

Chicago Fed Letter

Navigating a new community banking environment: A conference summary

by Julie A. Williams, senior vice president, Patrick Driscoll, portfolio manager, Wade Perry, portfolio manager, and Lea Whitney, communications analyst, all of Supervision and Regulation

The ninth 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 1, 2013. This article summarizes key presentations and discussions at the symposium.

More information about the symposium is available at www.chicagofed.org/webpages/events/2013/community_bankers_symposium.cfm.

Key presentations at the Community Bankers Symposium were delivered by Charles L. Evans, president, Federal Reserve Bank of Chicago; Kevin M. Bertsch, associate director, Board of Governors of the Federal Reserve System; Martin J. Gruenberg, chairman, FDIC; and John Ryan, president, Conference of State Bank Supervisors. More than 200 participants, mostly executive officers and directors of community banking organizations in the Seventh Federal Reserve District,¹ gathered to reflect on the financial progress community banks have made in the past year and to identify and discuss opportunities and related risks that lie ahead. A key focus was the importance of community banks to the communities they serve.

Evans opened the symposium by providing a brief summary of the economic environment. He said the U.S. economy continues to grow at a modest pace, reflecting the impact of reduced government spending and slow international economic activity. The current lower bound of interest rates, Evans explained, makes this recovery all the more challenging, requiring bolder monetary policy actions and more transparent communication by policymakers. A key part of these policy actions has been the Fed's open-ended asset purchase program.

Evans noted that the Federal Open Market Committee (FOMC) is monitoring this activity for rising inflation risk; so far in this recovery, it has remained relatively low. However, the FOMC cannot single-handedly solve the economic problems facing the country, Evans argued. The private sector has done fairly well given the considerable headwinds it is facing, Evans said, and he expressed confidence that the economy will eventually improve.

Against the backdrop of a difficult economic recovery, it is important to recognize the importance of community banks to the communities they serve. Cathy Lemieux, executive vice president, Federal Reserve Bank of Chicago, noted that regulators are very interested in the needs and concerns of community bankers, and the banking agencies have expanded their outreach programs to hear more regularly from the industry. This theme was shared by many of the speakers during the symposium. These topics are of particular interest to our District, as we have the second-highest number of community banks in the Federal Reserve System.

Progress of community banks

Community banks continue to play a key role in our economy, according to

both John Ryan,² Conference of State Bank Supervisors, and Martin Gruenberg, FDIC, who provided their organizations' views on the banking system.

Ryan reiterated the importance of maintaining the dual banking system, a structure that allows for the coexistence of different regulatory structures for state- and federally chartered institutions. He said community banks collectively serve as a better proxy for the health of the U.S. economy than do larger financial institutions. He pointed out that

peaked in March 2011, but has consistently dropped since then and is poised to fall further going forward. With the generally improving banking performance, progress has been made on the deposit insurance fund, which had a balance of \$38 billion and is more than halfway to the statutory minimum for the reserve ratio³ mandated for 2020.

Ryan and Gruenberg further supported their points by recapping data from the *Community Banking Study*,⁴ which was developed by the FDIC and included

community banks, particularly small community banks, but that the challenge of meeting their regulatory obligations undoubtedly remains considerable. However, he said the technical assistance provided by the FDIC and other banking agencies has improved the sector's understanding of its regulatory obligations.

Improving the supervisory model

Kevin Bertsch, Board of Governors of the Federal Reserve System, outlined the progress that community banks (those with less than \$1 billion in assets) have made in returning to normalcy since the recent recession. He said the financial condition of many banking organizations has improved remarkably, even though the FDIC's list of problem institutions⁵ remains longer than it was before the recession. Financial challenges for community organizations include tighter operating margins, reduced core earnings, shortening of deposit maturities, and concerns about boosting short-term performance by assuming more interest rate risk exposure. Bertsch said capital remains strained by asset quality weaknesses affecting many community banks. As a result, the supervisory priorities and focus of the Federal Reserve System include focusing on assessing community banks' asset quality, the adequacy of their loan-loss reserves, and the effectiveness of their strategies for managing interest rate and credit risk as they strive to enhance earnings.

Bertsch also highlighted two significant efforts of the Federal Reserve System to better understand the challenges facing community banks. A subcommittee of the Board of Governors was established in 2009 to focus on supervisory approaches for community and regional banks. The second action taken was the establishment of the Community Depository Institutions Advisory Council (CDIAC) in 2010 at the national and regional levels⁶ to provide insight from bankers to the Board on a semiannual basis regarding local economic conditions, lending conditions, and other issues of interest to community bankers. During these discussions, bank representatives have consistently cited the increasing regulatory burden as a major concern

The tenth annual Community Bankers Symposium will be held at the Chicago Fed on November 7, 2014.

the condition of community banks correlates directly to the health of the communities they serve.

Ryan suggested that the unique banking system in the United States owes its origins to the Founding Fathers' commitment to decentralized power, checks and balances, and economic self-determination. The same goal of decentralization could be said to underlie the U.S. model of supervisory authority and the need for the dual banking system. Even though the current banking model is more complex than some alternatives, the result is a system that was carefully considered and thoroughly debated over time. Ryan argued that other countries' banking models focus too narrowly on global markets, while ignoring many underserved market participants. While most European countries have only a handful of large firms, allowing for market discipline in these highly concentrated banking systems, he said, could result in lower risk tolerances and more prescriptive regulations. The American banking model is built on a need for both community and large financial institutions, with failure being an integral part of the system.

According to the FDIC, which is the primary federal regulator for most community banks, the number of problem and failing banks is falling fast, based on internal indicators. Gruenberg said the number of problem institutions

data back to 1985. One of the two key findings referenced by Gruenberg from the study was that community banks account for 14% of the banking industry's assets but 46% of all small loans made to businesses and farms. Without community banks, he said, access to credit in many locations would all but disappear. Further consolidation is expected, but traditional community banks will remain important and continue to thrive, he said. The study also looked at economies of scale and found that community banks with more \$300 million in assets did not benefit significantly from getting larger. Furthermore, in approximately 600 of the 3,000 counties in the U.S., the only banks with a physical presence are community banks. Therefore, at a very fundamental level, community-based institutions still matter for many consumers.

The second major finding cited from the FDIC study was that community banks that stuck with their basic business model did relatively well during the financial crisis. The FDIC highlighted three related commonalities of failed institutions: rapid growth; holding concentrations of risky assets, especially commercial real estate and land acquisition and development loans; and relying too much on brokered deposits.

In conclusion, Gruenberg discussed regulation of the community banking sector. He said that it is very hard to quantify the regulatory burden on

and a perceived threat to the viability of the community bank business model.

To address some of these concerns, the Federal Reserve System is also taking the following steps:

- Identifying whether new supervisory guidance is applicable for community banks and adopting several new supervisory and application standards to be more community bank friendly.
- Developing a common set of technology tools and continuing to evaluate completion of more examination work off-site to reduce the direct impact on community bank staff.
- Furthering communication of supervisory expectations to the industry through periodic newsletters and teleconferences.⁷

Finally, Bertsch commented that regulators need to ensure they are striking the right balance between establishing supervisory standards and reducing the regulatory burden, when feasible.

Bankers' ideas for improving the examination process

Bank presidents John Anderson, Quad City Bank and Trust, Davenport, IA; John J. Limbert, National Bank and Trust, Wilmington, OH; and Tom Oehler, Peoples Bank, Elkhorn, WI, provided their perspectives on ways to improve the examination process along with changing the risk-management culture within institutions.

The bankers' panel discussed a variety of strategies to promote a smoother examination process, including preparing staff and gathering requested material well in advance of the examination start date; holding an introductory meeting between the examination team and senior bank staff; and establishing ongoing meeting times. Banks could also develop an objective self-assessment of the bank's performance and share it with examination staff; invite select members of the bank's board to get involved in the examination process; and as problems arise, take corrective action immediately. Even as more supervisory work is conducted off-site, the panel agreed it is important that bankers continue to

maintain a relationship with examiners. Between supervisory events, bank management should do their best to ensure the right people are in the right position to succeed, hold staff accountable for addressing the previous examination recommendations, and communicate frequently with examiners to avoid surprises. One of the humorous bits of advice from the group was to treat the examiner like an ex-spouse with whom you have to raise a child (your bank)—the process should go more smoothly if you can be brutally honest with one another. To aid in the examination process and change the banking culture, bank management should also empower auditors and compliance officers with sufficient authority, rotate service providers, and consider the potential benefits of a chief risk officer position.

While the steps above might improve banks' relationships with regulators, the panel emphasized that it is more important for each bank to appropriately manage the underlying risk facing the organization while also preparing to address tomorrow's risks. Bankers need to stay vigilant as risk profiles continue to evolve steadily with the changing banking landscape.

Emerging risks facing banks

Joseph Davidson, vice president, Federal Reserve Bank of Chicago, moderated a panel of bank regulators from across the District. This panel featured John Meade, central district risk officer and deputy comptroller analyst, OCC; Anthony R. Gibbs, regional director, Consumer Financial Protection Bureau (CFPB); and Emily Greenwald, vice president, Federal Reserve Bank of Chicago. The panelists cited four major risk factors, relating to financial performance, credit, operations, and regulatory change.

The panel emphasized that financial performance is a major concern for many organizations, and even as the economy improves, community banks are challenged in their efforts to grow earnings. This was attributed to lower than optimal levels of economic activity, causing organic loan growth prospects to remain muted. While new deposits are easy to attract at comparatively low interest rates,

the panel noted that it remains difficult for banks to profitably deploy these funds under current market conditions.

Credit quality has strengthened substantially for many community organizations, although certain markets are still struggling. Concerns were also raised regarding the challenging low interest rate environment, along with earnings pressures that could cause banks to adopt strategies they would not have considered in the past. Panelists highlighted four potential concerns: weakening of underwriting standards, taking on more risk in the investment portfolio, reemergence of loosely controlled commercial real estate lending, and expansion into higher-risk lending products and services. The panel reiterated that related transactions and deal structures need to make sense from both a risk and return standpoint or the decisions made today could become problems tomorrow.

Another risk category mentioned by the panel was related to operations, specifically the areas of information technology, retention of staff, and growth strategies. As the pace of technological change advances, cyberattacks pose a threat. Aggressive cost cutting in control functions to

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*.

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maintain profitability could potentially expose more banks to heightened risks, including fraud or other operational breakdowns. Staff retention and management succession planning are also growing areas of focus for bankers and regulators alike. Bankers need to understand the risks they are taking on specific to their growth strategies and ensure that the right staff is in place to execute on strategic initiatives. Similarly, an effective vendor management program is important, given the frequency of outsourcing arrangements.

Finally, the panel noted that the required issuance of new compliance regulations in accordance with the 2010 Dodd–Frank Act might call for a more proactive compliance management program, particularly at a time when banks are looking at reducing operating costs. A very timely compliance topic discussed by the panel

was the new mortgage rules that go into effect in early January 2014. Gibbs explained that the broad focus of the CFPB is on the “4Ds: deception, debt traps, dead ends, and discrimination,” with additional emphasis on compliance and treating customers fairly. Future areas of focus for the CFPB will likely include student lending, transfer of mortgage servicing rights, and debt collections.

Conclusion

In closing, M. Anthony Lowe, regional director, FDIC, remarked that regulators need to continue to apply the lessons learned from the recent crisis, including the need to diversify risk. As noted by various conference speakers, challenges facing community banks remain considerable and successful navigation of these challenges will require an appropriate business plan, suitable policies and

procedures, timely and accurate reporting systems, and safeguards against cyberattacks. Both the federal and state banking agencies recognize the challenges facing the community banking sector and want to be a resource for community banks developing business strategies. Lowe stressed the importance of ongoing dialogue and constructive feedback among all interested parties to successfully navigate the challenges ahead.

This article provided some brief highlights 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 7, 2014. More information will be posted in the events section of our website (www.chicagofed.org/webpages/events/index.cfm) as it becomes available.

¹ The Seventh Federal Reserve District comprises the state of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

² The full text of Ryan’s speech is available at www.csbs.org/news/presentations/Documents/FinalRyanCommunityBankersSymposium.pdf.

³ More information on the deposit insurance fund and reserve ratio can be found at www.fdic.gov/deposit/insurance/.

⁴ Federal Deposit Insurance Corporation, 2012, *FDIC Community Banking Study*, report, Washington, DC, December, available at www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

⁵ *Quarterly Banking Profile*, Federal Deposit Insurance Corporation, available at www2.fdic.gov/qbp/. While the bank names are not made public, the FDIC’s problem bank list indicates the number and collective size of those banks that demonstrate weaknesses that threaten their financial viability.

⁶ More information on local representation of the CDIAC can be found at www.chicagofed.org/webpages/people/cdiac.cfm.

⁷ For more details, see “Ask the Fed” (www.stlouisfed.org/BSR/askthefed), Community Banking Connections (www.communitybankingconnections.org), and “FedLinks” (www.communitybankingconnections.org/fedlinks.cfm).