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Community banking: A time of promise and challenge

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The 13th 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 Federal Reserve Bank of Chicago on November 16, 2018. During a full day of speeches and panels, a group of 160 community bank executives, financial industry practitioners, and regulatory agency professionals who work in the Seventh Federal Reserve District[1] explored the evolving landscape of community banking.[2] This article provides an overview of the event's key presentations and discussions.

The conference's speakers focused on the current state of the economy, updates on regulatory changes, common supervisory findings, baseline risk-management expectations, leading industry practices, and efforts to reduce regulatory burdens. Additionally, panels of regulators and banking professionals discussed material risks to financial institutions, including credit risk and collaborating with financial technology companies (fintech).[3]

In his welcoming address, Richard Brunskill, vice president, Federal Reserve Bank of Chicago, highlighted the symposium's theme: a time of promise and challenge. Brunskill noted improved financial trends in the industry and strengthened risk management demonstrated by community banks, as well as innovations in technology that have brought a wider variety of product and service offerings. However, he added, the same technology advancements allowing community banks to generate more revenue are also allowing larger banks, credit unions, and fintech companies to compete more effectively in the traditional community bank space. Brunskill summarized Federal Reserve Governor Lael Brainard's recent speech[4] on the increased availability of artificial intelligence (AI) algorithms, processing power, and big data to all firms from the smallest start-ups to the bigger financial players. He cautioned that challenges facing community banks are not limited to a changing technology landscape, but also include difficulties in attracting the next generation of community bank leaders.

The conference agenda and some materials presented at the event are available online, https://www.chicagofed.org/events/2018/annual-community-bankers-symposium.

A Chicago Fed perspective on community banking

Charles Evans, president and CEO, Federal Reserve Bank of Chicago, began his remarks by discussing the importance of the collaborative working relationship between the regulatory agencies and community banks. He emphasized that the long-term success of community banking organizations is closely tied to the strength of their local relationships. Evans went on to describe the solid financial performance of community banks by highlighting improved earnings performance, robust loan growth, strong credit quality metrics, high capital levels, and a relatively low number of problem banks[5] in the Seventh Federal Reserve District's portfolio.

Emerging risks cited by Evans included the challenges in agricultural markets, core deposit competition, and cybersecurity. He noted the agricultural industry remains under pressure due to lower crop prices over a sustained period, constraining cash flows for many producers. He noted that farmland values are holding up comparatively well and allowing farmers to use land as collateral to secure borrowing needs. Still, Evans noted agricultural land values tend to be somewhat volatile and farmers' ability to prudently refinance carryover debt[6] could diminish if property values significantly decline. He said bankers will need to monitor the effect of rising interest rates on depositor behavior, given growing competition for deposits in certain markets. In addition to interest rate movements, Evans noted increasing deposit rates have influenced a shift in customer deposit preferences away from lower-costing nonmaturity deposit products to higher-yielding time deposit accounts, although at this point time deposit balances as a percentage of the balance sheet for community banks remain well below pre-recession levels. Nevertheless, Evans said, the shift in liability mix could reduce earnings or increase liquidity risk for financial institutions. Finally, Evans discussed cybersecurity, an area of significant concern for all financial firms. Cyberattacks can be far-reaching and highly destructive. Addressing cybersecurity risk will take efforts on several fronts, Evans said, including public–private partnerships, actions to mitigate vulnerabilities, and regular employee training. He noted that the regulatory agencies continue to monitor these risks and assess their impacts on Seventh District banks.

Evans concluded by elaborating on the interagency regulatory relief for community banks provided by the passage of the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act.[7] For example, the bill streamlined regulatory reports for the first and third quarters of the year;[8] increased appraisal thresholds to $400,000 for commercial real estate loans;[9] extended the examination cycle for qualifying banks below $3 billion in total assets;[10] and raised the assets threshold to $3 billion for inclusion in the Federal Reserve Board's Small Shell Bank Holding Company program.[11] In addition to regulatory relief efforts, Evans noted that the regulatory agencies continue to focus on making the supervisory process more efficient and less burdensome—for example, by having examination teams perform more of their work offsite, including loan review, to address firms' concerns about having a sizable onsite examiner presence. In addition, Evans stated that better use of data analytics is helping regulatory agencies develop a more risk-focused examination approach, allowing for a reduction in the scope of examinations and the associated hours for regulatory agencies to complete supervisory work at banks engaging in low-risk activities.

Keeping up in the digital age

Joshua Siegel, chairman and CEO, StoneCastle Financial Corporation, discussed the current community banking landscape with a focus on successes, challenges, and potential solutions in a digital age. Throughout his remarks, Siegel voiced strong support for the vital role community banks play in our society and their vibrant future if they evolve and embrace technology in order to remain competitive. According to Siegel, the two primary challenges facing the community banking industry are aging leadership teams and a lack of adaptability to an evolving technology environment.

Siegel pointed out that the average ages of community bank CEOs and boards are approaching 60 and 70, respectively, with those numbers steadily increasing. Even more concerning, Siegel highlighted a general lack of management depth. Banks' failure to develop younger leaders and robust succession plans in some cases might lead them to seek out merger partners rather than remain independent, he said. He argued in favor of developing talent internally, rather than recruiting external candidates, given the importance of community connections to grow the business and local knowledge helping to avoid costly missteps. Siegel stressed formal succession planning to help prepare organizations for the next transition in leadership, saying the plan needs to be formally documented, regularly reviewed, and enhanced to ensure continued relevance.

The other challenge cited by Siegel is the need for banks to embrace and adapt to technological innovation. Advances in technology are allowing community banks to deliver higher quality service at lower costs, he said. While community banks' smaller size means they lack the scale economies of larger institutions, it also means they can be more nimble and adaptable. Siegel noted that flexible core banking systems could help banks to respond more quickly to changing market conditions with better capabilities and data; and automation could deliver greater productivity gains, reduced processing costs, higher quality service, and faster implementation of new processes.

Fintech and community banks

Christopher Koopmans, vice president, Federal Reserve Bank of Chicago, moderated a panel of local community bank representatives, which featured David Findlay, president and CEO, Lake City Bank; Sarah Phalen, president and CEO, Illinois National Bank; and Ellie Reineck, president, IncredibleBank. Building off Siegel's comments, the panelists focused on how fintech has changed their respective banking operations and the future of fintech in community banks.

> The 14th annual Community Bankers Symposium will be held at the Chicago Fed on November 15, 2019.

Findlay and Reineck jointly defined fintech as any financial technology outside of the core banking system that improves operational processes or helps solve problems; they pointed out that many of these firms are not new to the banking industry and may already be included on many banks' critical vendor lists. The panelists concurred that most fintech firms are not direct competitors but rather provide enhancements to existing banking activities. They discussed a variety of fintech solutions and urged community banks to be agile with product innovation and fintech implementation. Findlay argued community banks should be "fast followers" of technology trends, while allowing large banks to bear the cost of developing the next innovative financial solutions. Reineck highlighted the importance of seeking customer feedback prior to implementing technologies to determine actual needs and pain points.

The panel also discussed lessons learned from the implementation of fintech solutions at their respective institutions. Findlay stressed the importance of vetting fintech firms to determine their reliability, getting employee buy-in to champion new technology offerings externally, and ensuring sufficient policies are established to guide institutions through the technological changes. Reineck emphasized the importance of early collaboration between an institution's core system provider and fintech vendor to ensure technology solutions can be integrated effectively within the core system. She noted the failure to do so could cause adoption challenges and create unnecessary workarounds. Phalen recommended involving bank employees in early conversations as the operational changes could directly affect their work production. Finally, the panelists noted that efficiencies created by fintech solutions could allow community bankers to reallocate staff to revenue-producing or problem-solving positions from purely operational roles.

View from the FDIC

Jelena McWilliams, chairman, FDIC, opened her remarks by noting the importance of community banks not only to their local markets but to the U.S. economy overall.[12] McWilliams noted that community banks play a large role in funding small businesses, accounting for roughly 50% of all small business loans as of June 30, 2018. Small businesses account for almost half of U.S. private sector employment, she added. Furthermore, McWilliams pointed out that community banks provide essential banking services to communities that may not otherwise be served.

To promote community banks' continued success, McWilliams stressed the need to tailor regulatory requirements to promote safety and soundness and financial resiliency, without hampering banks' ability to compete. The adoption of the Community Bank Leverage Ratio (CBLR), an interagency initiative scheduled for release for public comment, represents the first step in simplifying capital requirements for community banks, she said.[13] Under the proposed rule, a qualifying community bank would be exempt from existing risk-based capital requirements if it had a CBLR above 9%, she explained. The FDIC has estimated that more than 80% of community banks would qualify for CBLR relief, based on the proposed criteria. For nonqualifying CBLR banks, McWilliams highlighted plans to work with other regulatory agencies to simplify risk-based capital rules by finalizing the Economic Growth and Regulatory Paperwork Reduction Act capital simplification proposal.[14] She stressed that these efforts are not directed at reducing capital levels for the industry—as many community banks already maintain capital levels above regulatory minimums—but at reducing the regulatory burden by simplifying capital ratio calculations.

McWilliams closed her remarks by outlining additional initiatives the FDIC is working on to further reduce the regulatory burden faced by community banks, including issuing proposed rulemakings related to changes in the regulatory capital treatment of high-volatility commercial real estate;[15] exempting reciprocal deposits from being considered brokered deposits for certain insured institutions;[16] undertaking a comprehensive review of the FDIC's approach to brokered deposits and national rate caps;[17] and focusing on ways to encourage new bank formation and improve the de novo application process.[18] Finally, the Trust through Transparency initiative[19] will provide increased transparency via the publication of performance metrics, she said. McWilliams asked bankers to take the time to carefully review the forthcoming proposals and to provide input so regulators are made aware of potential pain points or unintended consequences.

Credit risk trends

Brunskill moderated a regulators panel on credit risk, featuring Debbie Bush, assistant regional director, FDIC; Joseph Nashar, supervision manager, Federal Reserve Bank of Chicago; and Dino Pasvankias, acting director for commercial credit risk, OCC. Panelists discussed agricultural lending, credit administration practices, and managing credit concentrations. Brunskill noted that despite robust loan demand, credit risk is low as reflected by the nominal levels of credit losses and nonperforming loans. However, he argued that "bad loans are often made during good times" and bankers need to remain vigilant in maintaining rigorous credit standards.

Building off Evans' earlier comments, Nashar discussed continued challenges within the agricultural sector and associated risk in lending, noting the widespread impact to the Seventh District as about half of community banks have an agricultural concentration.[20] Nashar said the past several years have been challenging for agricultural borrowers, with many producers experiencing a tightening in balance-sheet liquidity and an increasing likelihood of having carryover operating debt. While the 2018 harvest for corn and soybeans was highly productive, commodity prices are expected to remain low, he said, in part due to escalated trade disputes. The stability of Seventh District farmland values has helped support prudent underwriting, he added, although softness in certain market areas was noted by some symposium attendees. Nashar highlighted the interagency guidance of

SR Letter 11-14[21] regarding agricultural credit risk-management practices and encouraged bankers to develop cash flow projections based on reasonable assumptions, prudent policy guidelines to identify and manage carryover operating debt, conduct regular farm inspections, and formally document discussions with borrowers and associated action plans when necessary.

Pasvankias said recent OCC examination findings indicate commercial underwriting practices have incrementally eased for some banks over the past several years, but risk-management practices remain generally satisfactory. The panel shared some common commercial credit administration recommendations, including establishing prudent credit underwriting standards, ensuring accurate risk ratings, aligning loan policy standards with actual lending practices, regularly obtaining current financial information on obligators and guarantors to analyze their repayment ability, and aggregating and tracking policy exceptions to identify lending trends. Panelists advised lenders to conduct an independent credit analysis and have sufficient expertise to monitor any loan participations purchased, including shared national credits, from another originating organization.

Panelists discussed how excessive exposure to lending concentrations was a contributing factor to many financial institutions' failures during the financial crisis. The panel noted credit concentrations are not inherently bad, but present a real financial risk if not appropriately managed. Portfolio-level stress testing and sensitivity testing were highlighted by the panel as key elements to managing credit concentrations, especially in commercial real estate. Panelists commented that the sophistication of stress testing is dependent on the size and risk characteristics of the concentration and can be as simple as increasing charge-off rates beyond historical levels when assessing the impact on bank capital. They noted more advanced stress-testing techniques involving debt service coverage ratios, collateral capitalization rates, and loan-to-value ratios can be meaningful in identifying weaker credits in the portfolio and assessing potential risk to capital.

View from the OCC

Joseph Otting, comptroller of the currency, OCC, outlined steps the agency has taken to revamp the bank examination landscape, regulatory changes he plans to pursue, and broader industry issues the OCC plans to address during his tenure. When assessing the regulatory landscape for community banks, Otting suggested a need to reform the existing Community Reinvestment Act (CRA) framework, Bank Secrecy Act (BSA) requirements, and short-term, small-dollar consumer lending[22] expectations. He also mentioned a diminished interest by fintech firms in becoming banks due to the high regulatory requirements, providing opportunities for existing smaller banks to partner with fintechs.

CRA requirements have changed little since the act's inception in 1977, Otting said, despite major changes in the industry over those 40-plus years. He acknowledged some banks might have trouble deciphering how to be fully compliant with CRA requirements and invited bankers and other interested parties to provide input to the OCC's proposed rulemaking.[23] Areas for improvement cited by Otting included better measurement tools, clarification on qualifying investments, and the reevaluation of assessment areas. He said his goal is to modernize the CRA system so the objective of community reinvestment can be more easily achieved and have a better overall impact.

Otting noted that small-dollar consumer lending is another area of focus for the OCC.[24] He explained that banks have historically removed themselves from the short-term, small-dollar consumer lending business, resulting in borrowers turning to alternative lenders and nontraditional sources of credit. Otting encouraged community banks to reenter this business as they are in the best position to meet consumers' borrowing needs with reasonable pricing and repayment structures.

Finally, Otting discussed the BSA landscape and plans to improve supervisory work in this area. He argued for improving the risk focus of BSA exams and reducing the burden on banks. Otting said he is hopeful that a newly developed interagency workgroup will make significant progress in 2019 by refining and improving the BSA examination process. To reduce the reporting burden, he said, the financial industry may be able to leverage AI technology to detect suspicious banking activities and automatically file the necessary regulatory reports. Typically about 2% of the industry's transactions have a suspicious activity report[25] filed on them, he said, whereas banks using AI identify suspicious transactions at a higher rate of 10% with a 3% rate of false negatives.

Conclusion

Blake Paulson, deputy comptroller, OCC, concluded the symposium by thanking the participants for attending and participating. He encouraged interested parties to consider attending the next symposium, which will be held at the Chicago Fed on November 15, 2019. More details will be posted on the Chicago Fed's website[26] as they become available.

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[1] The Seventh District comprises parts of five midwestern states—all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

[2] Community banks are banking organizations with $10 billion or less in consolidated assets.

[3] The Financial Stability Board defines fintech as "technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services" in a June 2017 report, available online, http://www.fsb.org/wp-content/uploads/R270617.pdf.

[4] Available online, https://www.federalreserve.gov/newsevents/speech/brainard20181113a.htm.

[5] Federal regulators assign a composite rating to each financial institution, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" institutions are those with financial, operational, or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either 4 or 5.

[6] Carryover debt typically results from a borrower's inability to generate sufficient cash flow to repay production loans from the current operating cycle.

[7] A summary can be found at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf.

[8] Available online, https://www.fdic.gov/news/news/financial/2018/fil18074.html.

[9] Available online, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181204a.htm.

[10] Available online, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181221c1.pdf.

[11] Available online, https://www.federalreserve.gov/newsevents/pressreleases/files/2018-18756.pdf.

[12] The FDIC chairman's full speech can be found at https://www.fdic.gov/news/news/speeches/spnov1618.html.

[13] Available online, https://www.fdic.gov/news/board/2018/2018-11-20-notice-sum-b-fr.pdf.

[14] Available online, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170321a.htm. The proposal addresses capital treatment for such items as mortgage-servicing assets, certain deferred-tax assets, and investments in unconsolidated financial institutions.

[15] Available online, https://www.fdic.gov/news/news/financial/2018/fil18050.html.

[16] Available online, https://www.fdic.gov/news/news/press/2018/pr18060.html.

[17] Available online, https://www.fdic.gov/news/board/2018/2018-12-18-notice-sum-i-fr.pdf.

[18] Available online, https://www.fdic.gov/news/news/press/2018/pr18095a.pdf.

[19] Available online, https://www.fdic.gov/transparency/.

[20]Ag banks are commonly defined as insured institutions whose combined agricultural production loans and loans secured by farmland equal or exceed 25% of total loans.

[21]Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1114.htm.

[22]Short-term, small-dollar installment loans are typically two to 12 months in duration with equal amortizing payments.

[23]Available online, https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-87a.pdf.

[24]See OCC 2018-14, https://www.occ.gov/news-issuances/bulletins/2018/bulletin-2018-14.html.

[25]A banking organization is required to file an SAR whenever it detects a known or suspected criminal violation of federal law or a suspicious transaction related to money laundering activity or a violation of the BSA.

[26]Please consult the upcoming events section, https://www.chicagofed.org/events/upcoming-events.

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