Banking in a world of high inflation: what are the risks and challenges to banks and Supervisors

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- One of the most immediate challenges facing banks is rising interest rates. While the banking sector can expect to see net gains from a gradual increase in interest rates, the downside risks must not be overlooked. If the interaction between market expectations, monetary policy and inflation dynamics leads to a disorderly rise in market interest rates, this may indeed have a significant negative impact on banks' cost of funding and asset quality.

- Both banks and supervisors therefore need to remain vigilant. The tail risk of a severe economic recession must sharpen the supervisory focus on priority areas such as credit risk management and counterparty credit risk towards non-bank financial institutions.

- The prospect of a potential worsening in the credit risk outlook for banks in the short to medium-term serves only to heighten the relevance of supervisory priorities for the next two years. Particularly in the area of credit risk, it is more important than ever that banks have in place effective provisioning and risk management practices.

- This will enable them to identify, assess and implement solutions to effectively support distressed debtors. We are now entering a period of uncertainty that could see an increase in default rates and non-performing loan (NPL) levels. This will warrant a shift in NPL strategies from a singular focus on reducing legacy NPLs to also preventing NPLs from accumulating in the future. As legacy NPLs are reduced, internal workout becomes increasingly important.

- Early management of distressed debtors is key to containing the build-up of new NPLs, which could otherwise have a significant impact on the recovery of the economy once the crisis is over.

- We want to be sure that banks are well prepared, that their assessment of new risks is comprehensive, and that they intensify their efforts to conduct “look-through” credit analysis on a more granular basis to gain the clearest insight into the effects on businesses and households.

- We want to be sure that banks update their loss models to reflect the changed economic and business environment accordingly. Despite supervisory initiatives undertaken in recent years to help improve banks’ ability to cope with increasing asset quality deterioration, material deficiencies persist in the credit risk management frameworks of several banks.

Assessing Banks’ Interest Rate Risk Exposure :
Bank Balance Sheet Composition—The Asset Side
Bank Balance Sheet Composition— The Liability Side

A rising rate environment in conjunction with a continued flattening of the yield curve presents the potential for heightened interest rate risk. A flattening yield curve can pressure banks’ margins generally, and rising rates can be particularly challenging to institutions with a “liability-sensitive” balance sheet—an asset/liability profile characterized by liabilities that reprice faster than assets. The extent of this mismatch between the maturity or repricing of assets and liabilities is a key element in assessing an institution’s exposure to interest rate risk.

Supervisory Assessment of Interest Rate Risk :

Bank examiners assess the level of interest rate risk exposure in light of a bank's asset size, complexity, levels of capital and earnings, and most important, the effectiveness of its risk management process. At the core of the interest rate risk examination process is a supervisory assessment of how well bank management identifies, monitors, manages, and controls interest rate risk. This assessment is summarized in an assigned risk rating for the component known as sensitivity to market risk, which is part of the CAMELS rating system

Other key points:

- Loan-to-value ratios
- Corporate lending and SME lending
- Changes in loan quality
- Change in cost of risk
- Change in Stage 2 and Stage 3 loans 2Q22 vs the year-end
- Bank buffers remain the key
- Bank profitability (ROE) as of 2Q22
- Risk-based capital ratios vs leverage ratios

Conclusion

We expect bank loan quality to suffer from the difficult combination of high inflation, a slowing economy and high rates. The resulting higher loan loss provisions are likely to absorb part of the positive revenue impact from higher rates.