

# Regulatory Alert

Regulatory Insights for Financial Services

May 2023

## Supervisory Focus: FRB Highlights

The Federal Reserve Board (FRB) published two semiannual reports: 1) the Supervision and Regulation Report and 2) the Financial Stability Report. (These reports are typically published in November and May of each year. The editions released in November 2022 were covered in the KPMG Regulatory Alert, [here](#).)

The reports are outlined below.

### Supervision and Regulation Report

The FRB's [Supervision and Regulation Report](#) highlights supervisory priorities and regulatory developments as well as the FRB's current assessment of banking system conditions.

#### Supervisory Developments

The FRB summarizes that its current supervisory priorities include more in-depth monitoring and examinations of institutions with:

- Potentially vulnerable funding positions, including examinations directed toward assessing current valuations of investment securities, deposit trends, diversity of funding sources, and adequacy of contingency funding plans.
- High concentrations of commercial real estate (CRE) lending.
- Crypto-asset-related activities, complex third-party relationships with fintech companies to deliver banking products, or other novel activities.

#### 2023 Supervisory Priorities - Large Financial Institutions

(banking organizations, U.S. or foreign, with combined U.S. assets of \$100 billion or more)

- **Capital**
  - Financial risks impacted by economic changes, including interest rate (IR) risk, market and counterparty credit risk, and consumer and commercial credit risk.
  - Risk management practices in credit, market, and IR risk.
  - Implementation of regulatory phase-ins (e.g., counterparty rules).
  - LIBOR transition.
- **Liquidity**
  - Contingency funding plans and intraday liquidity risk management.
  - Changes in deposits and the effect on funding mix.
  - Asset/Liability management and stress testing.
  - Liquidity risk management at foreign banking organization branches.
- **Governance and controls**
  - Operational resilience, including cybersecurity, novel banking, and IT risks.
  - Third-party (vendor) risk management (TPRM).
  - Compliance, internal loan review, and audit.
  - Firm remediation efforts on previously identified MRAs (Matters Requiring Attention).
- **Recovery and resolution planning**
  - Recovery and resolution planning, including critical operations review.
  - Remediation of and follow-up on resolution plan deficiencies and shortcomings, as necessary.

- International coordination among global supervisors.

**2023 Supervisory Priorities - CBOs and RBOs** (where Community Banking Organizations (CBOs) have less than \$10 billion in total assets and Regional Banking Organizations (RBOs) have between \$10 and \$100 billion in total assets)

— **Credit Risk**

- High-risk loan portfolios and debt service coverage capacity in changing interest rate environment.
- Credit concentrations, particularly in CRE.
- Implementation of CECL with CBOs in 2023.

— **Liquidity Risk**

- Contingent funding plans.
- Liquidity coverage of uninsured deposits.

— **Other financial risks**

- Interest rate risk.
- Securities risk.
- Capital adequacy.

— **Operational risk**

- IT and cybersecurity preparedness.
- Fintech and banking-as-a-service activities.
- Adequacy of TPRM.

**Regulatory Developments**

“Significant” regulatory actions taken since November 2022, include actions in these areas:

— **Climate:**

- **Risk Management Principles:** The FRB released principles for climate-related financial risk management for financial institutions with over \$100 billion in assets. The six general principles and six key risk areas are substantially similar to those previously released by OCC and FDIC. (See KPMG Regulatory Alert, [here.](#))
- **Scenario Analysis Exercise:** The FRB published instructions for the six large banks participating in its pilot climate scenario analysis (CSA) exercise, which was initially announced in Fall 2022. The document provides details on how the FRB will conduct the exercise and information on risk management practices that will be gathered. (See KPMG Regulatory Alert, [here.](#))

- **SOFR:** The FRB issued a final rule implementing the Adjustable Interest Rate (LIBOR) Act by identifying benchmark rates based on SOFR that will replace LIBOR in certain financial contracts after June 30, 2023.

- **“Level Playing Field”:** The FRB issued a policy statement to promote a “level playing field” for all banks with a federal supervisor, regardless of deposit insurance status.
- **Crypto:** The FRB issued Joint Statements (FRB, FDIC, OCC) on crypto-asset risks to banking organizations, including i) risks from fraud and scams, legal uncertainties, significant volatility, contagion and run risks, and ii) liquidity risks resulting from crypto-asset market vulnerabilities, including deposits placed by crypto-asset related entities for their end customers or deposits that constitute stablecoin-related reserves.

**Banking System Conditions** (as summarized by the FRB)

- The banking system remains sound with high levels of capital and liquidity (“well above” the regulatory minimums). However, bank market indicators reflect some deterioration and uncertain economic conditions.
- Net interest margins (the difference between interest income and interest paid for funding) expanded in 2022 due to strong year-over-year growth in interest income.
- Loan balances continue to grow across most loan categories, but at a slower rate than in 2022. Tighter lending standards and weaker demand contributed to the slower growth in commercial and industrial (C&I) and CRE lending. Delinquency and net charge-off rates for some consumer loans (credit card and auto) and CRE segments have increased.

**Financial Stability Report**

The FRB’s [Financial Stability Report](#) distinguishes between shocks to, and vulnerabilities of, the financial system. It primarily focuses on vulnerabilities across four categories with identification of several potential near-term risks to the financial system. Highlights of each section of the report are below.

**Overview of financial system vulnerabilities** (as summarized by the FRB)

— **Asset Valuations**

- Analyses on Treasury yields, market volatility, equity prices relative to expected earnings, risk premiums in corporate bond markets, and valuations in residential and CRE.

— **Borrowing by Businesses and Households**

- Updates on the vulnerabilities related to borrowing by nonfinancial businesses and households, as well as measures of leverage and debt service coverage.

— **Leverage within the Financial Sector**

- Specific analyses of vulnerabilities related to leverage across financial sector participants, including uninsured

deposits, fair values of long-duration fixed-rate assets, and loss-absorbing capacities.

— **Funding Risks**

- Analysis of funding risks across the banking system, including in the areas of domestic deposits, money market funds, mutual funds, and stablecoins.

**Near-Term Risks to the Financial System**

The report also highlights several potential near-term risks to U.S. financial stability, including:

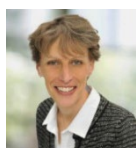
- Inflation and monetary tightening.

- Stresses in the banking sector and nonbank financial institutions.
- Commercial and residential real estate.
- Geopolitical tensions, including the Russia-Ukraine war and the relationship between the U.S. and China.

Additional topics covered include: the transition to the Secured Overnight Financing Rate (SOFR); financial institutions' exposure to CRE debt; and financial stability risks from private credit funds.

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