

How (In)effective was Bank Supervision During the 2022 Monetary Tightening?

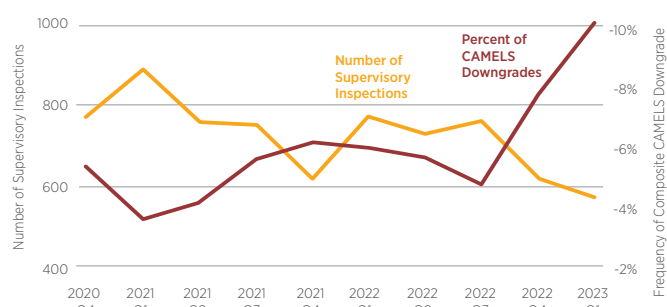
Based on BFI Working Paper No. 2023-130 “[How \(In\)effective was Bank Supervision During the 2022 Monetary Tightening?](#),”
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By limiting interest rate risk exposures and propping up the liquidity of many banks, supervisors safeguarded the banking system surrounding the monetary tightening episode of 2022.

The events that prompted the collapse of Silicon Valley Bank (SVB) and First Republic Corporation (FRC) in the first half of 2023 were simple enough: The banks’ holdings of long-term securities lost significant market value as the Federal Reserve began raising interest rates in 2022, sparking fear among uninsured depositors that the banks could not meet their obligations, and precipitating a bank run.

This “textbook” case seemed so obvious in hindsight that many commentators raised pointed questions about the role of bank supervisors. How, for example, could supervisors have let these banks accumulate such large exposures to interest rate and liquidity risks during 2021 and 2022? Were supervisors oblivious of the systemic risks that were so openly and obviously brewing in the banking system? Or did bank supervisors lack the resources to remain vigilant and the discretionary powers to enforce recommendations? Finally, once they acted, did supervisors successfully intervene to curb the interest rate risk exposure of some banks? If so, did such interventions remain secret due to the confidential nature of supervisory examinations?

Figure 1 • Number of Exams and Downgrade Rate of the Composite CAMELS Rating by Quarter



Note: This figure shows the total number of supervisory inspections on the left axis and the frequency of composite CAMELS downgrade on the right axis, illustrating how the number of supervisory examinations and frequency of CAMELS downgrades evolved during the authors’ sample period. Out of any given quarter, examiners engage in approximately 750 on-site supervisory examinations or about 15% of all commercial banks. During the last quarter of 2020 and first and second quarters of 2021, supervisors downgraded about 4 percent of banks. The rate of downgrade increased to approximately 6 percent throughout 2022. When the problems at SVB and FRC unraveled during the first quarter of 2023, supervisors raised this rate and downgraded approximately 10 percent of the banks that they inspected in that quarter.

These questions motivate this new working paper. However, before addressing them in the authors’ findings, it is useful to broadly review how supervisors quantitatively measure a bank’s financial condition. Supervisors evaluate banks using a CAMELS rating, which refers to capital

adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and sensitivity to risk (S). CAMELS ratings are the basis for important supervisory interventions such as merger approvals, dividend restrictions, and deposit insurance assessments fees.

These CAMELS ratings are the foundation for the authors' analysis. They use the near universe of CAMELS ratings assigned to every commercial bank in the United States to examine how supervisors assessed interest rate and liquidity risks before, during, and after the monetary tightening of 2022. In particular, they investigate if and when supervisors downgraded banks with large exposures to interest rate and liquidity risks, and if such supervisory actions helped curb these risks at the downgraded banks. They find the following:

- Bank supervisors incrementally increased the frequency of downgrading of the liquidity (L) and sensitivity to risk (S) ratings of banks that were most exposed to interest rate risks at the same time that the Federal Open Market Committee (FOMC) began raising interest rates in the spring of 2022. This key finding suggests that bank supervisors understood the impact that large exposures to interest rate risks could have on banks' financial health, and that supervisors acted accordingly by downgrading banks that were most exposed to these risks.
- Supervisors were not more likely to downgrade the capital (C), asset quality (A), management (M), and earnings (E) ratings of banks with high interest rate risk exposures.

This finding is consistent with the idea that bank supervisors downgraded the liquidity (L) and sensitivity to risk (S) ratings of these banks because they specifically targeted these risk exposures as the FOMC began raising interest rates.

- Throughout 2021 and 2022, bank examiners were not statistically more likely to downgrade the "L" and "S" ratings of banks that relied more heavily on uninsured deposits, suggesting that regulators did not fully appreciate the risks associated with this type of deposits.
- State regulatory agencies were just as strict as federal regulators.
- A supervisory downgrade of the "L" or "S" components of a bank's CAMELS rating is associated with a subsequent decline in the share of a bank's securities with long maturities. Moreover, downgraded banks seem to reallocate a significant fraction of their assets from securities to cash.

Bottom line: This work suggests that the "deer-in-the-headlights" charge against bank supervisors in light of the SVB and FRC failures misses the mark. Indeed, supervisory downgrades possibly prevented some banks from following the same path as SVB and FRC. Finally, what this work also suggests is that most supervisory effects are hidden, given the confidential nature of bank supervision. In other words, while failed banks get the headlines, the untold story is that many more banks are often likely saved by the concerted efforts of bank supervisors.

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