ESSAYS ON ISSUES
THE FEDERAL RESERVE BANK OF CHICAGO
JANUARY 2011
NUMBER 282a

Chicago Fed Letter

In the wake of financial reform: What's next for community banks?

by Mark H. Kawa, vice president, Supervision and Regulation, and Steven VanBever, lead supervision analyst, Supervision and Regulation

The sixth annual Community Bankers Symposium, co-sponsored by the Federal Reserve Bank of Chicago and the Federal Deposit Insurance Corporation (FDIC), was held at the Chicago Fed on November 19, 2010. This article summarizes the key presentations and discussions at the conference.

More information about the 2010 conference—Lessons to Lead Us Forward—is available at www.chicagofed.org/webpages/events/2010/community_bankers_symposium.cfm.

Over 220 participants, mostly representatives from community banks[1] in the Seventh Federal Reserve District,[2] gathered to consider lessons learned from the financial crisis and assess tools for navigating the risks and challenges on the road to economic recovery. A key focus was the impact on community banks of new requirements contained in the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank Act).

Mark H. Kawa, vice president, Federal Reserve Bank of Chicago, opened the symposium by highlighting a new outreach effort by the Federal Reserve System. The newly announced Community Depository Institutions Advisory Council, comprising representatives from community banks with different charters and regulators, thrift institutions, and credit unions, will provide input to the Federal Reserve Board on the economy, lending conditions, and other issues.

A challenging environment

Carl R. Tannenbaum, senior vice president, Federal Reserve Bank of Chicago, outlined the challenges facing community banks. The U.S. economy is in recovery, but the pace so far has been moderate. Housing markets are particularly challenged. Declines in home equity have diminished the ability of consumers to refinance or to purchase new homes. In addition, a "shadow" inventory of homes (i.e., homes in the process of foreclosure) compounds the problem of a large inventory of homes still on the market.

Mortgage modification programs have met with only modest success to date. Finally, considerable uncertainty surrounds the future roles and structure of government-sponsored entities Fannie Mae and Freddie Mac,[3] which guarantee or own about half of the nation's mortgages.

Tannenbaum said that, while overall credit conditions have improved, securitization markets have not. Impediments to the recovery of securitization include reduced demand for loans (the raw material of securitization), difficulties valuing the underlying collateral, new legal requirements on retention of credit risk by originators, reluctance on the part of credit rating agencies to rate some asset-backed securities, and the reduced risk appetite of investors.

Banks are healthier than they were at the time of the previous symposium, but challenges remain for them as well, Tannenbaum explained. Delinquencies for a number of loan categories have leveled off or declined, and the banking industry as a whole has returned to modest profitability. However, commercial real estate (CRE) lending[4] is still a major concern at many smaller banks.

Continuing high unemployment reduces the demand for office space. Many construction and land development projects will need to be deferred. A significant number of CRE loans come up for renewal in the next two years and will likely face tighter underwriting standards. Finally, rapidly changing market conditions make it difficult to accurately appraise commercial properties.

Tannenbaum also highlighted changing regulatory expectations concerning bank capital. Regulators are emphasizing the need for both higher levels and better quality of capital. The so-called Basel III capital rules currently under development for the largest banks will likely trickle down to community banks as well. More forward-looking approaches to capital planning will be necessary in the future at banks of all sizes.

Although banking conditions are beginning to improve, community banks still face a challenging environment.

Risk-management suggestions

Cathy Lemieux, executive vice president, Federal Reserve Bank of Chicago, offered a number of recommendations for community bankers to consider given the current environment. To address concentrations and weaknesses in CRE lending, bankers should ask probing questions about their credit administration and management information systems (MIS) in the lending area. For example, are MIS flexible enough to identify credit problems early and allow management to effectively monitor them on an ongoing basis? Is the bank's CRE loan workout function up to the task, or does it need additional specialized expertise? Lemieux also noted the importance of frequently reassessing CRE collateral values and of complying with the CRE loan workout guidance issued in 2009 by the banking agencies.[5]

Lemieux emphasized the need for community banks to engage in sound capital planning. This planning should be based on realistic earnings projections and a conservative assessment of the bank's ability to raise additional private capital. During the financial crisis, the banks that continued to perform well were those that identified, quantified, and took actions to reduce the impact of any loan concentrations.[6] Stress testing can be a valuable tool in this regard. The value of stress testing was affirmed by the Supervisory Capital Assessment Program (SCAP) conducted at the 19 largest bank holding companies in the spring of 2009. Furthermore, the Dodd–Frank Act includes stress testing requirements for banking organizations with $10 billion or more in assets, and the Conference of State Bank Supervisors has issued a white paper urging community banks to utilize stress testing to evaluate the potential impact of key risk factors.[7]

Finally, Lemieux placed special emphasis on sound corporate governance and strong, independent risk-management functions. The Basel Committee on Banking Supervision has issued revised principles for enhancing sound corporate governance practices at banking organizations, reflecting the most recent lessons learned.[8] Regulators have learned that risk-management functions at banks must identify risks from all sources and assess their potential impact on a firmwide basis. Risk management must also have the resources and stature within the organization to influence both day-to-day and longer-term strategic decisions. The Dodd–Frank Act addresses these needs by requiring publicly traded bank holding companies with total consolidated assets of $10 billion or more to have risk committees.

New consumer protections

Leonard Chanin, deputy director, Federal Reserve Board, outlined some of the key consumer protection provisions of the Dodd–Frank Act, aside from the formation of a new Consumer Financial Protection Bureau (CFPB). The new law requires the Federal Reserve Board to write approximately 50 new rules, including new mortgage rules, on its own or with other agencies. For example, lenders are now required to verify that borrowers have the financial ability to repay a loan, including the ability to handle payment increases. Lenders are also banned from steering consumers into high-cost, unaffordable loans. The law also eliminates yield spread premiums—i.e., compensation paid to a loan originator if a borrower accepts an interest rate higher than the rate required by the lender. Additional data will also be collected from lenders on mortgages under the Home Mortgage Disclosure Act and on small-business loans. Finally, a controversial section of the Dodd–Frank Act requires the Federal Reserve to regulate interchange fees.[9]

Independent of the Dodd–Frank Act, the Federal Reserve has issued a number of significant consumer protection rules over the past several years. For example, in November 2009 the Fed issued rules prohibiting financial institutions from charging consumers fees for paying overdrafts on ATMs (automated teller machines) and one-time debit card transactions, unless the consumer consents (or opts in) to the overdraft service. In June 2010 it completed the issuance of extensive rules implementing the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009. In August 2010 it issued a number of rules restructuring the ground rules for U.S. mortgage issuers, and in October 2010 it announced a rule to protect real estate appraisers from the influence of those with an interest in a particular transaction.

States' views

Neil Milner, president and CEO, Conference of State Bank Supervisors, moderated a panel that provided the states' perspectives on community banking and bank supervision. The panelists, from four Seventh District states, were Jorge A. Solis, director, Illinois Department of Financial and Professional Regulation; Ken Ross, commissioner, Michigan Office of Financial and Insurance Regulation; Thomas B. Gronstal, superintendent of banking, Iowa Department of Commerce; and Randall L. Rowe, bank supervisor, Indiana Department of Financial Institutions.

Overall, banking conditions in the four states have improved but are still far from satisfactory. However, the economic and banking picture varies significantly from state to state. For example, Iowa experienced slower growth in the run-up to the financial and economic crisis, as well as a less severe downturn. At 6.8%, Iowa's unemployment rate is relatively low. Michigan, in contrast, has an unemployment rate of 12.8% and has been undergoing a historic, long-term realignment of its automotive-dependent economy. Illinois has experienced by far the largest number of bank failures in the District—38 between October 2008 and November 2010.[10] For all the states, the recovery process for both the banks and the underlying economies is expected to be protracted.

In response to questions from the audience, the panelists maintained that recent downgrades in banks' supervisory ratings reflected deteriorating banking conditions and not a new, harsher attitude on the part of regulators. Regulators have been criticized both for being too lenient (by their internal inspector-general functions) and for being too severe (by the industry and by Congress). However, the panelists argued that examiners' assessments are still driven by objective data and also contended that multiple layers of review help promote consistency.

Regarding the effects of the Dodd–Frank Act on competition to community banks from nonbanks, panelists noted that this act levels the playing field by subjecting nonbanks to bank-like consumer supervision. However, much depends on how well the CFPB executes its responsibilities and is able to collaborate with its state counterparts.

Industry perspectives

The Independent Community Bankers of America (ICBA) is a trade association representing community banks. Karen M. Thomas, its senior executive vice president, outlined the ICBA's strategy regarding the Dodd–Frank Act and assessment of the positives and negatives in the new law.

Thomas called the Dodd–Frank Act "massive, landscape-changing, generational legislation." She emphasized that for the industry, implementation would be "a marathon, not a sprint," because many key elements still need to be determined through the rule-making process and the industry will need to continue to exert its influence. ICBA recognized that financial reform legislation was inevitable, Thomas said, and sought to obtain a "seat at the table." It then attempted to keep the focus on the role that the largest banks and nonbank companies had played in causing the financial crisis while differentiating and protecting the interests of community banks.

Community banks see both victories and disappointments in the new financial reform law.

According to Thomas, community banks achieved a number of victories in the new law. For example, FDIC deposit-insurance assessments will now be calculated on a different basis, which will significantly reduce assessments for community banks. The coverage limit for deposit insurance was permanently increased to $250,000, and unlimited coverage for non-interest-bearing transaction accounts under the FDIC's Transaction Account Guarantee was extended for two years. In addition, policies intended to reduce systemic risk and address the too-big-to-fail problem[11] should reduce risks to the financial system and provide for a more competitive marketplace for community banks.

Banks with less than $10 billion in assets are also generally exempt from examinations and enforcement actions by the CFPB. Community banks will continue to be examined by their existing bank regulators, who, Thomas argued, have a better understanding of the interplay between safety-and-soundness and consumer protection than the CFPB may have. Finally, banking organizations with less than $15 billion in assets obtained some relief from the Dodd–Frank Act's restrictions on trust preferred securities.[12]

Thomas also detailed some of the disappointing provisions of the Dodd–Frank Act. Although banks with less than $10 billion in assets will be exempt from the new interchange rules, she expected that the rules would still significantly reduce debit interchange income at community banks. Many community bank representatives also object to the creation of a stand-alone CFPB, the exemption of auto dealers from regulation by the CFPB, the requirement that shareholders of publicly traded community banks must be given a nonbinding vote on executive compensation, and new reporting requirements for loans to small businesses and minority-owned businesses.

Thomas noted that whether the too-big-to-fail problem is actually eliminated and how community banks are actually affected by the CFPB, among other aspects of the implementation of the Dodd–Frank Act, will not be clear for some time. She concluded by listing a wide range of other challenges community banks now face. These include strategic issues, CRE lending, the economic and interest rate environment, and the need to strengthen capital levels and risk management in the context of the current supervisory environment. In

ISSN 0895-0164

spite of these challenges, she praised community banks for their extraordinary resilience and predicted that well-managed banks would always find ways to overcome such challenges.

Conclusion

Lemieux also emphasized the continuing viability of the community bank model. Community banks are grounded in their local communities and thus are able to provide services that are personalized and tailored to meet local preferences and needs. By transforming local deposits into lending in the areas where depositors live and work, community banks contribute to local economic growth and vitality.

Community banks embody the notion of relationship banking. They are less dependent than larger banks on financial models and thus are able to take account of a wider range of factors when making loan decisions. In addition, they often can respond to lending requests faster than larger banks because they have a more direct window into customers' financing needs and capacities.

Closing the symposium, M. Anthony Lowe, regional director, FDIC, noted the contentious process that had led to the passage of the Dodd–Frank Act but also emphasized the clear benefits the law provided for community banks. These include the deposit insurance changes noted earlier, as well as attempts to end the too-big-to-fail problem and strengthen regulation of nonbank competitors. The combined effect of these changes should be to level the playing field for community banks.

Lowe predicted that CRE loan concentrations would take additional time to resolve. On the positive side, he noted that the pace of bank failures was slowing and that the number of failures for 2010 as a whole would be much lower than some had predicted. Some banks are seeing their earnings recover and new capital become available. Finally, Lowe stressed that regulators are committed to working with community banks to help them thrive and continue to support their local economies.

---

[1] Community banks are typically smaller 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 more details, see www.fanniemae.com and www.freddiemac.com.

[4] CRE lending refers to loans secured by commercial real estate (e.g., office buildings and shopping centers), whose repayment typically comes from rental income or sale/refinancing of the property.

[5] See www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm. This policy was issued by the Federal Reserve, the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Financial Institutions Examination Council State Liaison Committee.

[6] A loan concentration exists when a significant portion of a bank's loans have similar risk characteristics. For example, a concentration may exist for loans of a particular type (mortgages), to a particular industry, or from a particular geographical area.

[7] See www.csbs.org/news/press-releases/pr2010/Pages/pr102010a.aspx.

[8] See www.bis.org/publ/bcbs176.htm.

[9] An interchange fee is a fee that a merchant's bank pays a customer's bank when a merchant accepts cards using card networks, such as Visa and MasterCard, for a purchase.

[10] In contrast, there were nine failures in Michigan, three in Wisconsin, and only one each in Indiana and Iowa during the same time period.

[11] Regulatory authorities have strong incentives to prevent the failure of a large, highly interconnected financial firm because of the risks such a failure would pose to the financial system and the broader economy. However, the belief of market participants that a particular firm is considered too big to fail has a number of undesirable effects, including reducing market discipline, encouraging excessive risk-taking, and increasing costs to taxpayers.

[12] Trust preferred securities are cumulative preferred securities, issued through a special-purpose vehicle, that combine the benefits of debt and equity. These have become an important source of capital for community banking organizations.