SPEECH

Community Banking in an Ever Changing World

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F. Christopher Calabia, Senior Vice President

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As prepared for delivery

I am delighted to welcome you back to the Federal Reserve Bank of New York's annual conference on community banking. For 2016, our staff chose "Community Banking in an Ever Changing World" as our theme. Each year, the amount of change we face seems only to increase, and that seems particularly true for community and regional banks since the end of the financial crisis. As we'll discuss throughout the day, we've seen how the national and local economies have adapted and evolved as the economic recovery continues. We've experienced the onset of new regulations stemming from the Dodd-Frank Act and a new regulator—the Consumer Financial Protection Bureau. We've witnessed a renewed discussion on the culture within banks and the emphasis on setting the right "tone at the top" and filtering it down to all employees within a bank.

When it comes to changes like these, we may think of change as something that we observe. The poster we designed for our conference illustrates that form of change. This photograph of the historic Trinity Church, just a few blocks from the Federal Reserve, was drawn from an internal photography contest we held for staff in the Regional, Community, Foreign Institution Supervision and Consumer Compliance Function last year. Trinity Church was founded in the late seventeenth century, though the steeple in the foreground dates back to the 1840s and made Trinity Church a dominant building in the area then. Yet by the early 1900s, the first "skyscrapers" arose around the church, such as the Trinity and US Realty Buildings—22 stories high—visible just behind the steeple in the photo. Of course the photo also captures the modernistic tower of the new One World Trade Center rocketing considerably higher to become the tallest building in the western hemisphere.

So certainly change can be something that we observe. But as community bankers, you are leaders in your communities. You are not merely observers of change. You can be critical agents of change as well. Usually it takes many to change the world. In rare instances, significant change can begin with just one person. And few people exemplify how much a single person can change the course of history than a former parishioner of Trinity Church, Alexander Hamilton—the Revolutionary War hero and first Secretary of the Treasury.

If you haven't seen the astonishing show on Broadway yet, I'm afraid it may be easier to get your hands on a gold bar downstairs than on tickets to "Hamilton." This unlikely musical tells the unlikely story of an orphan from the West Indies who became our "ten dollar Founding Father without a father." Lin Manuel-Miranda, the composer and lyricist for the production, and Ron Chernow, the author of the biography that inspired the musical, breathe incredible depth and dimension into Hamilton and the other Founding Fathers (and Mothers) whom we otherwise know largely from marble statues and oil portraits.

Hamilton comes to life as someone who, as the hip hop influenced lyrics proclaim, "got a lot farther by working a lot harder, by being a lot smarter, by being a self-starter." Through his passion, intelligence, determination, and sometimes sheer stubbornness, Hamilton became a courageous leader in the Revolutionary War and then the outspoken champion for the Constitution. His ideas transformed our young country from a "nation of states" into a single nation. As the musical unforgettably relates as well, he argued vigorously in favor of establishing a "national" or central bank at the heart of his design for our financial system. So we at the Federal Reserve can trace our origins in part to Hamilton's vision for the U.S. economy.

Few may change the course of history and the destiny of our country—and perhaps the world—as dramatically as Hamilton did. But as community bankers, you know that you can change the world in other important ways, especially for members of your communities.

When you underwrite a young couple's first mortgage, you are changing the world for them by helping to establish their first family home. When you extend the first line of credit to a budding entrepreneur, you're changing the world not just for her, but also for others in the community she'll hire. You are often far closer to your neighbors and regions than any other financial service providers. You consequently serve businesses and consumers whom other firms might otherwise overlook.

So rather than feeling like you are an observer of change, please remember that as a community or regional banker, you create change. To paraphrase one of the most upbeat songs from the musical, don't throw away your shot. Be constructive agents of change for your communities.

In my remarks this morning, I'd like to address three themes for your consideration as you take stock of your own firm's recent performance and prepare yourselves to catalyze change in the future.

- First, I'd like to review the performance of community and regional banks in the ever changing regional economy over the past year.
- Second, I'd like to consider how the risk profiles of community and regional banks themselves appear to be changing. Over the prior year many firms continued to seek new lending opportunities especially in commercial real estate: I'd like to address this growing concentration of activity and the guidance we have offered regarding such lending.
- Finally, I'll conclude with thoughts on some of the key issues requiring attention that our examiners cited at community and regional banks in 2015.

Before continuing, I would like to remind you that I'm speaking for myself today. The views and musical preferences I express may not reflect those of the Federal Reserve Bank of New York or of the Federal Reserve System.[1]

I. Recent Performance of Community & Regional Banks in the Second Federal Reserve District

Asset Quality
First, let's talk about how community banks (banks with up to $10 billion in assets) and regional banks (banks with up to $50 billion in assets) have performed over the past year. The good news is that Second District bank managers in 2015 carried on the hard but necessary task of working out troubled assets—some of which predate the financial crisis—and have been writing them down or selling holdings such as defaulted real estate properties to third parties. In total, nonperforming assets in Second District community banks fell by 20 percent over the course of 2015, with similar declines in many of our regional banks, a favorable development.

At the same time, community and regional banks have sought new opportunities for lending. Asset expansion has been fortified in particular by pronounced increases in commercial real estate lending, which has outpaced the growth both in core funding sources as well as in capital levels.

Consequently, many firms are increasingly dependent on noncore sources of funding, such as brokered deposits, which have historically been less stable sources of funding than core deposits. Similarly, many firms are experiencing reductions in their regulatory capital ratios given that assets, and especially commercial real estate-related lending, have increased at a much faster pace than capital. We have taken note of this trend because larger concentrations of commercial real estate lending relative to capital have been associated with a stunning increase in bank failures statistically. I'll come back to this matter in my second theme.

I should note that one part of our District is experiencing the opposite trend. Bank holding companies in Puerto Rico have been increasing their core deposits while decreasing their brokered deposits, and generally capital has grown faster than risk-weighted assets. These developments seem appropriate given the conditions in Puerto Rico today.

Earnings
The sustained strengthening of asset quality in many firms in the Second District has kept earnings positive and generally stable, yet thin given the pressure of low interest rates on new loans. Moreover, competition for new lending may be adding to the pressure on rates and loosening lending standards: these trends should attract your attention as much as they do ours.

Liquidity
What's funding the growth in lending? Second District community and regional banks have continued to rely largely on core deposits to fuel the increase in their assets over the past year. Still, core deposits growth has not kept pace with asset growth in our District. Banks in 2015 instead increased markedly their dependence on noncore funding, particularly brokered deposits.

This relatively sudden increase in noncore funding is a red flag for all. I'll repeat the findings of an independent study[2] that I had shared at last year's conference, namely that community banks across the United States that were more dependent on core deposits—which tend to be "sticky" and more favorably priced—fared better during the financial crisis than did community banks that were more dependent on wholesale funding sources and were consequently more likely to fail.

Capital
This brings us to the firms' solvency. While capital ratios for Second District community and regional banks remain above regulatory requirements, the strong growth in lending has outpaced capital formation overall. From the first quarter to the final quarter of 2015, total assets when risk-weighted under U.S. capital guidelines grew by 13.6 percent. In contrast, the three measures of capital—Common Equity Tier 1 (CET1), Tier 1, and Total Capital—grew by only about 9.2 percent each.

To put this into context, the average Tier 1 risk-based capital ratio for community banks has fallen from 15.3 percent at the end of 2014 to 14.3 percent at the end of last year—a one hundred basis point drop. For mainland regional banks, the decline has been

greater, as the Tier 1 risk-based capital ratio fell from 13.7 percent to 12.0 percent over the same time period. Since capital serves as both a source for future growth as well as the last line of defense against unexpected losses, lower capital ratios can imply curtailed opportunities for future growth—and potentially less protection against the unexpected. When we encounter a firm with declining capital ratios, we seek to understand why the ratio is falling and whether the existing stock of capital suffices for the firm's risk profile.

II. Commercial Real Estate Concentrations (CRE) and Supervisory Guidance

In that regard, changes in the risk profiles of some community and regional banks in our District are worthy of closer management and supervisory attention. This change may be most evident precisely in the significant growth some firms pursued in commercial real estate lending last year, which brings me to the second theme for my remarks today.

The renewed zeal for commercial real estate lending has not been matched with similar growth in capital. For example, community banks grew their total volume of CRE lending by nearly 26 percent over the last four quarters and by just over 61 percent over the last eight quarters. Regional banks were within nearly the same range, increasing their total volume of CRE lending by almost 34 percent over the past four quarters and by almost 51 percent over the prior eight quarters. Recall that the three key measures of capital have grown by only about 9.2 percent over the past four quarters.

As a result, aggregate CRE loans are now equivalent to 367 percent of Total Risk-Based Capital for community banks and 451 percent for regional banks in our District.

Concentrations at these levels demand heightened management and supervisory attention because of the greater risk of failure. Research conducted in 2013 jointly by staff from the Federal Reserve and the Office of the Comptroller of the Currency found that firms with high concentrations of CRE lending tended to fail at vastly greater rates during the financial crisis compared to firms with lower concentrations.[3]

In particular, the researchers studied the failure rates of banks that exceeded certain thresholds for CRE lending concentration as defined in interagency guidance[4] that the Federal Reserve, the OCC, and the FDIC issued just prior to the financial crisis in 2006. Under the interagency guidance, when banks meet or exceed one of two thresholds for CRE-related lending, supervisors set heightened expectations for those firms' risk management and capital. The heightened expectations apply in either of the following situations:

- when banks have loans for construction, land, and land development (CLD) that represent 100 percent or more of their Total Risk-Based Capital; or
- when banks have loans for non-owner-occupied CRE loans (including CLD loans) that represent 300 percent or more of their Total Risk-Based Capital and those banks experienced growth in total CRE lending of 50 percent or more during the previous 36 months.

The researchers found that 23 percent of all U.S. banks that exceeded both thresholds set out in the 2006 interagency guidance failed during the financial crisis. In contrast, only 0.5 percent of all other U.S. banks that did not meet either of the thresholds failed.

Meeting just one of the two criteria was likewise associated with significantly higher rates of failure during the crisis: 21 percent of firms failed that had a CRE concentration over 300 percent and met the 50 percent growth rate over 36 months; 13 percent of firms failed that had a CLD concentration over 100 percent during the crisis.

As suggested in the aggregate statistics I cited, some community and regional banks in the Second District (and in other parts of the country) now already meet the supervisory threshold for CRE concentrations above 300 percent, and some of those firms furthermore meet the 50 percent growth measure over 36 months. Likewise, some firms already exceed the 100 percent threshold for CLD lending. I want to stress that these thresholds are not limits. Instead, when a firm approaches or breaches these thresholds, we look more closely at its risk management practices to manage exposures to this more cyclical asset class.

Consequently, I urge you to refer to the guidance in SR 07-01 [5] and supplemental guidance issued in SR 15-17 to evaluate where your firm stands with regard to either the 300 percent threshold for CRE lending concentrations or the 100 percent threshold for CLD lending concentrations. If your bank meets either threshold—or if it is trending upward toward those thresholds—please apply the guidance to ensure that you have established prudent board and management oversight over these concentrations. This includes the following considerations, among many others:

- You should establish an appropriate CRE lending policy and strategy, and you should ensure compliance with the policy and strategy.
- You should develop the ability to manage not just individual loans, but also the whole portfolio. As the guidance notes, even if every loan is underwritten appropriately on an individual basis, a bank may discover that these concentrations of CRE loans on a

collective basis make it more sensitive to cyclical changes in the market. Banks with such concentrations should conduct sensitivity analysis or portfolio-level stress testing to consider how ever changing conditions in the economy could affect overall asset quality. These analyses or stress tests should be consistent with your bank's size, complexity, and risk characteristics of the CRE portfolio.

- You should develop strategies for managing those concentrations, which should include a contingency plan to reduce or mitigate such concentrations.
- You should ensure that the bank's capital levels are commensurate with the heightened level and nature of the risk that such concentrations create. If capital is found to be inadequate, you should either increase capital levels or reduce the CRE concentrations.

I've highlighted only a handful of the steps that the two SR Letters suggest. For firms that are trending toward or have already exceeded either the CRE or the CLD threshold, you'll be better prepared to answer our questions when you adhere to the expectations set out in the SR Letters. More importantly, you'll create a better understanding of the significance of your concentrations and a better risk management infrastructure to administer them responsibly.

III. Other Risk Management Issues

On that note, our supervisory programs are designed to give us broad insight into the prudence and judgment of a firms' senior management and board of directors. So I'd like to turn to the final theme for my remarks and highlight some of the key issues that our examiners identified in 2015 as requiring the attention of senior management and appropriate oversight by the board of directors.

- First, we identified opportunities for firms to strengthen internal operations that support compliance with the Bank Secrecy Act and anti-money laundering requirements. Some of the challenges we observed related to weaknesses in the oversight of outsourced audits and in the independent testing of systems. Moreover, we saw a need in some firms to strengthen customer due diligence, including better monitoring customers initially thought to be low or medium risk to reduce surprises as their risk profiles change.
- A second area requiring attention centered on a range of weaknesses in information security, including developing better strategic plans for network security; strengthening internal risk assessments and audits of IT-related issues; and improving the firm's oversight over outsourced services and third party vendors.
- A third area of focus related to the quality of a firm's credit risk management infrastructure. An overarching theme that we noted included a need to report credit risk in a clearer fashion from the front office, to the back office, to the executive offices and up to the board room. In some cases, we saw reporting packages that were unclear or too complex to convey a sense of the true risks to the board of directors. In other cases, we noted a need to develop or improve policies and procedures regarding the management of risks arising from different products and services.
- A fourth issue related to banks' efforts to manage the evolving consumer protection landscape specific to fair lending, the Community Reinvestment Act, and consumer compliance. The response to managing the changes seemed to result in (1) decentralization of compliance programs, including outsourcing key internal controls and risk monitoring; (2) conversion of older core processing and platform systems to gain more automation and (3) expansion into new or different products and services. In some cases, problems in overseeing and completing these changes resulted in weaknesses emerging in banks' overall compliance programs and supervisory rating downgrades and enforcement actions.

These four sets of issues—establishing better internal frameworks to support compliance with the Bank Secrecy Act and anti-money laundering requirements; strengthening information security measures; enhancing the credit risk management infrastructure; and overhauling processes and systems used to manage compliance with consumer protection rules—resulted in the issuance of large numbers of "matters requiring attention" (MRAs) or matters requiring immediate attention (MRIAs) for community and regional banks in the District over the course of 2015.

While each of these issues represents distinct areas of focus, one theme that ties many of them together is resources. Community banks—and some regional banks—may have relatively small numbers of staff and smaller sets of resources available to them compared to larger firms. Consequently, rather than seeking to manage all processes internally, firms may decide to outsource activities to help reduce the costs of compliance. As outsourcing has evolved beyond core bank processing and information technology, smaller firms and quite a few larger ones increasingly are outsourcing other internal activities, such as internal audit, accounting, loan review or loan servicing, or asset and wealth management.

While a firm may decide to rely on a service provider to conduct some activities, its senior management remains responsible for ensuring that those activities are conducted in a safe and sound manner and in compliance with laws and regulations. The board of directors, in turn, must assure itself that management has developed an appropriate vendor management program. The Federal Reserve issued guidance in 2013 outlining the key risks involved when employing a service provider, what responsibilities the board and senior management have, and a broad overview of a framework and processes to manage the resulting risks. For those firms that are experiencing challenges with outsourced services—or may be contemplating hiring an external service provider in the future—this guidance is intended to help reduce the risk of supervisory actions, monetary losses, reputational damage, and litigation.[6]

Conclusion

As I noted at the outset of my remarks, we have no shortage of change in the world today.

As the economy continues to recover, some community and regional banks in our District have emphasized commercial real estate as a key part of their lending strategies, yet this emphasis is leading to an increasing dependence on noncore sources of funds and declining capital ratios.

That growth in CRE lending has furthermore increased the concentration of exposures to this more cyclical asset class. Given the elevated risk of bank failures associated with high concentrations of commercial real estate related lending, we set heightened supervisory expectations for ensuring adequate risk management and capital to offset those risks.

Finally, other risk management issues that require attention relate to building an appropriate infrastructure to support compliance with the Bank Secrecy Act and anti-money laundering expectations; strengthening information security; improving the credit risk management infrastructure; and thinking more strategically about the overhaul of processes and systems that support compliance with consumer protection issues or other priorities.

With so much change and so many issues, it's easy to get lost in the details. So please remember Hamilton's challenge to you: don't throw away your shot. Be an agent of positive change in your communities. We need you to continue to safeguard individuals' hard-earned savings and to serve as intermediaries of credit, the lifeblood of the modern economy, to businesses and consumers in the region. When you do so prudently and in a manner that is sustainable financially and that is fair to consumers, you can better fulfill the community banker's role as a leader in an ever-changing world.

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[1] Ralph Acevedo, Deborah Arndell, Jacqueline Fenton, Bettyann Griffith, Jordan Light, Jonathan McLeman, and John Walsh commented on and provided input for these remarks.

[2] Financial Institutions: Causes and Consequences of Recent Bank Failures, United States Government Accountability Office, January 2013.

[3] An Analysis of the Impact of the Commercial Real Estate Concentration Guidance, Keith Friend, Harry Glenos, and Joseph B. Nichols, Office of the Comptroller of the Currency and Board of Governors of the Federal Reserve System, Washington, D.C., April 2013.

[4] Interagency Guidance on Concentrations in Commercial Real Estate, Board of Governors of the Federal Reserve System, (SR 07-01) Washington, D.C., January 4, 2007.

[5] Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending, Board of Governors of the Federal Reserve System, (SR 15-17), Washington, D.C., December 18, 2015.

[6] Guidance on Managing Outsourcing Risk, Board of Governors of the Federal Reserve System, (SR 13-19, CA 13-12), Washington, D.C., December 5, 2013.