Business, Financial Services, Gaming & Trade - Work Session March 28, 2023

DEPARTMENT OF FINANCIAL INSTITUTIONS (DFI)

INDUSTRY RESILIENCE AND REGULATORY PROCESSES

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Agenda

- Resilience in the insured depository financial services sector.
- How Banks and Credit Unions are regulated, highlighting liquidity risk and interest rate risk.
- Recent Federal Actions and Safeguards.
- Changes since Dodd Frank / DFAST.

The U.S. financial system is safe, well capitalized, diverse and resilient.

- State and federal bank regulators acted quickly and decisively in recent weeks to protect bank customers and ensure the safety and soundness of the financial system.
- The FDIC deposit insurance fund is well funded - supported by all banks
- Regulatory supervision processes are robust, bank examiners are well trained.

"The capital and liquidity positions of the U.S. banking system are strong, and the U.S. financial system is resilient." March 12, 2023 Federal Reserve press release.

Regulatory Authority and Roles

- State – Issues Charters and Conducts Examinations/Enforcement.
- Federal Deposit Insurance Corporation (FDIC)/National Credit Union Association (NCUA) – Provides Deposit Insurance and Conducts Examinations/Enforcement.
- Federal Reserve – Conducts Examinations/Enforcement for Fed Member Banks, regulates bank holding companies and plays various other roles in the financial ecosystem.

State and Federal regulators work in close collaboration to supervise/examine/conduct enforcement on banks/credit unions

Types of Examinations

Safety and Soundness – Risk Assessment of the CAMELS components/composite

- **C**apital: Absorbs losses, supports growth, and provides depositor confidence.
- **A**sset Quality: Reflects the quantity of existing and potential credit risk associated with loans and investments.
- **M**anagement: The board and senior management of the bank/credit union, policies, procedures, risk frameworks.
- **E**arnings: The ability to generate a return on assets sufficient to remain competitive, fund expansion and augment capital.
- **Liquidity: The ability to accommodate decreases in deposits and funding increases in assets, both at reasonable costs.**
- **Sensitivity to Market Risk: Risk resulting from interest rate changes and other factors.**

Liquidity and Interest Rate Risk

- Banks/credit unions accept deposits from businesses and consumers and invest in assets (primarily loans/investment securities).

- Liquidity risk management requires banks and credit unions to:
  - Hold certain levels of cash and liquid assets at all times to repay depositors when they request to withdraw their funds;
  - Have contingency or secondary sources of liquidity, such as lines of credit from the Federal Home Loan Banks, The Federal Reserve, correspondent banks – these lines of credit generally require some form of collateral to be pledged;
  - Measure, monitor and control this risk to ensure depositor demands can be met.

- Banks/credit unions make money based largely on the interest/margin spread between yield on assets and cost of funding/deposits.

- Interest rate risk management requires banks and credit unions to measure, monitor and control the impact that various interest rate changes would have on their balance sheet, earnings and capital levels.

U.S Government Response and Action

FDIC – "Systemic Risk Exception" ensuring customer funds at both failed banks were immediately available when the bridge bank opened the following Monday March 13, 2023.

The Federal Reserve established the Bank Term Funding Program* on March 12, 2023

- Provides loans of up to one year to federally insured banks, savings associations, credit unions - collateralized with U.S. Treasuries, agency debt and mortgage-backed securities, and other qualifying assets.
- Assets will be valued at par to provide depository institutions with additional funding capacity.
- The Department of the Treasury will make available up to $25 billion from the Exchange Stabilization Fund as a backstop for the BTFP.

*Resource: Bank Term Funding Program (BTFP)

Dodd Frank Act Stress Testing

- DFAST is an annual forward-looking stress-test intended to assess the impact on a bank's capital levels as a result of an immediate financial shock and severely adverse economic conditions.
- DFAST came after the 2008-2010 banking crisis, originally banks over $10 Billion in assets were required to run the test and report publically annually.
- In 2018, the federal Economic Growth, Regulatory Relief, and Consumer Protection Act increased the threshold at which institutions are subject to DFAST from $10 billion to $250 billion.
- DFAST is not a liquidity stress test.
- All banks are expected to conduct stress testing activities based upon their size, business model, and inherent risks. Review of stress testing models and practices are a key component of normal bank regulation and oversight. Institutions are expected to do stress testing in many areas including liquidity/access to funding sources and interest rate risk.