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Bringing It Home: The 14th annual Community Bankers Symposium

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The 14th annual Community Bankers Symposium, cosponsored by the Federal Reserve Bank of Chicago, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), was held at the Federal Reserve Bank of Chicago on November 22, 2019. During a full day of speeches and panels, community bank executives, financial industry practitioners, and regulatory agency professionals who work in the Seventh Federal Reserve District explored the current landscape of community banking. This article provides an overview of the event's key presentations and discussions.

In his welcoming remarks, Ric Brunskill, vice president, Federal Reserve Bank of Chicago, addressed the symposium's theme, Bringing It Home, and focused on what it means to be a community bank in the age of fintech and increasing competition from nonbank entities. He noted that community banks are the foundation of many communities, providing loans and meeting the needs of the local (or home) market.

A Chicago Fed perspective on community banking

Julie Williams, executive vice president, Federal Reserve Bank of Chicago, opened with comments on the current conditions for community banks, which include sound earnings, loan growth, increased levels of capital, and a low level of problem institutions. She highlighted emerging risks related to the agricultural sector, cybersecurity, tightening liquidity, and the effect of interest rate changes on depositor behavior. The agricultural sector is facing significant challenges related to sustained low crop prices and fluctuations in commodity prices, although land values remain stable. Williams also noted that this economic expansion has seen loan portfolios grow to near pre-crisis levels, while fierce deposit competition has precluded deposits from funding this growth. Cyber risk remains in the forefront and requiring significant resources, training, and controls to manage potential issues and vulnerabilities. Fraud within banking organizations also represents a significant risk. Williams emphasized the importance of creating a culture where employees feel comfortable escalating concerns and where risk can be managed proactively. Finally, she noted that federal banking agencies continue to focus on reducing the

The conference agenda is available online at https://www.chicagofed.org/events/2019/community-bankers-symposium.

burden related to the supervisory process through additional offsite exam work, including loan review, as well as through the use of data analytics to tailor supervision to risk.

Protecting against fraud

Kelly Richmond Pope, forensic and accounting expert and associate professor at DePaul University in Chicago, discussed how management can help protect against fraud in their own organizations, in part, by understanding how the largest municipal fraud in U.S. history occurred. During the 22 years between 1990 and 2012, Treasurer Rita Crundwell of Dixon, Illinois, embezzled roughly $54 million and possibly as much as $75 million, through manipulation of a fraudulent bank account that went undetected by outside accountants and state auditors.

Pope noted that every organization has a Rita Crundwell, a trusted administrator for whom internal controls have been relaxed. She acknowledged the mistaken assumption that all employees are ethical and no internal fraud could possibly succeed. However, in most fraud or embezzlement schemes there are a number of red flags, which in this case included the lack of internal controls and inadequate segregation of duties, as well as a financial administrator living well beyond their means. Dixon's organizational structure of commissioners with limited oversight responsibilities contributed to the lack of internal controls. Accountants, auditors, bankers, and local residents failed to recognize the numerous red flags typical of fraud. All organizations can establish a sound system of internal controls, Pope argued, including proper segregation of duties and oversight and a culture that acknowledges when things are too good to be true.

Liquidity and funds management

Ryan Hayhurst, managing director, the Baker Group, discussed financial performance at community banks, with a particular focus on liquidity levels and risk. He noted that community banking is the lifeblood of the economy and discussed how achieving strong earnings performance and managing liquidity levels require a balanced approach. It is vital to find a balance between earnings and liquidity, he said, while controlling the level of credit and interest rate risk. Hayhurst emphasized that the highest performing banks in the U.S. also had relatively high levels of asset liquidity, proving banks do not have to sacrifice liquidity to achieve strong earnings performance. He also noted that the investment portfolio is a vital tool for earnings stability and risk management. During times of economic stress, he said, there is a direct correlation between securities allocation and profitability, since the portfolio acts as a countercyclical hedge against the natural cyclicality of banking. The key is to build a conservative, highly liquid, and diversified portfolio of stable cash flow, Hayhurst added. He also emphasized that a cushion of highly liquid assets is the first line of defense and is a critical component of a bank's ability to respond to stress. These assets should be readily marketable, he said, even during times of stress and free from legal, regulatory, or operational impediments.

Hayhurst noted that liquidity risk has been increasing, with loan-to-deposit ratios rising steadily since 2012 and approaching the pre-crisis peak. Meanwhile, he added, liquid assets have been falling steadily since 2012 and are approaching the pre-crisis trough. Deposit growth has slowed in recent years and competition from larger banks has increased dramatically as the new liquidity coverage ratio required for the larger banks favors retail deposits over more volatile liabilities or borrowings, Hayhurst said. Reliance on wholesale funding rose steadily from 2012 to 2017, he added, but appears to have peaked and has declined in the past two years.

Hayhurst also discussed regulatory expectations for liquidity risk management, noting the importance of effective corporate governance and appropriate strategies, policies, procedures, and limits. He said banks need to maintain the following: comprehensive liquidity risk measurement and monitoring systems; an appropriately diverse mix of existing and potential future funding sources; adequate levels of highly liquid marketable securities; comprehensive contingency funding plans that are consistent with actual practices; and adequate internal controls and audit processes. Hayhurst emphasized the importance of monitoring noncore funding concentrations and discussed the importance of liquidity stress-testing. He also emphasized the importance of running a stress scenario in which the bank would become less than well capitalized. It is key for banks to understand what happens to current deposits and contingent liquidity sources in a less than well-capitalized situation, he said.

Lastly, Hayhurst emphasized the importance of the contingency funding plan (CFP). Bank management needs to review the CFP and ask the following questions: Does it still make sense? Are all the assumptions and time frames reasonable? Are all the funding sources listed? Are more needed? Management needs to test the CFP and funding sources at least annually and ensure its actions are consistent with the CFP, he added.

A view from the OCC

Grovetta Gardineer, senior deputy comptroller, OCC, discussed the federal banking agencies' focus on removing unnecessary regulatory burdens and noted that the strength of the nation's financial system depends on the ability of financial institutions to operate efficiently and effectively. The agencies' approach continues to be streamlining and modernizing the regulatory and supervisory frameworks through revisiting regulations and guidance, while focusing on the supervisory and examination approach.

Gardineer mentioned the issuing of the final rule[1] on the community bank leverage ratio to reduce the regulatory reporting and compliance burden. In July 2019 the agencies also released a final rule[2] to simplify regulatory capital rules. The Economic Growth Act[3] is another area the agencies have been focused on, said Gardineer. The agencies issued a final rule[4] to make additional smaller institutions eligible for the extended 18-month onsite examination cycle. Additionally, the agencies expanded eligibility for the most streamlined Call Report[5] and established reduced reporting for the first and third reports for the year. Gardineer noted that tailoring regulatory requirements to reduce the regulatory burden is a way to help community banks operate more efficiently and effectively.

Gardineer commented on the OCC's focus on updating and modernizing the Community Reinvestment Act (CRA). The OCC and FDIC are currently working toward issuing a Notice of Proposed Rulemaking on the CRA. Fair lending remains an area of heightened oversight for the OCC, she said. Gardineer also discussed the communication of supervisory expectations for the Bank Secrecy Act/Anti-Money Laundering (BSA/AML) regime. The OCC is actively engaged in several related interagency projects, which include issuing interagency statements.[6] The agencies are also involved in efforts to update the *FFIEC Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) Examination Manual*. Gardineer noted that the emerging area of marijuana banking presents heightened BSA compliance risk due to the conflict between state and federal laws. The U. S. Department of Agriculture recently issued an interim final rule[7] for growing hemp, and the banking agencies, along with the Financial Crimes Enforcement Network (FinCEN), will soon be following up with guidance, she said.[8] Lastly, Gardineer highlighted the possible discontinuation of the London Interbank Offered Rate (LIBOR). The OCC is preparing examiners for conversations with banks about how they should prepare for this.

Perspectives from the Federal Reserve Board

Michael Gibson, director, Supervision and Regulation, Board of Governors, discussed the three key principles of the supervision program that have been instituted after a decade of post-crisis regulation—transparency, efficiency, and simplicity.

Transparency efforts include semiannual testimonies to Congress by Governor and Vice Chair for Supervision Randal Quarles, as well as public reports and events for associated stakeholders. The Federal Reserve Board's *Supervision and Regulation Report*[9] provides data and analysis on banking conditions and the Federal Reserve's supervisory and regulatory activities. Gibson also highlighted Governor Michelle Bowman's priorities for appropriately tailoring supervision and regulation to the size, complexity, risks, and capacity of a community bank. A recently formed work group, which includes experts from across the Federal Reserve System, has been tasked with launching a comprehensive review of the supervisory work within the small and regional community banks. Gibson invited attendees to visit the Community Banking Connections[10] website for guidance, resources, and tools.

The next Community Bankers Symposium will take place on October 23, 2020, at the Chicago Fed.

Gibson also discussed efficiency initiatives, which include simplifying regulatory and examination practices to minimize the burden on community banks without sacrificing a safe, sound, and efficient financial system. He discussed the Community Bank Leverage (CBLR) framework and the Bank Exams Tailored to Risk (BETR) program. The latter aims to identify low-risk activities within state member banks in order to streamline examination work. Additional initiatives have included lengthening the amount of time between examinations and expanding the number of community bank holding companies that qualify for an exemption from the Federal Reserve's capital rules. Gibson also detailed future initiatives related to how technology is used for collaboration.

Gibson concluded with a discussion of emerging risks for community banks, focusing on risks related to credit concentrations (commercial real estate, construction and development, and agricultural), liquidity, and information technology.

Regulatory panel: Cleaning your garage

The regulatory panel consisted of Ric Brunskill, vice president, Community Banking Organization Supervision, Federal Reserve Bank of Chicago; Nicole Orlando, assistant regional director, FDIC; and Blake Paulson, senior deputy comptroller, OCC. Moderator Kristin LaPorte, vice president, Risk Specialists, Resiliency and Policy, Federal Reserve Bank of Chicago, stressed that the theme of "cleaning your garage" was a recommendation for financial institutions to strategically reinforce their own risk management to better position their organizations to identify and navigate future challenges.

Paulson highlighted the importance of credit risk and credit risk management—especially in "peacetime," when deliberate and thoughtful efforts can be undertaken. Controls and monitoring of concentrations exposures would benefit from established limits, aggregation parameters, monitoring discipline, and "downside" stress-testing, he said. Paulson also urged banks to continue to maintain vigilance against any potential erosion of underwriting standards and aim to identify problem loans early.

Orlando identified some interesting indicators for elevated liquidity risk. A flattening yield curve is squeezing net interest margins, she said, and making it costlier to hold larger volumes of liquid assets. The number of outlier institutions based on liquidity metrics has declined, she added, but liquidity management continues to be challenging and competition for deposits remains intense. Also, she noted, liquidity component rating downgrades continue to outpace upgrades, primarily due to poor risk-management practices. Orlando urged banks to maintain reasonable limits, stress scenarios, and contingency funding plans, while consciously managing capital and liquid asset levels to accommodate future needs.

Agricultural banks, which represent about 20% of banks in the FDIC Chicago region, are facing particular challenges related to lower commodity prices and yields due to trade wars and weather-related disruptions, she said. Past-due ratios are relatively low, she added, but may be understated due to increased carryover debt. Orlando argued that banks need to be diligent in shoring up their credit administration and other credit risk management weaknesses.

Brunskill provided a sobering take on operational risk, especially cyber risk, which seems to be on the increase. Intrusion detection and prevention remain a paramount concern with continued vigilance required for banks to remain "hard" targets, diligently employing patches, maintaining controls, and transparently facilitating communication throughout the organization to ensure that internal cyber assessment is as up to date as possible.

Brunskill also discussed other operational risk areas requiring vigilance, such as fraud and BSA risk. Vulnerabilities to fraud events can be mitigated by early identification of adverse motives, rationale, and opportunity, he said. While the first two are difficult to control, the last can be controlled, he added. Open and honest feedback and awareness of red flags (i.e., unexpected growth, changes in balance-sheet and income statements) will help build a resilient culture. Similarly, he noted, timely and accurate filing of SARs and CTRs is a good practice.

Demographic changes and what they mean for community banks

Daniel Aaronson and Eugene Amromin, vice presidents, Federal Reserve Bank of Chicago, reviewed trends in the community banking industry. In 2018 there were 7,288 community banks in the United States (defined as banks with less than $10 billion in real assets), of which 1,324 would be considered very small (under $100 million in assets). Using a variety of data from Call Reports, Home Mortgage Disclosure Act reporting, deposit summaries from the FDIC, and the Board of Governors' *Survey of Consumer Finances*, Aaronson and Amromin showed a decreasing trend in community banks' share of branches, deposits, and lending over the past three decades. The largest presence of community banks is in the Midwest, Great Plains, and Texas, where they account for a relatively high share of core deposits.

The presenters used the *American Community Survey*, an annual mini-census of the U.S., to describe the composition of the counties that are reliant on community banking. Counties with heavier usage of community banks tend to be older, have a lower share of college graduates, and are less racially diverse. In addition, they were slower to recover from the financial crisis and are characterized by lower household income and higher poverty rates. House prices are substantially lower in these counties, the presenters noted, making housing more affordable and keeping homeownership rates high.

Lastly, Aaronson and Amromin used a nationally representative survey of households to explore the characteristics of community bank customers, who comprise roughly one-fifth to one-quarter of all U.S. households since 2007. The data also show community bank users tend to be older, less educated, and to have lower income than customers of national banks. These differences have been roughly consistent over the last decade. Community bank customers are just as likely to own a small business, the presenters added, but the average size of their businesses is significantly smaller. They have smaller car and housing loans and less savings and wealth. Despite fewer formal financial relationships, they are just as likely to be able to access funds in an emergency through family and friends.

Conclusion

In closing, Paulson emphasized the importance for bankers to foster their relationship with their regulators. He stressed that building a positive relationship outside of the regular exam process will be crucial during more difficult economic times. He also stated that bankers are welcome to visit the regulators' offices and invite the regulators to meet with the bank's management team and board. Finally, he said, this effort can provide a clear understanding of what each side's expectations are and this relationship-building can be beneficial in any economic environment.

Notes

[1] Available online, https://www.occ.gov/news-issuances/news-releases/2019/nr-ia-2019-125.html.

[2] Available online, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190709a.htm.

[3] Available online, https://www.congress.gov/bill/115th-congress/senate-bill/2155.

[4] Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1807.htm.

[5] Available online, https://www.chicagofed.org/banking/financial-institution-reports/call-report-regulatory-reporting-guide.

[6] See details online, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181003a1.pdf, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181203a1.pdf, and https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190722a1.pdf.

[7] Available online, https://www.ams.usda.gov/rules-regulations/hemp.

[8] Available online, https://www.fincen.gov/resources/statutes-regulations/guidance/bsa-expectations-regarding-marijuana-related-businesses.

[9] Available online, https://www.federalreserve.gov/publications/supervision-and-regulation-report.htm.

[10] Available online, https://www.communitybankingconnections.org/.

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