

Chicago Fed Letter

Exploring risks and opportunities for community banks in an improving environment

by Jane Frost, examiner; Pamela Kennedy, senior examiner; Courtney Markovich, portfolio manager; Wade Perry, portfolio manager; and Lea Whitney, communications analyst, all of Supervision and Regulation

The tenth annual Community Bankers Symposium, cosponsored by the Federal Reserve Bank of Chicago, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), was held at the Chicago Fed on November 7, 2014. This article summarizes key presentations and discussions at the symposium.

More information about the symposium is available at <https://www.chicagofed.org/events/2014/annual-community-bankers-symposium>.

Key presentations at the Community Bankers Symposium were delivered by Charles Evans, president and CEO, Federal Reserve Bank of Chicago; Thomas Curry, comptroller, Office of the Comptroller of the Currency; Daniel Tarullo, member, Board of Governors of the Federal Reserve System; Richard Brown, chief economist and associate director of regional operations, FDIC; and John Ryan, president, Conference of State Bank Supervisors. Nearly 200 participants, mostly executive officers and directors of community banking organizations in the Seventh Federal Reserve District,¹ gathered to discuss both the opportunities and key emerging risks that lie ahead for community banks. The major themes of the symposium were the critical role that community banks play in the communities they serve; the importance of managing “strategic risk” (i.e., the risk that earnings and capital will be negatively impacted by improperly executed or poor business decisions); the need to tailor supervisory oversight to the size and complexity of the financial institution; and the increasing risks related to cyberthreats.

Economic implications for banking

Remarks by both Evans and Brown indicated a favorable outlook for the U.S. economy, boding well for the banking

sector in the upcoming year. Some of the reasons for their optimism included economic growth that is expected to be above its long-term trend; well-controlled inflation; firming labor markets, with the actual unemployment rate approaching its natural rate;² and rising levels of consumer and business confidence and spending. While the U.S. economy’s pace of expansion is clearly improving, challenges remain. Most notably, the weak global economy continues to present considerable downside risks to the U.S. economic outlook. A stronger U.S. dollar could hurt net exports and dampen inflation, which has already been tracking well below the Federal Reserve’s long-term goal of 2% for an extended period. Evans offered the view that the Federal Open Market Committee needs to be patient on the timing (and pace) of raising the federal funds rate (i.e., the traditional short-term interest rate policy tool) until economic growth is more assured. Tightening monetary policy too soon (or too quickly) could halt the recovery and potentially require a return to accommodative monetary policy support. According to Evans, at the time of the conference, the downside risk of prematurely raising short-term interest rates continues to outweigh the risk of inflation rising somewhat above the Fed’s 2% target

while accommodative monetary policy remains in place.

In regard to the economy and the banking sector, Brown made several notable comments, including the following:

- Residential properties are experiencing a remarkable turnaround in price appreciation; this positive development should reduce losses due to defaults on these properties and should translate into less risk for the banking system.

seeking agricultural holdings facilitated the doubling of farmland values over the past few years. The developments in domestic oil extraction, accomplished largely through hydraulic fracturing, were unthinkable a decade ago. However, falling commodity prices in both of these sectors are likely to hurt producers and the communities that service their industries. That said, the wider economy is expected to benefit from lower agricultural and energy commodity prices. Brown indicated that a farmland

highlighted several issues related to strategic risk, the drive to improve financial performance, and consumer topics.

Given the challenging banking environment, Gerbick and Greenup emphasized that strategic risk continues to be a potential focal point. Bankers are encouraged to engage in strategic planning to ensure their organizations are focused on expansion and growth opportunities consistent with their strengths. Moreover, strategic planning helps ensure sufficient capital, human resources, and controls are in place to accomplish bankers' plans for growth while identifying the risks embedded in their strategies.

The OCC and FDIC panelists also indicated that some community banks, under pressure to strengthen earnings, appear to be assuming greater risk. First, increasing commercial real estate and commercial and industrial concentrations combined with a general weakening of credit standards are evident, as banks seek to bolster interest income through loan growth. Given that the majority of banks that failed in the recent downturn had high lending concentrations, examiners will more closely supervise institutions with similarly high loan concentrations and ensure that Board-approved limits on concentration levels are in place and monitored. Competition has led to more relaxed credit standards, as evidenced by an increase in the number of commercial loan policy exceptions and more lenient terms for consumer auto loans. Second, a panelist observed instances where the duration of securities portfolios lengthened as some banks are focusing more on yield than on controlling their long-term interest rate risk exposure. Panelists cautioned that there will be increased examiner scrutiny on banks' programs to manage interest rate risk to ensure that there are acceptable risk tolerances in place and that the balance sheet is well positioned for increasing or volatile rate environments. Finally, Greenup indicated that some banks are entering new lines of business that are designed to generate fee income, such as third-party overdraft protection plans and prepaid cards. Such banks should conduct appropriate due diligence, he argued, prior

The 11th annual Community Bankers Symposium will be held at the Chicago Fed on November 13, 2015.

- The positive traction in declining vacancy rates in the U.S. office market is generally reflective of the slow pace of new commercial construction during this expansion. Multifamily and warehouse units are experiencing relatively higher demand, prompting new construction projects.
- Commercial real estate capitalization rates remain near decade lows in part due to low long-term interest rates, although existing property values are vulnerable to declines if investors continue to demand higher rates of return when rates begin to rise.
- The growth in construction and real estate development varies widely across the nation, although the collective size of this business line is down by about 66% from its 2006 peak.
- The economy is becoming less entrepreneurial as the rate of newly created businesses lags the number of firms exiting the market. This is problematic for smaller banks, as they devote a far larger portion of their lending to small business loans.

Other relevant economic topics at the symposium included the booms in the agricultural and energy sectors during the recovery. As a result of these booms, many farmers saw significant increases in farmland values and the United States became a top producer of crude oil and natural gas. Greater global demand for farm goods and more capital investment

bubble is less of a certainty because of lower farm debt levels and the prevalence of cash deals (as opposed to mortgages) used to buy farmland.

Finally, Brown argued a sizable profitability gap between community and noncommunity banks³ arose in the pre-crisis years and has persisted to a smaller extent since the crisis. Compared with larger commercial banks, community bankers have been less successful at generating noninterest income from off-balance-sheet activities. Deterioration in community bank efficiency ratios in recent years can be almost entirely explained by the squeeze in the net interest margin in a low rate environment, with overhead expenses playing a much smaller role.⁴ In this light, improvement in earnings performance depends on interest rates moving up from their historic lows. When this occurs, according to Brown, bankers may see an uptick in *de novo* (new) bank activity, given the high correlation between new banking charters and economic variables, including the federal funds rate.

Emerging risks facing banks

Joseph Davidson, vice president, Federal Reserve Bank of Chicago, moderated a panel of bank regulators that featured Philip Gerbick, senior advisor for thrift supervision, OCC; Scott Greenup, chief of the emerging issues section, FDIC; and Christopher Lombardo, assistant regional director, Consumer Financial Protection Bureau (CFPB). The panelists

to entering into these agreements, as well as implementing an appropriate vendor management program to provide effective ongoing oversight.

Lombardo shared that the CFPB's role is to protect consumers. Current CFPB rulemaking efforts are focused on addressing unfair and deceptive debt collection practices. A future area of focus is likely to be the reverse mortgage, whose pattern of use is changing dramatically as the population ages, the CFPB has noted. An increasing number of seniors who have little in terms of retirement savings are entering into reverse mortgages on a more frequent basis at a younger age, indicating the potential for risks related to this product to be increasing.

Tailoring regulation and supervision

John Ryan (Conference of State Bank Supervisors) shared his views regarding the progress and obstacles toward achieving a diverse, thriving dual banking system—a structure that allows for the coexistence of different regulatory structures for state- and federally chartered institutions of varying sizes.⁵ Ryan noted a number of positive legislative and regulatory developments for community banks, such as the exemption of small banks from the Basel III global liquidity rules and increased congressional activity on improving the “qualified mortgage” rules for loans held in portfolio. However, Ryan stressed that there is still more progress to be made. He urged Congress and federal regulators to take steps to tailor financial policy and supervision so that they are commensurate with a bank's size, business model, and risk profile. As a part of his approach to reforming regulation, Ryan proposed several short-term steps that could be taken, including the following:

- Remove barriers to private capital investment for small bank-holding companies;
- Provide community banks with regulatory clarity and transparency regarding fair lending requirements;
- “Speed up the application process for community banks by evaluating merger, acquisition, and new activities applications based on their business

model and not on how application decisions might establish a precedent for large banks to exploit;” and

- Eliminate the brokered deposit designation for reciprocal deposits.

His speech concluded by offering two challenges to state and federal regulators. The first, which he initially proposed at the 2013 symposium, is to ensure that small banks in rural America do not go out of business because of the increased cost of regulation. The second challenge is to make sure the future of bank chartering does not shut out new market entrants. “The opportunity to form a de novo bank should not be only limited to communities in the largest metropolitan areas or in the fastest-growing states,” said Ryan.

Via video conference, Tarullo (Board of Governors of the Federal Reserve System) discussed the changing role of supervision and regulation.⁶ Similar to Ryan, Tarullo stated the financial crisis provoked a fundamental reassessment of the aims of prudential regulation, and stressed that rules and examination procedures that apply to larger banking organizations do not make sense for supervising community banks. There is now more widespread agreement that these rules and procedures should vary according to the size, scope, and range of activities conducted by banking organizations. Most significantly, banks that pose serious risks to the entire financial system need regulation incorporating the macroprudential aims of protecting financial stability. Tarullo relayed that there is also a good argument that very large banks that fall somewhat short of systemic importance should nonetheless be regulated with a macroprudential approach. Although individual community banks may be an important source of credit (particularly in local economies outside urban areas), neither systemic risk concerns nor broad macroprudential considerations are important for their supervision.

When asked what the fundamental aim of financial regulation should be, Tarullo's answer was that it should be to protect the deposit insurance fund. The traditional microprudential approach (focused

on the safety and soundness of the individual financial institution) continues to be appropriate for community banks. The supervision of community banks relies on traditional capital regulation to ensure their solvency, as well as traditional examination practices to monitor the basic soundness of their lending practices. Increased scrutiny may be appropriate when community banks engage in more-complex lines of business. Tarullo provided insight into how the Board of Governors is tailoring the regulation and supervision of community banks to achieve these prudential regulation aims, and indicated there are two complementary ways to implement a tiered approach: Apply specific regulations only to those classes of banking organizations whose activities and scale require those measures and/or tailor the usage of generally applicable measures based on the bank's size and complexity or other characteristics.

Moreover, Tarullo said he supported the expansion of the Federal Reserve's Small Bank Holding Companies Policy Statement to noncomplex banking organizations up to \$1 billion in assets from the current \$500 million threshold through an act of Congress. A statutory

Charles L. Evans, *President*; Daniel G. Sullivan, *Executive Vice President and Director of Research*; Spencer Krane, *Senior Vice President and Economic Advisor*; David Marshall, *Senior Vice President, financial markets group*; Daniel Aaronson, *Vice President, microeconomic policy research*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Richard Heckinger, *Vice President, markets team*; Anna L. Paulson, *Vice President, finance team*; William A. Testa, *Vice President, regional programs, and Economics Editor*; Helen O'D. Koshy and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*; Sheila A. Mangler, *Editorial Assistant*.

Chicago Fed Letter is published by the Economic Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

© 2015 Federal Reserve Bank of Chicago
Chicago Fed Letter articles may be reproduced in whole or in part, provided the articles are not reproduced or distributed for commercial gain and provided the source is appropriately credited. Prior written permission must be obtained for any other reproduction, distribution, republication, or creation of derivative works of *Chicago Fed Letter* articles. To request permission, please contact Helen Koshy, senior editor, at 312-322-5830 or email Helen.Koshy@chi.frb.org. *Chicago Fed Letter* and other Bank publications are available at <https://www.chicagofed.org>.

ISSN 0895-0164

amendment is now needed to provide relief from the regulatory capital guidelines, reduce reporting requirements, and facilitate transfers of ownership while sufficient supervisory controls remain in place to limit excessive risk-taking by these noncomplex designated entities.

Throughout the crisis, attention was understandably focused on “too big to fail” and other systemic risks, but now it is time to look at the other end of the banking industry where the contrast is substantial. Smaller banks present a very different set of business models. Their risks and vulnerabilities tend to grow from different sources, and explicit tailoring of regulation and supervision for community banks, which both Ryan and Tarullo advocated, is an important next step in regulatory reform.

Cybersecurity

Cybersecurity—a top concern raised by several panelists throughout the day—was the topic of a panel led by Sandeep Dhameja, risk management team leader, Federal Reserve Bank of Chicago, and featuring Kevin Greenfield, director of bank information technology, OCC, and Troy Land, supervisory special agent, Electronic Crimes Task Force, U.S. Secret Service, Chicago.

Curry and Greenfield discussed the Federal Financial Institutions Examination Council’s (FFIEC) Information Technology Subcommittee and how it promotes uniform and effective information on technology-related policies, as well as supervisory programs for financial institutions and their service providers. In 2014, the FFIEC piloted a cybersecurity assessment at more than

500 community banks to gain an understanding of the current state of cybersecurity preparedness and to identify ways to improve regulatory oversight to help strengthen cybersecurity. Released in November 2014, the results of the assessment included questions that CEOs and boards of directors may want to consider when evaluating their institutions’ cybersecurity.⁷

While regulatory agencies work to educate and disseminate information as quickly as possible, they should not be viewed as a first line of defense, the panelists noted. The FFIEC recommends that financial institutions participate in the Financial Services Information Sharing and Analysis Center (FS-ISAC). The FS-ISAC is a nonprofit, information-sharing forum established by financial services industry participants to facilitate the public and private sectors’ sharing of physical and cybersecurity threat/vulnerability information. Institutions that are involved in FS-ISAC and other information-sharing vehicles tend to be better prepared to combat cyberthreats.

The panelists emphasized the importance of incorporating cybersecurity into business continuity planning. If utilizing a third-party service provider, it is important to recognize that the third party can expose the bank to significant risks, so an appropriate vendor risk-management program should be in place. Personnel should be aware of specific cybersecurity threats to the banking industry, which include malware, ATM (automated teller machine) cash-outs through skimming, and phishing schemes. The audience was reminded

that once someone gains access on any level, the better chance of gaining access to deeper security levels. Finally, if a security incident occurs, bank management should be able to provide law enforcement with the following information:

1) who the bank’s security contact people are; 2) how quickly the bank can provide information; and 3) what third parties are involved with the bank for security purposes (e.g., a law firm or third-party forensic company). Timing is everything for investigative purposes as the money, in an overwhelmingly large number of these fraud cases, is transmitted overseas quickly, and the likelihood of positive resolution diminishes when the criminals reside outside U.S. borders.

Conclusion

In closing, Comptroller Curry and Governor Tarullo acknowledged that every bank is unique, requiring more than a “cookie-cutter” approach to supervision. Adjusting the examination scope and risk-management expectations based on the size and complexity of the institution is important to help deliver meaningful supervision of smaller banks and thrifts.

This article provided an overview of the conference. We encourage those interested to consider attending our next annual Community Bankers Symposium, which will be held at the Chicago Fed on November 13, 2015. More information will be posted in the events section of our website (<https://www.chicagofed.org/events/upcoming-events>) as it becomes available.

¹ All of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

² The rate that would prevail in an economy making full use of its productive resources.

³ See the recently added Community Bank Performance Section in the FDIC *Quarterly Banking Profile*, at <https://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP>.

⁴ The efficiency ratio measures the proportion of net operating revenues that are

absorbed by overhead expenses; net interest margin is the income generated by a bank minus the interest paid on its borrowed funds, divided by the average value of the assets on which it earned income.

⁵ Read the speech at www.csbs.org/news/presentations/Documents/Ryan,%20The%20Banking%20System%20We%20Need%20-%20One%20Year%20Later,%20FINAL.pdf.

⁶ Read the speech at www.federalreserve.gov/newsevents/speech/tarullo20141107a.htm.

⁷ <https://www.ffiec.gov/press/pr110314.htm>.