

# Chicago Fed Letter

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## The impact of the financial crisis on community banks: A conference summary

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The fifth annual Community Bankers Symposium, co-sponsored by the Federal Reserve Bank of Chicago and the Midwest Region of the Federal Deposit Insurance Corporation, was held at the Chicago Fed on November 6, 2009. This article summarizes the key presentations and discussions at the conference.

Materials presented at the conference are available at [www.chicagofed.org/webpages/events/2009/community\\_bankers\\_symposium.cfm](http://www.chicagofed.org/webpages/events/2009/community_bankers_symposium.cfm).

**Representing** the Federal Reserve System at the Community Bankers Symposium were Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System; and Charles L. Evans, president and CEO, Carl R. Tannenbaum, vice president, and Mark H. Kawa, vice president—all from the Federal Reserve Bank of Chicago. Speakers from the Federal Deposit Insurance Corporation (FDIC) were Richard Brown, chief economist, and M. Anthony Lowe, regional director of the Midwest Region. Mark Zandi, chief economist and co-founder, Moody's Economy.com, also addressed the gathering. Nearly 300 individuals, primarily representatives from community banks<sup>1</sup> in the Seventh Federal Reserve District,<sup>2</sup> attended the symposium.

This year's theme for the symposium was "Are We There Yet?" Symposium participants discussed whether the overall economy had yet reached the point of recovery from the financial crisis. They also explored the risks facing community banks in the current environment and helped identify key supervisory and policy issues.

On the surface, the current financial crisis appears to be mainly a story about very large banks. Many of these banks undertook excessive risks in the environment of strong economic growth that existed until around mid-2007. When economic conditions changed dramatically, banks

began facing severe liquidity strains and a loss of market confidence. The financial system was stabilized only through an unprecedented range of new federal government and Federal Reserve programs to support firms and consumers and to restore the flow of capital in the economy.

Less obvious is the connection between community banks and risks to the financial system. The failure of a single community bank does not generally have a significant impact on the financial system as a whole. However, because community banks individually lack the geographical and product diversification available to larger banks, they can become exposed collectively to regional and sectoral economic downturns—such as a downturn in residential and commercial real estate (CRE) markets.<sup>3</sup> These downturns can then cause a large number of community banks to weaken or fail, which in turn can lead to significant credit constraints on firms (particularly small businesses) that rely heavily on these banks for working capital. This can then adversely affect local communities and the broader economy. It is this dynamic that we have been seeing in the current crisis.

### Community banks and the financial crisis

Tannenbaum proposed that, while the extent and magnitude of the recent

financial crisis were unexpected, the groundwork for such an event was formed over the past generation by evolutions in financial products, business models, and government regulations. These evolutions affected banks of all sizes.

Prior to the 1970s, commercial banking was heavily regulated, quite stable, and profitable, but not especially innovative or dynamic. Then, beginning in the 1970s, the traditional bank business model came under increasing pressure from macroeconomic volatility, new technologies, and business innovations, such as

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securitization<sup>4</sup> and the originate-to-distribute model.<sup>5</sup> It also appears that in some cases incentives were misaligned, said Tannenbaum. The existence of a “shadow banking system”<sup>6</sup> created incentives to shift risks to unregulated or less regulated firms. Finally, bankers, investors, and rating agencies should have adopted a more critical attitude toward new financial products; they should have also been more skeptical about the mathematical models used to measure and manage risk.

According to Tannenbaum, these industry-wide developments “trickled down” to community banks in various ways. Some banks invested in complex securities. Some relied on selling assets into the credit markets. Some adjusted their pricing and underwriting to compete with larger organizations. And some increased their reliance on wholesale funding sources,<sup>7</sup> which are less stable than the retail (or “core”) deposits community banks have historically relied on for funding.

### Current banking conditions

Duke, Brown, and Tannenbaum all addressed banking conditions at the time of the conference. These conditions continued to deteriorate, lagging trends in the overall economy. High loan loss provisions<sup>8</sup> still severely depressed bank earnings. Credit deterioration had centered so far in real estate construction and

development lending but was spreading to other types of loans. Nonperforming loan and net charge-off ratios continued to increase, but not as quickly as before. Growth in loan loss reserves was still lagging the rise in nonperforming loans. For the industry as a whole, reserves covered only about 60% of these loans (about 50% at community banks). This low coverage suggested that additional provisions would be needed in future quarters.

The number of banks on the FDIC’s “Problem List” continued to rise, reaching 552 as of September 30, 2009. In

addition, the number of bank failures remained elevated. The 115 institutions that had failed or received assistance from the FDIC in 2009 by the date of the conference was the most in any year since 1992.

These speakers also noted that capital ratios for the banking industry remained satisfactory overall, with the vast majority of banks still considered well capitalized under regulatory standards. However, continuing credit deterioration raised questions about the adequacy of capital going forward. Other strains on capital were weak earnings, unreceptive capital markets, and the potential stigma associated with using federal government and Federal Reserve support programs. These were leading banks to conserve capital (e.g., by reducing dividends) and/or decrease the overall size of their balance sheets, which could reduce the availability of credit to the economy.

### Recent policy initiatives

Speakers discussed two recent policy initiatives that will significantly affect community banks. Duke presented the recent interagency policy on CRE loan workouts.<sup>9</sup> This statement provides guidance for examiners and for financial institutions working with CRE borrowers experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties. Duke emphasized

that performing loans made to credit-worthy borrowers—including those renewed or restructured on reasonable modified terms—will not be adversely classified solely because the value of the underlying collateral has declined. She also stressed that prudent loan workouts are often in the best interest of both financial institutions and borrowers. Duke recommended that bankers maintain good documentation on the status of real estate projects, cash flows (both borrowers’ and guarantors’), and current collateral values. Finally, she encouraged bankers to continue to lend to sound borrowers and expressed the hope that the new guidance would help them assess new loan prospects, as well as existing credits.

Brown outlined the FDIC’s proposal to have banks prepay deposit-insurance assessments<sup>10</sup> in order to provide additional liquidity to the Deposit Insurance Fund. The FDIC proposed that insured institutions prepay their estimated quarterly assessments for all of 2010, 2011, and 2012 by year-end 2009, which would yield approximately \$45 billion. The FDIC determined that this arrangement, unlike a one-time special assessment, would not significantly affect banks’ earnings, capital, or lending.

### Economic challenges

Community banks in virtually every region of the country face significant economic challenges in the near and medium term. According to Evans, while many broad indicators of economic recovery are becoming more favorable, unemployment remains very high and is likely to continue to be high for some time. A number of crosscurrents in the economy introduce significant uncertainty into any forecasts. Downside risks include a lagging labor market, weakness in CRE, the prospect of further asset losses at financial intermediaries, higher personal savings rates impinging on consumption, and the weak fiscal condition of state and local governments. Positive trends include financial market improvements, inventory levels that are under control, good productivity numbers, the beginnings of a worldwide economic recovery, and effects of the fiscal stimulus.

According to Evans, two extreme outlooks for inflation are frequently expressed today. One view has inflation greatly increasing in the future, based on the explosion of the Federal Reserve's balance sheet, which has enormously increased the money supply. The other view sees strong deflationary forces, based on high unemployment rates and slack capacity utilization,<sup>11</sup> which are often associated with falling inflation. Evans argued that sound macroeconomic policies would allow us to avoid the extremes of either scenario.

troubled or are failing. Current debates center on which regulator(s) should be responsible for this process and how it should be funded. A second reform is to make it more expensive for firms to be systemically important. This could be achieved through higher deposit-insurance premiums, greater oversight, higher capital and liquidity requirements, and other methods.

Conference participants also discussed the restructuring of regulatory agencies. Brown contended that the creation of a

in identifying potential effects on earnings and capital and developing appropriate responses. Since market analysts are conducting their own stress tests of banks' exposures, it is better for banks to be ahead of the curve.

In an effort to diversify away from CRE lending, many community banks have increased their exposure to commercial lending.<sup>13</sup> However, credit deterioration is spilling over to this type of lending as well. Banks now focusing on increasing commercial lending, Kawa recommended, should develop sound business strategies based on a realistic assessment of internal and external strengths and weaknesses. They should also have a robust process for approving new products or activities and appropriate policies and limits governing loan participations and purchases.

For most community banks, funding has stabilized since the earlier stages of the financial crisis. However, funding sources can disappear when a bank is perceived to have asset quality or earnings problems. Therefore, banks should perform liquidity risk analyses that consider potential funding pressures, Kawa advised. These analyses should make use of forward-looking metrics as much as possible and consider a wide range of stress scenarios.

## Many speakers expressed confidence that community banks would continue to play a key role in the financial system.

Zandi agreed that the recovery will be difficult. Hiring by businesses remains dormant, he said, and the residential mortgage foreclosure crisis shows no indication of letting up. The current bust in the CRE market is also a serious threat. Furthermore, the budget problems of state and local governments continue to intensify, and credit is still impaired because securitization markets remain frozen.

According to Zandi, monetary and fiscal policy will provide just enough additional support in 2010 to prevent the economy from sliding back into recession. He predicted that in mid-2010, foreclosures and unemployment would peak and housing prices would bottom out. Zandi also projected that in 2011, a self-sustaining expansion would begin, bank failures would subside, and securities markets would return to more normal functioning. Some long-term trends highlighted by Zandi were the growth of exports to fill the void left by cautious U.S. consumers and the eventual need to return to greater fiscal austerity.

### Regulatory reform

As a result of the financial crisis, community banks face the prospect of major changes in bank regulation. Brown outlined some of the changes the FDIC supports in response to the financial crisis. Two reforms could help solve the too-big-to-fail problem.<sup>12</sup> One is an effective resolution process for handling large, complex financial firms that become

single federal bank regulator might not be necessary. Instead, he said, the FDIC supports the creation of a systemic risk council to identify, monitor, and take action on future systemic risks, as well as the increased use of "macroprudential" supervision (i.e., supervision focusing on emerging risks to the financial system as a whole). Finally, to remedy weaknesses in consumer protection highlighted by the financial crisis, he noted, the FDIC supports establishing a new agency dedicated to creating standards and protections for consumers.

Duke outlined several interconnected reforms the Federal Reserve is seeking. These included consolidated supervision of, and a resolution regime for, systemically important institutions; a more macroprudential view of risk; and enhanced consumer-compliance supervision for nonbank firms. The Federal Reserve is also seeking greater powers to oversee systemically important payments systems.

### What should community banks focus on?

Kawa provided a number of suggestions for how community banks can respond effectively to current risk-management challenges. In light of current weaknesses in CRE lending, he said, banks should "expect the unexpected." This means anticipating a range of adverse scenarios that reflect local economic conditions and the bank's individual risk profile. Such "stress testing" can be very helpful

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In today's volatile environment, capital adequacy is critical. While many banks have capital ratios well above regulatory minimums, Kawa said, this does not guarantee that a bank will have enough capital to survive a severe shock. Regulators are placing more emphasis than ever on sound capital planning. Capital plans should include forward-looking analyses of different economic scenarios. They should also take into account dividend payouts and stock repurchases and redemptions.<sup>14</sup>

## Conclusion

While the symposium highlighted numerous challenges facing community banks, many of the speakers also expressed confidence that community banks would continue to play a key role in the financial system. Community banks' local connections and greater familiarity with local conditions can give them an edge in meeting the needs of households and small businesses. The information they possess about local borrowers can be a source of competitive advantage in making judgments about creditworthiness. In the

current crisis, as some larger banks are improving their capital and liquidity positions and cutting back on new lending, community banks may discover new opportunities to serve customers. Community banks continue to be a leading provider of credit to small businesses, whose growth is critical to creating new jobs and improving the broader economy. In his closing comments, Lowe stressed that the FDIC and the other regulators will work with community banks to find solutions and strategies that address their mutual concerns.

<sup>1</sup> Community banks are typically smaller banks that conduct most of their business in their local communities. The size threshold most often used is \$1 billion in assets.

<sup>2</sup> The Chicago Fed serves the Seventh Federal Reserve District, which comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

<sup>3</sup> CRE lending refers to loans secured by commercial real estate (e.g., office buildings and shopping centers), whose repayment typically comes from rental income or sale/refinancing of the property.

<sup>4</sup> Securitization is the process of taking an illiquid asset (or group of assets) and, through financial engineering, converting it into a security.

<sup>5</sup> Originate-to-distribute is a business model for financial intermediation, under which financial institutions originate loans such as mortgages, repackage them into securitized products, and then sell these products to investors.

<sup>6</sup> The shadow banking system is a network of lenders, brokers, and opaque financing vehicles outside the traditional banking system that has grown substantially in recent years and is much less regulated than the traditional banking system.

<sup>7</sup> Examples of wholesale funding are federal funds, Federal Home Loan Bank advances, and brokered certificates of deposit.

<sup>8</sup> The provision for loan losses is the amount set aside by a bank to maintain its loan loss reserve at a level sufficient to absorb estimated loan losses.

<sup>9</sup> See [www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm). This policy was issued by the Federal Reserve, the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Financial Institutions Examination Council State Liaison Committee.

<sup>10</sup> For the final rule, see [www.fdic.gov/news/news/press/2009/pr09203.html](http://www.fdic.gov/news/news/press/2009/pr09203.html).

<sup>11</sup> Capacity utilization is calculated as the actual output produced with installed equipment divided by the potential output that could be produced with it if used to its full capacity.

<sup>12</sup> Regulatory authorities have strong incentives to prevent the failure of a large, highly interconnected financial firm because of the risks that such a failure would pose to the financial system and the broader economy. However, the belief of market participants that a particular firm is considered too big to fail has a number of potential undesirable effects, including reduced market discipline, excessive risk-taking, and increased costs to the Deposit Insurance Fund.

<sup>13</sup> Commercial loans are loans made to businesses for a wide variety of business purposes (such as inventory financing and investments in equipment).

<sup>14</sup> See [www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm](http://www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm).