Andy Beshear
GOVERNOR

Jacqueline Coleman
LIEUTENANT GOVERNOR

PUBLIC PROTECTION CABINET
**Kentucky Department of Financial Institutions**
500 Mero Street, 2SW19
Frankfort, KY 40601
Phone: (502) 573-3390
KFI@ky.gov

Ray A. Perry
SECRETARY

Justin M. Burse
ACTING COMMISSIONER

# Notice to Kentucky Depository Financial Institutions

## 2023 Exam Priorities

Moving into 2023, rising interest rates and economic uncertainties are creating heightened risks within depository institutions. Of particular focus are liquidity pressures, increased interest rate risk, historically low net interest margins, and the potential for deteriorating asset quality. Depository institutions must also continue to manage staffing shortages, succession planning, and cyber risks, while also implementing a significant new accounting standard (Current Expected Credit Losses) in 2023. A brief discussion of each of these areas is included below.

### Liquidity

In 2020 and 2021, the U.S. Government issued stimulus payments to help aid Americans amid the COVID-19 pandemic. Those payments brought the largest influx of deposits into financial institutions in recent history. Additionally, with interest rates at all-time lows, many institutions experienced a notable shift in the composition of their loan portfolios to higher concentrations of longer-term loans. In the wake of the pandemic, supply chain and staffing issues set off a chain of events leading to an inflation rate of nearly 8.5 percent, the highest rate since 1982. To combat inflation, the Federal Open Market Committee increased the federal funds rate by 425 basis points between March and December 2022. Consequently, many institutions have a heavy concentration in long-term loans at historically low rates with low probability of refinancing, coupled with rising interest rates on deposits. Consumers are now beginning to withdraw excess savings, reducing available balance sheet liquidity to fund current and expected needs. Compounding the liquidity issue is the increasing amount of unrealized losses on available-for-sale securities limiting institutions' ability to sell securities without incurring significant losses. These unrealized losses could cause a reduction in tangible equity capital and potentially limit access to secondary sources of liquidity.

### Interest Rate Risk

The sharpest increase in interest rates in 40 years comes with potential exposure to interest rate risk (IRR) for our institutions. Higher IRR caused by extended duration from long-maturity loans and investments, liability structure, or rapidly rising market rates can amplify risk exposures to capital and earnings. Asset quality, liquidity risk and strategic risk could all be affected by the unprecedented rise in IRR. Holding long-term investments and loans at low rates in a rising rate environment increases IRR, as institutions may experience rising cost of funds and extensions in the average life of assets limiting reinvestment and lending opportunities at

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higher yields, resulting in a lower net interest margin, a decline in overall earnings, and higher longer-term risk to capital. As interest rates increase, longer-term loans and investments remain stagnant at lower market rates while institutions experience competitive pressures to pay higher rates on deposits.

## Earnings

A prolonged, historically low interest rate environment resulted in compressed net interest margins leading up to the period of high inflation and rapidly rising interest rates. The significant monetary policy changes have exposed balance sheet mismatches and put continued pressure on net interest margins and overall earnings. The significant fee income source from generating Paycheck Protection Program loans to businesses throughout the Pandemic has now dried up, and institutions are seeking other ways to generate noninterest income in an increasingly competitive market.

## Asset Quality

Government-issued stimulus payments and reduced consumer spending throughout the Pandemic resulted in very low delinquency and charge-off rates in institutions' loan portfolios. However, as interest rates and inflation rise, consumers are beginning to experience financial pressures. Institutions will likely see increases in delinquency and charge-offs, especially those with high volumes of adjustable-rate loans. Institutions should closely monitor loan portfolios and stress test repayment abilities of borrowers.

## Other Topics

A historically low unemployment rate has led to staffing pressures for virtually all businesses, the Department of Financial Institutions included. Depository institutions have indicated they are experiencing vacancies in numerous positions and having difficulty finding qualified and interested employees. Additionally, many institutions have experienced an increase in salary and benefit expenses to retain and attract employees. This issue is compounded for institutions in rural communities with more limited pools of viable candidates.

Cybersecurity remains a significant focus area for financial institutions, as cyber threats occur and escalate in complexity daily. Institutions maintain a large volume of personally identifiable information and transmit large sums of money through electronic means, making them prime targets for cyber criminals.

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As of January 1, 2023, the Current Expected Credit Losses (CECL) accounting standard went into effect for financial institutions required to follow Generally Accepted Accounting Principles. The CECL standard replaces the long-standing incurred loss method and will require institutions to overhaul their methodologies for accounting for potential loan and securities losses.

We hope the release of these exam priorities provides a little insight into the mindset of the Department as we begin our calendar year examinations. Please also know that the Department is always open and willing to discuss areas of concern you see in our state-chartered depository institutions.