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What are the risks and opportunities on the horizon for community banking?

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The seventh annual Community Bankers Symposium, co-sponsored 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 on November 18, 2011. This article summarizes the key presentations and discussions at the symposium.

More information about the 2011 Community Bankers Symposium is available at www.chicagofed.org/webpages/events/2011/community_bankers_symposium.cfm.

Nearly 300 participants—mostly representatives from community banks[1] in the Seventh Federal Reserve District—gathered to discuss the risks and opportunities for community banks in the current economic and regulatory environment.[2] One key topic was the direct and indirect effects of the Dodd–Frank Wall Street Reform and Consumer Protection Act (DFA) on community banks.

In his welcoming remarks, Mark H. Kawa, vice president, Federal Reserve Bank of Chicago, noted that the Seventh District's Community Depository Institutions Advisory Council—introduced at the previous year's symposium—was up and running. The council is made up of representatives from community banks (with different charters and regulators), thrift institutions, and credit unions located across the district.[3] Council members have direct access to Federal Reserve policymakers, with whom they share their thoughts and concerns about local market and banking conditions, economic conditions, and key policy issues. Such topics were also discussed at the 2011 symposium.

Chicago Fed view

Charles L. Evans, president and CEO, Federal Reserve Bank of Chicago, noted that regulators have been busy implementing the DFA, which is particularly concerned with mitigating risks posed by systemically important financial institutions, or SIFIs (many of which are large banks). Toward that end, the Federal Reserve and other regulatory agencies have been developing new rules to help reduce the risk of SIFI failures. These agencies have also been devising rules to help minimize the losses to the financial system and the broader economy, should such failures occur. As the lengthy DFA rulemaking process unfolds, some uncertainty surrounds its impact on community banks. Additionally, it is not clear how community banks will be affected by changes instituted by the Consumer Financial Protection Bureau (CFPB).[4]

According to Evans, community banks continue to face a very challenging environment—defined by slow economic growth and high unemployment, along with dampened consumer sentiment and muted loan growth. Such negative trends persist despite historically low interest rates. Fortunately, conditions do seem to be improving across the Seventh District: Banks' balance sheets are stabilizing; the quality of their assets (e.g., their loan portfolios) is improving; and loan payment delinquencies, loan charge-offs, and loan-loss provisions are declining. Additionally, high liquidity and capital levels are not uncommon at Seventh District banks. That said, ultimately, only a significant increase in economic activity will provide the confidence necessary to spur lending.

Next, Evans briefly discussed the Federal Reserve's dual mandate of fostering maximum employment and managing price stability. He said that the Federal Open Market Committee (FOMC) anticipates short-term interest rates to remain low through mid-2013, given the recent economic data and projections for near- and medium-term inflation. Households, businesses, and markets have concerns about these rates rising as a result of the Fed tightening monetary policy in the near or medium term. To ease such concerns and to encourage increased economic activity now, Evans suggested that the FOMC make a statement explaining that an accommodative monetary policy will be maintained until either the unemployment rate goes below 7% or the outlook for inflation over the medium term goes above 3%. He argued that announcing this conditional approach would enhance economic growth and employment today while sustaining a disciplined inflation performance.[5]

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A U.S. Treasury view

Don Graves, deputy assistant secretary, U.S. Department of the Treasury, said that the U.S. economy is slowly recovering from the deepest and longest recession since the Great Depression. During the recession, which was accompanied by a severe financial crisis, the average U.S. household lost 23% of its pre-recessionary wealth and millions of Americans lost their jobs. Laying the foundation for future economic growth, Graves said, requires adequate capital to allow firms to grow and generate employment. The community banking sector does play an important role in these efforts.

Graves argued that the DFA helps level the playing field between the largest financial institutions and their smaller counterparts. In particular, the DFA puts new capital and liquidity requirements on the largest financial institutions, and shifts more of the burden of deposit insurance costs to larger and riskier banks by requiring premiums to be assessed based on total liabilities, not just deposits. The DFA also permanently increased the deposit insurance ceiling to $250,000 per account from $100,000, strengthening a main source of funding for community banks by encouraging larger deposits. And under the DFA, for the first time, nonbank competitors, such as mortgage brokers and payday lenders, will be subject to regulations on unfair and deceptive practices, as well as regulatory compliance examinations by the CFPB. By targeting larger and riskier institutions, recent consumer protections and financial reforms have not been overly burdensome on smaller institutions, Graves contended. Community banks did not cause the financial crisis, said Graves, and they should not be penalized by the new reform measures.

Consumer protection compliance

Julie A. Williams, vice president, Federal Reserve Bank of Chicago, moderated a panel on consumer protection compliance, which featured Sandra F. Braunstein, director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System; Edwin L. Chow, regional director, CFPB; Grovetta N. Gardineer, deputy controller for compliance policy, OCC; and M. Anthony Lowe, regional director, FDIC.

Given the current economic and regulatory environment, the panel of regulators offered the following advice to bankers: First, bank executives should include regulatory compliance officers at meetings about new business strategies and new products. There are significant risks in letting compliance issues slip. Making sure regulatory compliance becomes a part of an enterprise's culture can help mitigate unnecessary legal liabilities, prevent costly efforts to fix problems after the fact, and deal proactively with public relations issues. Second, clear communication with regulators is critical during these turbulent economic and regulatory times. Indeed, both sides should encourage transparency in how they are dealing with the various changes.

Chow pointed out that the CFPB opened on July 21, 2011, and now has approximately 700 staff members, mostly in Washington, DC. The CFPB is focusing its regulatory efforts on insured depository institutions and credit unions with more than $10 billion in assets, as well as their affiliates. Additionally, the CFPB is expected to build a regulatory system for nondepository organizations, such as mortgage brokers and payday lenders. For insured depository institutions and credit unions with $10 billion in assets or less (e.g., community banks and their affiliates), the CFPB may join examinations conducted by other regulators to gain a perspective on the compliance environment, but this is not being done now. Chow emphasized that curtailing abuses in the home mortgage and payday lending markets are among the CFPB's top policy priorities.

FDIC view

Martin J. Gruenberg, acting chairman, FDIC, noted that the FDIC is cautiously optimistic about the current state of the banking industry. Gruenberg pointed out that even though the pace of the economic recovery has slowed somewhat over the past six months, some banking indicators are now moving in a positive direction. For instance, the number of banks on the FDIC's "Problem List" had been steadily growing over the past five years, but it actually declined for the first time on June 30, 2011. Additionally, the number of failed institutions stood at 80 in 2011 by the date of the symposium—far fewer than the 140 at the same time in 2010; Gruenberg said that the year-end estimate of bank failures was 100 for 2011 versus 167 for 2010.

Gruenberg also touched on the FDIC's new resolution authority over SIFIs. In 2008, the troubles of AIG (American International Group Inc.), Bear Stearns, and Lehman Brothers all contributed to the financial crisis. These institutions had virtually no prudential regulation, although they were all systemically important. In 2008, only the bankruptcy court had the authority to resolve these entities (only Lehman Brothers actually filed for Chapter 11 bankruptcy), and it was ill-equipped to deal with such large, complex, and systemically important institutions. Gruenberg stated that the lack of resolution authority over nonbank financial institutions like AIG significantly constrained the ability of the regulatory agencies to respond to the financial crisis; without this authority, regulators were not able to identify risks across the system at banks and nonbank financial institutions and prepare responses to them.

Turning his attention to community banks, Gruenberg stated the FDIC is developing plans to help community banks communicate and address their concerns over the coming year. For instance, the FDIC will host a conference in 2012:Q1 on the present and future challenges for community banks, as well as follow-up roundtables in each of the six FDIC regions. Also, new FDIC research will examine the history of community banks over the past 20 years; current challenges (such as the difficulties of raising capital, keeping up with technology, and recruiting capable personnel); and potential roadblocks they may need to overcome. Lastly, supervisory and compliance examinations at community banks will be studied by the FDIC to see if there are ways to simplify and streamline the process, helping to make them more cost-effective.

A Federal Reserve Board view

Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, said that bank regulators now have an opportunity to revamp the supervision process for community banks in the wake of the financial crisis. Figuring out how to change the supervision of community banks involves understanding the key differences between community banks and their larger counterparts. The business models for community and large banks have become so divergent that the supervisory approach should be tailored for each type of bank, Raskin argued. The vast majority of banks (99%) hold less than $1 billion in assets. In contrast, each of the four largest commercial banks holds over a trillion dollars in assets; collectively, these four banks control nearly half of all the U.S. banking assets. Clearly, community banks are less complex, more conservative, and relatively risk averse compared with large banks. Thus, the supervisory examination of community banks does not need to be as extensive as that of large banks, Raskin contended.

Through several initiatives, the Federal Reserve Board is trying to help strike the appropriate supervisory balance for community banks, said Raskin. A subcommittee of Fed governors has been established to specifically deal with community banking issues; the policies and rules required to be developed by the DFA are being reviewed with an eye toward how they will affect community banks. In addition to policy-related matters, a Community Depository Institutions Advisory Council in each Federal Reserve District is giving the Board unique insights into community banking issues. The Board also hosts the Ask the Fed program—a series of teleconferences focusing on various topics of the day affecting community banks.

Troubled debt restructuring

Lynn B. Dallin, deputy regional director, FDIC, moderated a panel of seasoned bank examiners. This panel featured Archa Chadha, lead examiner, Federal Reserve Bank of Chicago; Randy J. Bollenbacher, retail credit lead expert, OCC; and James D. Eisfeller, supervisory examiner, FDIC. Drawing on their experience, the panelists primarily discussed troubled loans and the use of troubled debt restructuring (TDR),[6] which has increased since the financial crisis.

The panel emphasized that the primary purpose of a TDR is to help a borrower experiencing financial difficulty to continue servicing the loan, rather than to default on it; a bank usually accommodates this by modifying the loan's contractual terms. Once the optimal modification (if any) is made, consistent determination of whether a TDR exists (and therefore needs to be reported) should be done by referencing established policies and procedures. The panelists stated it would be prudent for banks to discuss potential restructuring programs (which may result in TDRs) with their regulators to ensure any risk-management and compliance issues surrounding such programs are addressed.

According to the panelists, banks might also consider splitting a troubled loan into two loans, or notes. The first note would be a new legally enforceable note that is reasonably assured of repayment—it would perform according to prudently modified terms. The second note, however, would not be reasonably assured of repayment and would typically be charged off. Although the first note would be considered a TDR in this case, this restructuring allows the first note to be excluded from TDR reporting in the next calendar year, as long as it is performing under the modified terms and is at a market rate of interest (an interest rate commensurate with the loan type and the risk profile of the borrower).

Community bank CEO views

The moderator for the community bank CEO panel was Bert A. Otto, deputy controller, OCC. This panel consisted of Robert B. Atwell, CEO, Nicolet National

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Bank, Green Bay, WI; Micah R. Bartlett, president and CEO, Town and Country Bank, Springfield, IL; and Thomas E. Spitz, CEO, Settlers Bank, Deforest, WI. While discussing lessons learned from the financial crisis, Bartlett stated that although bankers generally understand the practices that constitute sound banking, they tend to move away from those practices when stretching for higher earnings or faster growth. Strong board oversight can help bank management adhere to sound practices.

Otto inquired about how community bank management and board members should deal with potential new product and service offerings. Spitz responded that management and board members need to ensure that the possible new products and services align with a community bank's established business plan; if those products or services do not align but are still not rejected, they need to be properly researched to see if the institution has the expertise necessary to manage the risks associated with them. Spitz shared that many products new to his bank fell outside his bank's plan and therefore were abandoned. Concurring with Spitz, Bartlett added that even nuances introduced into existing products and services should be carefully examined for the risks they may bring.

As the discussion turned to bank examinations, Atwell and other panel members did not offer much criticism of the examination process; in fact, they generally agreed that experienced and knowledgeable examiners are very helpful to their banks. However, Bartlett did point out some cases where an overly prescriptive solution may not be the best tactic. For example, in response to errors found in mortgage documentation, an examiner suggested a 100% pre-close documentation review. Subsequently, many employees were less careful during the mortgage closing process, thinking any errors would be caught in the final pre-close review. Thus, the examiner's prescription ironically resulted in more errors than before. The bank has since eliminated the 100% pre-close review and is now checking a sample of the mortgage packages for regulatory compliance.

Summing up

In the midst of a slow economic recovery from a long and deep recession, community bankers are cautious of supervisory policies and regulations that could disrupt banking conditions that have just begun to improve. Although the vast majority of DFA rules are not directly aimed at community banks, banking regulators and government officials acknowledge the need to distinguish between large and small financial institutions as other policy matters and supervisory procedures are developed. Active participation and cooperation by community bankers in the evolving regulatory process will help ensure the challenges of the community bank sector are met.

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[1] Community banks are typically small banks, which conduct most of their business in their local communities. The size threshold most often used is $1 billion in assets.

[2] The Chicago Fed serves the Seventh Federal Reserve District, which comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

[3] For a list of the council's members, see www.chicagofed.org/webpages/people/cdiac.cfm.

[4] The CFPB, established under the DFA, protects consumers by enforcing federal consumer financial laws. For the CFPB's core functions, see www.consumerfinance.gov/the-bureau/.

[5] For more details about this approach, see Evans' October 17, 2011, speech at www.chicagofed.org/webpages/publications/speeches/2011/10_17_11_mcee.cfm.

[6] According to the Financial Accounting Standards Board's Accounting Standards Codification, a loan restructuring or modification of terms is a TDR if the bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider.