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Supervision in Brief

A Regulator's Perspective on Issues Facing Twelfth District Banks

Dear Colleagues,

This July, the Federal Reserve System welcomed its new Vice Chair for Supervision, Michael Barr. Since then, the Supervision + Credit (S+C) group at the SF Fed has worked diligently with our Board colleagues to inform his agenda and priorities, which he recently delivered at The Brookings Institution. Vice Chair Barr emphasized that his priorities would focus on both safety and fairness within the financial system, and many of the topics Vice Chair Barr spoke about align with what's top of mind for our work in the Twelfth District, including:

- **Financial risks from climate change**: The Federal Reserve continues to work on understanding how climate change poses risks to individual banks and the financial system. Vice Chair Barr mentioned, "The Federal Reserve's mandate in this area is important, but narrow, focused on supervisory responsibilities." In the immediate term, the Supervision Climate Committee (SCC) will work with the OCC and FDIC to provide guidance to large banks ($100B+) on how they are expected to identify, measure, and monitor financial risks of climate change. And, in 2023, we will conduct a micro-prudential climate scenario pilot exercise that is expected to advance both our internal and firm climate risk management knowledge and capabilities.

- **Fintech**: Regulation and oversight of new forms of private money created through stablecoins is also a priority as they could pose financial stability risks. Vice Chair Barr stated that Congress should work expeditiously to pass legislation to bring stablecoins inside the regulatory perimeter. He also mentioned that crypto-asset activity requires oversight so that people are fully aware of their risks. “I plan to make sure that the crypto activity of banks that we supervise is subject to the necessary safeguards that protect the banking system and bank customers,” he said.

- **Financial Fairness & the Community Reinvestment Act**: Vice Chair Barr concluded with remarking on bringing access to the unbanked through promoting access to the financial system and changes to the Community Reinvestment Act, which the Twelfth District has sought to highlight through S+C’s Fintech team and the District’s Community Development group. “Under financial inclusion, one example would be promoting access to low-cost and safe banking services for low- and moderate-income (LMI) consumers. And consumer protection involves using supervision and regulation to fully implement laws to promote fair lending, consumer protection, and transparency in the consumer financial services marketplace.”

In other news, S+C is continuing to focus on Commercial Real Estate (CRE). At 334%, District banks’ median CRE loan-to-capital and reserves ratio was well above a nationwide median of 196%. Roughly two-thirds of this lending is related to nonowner-occupied properties, which rely on CRE for both the primary and secondary sources of repayment. Exposures were especially high among banks in California and Washington, but median midyear concentration ratios in most District states exceeded the United States. Rising interest rates may pressure CRE cash flows, particularly among the COVID-sensitive hotel, retail, and office sectors. Also, valuations could suffer if cap rates respond to higher interest rates. On the positive side, construction loans represent a smaller share of lending among Twelfth District banks than before the Great Recession, so our supervised firms are better able to withstand a shock to this sector than they were in 2008.

We are also watching our District banks' funding mix and deposit competition. Annual growth in deposits, particularly low/noninterest-bearing non-maturity deposits (NMDs), surged in 2020 and 2021, led by flight-to-safety and stimulus-related funding. However, median quarterly NMD growth stalled among community banks and turned negative among Mid-Sized and Large banks in 2Q 2022. Ebbing pandemic-era NMDs may migrate to more price-sensitive deposit products, or banks may need to replace runoff with pricier CDs or noncore funding sources. An IntraFi Network survey conducted in June found that 71% of bankers in the West expected deposit competition to worsen in the coming 12 months (up 10 points from April 2022) and 86% expected funding costs to increase (up eight points from April 2022).

You can read more about CRE and other topics on our radar in the latest 12L First Glance.

Best,

Federal Reserve Bank of San Francisco