

# Chicago Fed Letter

## Paving the road forward: Regulators and community banks working together

by Mark Kawa, vice president, Paul Jordan, risk management team leader, and Robert Millerick, risk management specialist, Supervision and Regulation

The eighth 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 9, 2012, at the Federal Reserve Bank of Chicago. This article summarizes the key presentations and discussions at the symposium.

For more information about this event, see [www.chicagofed.org/webpages/events/2012/community\\_bankers\\_symposium.cfm](http://www.chicagofed.org/webpages/events/2012/community_bankers_symposium.cfm).

Nearly 300 participants—mostly representatives from community banks in the Seventh Federal Reserve District<sup>1</sup>—gathered under the theme of Paving the Road Forward: Regulators and Community Banks Working Together. This year's speakers included Charles L. Evans, president and chief executive officer, Federal Reserve Bank of Chicago; Steve Antonakes, associate director of supervision, enforcement, and fair lending, Consumer Financial Protection Bureau (CFPB); Thomas J. Curry, OCC; Carl R. Tannenbaum, chief economist, Northern Trust Company; and Elizabeth A. Duke, governor, Board of Governors of the Federal Reserve System.

Evans offered his perspective on the state of the U.S. economy and the significant risks facing the economy today: 1) uncertainty in the global economy; 2) financial crises in Europe; and 3) the fiscal cliff.<sup>2</sup>

Against the backdrop of these significant challenges facing the world and U.S. economies in 2013, Antonakes of the CFPB<sup>3</sup> discussed specific developments affecting the community banking sector. Among the topics he discussed were rulemaking,<sup>4</sup> consumer protection rules, and nonbank financial providers. The latter sparked a lively discussion among the audience.

### Role of the Consumer Financial Protection Bureau

Antonakes defined a nonbank as a company that provides consumer financial products or services but does not have a bank, thrift, or credit union charter. He said there are currently thousands of nonbank businesses that offer consumer financial products and services, and consumers interact with them all the time. While banks, thrifts, and credit unions historically have been examined by various federal regulators as well as their state regulators, nonbanks generally have not. By requiring the CFPB to examine nonbanks, the 2010 Dodd-Frank Act (DFA) sought to ensure that consumers get the protection of federal consumer financial laws on a consistent basis. This consistent supervisory coverage will help level the playing field, he explained, for all industry participants, creating a fairer marketplace for consumers and the responsible businesses that serve them.

The purpose of the CFPB's nonbank supervision is to prevent harm to consumers and promote the development of markets for consumer financial products and services that are fair, transparent, and competitive. To accomplish these goals, the CFPB will assess whether nonbanks are conducting their business

in compliance with federal consumer financial laws, such as the Truth in Lending Act and the Equal Credit Opportunity Act.

The CFPB's approach to nonbank examination will be the same as its approach to bank examination. According to Antonakes, it may include a combination of any of the following tools: requiring nonbanks to file reports, reviewing the materials the companies actually use to offer those products and services, reviewing their compliance systems and

specific aspects of the proposals and the potential impact on mortgage lending. Duke went on to say that, as she was reviewing the data, she realized that there was very little about mortgages on the books of community banks. Thus, Duke argued, there are regulatory issues that go far beyond those raised in the capital proposals. The totality of new mortgage lending regulations might still seriously impair the ability of community banks to continue to offer their traditional mortgage products. In fact,

loss of community banks' participation in that part of the market.

Based on these concerns, Duke asked staff at the Board of Governors to examine available data to try to come up with answers to questions about collecting annual data on home mortgage lending as well as what she sees as the role of community banks in the mortgage lending market.

According to Duke, analysis of annual data on home lending reported pursuant to the Home Mortgage Disclosure Act (HMDA) provides insight into the role of community banks in the mortgage market.<sup>6</sup> HMDA requires banking institutions, credit unions, and mortgage companies with offices in metropolitan areas to report details about the applications they receive and the loans they extend each year.

The HMDA data indicate that community banks account for a significant fraction of total home loan originations each year. Smaller community banks account for about 5% of the originations annually, and larger community banks make up an additional 13%. Credit unions, which are nearly all small, now account for an additional 7% of home loan originations. Thus, taken together, community banks and credit unions accounted for one-quarter of the new origination market in 2011. This is up from a combined market share of only 16% in 2004. The share of loans originated by nonbanks dropped from nearly one-third of all originations in 2004 to slightly more than one-quarter in 2011.

Duke added that the same data that were used to examine the role of community banks in the mortgage market can also be used to analyze the importance of mortgage products to community banks. Overall, community banks accounted for approximately one-fifth of closed-end, first-lien mortgages retained in portfolio by all banks as of June 2012. Mortgage lending appears to be just as important to community banks as it is to larger banks, as both tend to devote about one-quarter of their on-balance-sheet loan portfolios to home loans. Moreover, the share of first-lien mortgages as a percentage of loans held in portfolio has increased substantially since 2008.

## Mortgage lending appears to be just as important to community banks as it is to larger banks.

procedures, and reviewing what they promise consumers. Similar to the procedure for bank exams, nonbanks will be notified in advance of an upcoming examination by the CFPB.

Antonakes concluded that to be consistent with the DFA, the CFPB is implementing a risk-based nonbank supervision program. On an ongoing basis, the CFPB will be assessing the risks posed to consumers in the relevant product markets. When assessing supervision needs for particular nonbanks, the CFPB will consider several relevant factors, including the nonbank's volume of business, types of products or services, and the extent of state oversight.

### Update on Basel III

Federal Reserve Governor Elizabeth Duke provided an update on Basel III, the global regulatory standard on bank capital adequacy, stress testing, and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010–11.<sup>5</sup> The accord is scheduled to be implemented from 2013 until 2018. The Board of Governors of the Federal Reserve System is in the process of collecting and sorting through data on the proposed changes.

The Board is examining the operational costs that would be incurred to track data that are not currently needed to calculate capital ratios. The Board is also assessing the potential volatility in regulatory capital that may arise from

in Duke's previous discussions with community bankers, she said more of them reported that they are reducing or eliminating their mortgage lending due to regulatory burdens than reported that they are entering or expanding their mortgage business in response to low mortgage rates. In Duke's view, this represents a real concern, both for mortgage availability and for the viability of community banking.

Duke pointed out that she began her career in financial services at a community bank and always envisioned a role for traditional community banks, serving customers in one or more well-defined local markets, making a variety of loans, and funding themselves primarily with local core deposits.

Evaluating the impact of increasing regulation on community banks, Duke divided the potential burden into three categories: 1) additional operational costs associated with compliance; 2) restrictions on fees, interest rates, or other potential forms of revenue; and 3) unintentional barriers to offering a service that may result from regulatory complexity. If the effect of a regulation is to make a traditional banking service so complicated or expensive that significant numbers of community banks believe they can no longer offer that service, Duke argued, the regulation should be reassessed. Specifically, policymakers need to consider whether the potential benefits of the regulation outweigh the potential

In conclusion, Duke reiterated that community banks are important to the mortgage market, that they are able to relieve some capacity constraints at the margin, that mortgage lending is important to their balance sheets and their profitability in the aggregate, and that they are a source of responsible lending. Community banks' lending is likely most important in the market for non-standard properties or borrowers.

Duke argued that the best course for policymakers would be to abandon efforts for a one-size-fits-all approach to mortgage lending. Balancing the cost of regulation that is prescriptive with respect to underwriting, loan structure, and operating procedures against the lack of evidence that balance-sheet lending by community banks has created significant problems, she continued, it would be appropriate to establish a separate, simpler regulatory structure to cover such lending. Such a framework could establish appropriate safeguards to protect consumers, but it should do so in a way that recognizes the characteristics of community bank lending, perhaps by focusing on appropriate disclosures and relying on regular on-site supervision to test for appropriate underwriting and loan structuring.

### Thoughts on the economy

Carl Tannenbaum, Northern Trust Company, explained that, while the U.S. economy has been expanding for the last three years, the economic recovery still faces headwinds. Households have taken significant hits to personal finances, with many losing jobs and many more seeing declines of 30% or more in home equity values. The election season created further uncertainty regarding what actions Congress would take to avoid the fiscal cliff of automatic spending cuts set to take effect in the new year. With Congress and the Obama administration currently trying to reach a deal on spending cuts and revenue increases, much uncertainty remains. Tannenbaum noted any contraction in the economy in 2013 as a result of fiscal policy would hurt still-struggling local and state economies. As Evans stated in his opening address, ongoing financial crises in

European countries pose additional risks to the U.S. economic outlook. The Federal Reserve System continues to monitor financial institutions' and multinational companies' exposure to EU sovereign debt, and a number of American banks have taken steps to reduce that exposure.

### Importance of risk management

Thomas Curry, OCC, was the final keynote speaker at the symposium. Curry devoted his presentation to the subject of risk management and, in particular, to enterprise risk management, including capital planning, stress testing, and operational risk. He encouraged symposium attendees to take a look at the OCC's *Semiannual Risk Perspective*, which was published for the first time in the spring of 2012. Curry went on to say the report highlights three areas of risk that are front and center for the OCC, and each of them illustrates the importance of enterprise risk management. The first has to do with the aftereffects of the housing-driven, boom-to-bust credit cycle. The second involves the challenge of increasing revenues in a slow-growth economy. And the third focuses on the danger of banks and thrifts taking excessive risks to improve profitability.

Curry argued that a strong enterprise risk management system or a strong risk-assessment system is essential to the community bank model. Enterprise risk management is an integrated approach to identifying, assessing, managing, and monitoring risk in a way that maximizes business success. According to Curry, risk management starts at the top, with the board and senior management making decisions about the institution's business model and its appetite for risk, but it can't be successful unless those policies filter throughout the bank's culture. A strong risk-management culture is proactive, and it drives the way a bank sets strategy and makes decisions. This can be translated into how the management team and employees anticipate and respond to risk throughout the bank. Individual risks aren't considered only within the lines of business or by function, although the board and management can and should think about them

in this way. However, they need to also think about risk and risk management in their totality across the bank, as well as how different risks are related and interact with one another. One aspect of enterprise risk management involves sharing information and breaking down silos that may exist, separating areas of the bank and limiting cooperation. Curry argued that regulatory agencies can be helpful resources to banks and can help them ensure they can identify all aspects of new product decisions that should be considered. Another key element of bank risk management, Curry said, involves taking advantage of the guidance issued by the OCC and other regulators and tailoring it to each bank's own particular circumstances.

Curry also highlighted the importance of operational risk. Operational risk failures are the surest way to undermine the reputation of a bank; and one of the greatest advantages community banks and thrifts have in today's marketplace is their relatively good reputation.

In conclusion, Curry reiterated the vital role community banks and thrifts play in supporting local economies throughout the country. The regulator's goal is

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to promote sound risk management practices that will help ensure that the nation's smaller banks continue to thrive.

### Bankers' panel

The final session of the symposium was a bankers' panel entitled "Management Succession and How to Build a Sound Banking Strategy in Today's Environment." The panel was moderated by Blake Paulson, associate deputy comptroller of the OCC. The panelists were Dan Eversole, senior vice president, Isabella Bank; David A. Dykstra, senior executive vice president and chief operating officer, Wintrust Financial; James G. Hiatt, president, First State Bank; and John K.

Schmidt, executive vice president and chief financial officer, Heartland Financial USA. Paulson led a discussion of where the community bank model has been and where it seems to be headed. Each panelist gave the audience a sense of what leads to success in their particular banking environment, as well as what matters for a successful management team succession. It was clear during the panel discussion that culture is key to succession planning at community banks. Each panelist discussed their institution's strategy for identifying the future leaders within their organization and developing plans to "grow their own" management teams of the future.

### Conclusion

Cathy Lemieux, executive vice president of Supervision and Regulation at the Chicago Fed, wrapped up the conference by thanking the presenters and attendees for a stimulating meeting. Recapping some of the day's discussions, Lemieux noted that the role of the CFPB continues to grow and that a strong risk-assessment system is essential to the community bank model.

As this year's symposium came to a close, attendees were reminded that preparations for the ninth annual Community Bankers Symposium, scheduled to take place on September 13, 2013, are under way.

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<sup>1</sup> The Chicago Fed serves the Seventh Federal Reserve District, which comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

<sup>2</sup> Evans delivered a very similar speech on September 26, 2012, at the Lakeshore Chamber of Commerce Business Expo in Hammond, IN. The speech is available at

[www.chicagofed.org/webpages/publications/speeches/2012/09\\_26\\_12\\_hammond.cfm](http://www.chicagofed.org/webpages/publications/speeches/2012/09_26_12_hammond.cfm).

<sup>3</sup> The CFPB, established under the Dodd-Frank Act, protects consumers by enforcing federal consumer financial laws. For the CFPB's core functions, see [www.consumerfinance.gov/the-bureau/](http://www.consumerfinance.gov/the-bureau/).

<sup>4</sup> The rulemaking authority in Regulation C of the Home Mortgage Disclosure Act, which requires lending institutions to report public loan data, was transferred to the CFPB in 2011.

<sup>5</sup> For more details, see [www.bis.org/bcbs/basel3.htm](http://www.bis.org/bcbs/basel3.htm).

<sup>6</sup> For more details, see [www.ffc.gov/hmda/](http://www.ffc.gov/hmda/).