THE FEDERAL RESERVE BANK
OF CHICAGO

ESSAYS ON ISSUES
2017 NUMBER 383

Chicago Fed Letter

A new era of community banking

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The 11th 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 18, 2016. This article summarizes key presentations and discussions at the event.

Key speakers for the 2016 symposium were Charles Evans, president and CEO, Federal Reserve Bank of Chicago; Thomas Curry, comptroller, OCC; Maryann Hunter, deputy director, Board of Governors of the Federal Reserve System; Thomas Hoenig, vice chairman, FDIC; and Jim Glassman, head economist, JPMorgan Chase. About 175 participants, mostly executive officers and directors of community banking organizations in the Seventh Federal Reserve District,[1] gathered to discuss both the opportunities and emerging risks for community banks. The major themes of the symposium were the current state of the economy, cybersecurity, technological innovation, and alternative lending models.

More information about the 2016 symposium is available at https://www.chicagofed.org/events/2016/annual-community-bankers-symposium.

Patrick Wilder, vice president, Federal Reserve Bank of Chicago, delivered the welcoming remarks and introduced Evans to kick off the event. Wilder's comments focused on the importance and impact of outreach events such as this one, where bankers are presented with vital supervisory information and initiatives and where regulators can share ideas and suggestions to improve supervisory practices and procedures.

Lower for longer in today's banking environment

Evans's remarks focused on local and national economic indicators, as well as on the influence of current monetary policy. He said the Federal Open Market Committee (FOMC) envisions a gradual increase in the federal funds rate[2] (from an accommodative range of 0.25% to 0.50% at the time of the symposium) over the next couple of years. He also noted that once policy normalizes, both nominal and real interest rates may be a good deal lower than they were in the past. He further discussed the rationale behind this "lower-for-longer" interest rate scenario and commented on what this scenario may mean for financial institutions' profitability. The long-run trend in economic growth has possibly slowed, partly on account of baby boomers entering retirement age and fewer people, especially the young, participating in labor markets than in earlier times. Moreover, educational

achievement has plateaued and highly experienced workers are retiring, which mean that workforce improvements are contributing less to productivity gains than before. Additionally, the productivity surge of the mid-1990s through the mid-2000s due to information technology (IT) investments has waned. These factors, coupled with sluggish capital spending and tremendous worldwide demand for safe assets (such as U.S. Treasury bonds), are likely to keep interest rates in the U.S. and other advanced economies lower than they were before the Great Recession, Evans argued. While many of the current economic forecasts bode well for the banking sector (particularly given that short-term nominal interest rates are expected to move up), Evans stressed the importance of community banks preparing for a new normal in which interest rates are generally lower than experienced in the past. Indeed, a lower-for-longer interest rate environment will pose a challenge to community banks' current and longer-term profitability. Evans concluded by encouraging community bankers to adjust how interest rates enter their firms' business models while still focusing on prudent and proactive risk-management practices, especially when "reaching for yield" with alternative investment strategies.[3]

Responsible innovation

Thomas Curry, of the OCC, discussed his optimism about the future of community banking and the benefits that technological innovation is capable of providing. Curry said the vitality of community banks is his personal focus, and he went on to share the OCC's supervisory priorities, in conjunction with details on its responsible innovation initiative. He also presented recommendations on how community banks can use collaboration to meet their business goals and better serve their customers.

The OCC has responded to the surge in financial technology, or "fintech," companies[4] over the past few years by launching its responsible innovation initiative, demonstrating the agency's receptiveness to and support for fintech, said Curry. The rapid rise of fintech startups has also led the OCC to establish a stand-alone Office of Innovation, Curry noted. The newly formed office will develop a formal framework for responsible innovation and will be the central point of contact and clearinghouse for requests and information related to financial services innovation. The acting chief innovation officer reports directly to Curry and will be supported by OCC staff based in Washington, DC; New York; and San Francisco. The office is expected to be fully operational in early 2017, Curry stated.[5]

Curry also referenced the OCC's January 2015 publication describing how community banks could collaborate in ways that incorporate both suitable risk management and comprehensive strategic planning.[6] Curry said that such collaboration among community banks could reduce the costs of vetting and overseeing innovative solutions provided by third parties. Moreover, this kind of cooperation among community banks could facilitate direct partnerships with nonbank fintech companies, he indicated.

A view from the Federal Reserve Board

Cathy Lemieux, executive vice president, Supervision and Regulation, Federal Reserve Bank of Chicago, sat down with Maryann Hunter to get a view from the Board of Governors of the Federal Reserve System on a variety of topics. Hunter first described both the interagency work (among the major bank regulators) and the Fed's work being considered and/or done in response to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA).[7] Interagency work has focused on modernizing the Community Reinvestment Act (CRA),[8] simplifying capital requirements for small banks, and raising the threshold for real estate appraisals. Changes to the Call Report[9] have also been proposed, which would result in a 40% reduction in reportable items, positively impacting 90% of banks. Hunter also noted that the Fed is reviewing existing bank regulations, and has already implemented several other changes, including the interagency joint rule altering the examination frequency to 18 months (from 12 months) for well-capitalized and

well-managed institutions with less than $1 billion in total assets.[10] Additionally, the Fed is leveraging its "outlier project" (which identifies high-risk banking activity) to restructure examinations to focus more on higher-risk areas. These adjustments have resulted in Reserve Banks adjusting examination scopes, hours, and resources. Additionally, the Fed has implemented off-site loan review across all 12 Reserve Banks,[11] which has also lessened the regulatory burden on banks.

Hunter noted that the percentages of banks having historically high commercial real estate (CRE) lending concentrations in their portfolios[12] are much lower than before the financial crisis. However, these percentages are moving up again, thus raising the question of whether banks' current risk-management practices and underwriting standards remain in line with their corporate strategies (or are now deviating). She said that the new current expected credit losses methodology (CECL)[13] will allow for a more forward-looking analysis of expected future losses—which may help encourage some banks to curb their exposure to CRE.

Hunter also covered some of the Fed's efforts to get banks to reduce their cybersecurity risk. She said the Fed encourages banks to establish strong password protocols, provide training to thwart social engineering attacks, and install software patches in a timely manner. In closing, Hunter said the Fed is focusing on electronic payments at the largest institutions to ensure their security and is utilizing the new Information Technology Risk Examination (InTREx) Program at smaller banks to ensure they are adequately monitoring cybersecurity risk.

Corporate governance, risk management, and consumer protection

Joseph Davidson, vice president, Federal Reserve Bank of Chicago, moderated a panel of bank regulators, which featured Ric Brunskill, assistant vice president, Federal Reserve Bank of Chicago; Hilario Gonzalez, assistant regional director, Consumer Financial Protection Bureau (CFPB); Chris Newbury, deputy regional director, FDIC; and Sheila VanOrnum, district risk and operations officer, OCC. The panelists focused on corporate governance, managing credit and operational risks, and consumer protection.

Newbury went over the fundamental aspects of corporate governance. He noted corporate board directors are primarily charged with selecting and retaining competent management; developing a directorate and management succession plan; helping to formulate strategic plans with short- and long-term objectives and prudent risk limits (and monitoring how those plans are carried out); and establishing a risk-management program that ensures policies are consistent with supervisory guidance.

VanOrnum referenced the OCC's 2016 *Survey of Credit Underwriting Practices*,[14] which reported that banks are easing underwriting practices and issuing more loans relative to the previous year as a result of growing competition. These changes are evidenced by notable growth in higher-risk commercial lending and a lack of robust concentration-risk-management programs (which monitor and control the volume of a particular loan product a bank issues). VanOrnum also pointed out signs of an increase in highly leveraged borrowers.

Newbury stated that maintaining strong cybersecurity policies and practices is vital, and shared that banks can access cybersecurity information and various training programs through the Federal Financial Institutions Examination Council. Additionally, Brunskill discussed the importance of managing outsourcing risk—as set forth in specific Fed guidance issued in 2013[15]—by identifying all vendors (beyond just IT service providers) and designating critical vendors, developing a continuity plan in case third parties are unable to provide services, and setting termination requirements if services are to be severed, among other measures.

The panelists also discussed incentivized cross-selling of banking products and services without appropriate checks and balances and how this can lead to problems for both consumers and banks.

According to Gonzalez, sales incentives programs should be overseen through appropriate risk-management and internal control programs to minimize any adverse effects on consumers. Brunskill indicated that incentives plans should be focused not solely on the volume of sales, but also on the sustainability of the business line and the creditworthiness of the consumers brought in.

As the panel drew to a close, attendees were reminded of the November 2016 issuance of the updated Uniform Interagency Consumer Compliance Rating System,[16] which would go into effect for bank examinations that start on and after March 31, 2017. The revised rating system focuses not only on federally regulated banks' compliance with consumer protection laws and regulations, but also on how banks handle any violations of said laws and limit or redress any resulting consumer harm.

Regulatory relief

Thomas Hoenig, of the FDIC, presented his recommendations for providing regulatory relief to a large number of commercial banks, including most community banks. Hoenig discussed how the repeal of the Glass–Steagall Act[17] contributed to the financial crisis, which ultimately led to the passage of the Dodd–Frank Act[18] and related regulations designed to address the increasing complexity of certain financial services activities. He said that some commercial banks—which have broad access to the government's safety net—have indeed been engaging in such complex activities that were previously reserved for investment banks, wealth managers, insurance companies, and commercial and industrial firms, as well as other types of businesses. While only a small minority of commercial banks have expanded into these less-traditional activities, virtually all commercial banks, including community banks, now face a much larger regulatory burden than before the crisis. As Hoenig proposed, under the current regulatory regime, regulatory relief should be provided to institutions that 1) hold zero trading assets or liabilities; 2) hold no derivative positions other than interest rate swaps and foreign exchange derivatives; and 3) have a total notional value of less than $8 billion for all derivatives exposures (including trades cleared through an exchange and bilateral, or noncleared, trades). Within the U.S. banking system, about 400 institutions fall outside of these three criteria, noted Hoenig, and none of the banks with more than $100 billion in consolidated assets (the largest banks) meet the criteria. Under Hoenig's proposed framework, any commercial bank seeking regulatory relief would also be required to maintain an equity-to-assets ratio of 10% (according to generally accepted accounting principles) in order to qualify. A significant majority of community banks already meet this final criterion, he said, while for many more banks, this threshold is readily achievable. Hoenig argued that such an approach to regulatory relief would offer a beneficial and prudent trade-off for banks by incentivizing traditional banking activities. In conclusion, Hoenig stated banks that engage in nontraditional banking activities must accept the additional regulatory burden of existing rules to protect the government's safety net for bank failures.[19]

A new chapter for the U.S. economy

Jim Glassman, of JPMorgan Chase, provided his views on the state of the U.S. economy as it moves from a recovery period to a sustained expansion. By many measures, the U.S. economy is recovering well and performing favorably relative to its international peers. However, the perceived "anemic" national gross domestic product (GDP) growth rate of less than 3% has adversely affected American confidence in the economy, he said. This subpar performance is well below both the long-term historical growth average and economic expectations for the U.S. economy, Glassman claimed. He said rather than focusing solely on GDP growth, observers should take a broader view of current economic conditions: He pointed to a number of indicators signaling a favorable economic environment, such as the low unemployment rate, falling jobless claims, fading global economic risks, controlled inflation and energy costs, shrinking budget deficits, and worsening highway congestion due to more business activity. Glassman said he dubs the dissonance between economic conditions and growth expectations as "The Great Confusion."

According to Glassman, the U.S. economy is recovering to a more normal state, but many workers, particularly those in the industrial sector, are still struggling financially. Glassman said these workers have not reaped the benefits of the sustained recovery and hold a negative view of the health of the economy. Innovation and globalization have led to increased productivity, stated Glassman, but they are steadily displacing unskilled workers in the U.S. manufacturing sector.

In Glassman's view, a growing national debt could be problematic, since the American economy is already facing large structural deficits and long-term labor force challenges. Also, Glassman enumerated various constraints on better output growth, such as slowing labor productivity gains, declining labor force participation, an aging population, and the growing costs of health care programs. In 2016, forecasts from the nonpartisan Congressional Budget Office (CBO)[20] had health care program expenditures and interest payments crowding out other government needs over the longer term, he said. Glassman argued that fixing health care would solve many U.S. budgetary problems.

Addressing fintech's alternative lending models

In a presentation about the rapid rise of fintech firms, supervisory staff members from the Chicago Fed—Marshall Eckblad, Jamie James, and Ana Oppenheimer—explored the impact of these alternative lenders on the banking industry. The presenters used publicly available data to project that by roughly 2020, fintech online lenders are likely to occupy a significant share of total U.S. consumer and small business lending—perhaps as much as 10% to 20% of annual issuance, based on current forecasts. "It is possible online lenders will reach those levels before almost anyone expected," said Eckblad, after explaining the 2014–15 estimates had been lower than the actual shares. In most cases, fintech online lenders attract customers by offering faster and easier loan processing (application, underwriting, funds disbursement, etc.) than traditional banks in exchange for higher borrowing charges (rates, fees, etc.). Most fintech-based lenders are not chartered like banks, and are, therefore, not subject to bank supervision—a growing concern among many bankers and regulators. The Chicago Fed presenters noted that online lenders that operate outside the banking sector are still subject to all state and federal statutes that apply to all places of business (e.g., those relating to discrimination and fair dealing). "The issue is not that online lenders aren't regulated, because they are in fact subject to regulations. The issue is they are not actively supervised—because, at the moment, it is not clear which agency should be the primary regulator," said James.[21]

The 12th annual Community Bankers Symposium will be held at the Chicago Fed on November 17, 2017.

The Chicago Fed presenters demonstrated that fintech lenders have come to be both competitors and business partners with community banks. Even as these online lenders have come to make up a meaningful, if minority, share of all U.S. small-dollar lending,[22] traditional banks of all sizes have moved to partner with them in a number of ways—from closely held partnerships to cobranding and customer referral arrangements. Though not without risks, these bank–fintech relationships represent an array of opportunities for community banks looking to find new and improved ways to serve their customers. By using fintech solutions to process customer and application data, some banks have been able to restore profitability to some forms of consumer and small business lending after several decades of thinning and/or negative operating margins. But the risks to banks are both plentiful and serious, including the potential to unwittingly run afoul of any number of statutes, including those relating to fair lending, usury, anti-money-laundering, and personal privacy. "Partnering banks are responsible to ensure that loans underwritten by, originated by, and/or purchased from alternative lenders comply with all relevant regulations," said Oppenheimer.

Conclusion

In closing, Blake Paulson, deputy comptroller, OCC, remarked on how valuable the annual Community Bankers Symposium has become to both bankers and regulators. This article summarized the 2016 edition. We encourage those interested to consider attending our next symposium, which will be held at the Chicago Fed on November 17, 2017. More information will be posted in the events section of our website (https://www.chicagofed.org/events/upcoming-events) as it becomes available.

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[1] The Seventh Federal Reserve District (which is served by the Chicago Fed) comprises the state of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

[2] The federal funds rate is the main policy rate of the FOMC, the monetary policymaking arm of the Fed. For more details on the rate, see https://www.chicagofed.org/research/dual-mandate/the-federal-funds-rate.

[3] Earlier in 2016, Evans gave a similar speech at a St. Louis Fed event; see https://www.chicagofed.org/publications/speeches/2016/09-28-2016-lower-for-longer-in-todays-banking-environment-stlouis.

[4] While there is no single definition of fintech, many agree that a common characteristic among those working at fintech companies is an ability to see challenges to traditional banking as questions of engineering and technology—specifically, as problems that can be addressed through a combination of high-quality data and automation. Moreover, fintech innovation often allows those underserved by traditional banks to gain access to financial products and services.

[5] Further details on the Office of Innovation are available at https://www.occ.treas.gov/topics/responsible-innovation/index-innovation.html.

[6] https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-community-banks-working-collaborately.PDF.

[7] http://egrpra.ffiec.gov/.

[8] https://www.ffiec.gov/cra/.

[9] Call Reports (formally known as *Consolidated Reports of Condition and Income*) contain financial information about banks and must be filed quarterly by all regulated financial institutions in the U.S. with their respective regulators. For more details, see https://www.fdic.gov/regulations/resources/call/index.html.

[10] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20161212a1.pdf.

[11] https://www.federalreserve.gov/aboutthefed/federal-reserve-system.htm.

[12] For the supervisory criteria identifying institutions that are potentially exposed to significant CRE concentration risk, see https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin07/article02_real_estate.html.

[13] For details on CECL, see https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160617b1.pdf.

[14] https://www.occ.treas.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/pub-survey-cred-under-2016.pdf.

[15] https://www.federalreserve.gov/supervisionreg/srletters/sr1319.htm.

[16] https://www.federalreserve.gov/supervisionreg/caletters/caltr1608.htm.

[17] https://www.federalreservehistory.org/essays/glass_steagall_act.

[18] https://www.federalreservehistory.org/essays/dodd_frank_act.

[19] For more details on Hoenig's proposal, see https://www.fdic.gov/about/learn/board/hoenig/reliefplan.pdf and https://www.fdic.gov/about/learn/board/hoenig/faq.html.

[20] https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52142-budgetoptions.pdf.

[21] Since the November 2016 symposium, the OCC has announced plans to offer a limited-purpose charter for fintech firms; see https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-152.html.

[22] While definitions vary considerably, small-dollar lending in most cases refers to consumer or small business loans up to $500,000. For bank regulatory data, small business loans are defined as those below $1 million in balance.

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ISSN 0895-0164