, on March 27, 2023. His speech, titled "Implementation and Transmission of Monetary Policy," is available at www.federalreserve.gov/newsevents/speech/jefferson20230327a.htm.

Governor Michelle W. Bowman gave a speech at the Independent Community Bankers of America ICBA Live 2023 Conference, Honolulu, HI, on March 14, 2023. Her speech, titled "The Innovation Imperative: Modernizing Traditional Banking," is available at www.federalreserve.gov/newsevents/speech/bowman20230314a.htm.

Vice Chair for Supervision Michael S. Barr gave a speech at the Peterson Institute for International Economics, Washington, D.C., on March 9, 2023. His remarks and a video of the speech, titled "Supporting Innovation with Guardrails: The Federal Reserve's Approach to Supervision and Regulation of Banks' Crypto-Related Activities," are available at www.federalreserve.gov/newsevents/speech/barr20230309a.htm.

Governor Michelle W. Bowman provided remarks at the Chicago Booth Initiative on Global Markets Workshop on Market Dysfunction, Chicago, on March 3, 2023. Her panel remarks, titled "Design Issues for Central Bank Facilities in the Future," are available at www.federalreserve.gov/newsevents/speech/bowman20230303a.htm.

Governor Philip N. Jefferson gave a speech at the Ec10, Principles of Economics, Lecture, Faculty of Arts and Sciences, Harvard University, Cambridge, MA, on February 27, 2023. His remarks and a video of the speech, titled "Recent Inflation and the Dual Mandate," are available at www.federalreserve.gov/newsevents/speech/jefferson20230227a.htm.

Governor Michelle W. Bowman gave welcoming remarks at the Midwest Cyber Workshop, organized by the Federal Reserve Banks of Chicago, Kansas City, and St. Louis, on February 15, 2023. Her remarks are available at www.federalreserve.gov/newsevents/speech/bowman20230215a.htm.

Governor Michelle W. Bowman gave a speech at the American Bankers Association Community Banking Conference, Orlando, FL, on February 13, 2023. Her speech, titled "Independence, Predictability, and Tailoring in Banking Regulation and Supervision," is available at www.federalreserve.gov/newsevents/speech/bowman20230213a.htm.

Governor Christopher J. Waller gave a speech at the Global Interdependence Center Conference: Digital Money, Decentralized Finance, and the Puzzle of Crypto, La Jolla, CA, on February 10, 2023. His speech, titled "Thoughts on the Crypto Ecosystem," is available at www.federalreserve.gov/newsevents/speech/waller20230210a.htm.

Governor Christopher J. Waller gave a speech at the 2023 Arkansas State University Agribusiness Conference, Jonesboro, AR, on February 8, 2023. His speech, titled "The Inflation Rate for Necessities: A Look at Food, Energy, and Shelter Inflation," is available at www.federalreserve.gov/newsevents/speech/waller20230208a.htm.

Vice Chair for Supervision Michael S. Barr gave remarks at the Hope Economic Mobility Forum at Jackson State University, Jackson, MS, on February 7, 2023. His speech, titled "Remarks at the Banking on Financial Inclusion Conference," is available at www.federalreserve.gov/newsevents/speech/barr20230207a.htm.

Governor Lisa D. Cook gave remarks at the 110 Years of Deltas Embracing the Past While Shaping the Future event, Norfolk, VA, on January 21, 2023. Her speech, titled "Remarks to Delta Sigma Theta," is available at www.federalreserve.gov/newsevents/speech/cook20230121a.htm.

Governor Christopher J. Waller gave a speech at the C. Peter McColough Series on International Economics, Council on Foreign Relations, New York, on January 20, 2023. His speech, titled "A Case for Cautious Optimism," is available at www.federalreserve.gov/newsevents/speech/waller20230120a.htm.

Vice Chair Lael Brainard gave a speech at the University of Chicago Booth School of Business, Chicago, on January 19, 2023. Her speech, titled "Staying the Course to Bring Inflation Down," is available at www.federalreserve.gov/newsevents/speech/brainard20230119a.htm.

Governor Michelle W. Bowman gave brief remarks at the Florida Bankers Association Leadership Luncheon Events, Miami, FL, on January 10 and 11, 2023. Her remarks, identical on both days, are available at www.federalreserve.gov/newsevents/speech/bowman20230110a.htm.

Chair Jerome H. Powell gave comments on the "Central Bank Independence and the Mandate: Evolving Views" panel at the Symposium on Central Bank Independence, Sveriges Riksbank, Stockholm, Sweden, on January 10, 2023. His comments are available at www.federalreserve.gov/newsevents/speech/powell20230110a.htm.

Governor Lisa D. Cook gave a speech at the 2023 Allied Social Science Associations Annual Meeting, New Orleans, on January 6, 2023. Her speech, titled "Thoughts on Inflation in a Supply-Constrained Economy," is available at www.federalreserve.gov/newsevents/speech/cook20230106a.htm.

Vice Chair for Supervision Michael S. Barr gave a speech at the American Enterprise Institute, Washington, D.C. (virtual), on December 1, 2022. His speech, titled "Why Bank Capital Matters," is available at www.federalreserve.gov/newsevents/speech/barr20221201a.htm.

Chair Jerome H. Powell gave a speech at the Hutchins Center on Fiscal and Monetary Policy, Brookings Institution, Washington, D.C., on November 30, 2022. His speech, titled "Inflation and the Labor Market," is available at www.federalreserve.gov/newsevents/speech/powell20221130a.htm.

Governor Lisa D. Cook gave a speech at the Detroit Economic Club, Detroit, on November 30, 2022. Her speech, titled "The Economic Outlook and U.S. Productivity," is available at www.federalreserve.gov/newsevents/speech/cook20221130a.htm.

Vice Chair Lael Brainard gave a speech at the 21st BIS Annual Conference Central Banking After the Pandemic: Challenges Ahead, Bank for International Settlements, Basel, Switzerland, on November 28, 2022. Her speech, titled "What Can We Learn from the Pandemic and the War About Supply Shocks, Inflation, and Monetary Policy?," is available at www.federalreserve.gov/newsevents/speech/brainard20221128a.htm.

Governor Philip N. Jefferson gave a speech at the 2022 Institute Research Conference, hosted by the Opportunity and Inclusive Growth Institute, Federal Reserve Bank of Minneapolis, Minneapolis, on November 17, 2022. His speech, titled "Opportunity and Inclusive Economic Growth," is available at www.federalreserve.gov/newsevents/speech/jefferson20221117a.htm.

Governor Michelle W. Bowman gave a speech at the Financial Literacy and Education Commission Public Meeting, Financial Literacy and Education Commission, Washington, D.C., on November 17, 2022. Her speech, titled "Financial Education," is available at www.federalreserve.gov/newsevents/speech/bowman20221117a.htm.

Governor Christopher J. Waller gave a speech at the 59th Annual Economic Forecast Luncheon, Phoenix, on November 16, 2022. His speech, titled "The Economic Outlook and a Word of Caution on Inflation," is available at www.federalreserve.gov/newsevents/speech/waller20221116a.htm.

Governor Michelle W. Bowman gave welcoming remarks at Toward an Inclusive Recovery, a research seminar sponsored by the Board of Governors of the Federal Reserve System, Washington, D.C., (via webcast) on October 20, 2022. Her remarks and a video of the speech are available at www.federalreserve.gov/newsevents/speech/bowman20221020a.htm.

TESTIMONIES

Vice Chair for Supervision Michael S. Barr testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on March 28, 2023, and before the U.S. House of Representatives Committee on Financial Services, on March 29, 2023, Washington, D.C. His remarks on "Bank Oversight" are available at www.federalreserve.gov/newsevents/testimony/barr20230328a.htm.

Chair Jerome H. Powell testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on March 7, 2023, and before the U.S. House of Representatives Committee on Financial Services on March 8, 2023, Washington D.C. His "Semiannual Monetary Policy Report to the Congress" is available at www.federalreserve.gov/newsevents/testimony/powell20230307a.htm.

ask the Fed® The Bank Term Funding Program — Overview and Important Program Details for Depository Institutions

On March 15, 2023, Federal Reserve Board staff from the Division of Monetary Affairs (Matthew Malloy) and the Legal Division (Kelley O'Mara and Ben Snodgrass) conducted an Ask the Fed webinar on the Federal Reserve's Bank Term Funding Program (BTFP). The webinar is available at https://bsr.stlouisfed.org/askthefed/Home/ArchiveCall/340. The presenters addressed bankers' questions about the program, including questions relating to borrower and collateral eligibility, disclosure and reporting requirements, and how the BTFP compares to the discount window.

Pursuant to section 13(3) of the Federal Reserve Act, the Federal Reserve Board authorized all 12 Reserve Banks to establish the BTFP on March 12, 2023. The program is designed to support American businesses and households by making additional funding available to eligible depository institutions to help ensure that banks have the ability to meet the needs of all their depositors. It is an additional source of liquidity against high-quality securities, eliminating an eligible depository institution's need to quickly sell those securities in times of stress. Under the BTFP, eligible depository institutions can request advances until at least March 11, 2024.

For more information about the program, refer to the Federal Reserve — Discount Window/Payment System Risk website at www.frbdiscountwindow.org/GeneralPages/bank_term_funding_program.

FEDERAL RESERVE SYSTEM

COMMUNITY BANKING CONNECTIONS®

A SUPERVISION AND REGULATION PUBLICATION

A Message from Governor Bowman*

by Governor Michelle W. Bowman

First Issue 2023

Governor Michelle W. Bowman

The recent failures of three large banks continue to be a focal point in the news and of interest to community bankers. Therefore, I would like to focus my *Community Banking Connections* message on the events leading up to and following the failures of Silicon Valley Bank, Signature Bank, and First Republic. At the time of their failures, Silicon Valley Bank had approximately $218 billion in assets, Signature Bank held approximately $110 billion, and First Republic had approximately $229 billion in assets. The Federal Deposit Insurance Corporation (FDIC) estimates that the failure of Silicon Valley Bank will cost the Deposit Insurance Fund approximately $20 billion and that the failure of Signature Bank will cost $2.5 billion.[1] The FDIC estimates the cost to the Deposit Insurance Fund of the First Republic failure to be $13 billion.[2] Ultimately, the failures of Silicon Valley Bank and Signature Bank were largely due to their inability to fund the rapid outflow of deposits. More precisely, customers with deposits above the FDIC-insured amount of $250,000 per depositor, per account type, withdrew or tried to withdraw their deposits over the course of a few days, resulting in these banks having insufficient liquidity to meet their deposit outflows.

In March 2023, the U.S. Treasury, the Federal Reserve, and the FDIC announced that all depositors at Silicon Valley Bank and Signature Bank will be made whole.[3] On May 1, 2023, the FDIC entered into a purchase and assumption agreement with JPMorgan Chase Bank, N.A. to assume all of the deposits (including uninsured deposits) and substantially all of the assets of First Republic Bank.

The Federal Reserve Board created the Bank Term Funding Program (BTFP) to provide additional funding support to financial institutions beyond the Fed's discount window.[4] The BTFP, which expires on March 11, 2024, offers one-year loans to institutions that are collateralized by U.S.

* The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee or the Board of Governors.

[1] See the FDIC's press releases at www.fdic.gov/news/press-releases/2023/[illegible].html and www.fdic.gov/news/press-releases/2023/[illegible].html.

[2] See the FDIC's press release at www.fdic.gov/news/press-releases/2023/[illegible].html.

[3] See the FDIC's press release at www.fdic.gov/news/press-releases/2023/[illegible].html.

[4] The Federal Reserve presented an Ask the Fed webinar on this topic: The Bank Term Funding Program — Overview and Important Details for Depository Institutions; see page 24 of this issue for more information.

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With each issue of *Community Banking Connections*, we aim to highlight the supervisory and regulatory matters that affect you and your banking institution the most, providing examples from the field, explanations of supervisory policies and guidance, and more. We encourage you to contact us with any ideas for articles so that we can continue to provide you with topical and valuable information.

Direct any comments and suggestions to editor@communitybankingconnections.org.

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