A Discussion of Unrealized Losses at Community Banks in a Rising Interest Rate Environment

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Session Overview

- Discuss how the current rising rate environment impacts bank balance sheets
- Discuss risks associated with low or negative tangible common equity
- Identify what banks with elevated risk profiles can do now and the implications for capital, liquidity, and earnings
- Explain our supervisory posture and communications strategy for banks demonstrating elevated risks from rising interest rates

Financial Risks are Growing for Many Banks

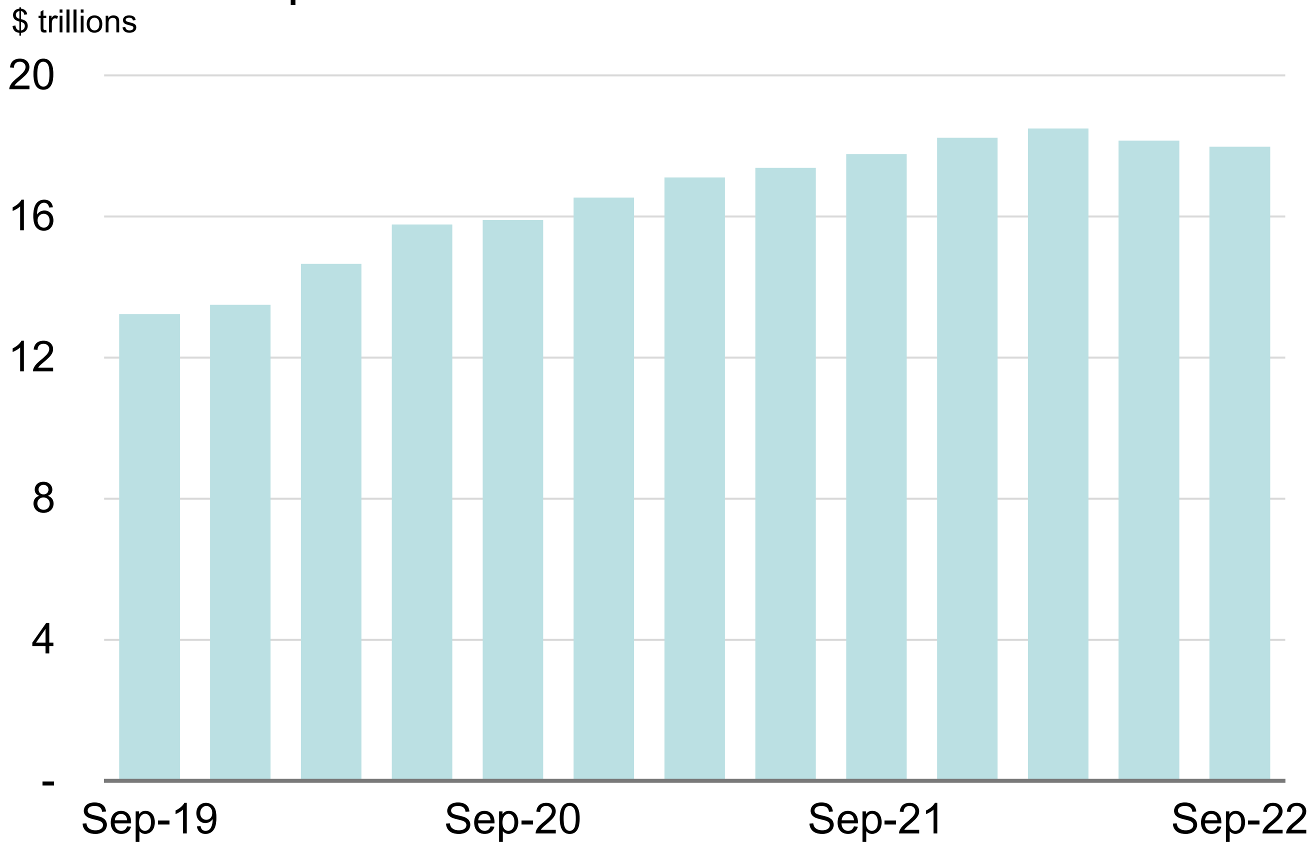
- **Most community banking organizations are in stable financial condition and have benefited from the recent rise in interest rates with improvement in their net interest margins.**
- **During the pandemic, community banks experienced a surge in deposits, and some banks invested their deposit growth into longer-dated securities for earnings.**
- **More recently, some banks are reporting sizeable unrealized losses on their fixed rate assets, including debt securities.**
- **As a result, banks with sizable available-for-sale (AFS) securities portfolios are reporting low or negative tangible common equity (TCE).**
- **Further, banks with large unrealized losses could experience liquidity and funding challenges, earnings pressures, and in some cases capital issues.**

Deposit Levels Increased During the Pandemic

- Industry deposits grew by nearly $4 trillion from 1Q20 to 1Q22

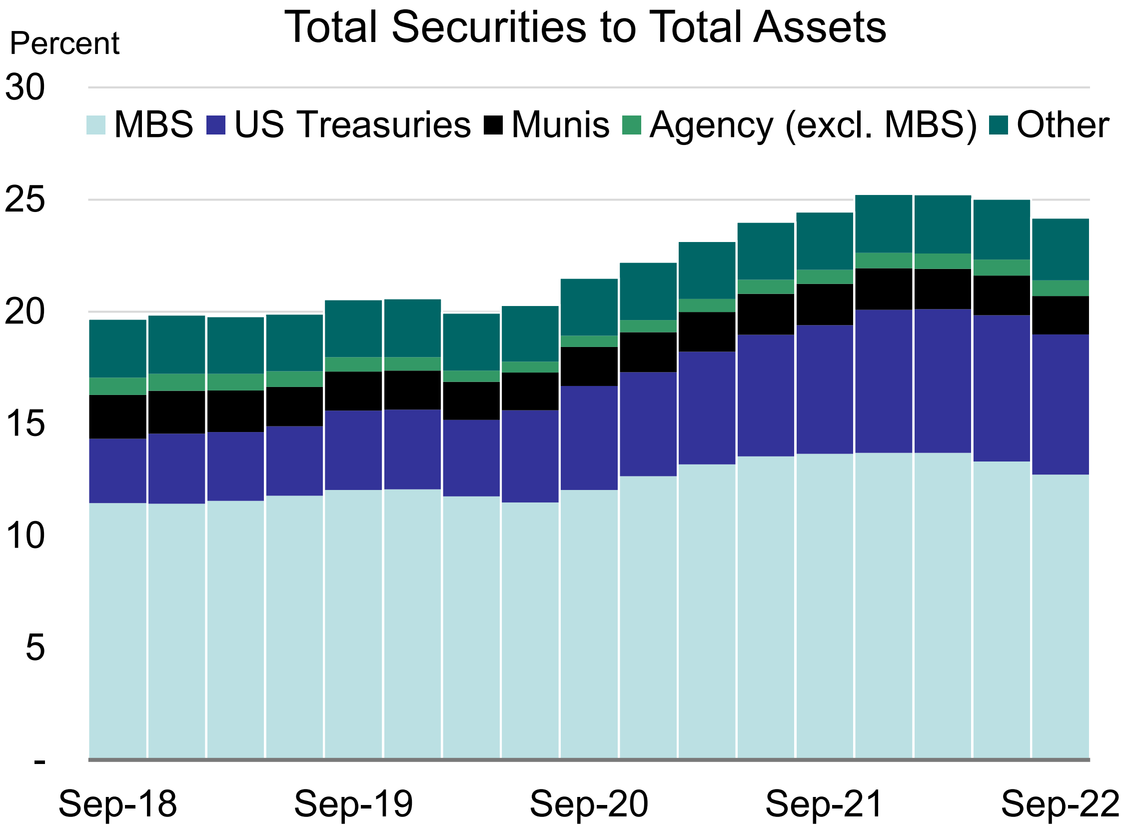
❖ ***Note:*** *The stickiness of new deposits is unknown. Banks should be updating deposit beta and decay assumptions in interest rate risk (IRR) and liquidity measurement tools to reflect the current environment.*

Deposit Growth Since Start of Pandemic

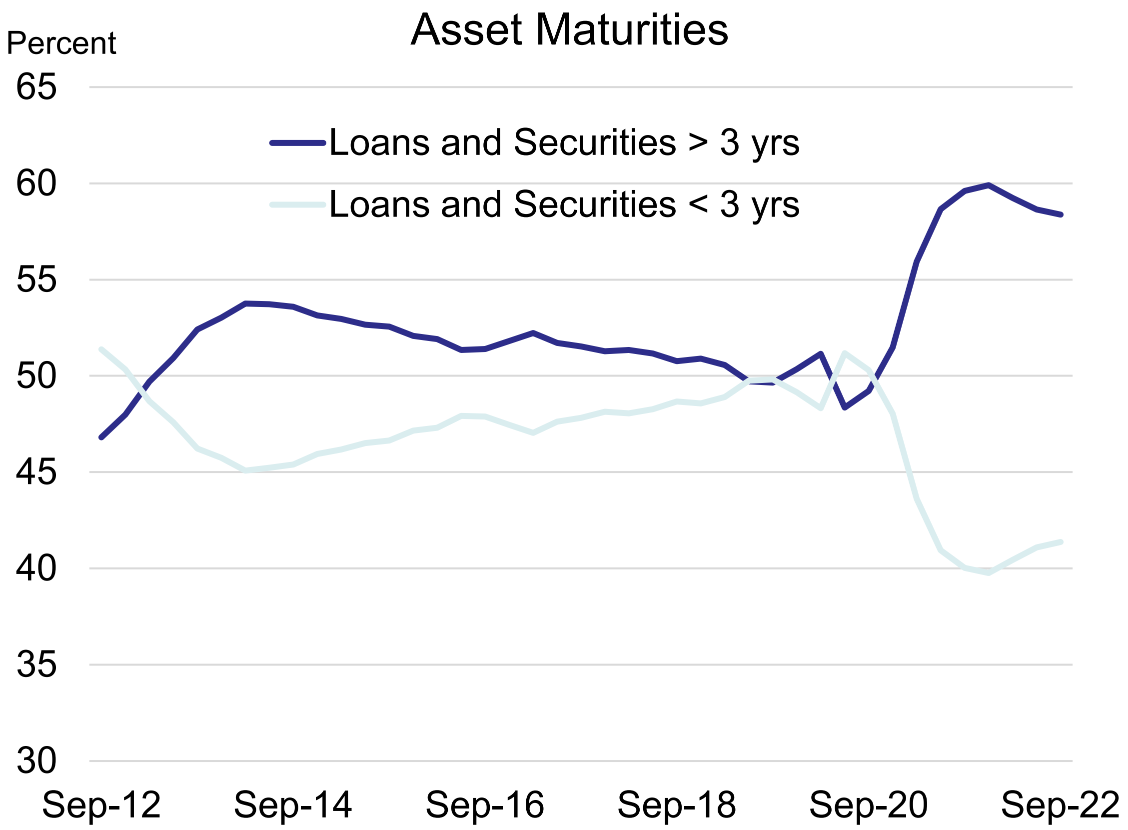


Note: All U.S. commercial banks.
Source: Reports of Condition and Income.

Securities Holdings and Duration Increases

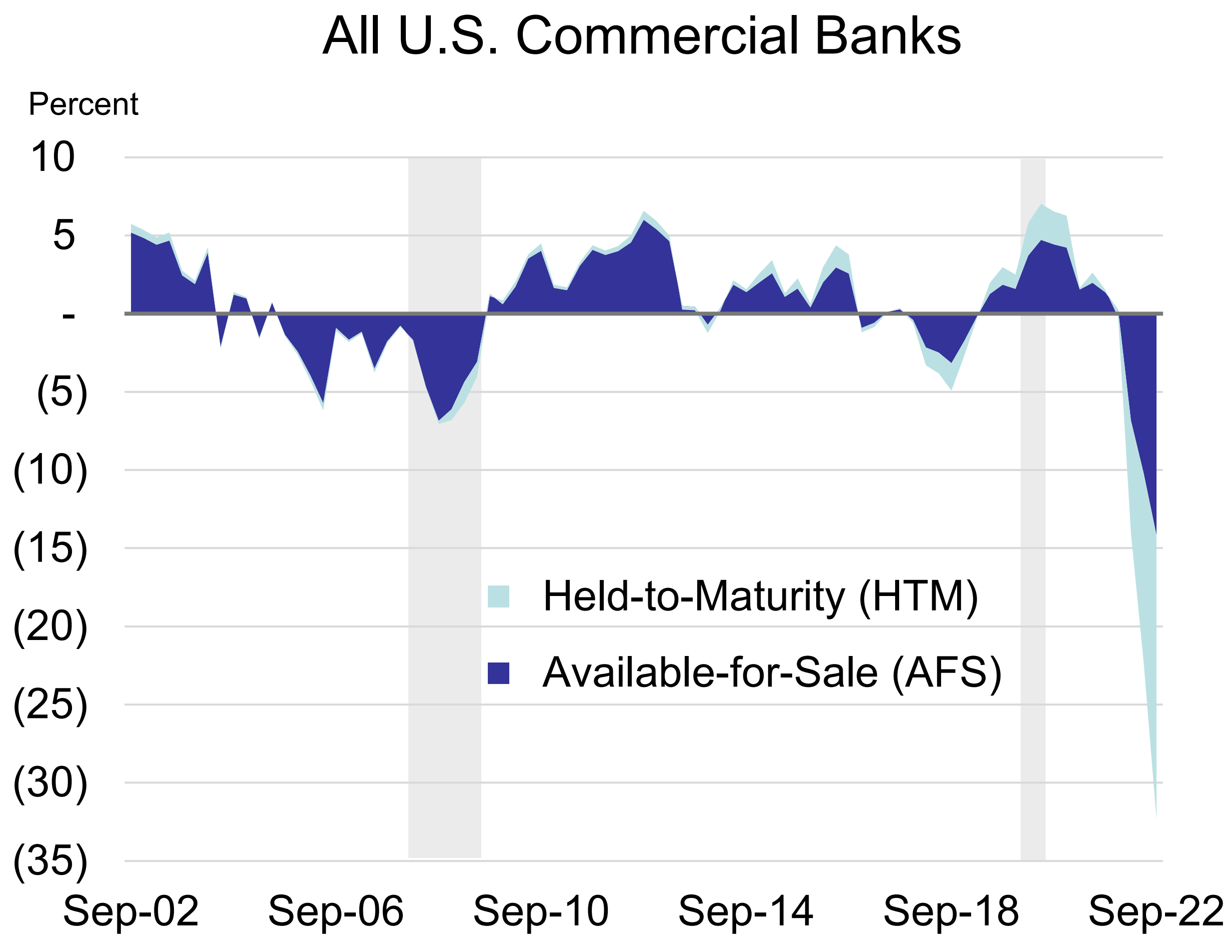


Note: All U.S. commercial banks.
Source: Reports of Condition and Income.



Note: Data for all commercial banks with less than $10 billion in assets (community banks).
Source: Reports of Condition and Income.

Unrealized Losses are at Historical Levels



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.

- Losses are highest at banks with concentrations of long-duration securities and/or a large securities portfolio as a percent of assets.

- Community banks have predominantly opted out of reporting accumulated other comprehensive income (AOCI) in regulatory capital. Therefore, these banks have a larger share of their securities portfolios classified as available for sale.

❖ ***Note:** Regardless of accounting classification, unrealized losses are an economic reality. Risks related to liquidity, earnings, and capital should be fully understood.*

Polling Question #1

- **Which best describes your most significant concern as rates rise?**

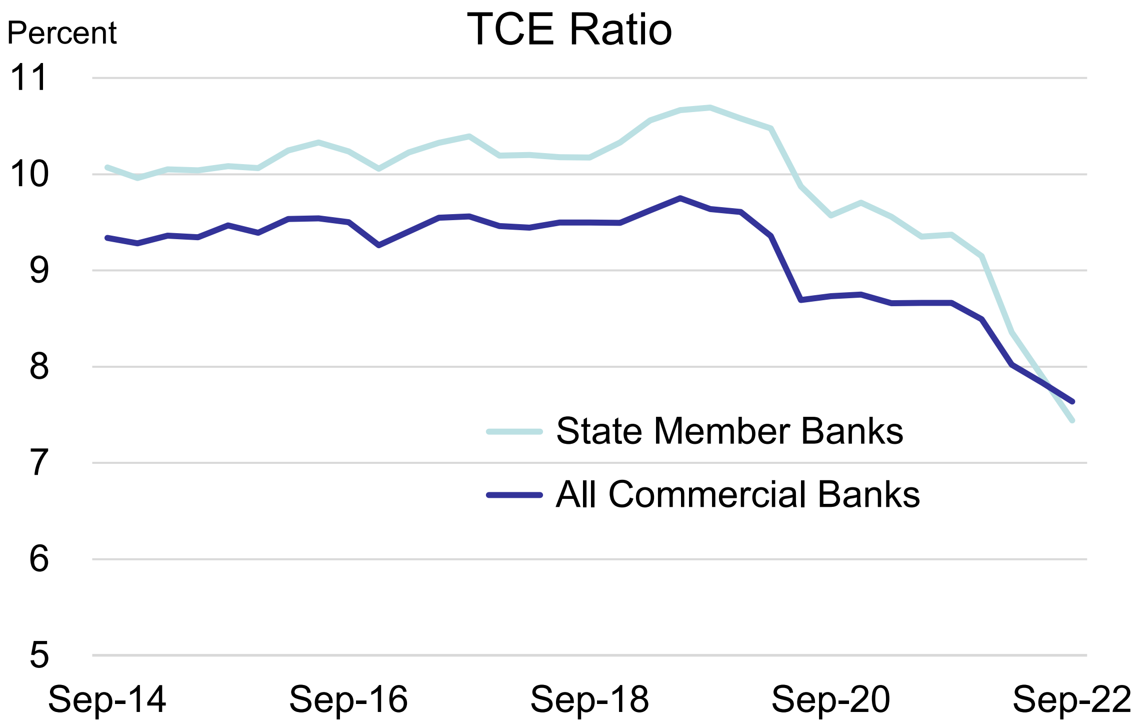
A. Liquidity withdrawals and reduced contingency funding availability
B. Narrowing net interest margins and earnings reductions
C. Further reductions of leverage ratios
D. Increased loan delinquencies from higher variable rate loan payments
E. N/A or Unsure

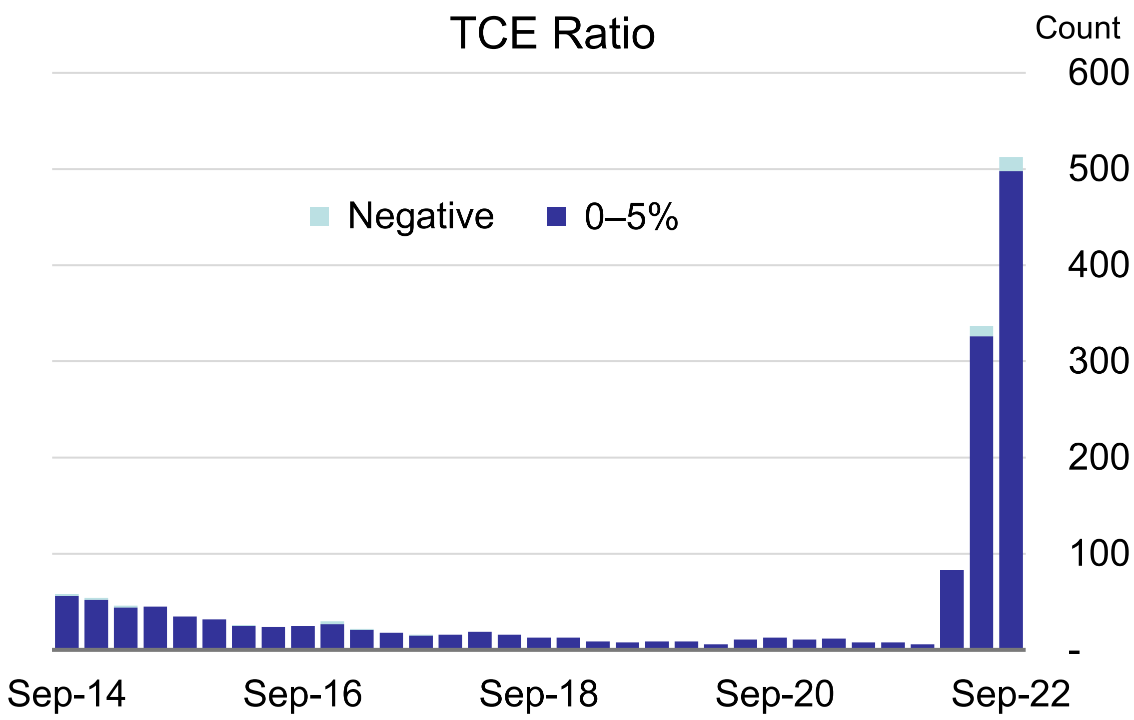
Discussion Topic

How is tangible common equity (TCE) different from regulatory capital, and what are the implications of negative TCE?

Unrealized Losses Lowering TCE

- Unrealized losses on AFS securities are not included in regulatory capital calculations for community banks; however, these losses are included in TCE.
- TCE is declining industry wide due to banks' AFS securities holdings and rising rates.





Notes: TCE is calculated as equity capital less goodwill, other intangibles, and disallowed mortgage servicing rights as a percent of average tangible assets. State member banks limited to banks with less than $100 billion in assets.
Source: Reports of Condition and Income.

Polling Question #2

- **Were you aware of the differences between TCE and regulatory capital?**

A. Yes
B. No
C. This Ask the Fed® session is advancing my knowledge on the topic

Discussion Topic

What challenges might a bank face due to low or negative TCE?

- Federal Home Loan Bank (FHLB) borrowing restrictions
- Restrictions from Fannie Mae, Freddie Mac, and Ginnie Mae
- Certain states and municipalities may restrict activity based on TCE

Other Risks to Consider

- Banks with large unrealized losses and/or low, declining, or negative TCE positions have an increased risk profile; however, the level of risk at a particular institution varies.
- Banks that are not well matched and/or are experiencing higher than anticipated deposit outflows could face:
  - Net interest margin compression
  - Difficulty in securing funding or securing funding at reasonable costs
    - *FHLB is restricted from making new loans to banks with negative TCE*
    - *Existing FHLB loans may be renewed for short terms (30 days) only*
  - Losses on the sale of securities to meet liquidity needs
  - Lower capital, if earnings are eroded from net interest margin compression and/or losses are taken on the sale of securities

Polling Question #3

- **What do you consider to be the most significant implication of declining or negative TCE for your institution?**

A. Net interest margin compression

B. Challenges to renew or obtain funding (liquidity)

C. Having to sell securities at a loss to meet liquidity needs

D. Not anticipated to be an issue

E. N/A or Unsure

Discussion Topic

What can banks do now?

- Liquidity and Interest Rate Risk Management
- Capital Planning
- Accounting Changes and Implications
- Other Considerations

What can Banks do now?

- **Liquidity Planning**
  - Balance Sheet Management
    - Preservation of asset liquidity (especially outside of the investment portfolio)
    - Identify securities with minimal/no unrealized loss or understand earnings and capital impact of selling securities at a loss
  - Contingent Funding
    - Confirm availability of existing contingent funding
    - Further diversify contingency sources, particularly secured funding
      - Discount Window
      - Other correspondent banks
  - Scenario Analysis
    - Ensure runoff scenarios include significant deposit runoff and/or FHLB restrictions
    - Scenarios should be severe enough to highlight potential weaknesses

What can Banks do now? (cont.)

- **Capital Planning**
  - Incorporate all risk exposures and provide meaningful measures to protect capital position
    - Project impact of low-yielding assets on future earnings
    - Assess the possible impact of further interest rate shocks
    - Limit loan funding or reduce assets
    - Be mindful of long-standing capital policy statements and understand reducing or eliminating dividends may be necessary
    - Raise capital from parent company or existing shareholders
- **Accounting Changes**
  - Reclassify AFS to HTM
  - Place new investment purchases in HTM
  - Please confer with accounting professionals to fully understand implications of transfers or material HTM holdings

Polling Question #4

- **What is your bank currently doing to address declining or negative TCE?**

A. Enhancing liquidity and interest rate risk management processes
B. Incorporating these risks into the capital planning process
C. Having discussions with our accountant(s)
D. Having discussions with examiners
E. All of the above
F. N/A or Unsure

Discussion Topic

Supervisory Approach

- Reserve Bank outreach
- Target examinations/accelerated examinations
- Ongoing monitoring

CAMELS Component Considerations

- **S**ensitivity to Market Risk
  - Rating reflects the degree to which **changes in interest rates can adversely affect a financial institution's earnings or economic capital**
  - Considerations include:
    - Management's ability to identify, monitor, and **control market risk** and the adequacy of its capital and earnings in relationship to its market risk exposure
    - Sensitivity of the bank's earnings or economic value of its capital to **adverse changes in interest rates**
    - The nature and complexity of **interest rate risk exposure**
- **L**iquidity
  - Rating reflects the ability of the institution to manage **unplanned changes in funding sources**, as well as react to changes in market conditions that affect the **ability to quickly liquidate assets with minimal loss**

Source: SR Letter 96-38, "Uniform Financial Institutions Rating Systems (UFIRS)"

CAMELS Component Considerations (cont.)

- **E**arnings
  - Rating reflects factors that may affect the sustainability or quality of earnings
  - Considerations include the earnings exposure to **market risks such as interest rate**, foreign exchange, and price risks
- **C**apital
  - Rating reflects the effects of credit, market, and other risks on a bank's financial condition
  - Considerations include the level of **TCE relative to average total assets**
- **M**anagement / **R**isk **M**anagement
  - Ratings reflect the ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that **may arise from changing business conditions**

Source: SR Letter 96-38, "Uniform Financial Institutions Rating Systems (UFIRS)"

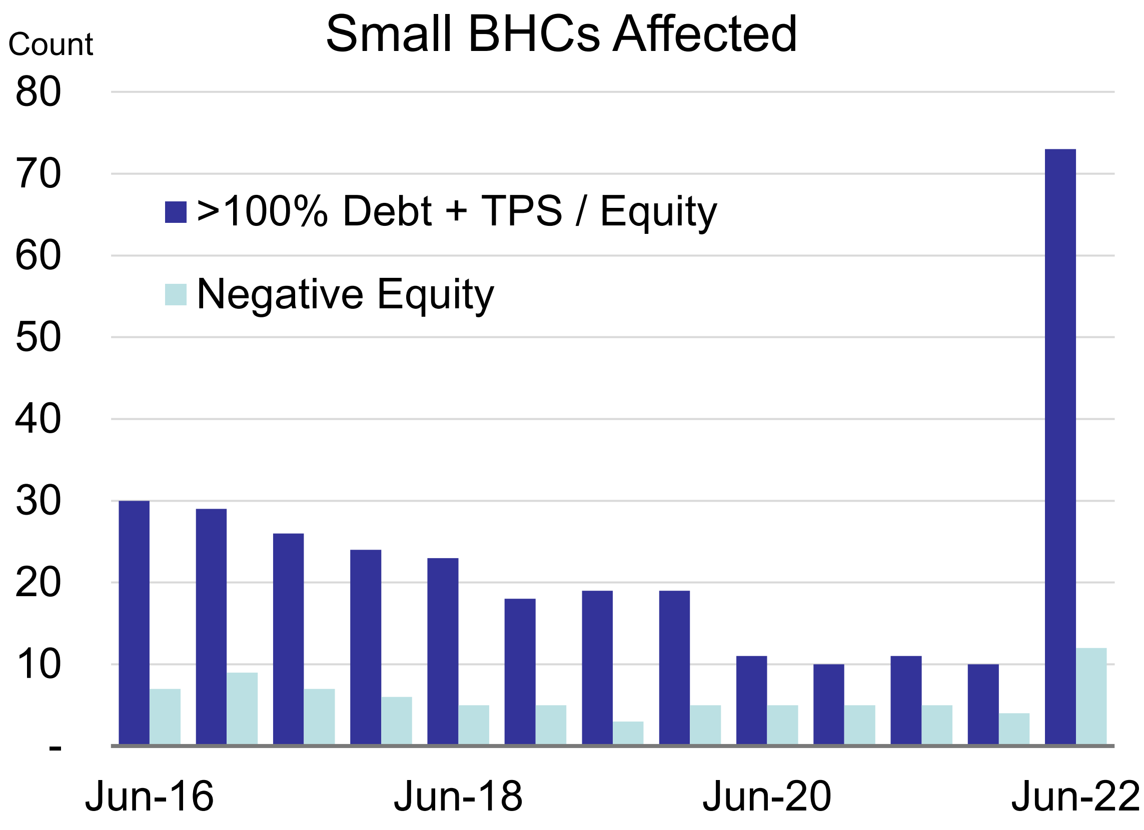
Discussion Topic

What are the risks a Small Shell Bank Holding Company (BHC) should consider?

Risk Implications for the Holding Company

Parent Company Equity Implications

- A bank's unrealized loss positions can negatively impact parent company equity ratios.
- Key Questions to Consider:
  - How does elevated leverage or negative equity impact the HC's ability to serve as a source of strength?
  - Has elevated leverage/negative equity negatively impacted the ability to access additional capital (or access at a reasonable cost)?
  - Are there any debt contracts that contain clauses or covenants linked to TCE or certain leverage ratios thresholds?



Source: FR Y-9SP.

Risk Implications (cont.)

Small BHC and SLHC Policy Statement Implications:

- Policy Statement generally applies to holding companies with total assets of $3 billion or less.
- A small bank holding company whose debt-to-equity ratio is greater than 1.0:1 is not expected to pay corporate dividends until such time as it reduces its debt-to-equity ratio to 1.0:1 or less and satisfies other criteria as described in Regulation Y (12 CFR part 225) .
- For small holding companies exceeding the 1.0:1 debt-to-equity ratio, any contemplated dividend or other capital transaction should be discussed with the local Reserve Bank prior to conducting the transaction.

Note: While the policy statement is an appendix of Regulation Y, much of the statement is considered guidance and not a binding regulation. See SR Letter 09-04, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” that provides further clarification of regulatory requirements related to capital transactions.

Abbreviations and Acronyms

AFS: Available-for-Sale

AOCI: Accumulated Other Comprehensive Income

BHCs: Bank Holding Companies

CAMELS: Uniform Financial Institutions Rating System acronym. The acronym stands for Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk.

FHLB: Federal Home Loan Bank

GAAP: U.S. Generally Accepted Accounting Principles

HCs: Holding Companies (both BHC and SLHCs)

HTM: Held-to-Maturity

IRR: Interest Rate Risk

MBS: Mortgage-backed Securities

Munis: Municipal Bonds

SLHCs: Savings and Loan Holding Companies

SR Letter: Supervision and Regulation Letter

TCE: Tangible Common Equity

Resources

- **SR Letters**
  - SR Letter 16-11, Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion
  - SR Letter 12-2, Questions and Answers on Interagency Advisory on Interest Rate Risk Management
  - SR Letter 10-6, Interagency Policy Statement on Funding and Liquidity Risk Management
  - SR Letter 10-1, Interagency Advisory on Interest Rate Risk
  - SR Letter 09-4, Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies
  - SR Letter 96-38, Uniform Financial Institutions Rating System

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