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The winds of change for community banking: Headwinds, tailwinds, and regulation

by Romel Bonilla, examiner, Jenna Cooper, examiner, Adam Emmerich, senior examiner, Theresa Hembd, examiner, Pamela Kennedy, senior supervision analyst, Blake Marquart, assistant examiner, and Joseph Nashar, supervision manager, all of Supervision and Regulation

The 12th 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 Chicago Fed on November 17, 2017. During a full day of speeches and panels, a group of 125 community banking executives, financial industry practitioners, and supervisory agency professionals who work in the Seventh Federal Reserve District[1] explored the changing landscape for community banking. This article summarizes the event's key presentations and discussions.

The conference's speakers focused on the current state of the economy, updates on key accounting and regulatory changes, common examination findings, and views on regulatory requirements and supervisory initiatives. Additionally, panels of agency ombudsmen[2] and consumer regulatory compliance professionals discussed current material risks to financial institutions, as well as related evolving supervisory expectations for mitigating those threats.

Patrick Wilder, vice president, Federal Reserve Bank of Chicago, welcomed attendees by addressing the symposium's theme, which focused on the shifting headwinds, tailwinds, and regulatory requirements for community banks.[3] He noted that adverse headwinds facing small-scale banking organizations include the perceived heavy cost of complying with rules and regulations, difficulty attracting the next generation of employees, and stiff competition from other banks and nonbank financial firms. According to Wilder, favorable tailwinds for community banking organizations include healthy earnings that are comparable with pre-recessionary levels, several years of strong loan demand, high capital levels, and considerable enhancements in risk-management practices that will be helpful to these firms in meeting the challenges ahead. In addition, Wilder noted that federal banking agencies are working on ways to reduce the regulatory burden for community banks.

The conference agenda and some materials presented at the event are available online, https://www.chicagofed.org/events/2017/annual-community-bankers-symposium.

A Chicago Fed perspective on the economy and monetary policy

Charles Evans, president and CEO, Federal Reserve Bank of Chicago, began his remarks by stressing the prominent role that community banks play within their local economies, as well as ways they

help shape the Fed's ongoing assessment of local and regional markets. He noted that the long-term success of community banking organizations is typically closely tied to the strength of their local relationships. Evans continued with an assessment of the U.S. economy, which included an expectation for positive momentum to continue into 2018. In describing the economic environment, he highlighted solid gains in consumer spending, a healthy labor market, improved balance sheets among both consumers and businesses, and growth in business capital spending.

Evans also noted some concerns about the economy, including an inflation rate that has remained below the Federal Open Market Committee's (FOMC) 2% longer-run target[4] throughout most of the post-crisis recovery. Evans said this underperformance could be attributable to the public's view that 2% is effectively an inflation ceiling; he stressed that the 2% inflation target is symmetric, meaning that inflation could be allowed to rise above this threshold for a period of time in order to meet the long-term aim. In closing, Evans called for a broad commitment by policymakers to inflation target symmetry, which supports current Fed policy and shores up Fed credibility.[5]

A view from the Federal Reserve Board on supervisory matters

Cathy Lemieux, executive vice president, Federal Reserve Bank of Chicago, held a discussion with Maryann Hunter, deputy director, Board of Governors of the Federal Reserve System, about the Board's views on some important supervisory matters. The conversation started with the Fed's ongoing efforts to reduce regulatory burden for community banks, which Wilder touched on earlier. Hunter noted that federal banking agencies have already taken steps to reduce this burden through their authority under current banking laws and have plans to do more. She described a recent public proposal to simplify capital standards,[6] as well as a newly proposed rule to raise the appraisal threshold for commercial real estate (CRE) loans.[7] Hunter encouraged industry practitioners to provide input on key matters through the public comment process; she noted that Federal Reserve policymakers review all comments submitted for each proposal. She described other notable efforts by the Federal Reserve and other banking agencies to reduce regulatory burden, such as

- revisiting existing policy statements to ensure they remain relevant;[8]
- increasing to $1 billion, from $500 million, the threshold at which noncomplex small bank holding companies are exempt from consolidated capital requirements;[9] and
- reminding financial institutions about two existing options—temporary practice permits and temporary waivers—for addressing CRE appraiser shortages (a trend that has been pronounced in rural markets).[10]

To provide more-immediate relief to community banks, Hunter noted, the Fed has also focused on implementing new supervisory procedures, rather than changing the regulatory framework of laws, rules, and interagency statements, which require lengthy and challenging coordination among an array of policymaking bodies.[11] She identified two key supervisory initiatives relevant to community banks. The first is the Fed's use of existing technology to securely conduct aspects of examination work off-site, including commercial file review, which should result in less burden to institutions relative to on-site visits.[12] This arrangement is available at the discretion of banking organizations, provided they can demonstrate the necessary technological capabilities to be examined this way. The second initiative Hunter discussed is the Fed's development of risk models from existing regulatory reporting data to assist in assessing risk levels at individual community banks, as well as tracking industry trends. These models help examiners discern relatively high-risk exposures from low-risk ones, resulting in a more effective risk-focused scope of examination. Once an exam's scope is properly determined, the depth of review and analysis can then be tailored accordingly.

Hunter finished her remarks by discussing some risks community bankers should be aware of in maintaining the safety and soundness of their institutions. She cautioned participants about the

ever-present threat from cyberattacks, the rising prevalence of lending concentrations, and growing liquidity challenges. Cybersecurity is one of the top concerns for community banks because of their increasing reliance on complex computer networks and the frequency of security breaches. Hunter encouraged technology managers to implement, at minimum, three simple technology solutions to mitigate most security threats: promptly applying software patches, training employees to be more cognizant of phishing attempts, and restricting user access based on job function. Next, Hunter remarked that market monitoring by itself is not an adequate method for effectively reducing lending concentrations, which became evident during the 2007–08 financial crisis. Highly concentrated banks need reasonable risk tolerances; eventually, firm management may need to make hard choices between raising capital levels and restricting lending activities in concentrated areas. Finally, Hunter described recent instances of liquidity challenges for banks that have an excessive dependence on nontraditional funding sources.[13] She noted that when a bank fails to meet minimum regulatory capital standards as a result of credit quality concerns, this could trigger deposit rate restrictions and requirements for FDIC waivers before the acceptance, renewal, or rollover of restricted deposits.[14] Hunter recommended risk managers at organizations with nontraditional funding structures stay abreast of these restrictions and include these liquidity events in their funds-management stress testing scenarios to adequately plan ahead.

Preparing for new accounting standards

A significant and imminent accounting change for the banking industry is the adoption of the current expected credit losses methodology (CECL) for estimating allowances for credit losses.[15] Lara Lylozian, assistant chief accountant, Board of Governors of the Federal Reserve System, discussed some basic elements of the new standards as well as the Fed's implementation plan. In an attempt to be more transparent and to ensure consistent application of standards, the federal banking agencies have committed to a unified implementation approach, which they intend to reinforce through more frequent interagency outreach events. The interagency frequently asked questions (FAQs)[16] will continue to serve as the primary communication tool between the banking agencies and supervised financial institutions.

Since most community banks will not be required to adopt CECL standards until January 1, 2021, the lengthy implementation period poses, for some institutions, the potential risk of inaction. Lylozian urged bankers to be proactive in formulating transition plans. The first step she recommended is to think through the basic framework and continue collecting credit loss data under today's "incurred loss" model, as the data will likely be applicable under CECL. For some organizations, segmentation of loan portfolios could be as simple as aggregating and disaggregating regulatory reporting categories, to group loans by similar risk characteristics, as applicable, while many of the existing environmental factors (such as changes in industry and economic trends) will remain relevant in the calculation for credit loss allowances. Lylozian emphasized that CECL rules are scalable and, therefore, do not require traditional banks to use either complex models or third-party service providers to meet the new standards. Lylozian noted that bankers should expect examiners in 2018 to begin to assess institutions' level of readiness, although formal adverse findings are not likely until after CECL's effective date; until then, she said, examiners will be looking for a good faith effort from institutions. Lastly, Lylozian reminded attendees that reserve levels under CECL might not necessarily increase from existing levels; however, all financial managers will need to adequately support and document their conclusions.

Role of the ombudsman

Ombudsmen play a critical function within the supervisory process by providing regulated firms and consumers with an independent resource for raising concerns and lodging complaints, sharing confidential feedback, initiating internal investigations, mediating disagreements between parties, reporting or elevating systematic issues that require a formal response, and establishing procedures

for appealing material supervisory determinations. To bring awareness to the important function of ombudsmen, the conference included a panel consisting of Michele Fennell, acting ombudsman, Federal Reserve System; Larry Hattix, ombudsman, OCC; Wendy Kamenshine, ombudsman, Consumer Financial Protection Bureau (CFPB), and M. Anthony Lowe, ombudsman, FDIC. The panel was moderated by Chris Newbury, deputy regional director, FDIC. The panelists described the responsibilities of their respective agencies' ombudsman offices. At all of the agencies, ombudsmen ensure anonymity for participants throughout an inquiry or investigation, remain neutral parties advocating for a fair process, and help safeguard against examiner retaliation.

In cases when disagreements arise during the supervisory process, bankers were encouraged to engage examiners early, rather than wait until disputed issues become finalized. Prominent areas of disagreement historically include supervisory assessments, bank application decisions, potential violations of law, loan classification treatment, and consumer compliance matters. Panelists recommended that bankers start by escalating concerns within the agency's regional chain of command and, if unsatisfied or uncomfortable, proceed to the ombudsman's office to get staff there involved—an option to firms at any point in the process. Informal resolution with examination teams is the ideal solution, as it tends to lead to quicker and more amicable outcomes than formal appeals. Finally, panelists noted agency ombudsman offices are vigilant against potential retaliation by routinely following up with institutions that have filed appeals.

A banking and economic outlook from the FDIC

Richard Brown, chief economist, FDIC, opened his remarks with commentary about the economic impact of the 2007–08 financial crisis and then provided an outlook on the U.S. economy and banking sector. Brown highlighted how the current economic expansion has produced slow annualized growth, relative to historical experience, due to low capital expenditures and sluggish productivity. Next, Brown discussed his concerns about ongoing consolidation in the banking industry. There are a number of forces driving consolidation, such as bank failures, changing regulatory requirements, increased competition, and a slowdown in de novo bank formations. He noted that over the past 32 years, approximately 2,700 banks have failed in the wake of two major financial crises, spurring consolidation. Voluntary consolidation has also contributed significantly to the overall pattern—with annual voluntary bank attrition rates peaking above 5% in the 1990s, following major deregulation changes, and these attrition rates later returning to above 4% in the low bank earnings environment of the past few years. Regulatory pressures have also incentivized large community banks approaching the $10 billion size threshold for enhanced prudential supervision to make sizable acquisitions in order to significantly exceed the regulatory benchmark. By doing this, banks can better justify the more stringent supervision and associated costs they must face. Not surprisingly, only a minority of institutions crossed this threshold organically (four of 39, as of January 2018). Additionally, Brown noted an unprecedented drought in new bank charter activity. He cited a 2014 Federal Reserve Board study[17] showing that 75% to 80% of the decline in new charters can be attributed to economic factors, especially low interest rates. The study noted how federal funds rate[18] data are, historically, positively correlated with new charter creation. Consistent with that study, the recent rising interest rate environment has coincided with new interest in de novo opportunities.

Throughout his speech, Brown noted some recent normalization in the banking environment. The FDIC's problem-bank list has fallen to approximately 100 institutions, after peaking at almost 900 in the recent financial crisis. Ultimately, about 1,800 individual banks have been included on the FDIC watch report since 2005. Brown was encouraged that the majority of banks that reached problem status did not fail and recovered independently. Brown next turned to financial trends in the banking sector. The banking industry has reported record annual earnings in three of the past four years; however, the pretax profitability ratio continues to lag the pre-crisis levels by about 40 basis points, largely because of the low interest rate environment. Brown suggested that a consistent increase in interest rates, combined with faster economic growth, would aid in restoring profitability

to pre-recessionary levels. Furthermore, the rising price-to-book premiums paid by buyers in recent bank mergers and acquisitions signal optimism about future profitability and new bank formation. In recent years, credit quality conditions have improved to historically strong levels even as lending has trended positively, particularly for community banks. Brown concluded by cautioning that lengthened investment portfolio durations and increased concentrations in CRE lending could lead to elevated liquidity and credit risks.

Consumer regulatory compliance

Evolving standards for banks' compliance with consumer protection rules continue to demand the attention of community bank risk managers. To highlight some of these changes, a regulatory panel of consumer compliance professionals from the federal banking agencies discussed current hot topics, including the new consumer compliance rating system; recently implemented and planned regulatory changes; fair lending concerns;[19] and risks associated with unfair, deceptive, or abusive acts or practices (UDAAP).[20] Joseph Davidson, vice president, Federal Reserve Bank of Chicago, moderated the panel, which featured Janis Frenchak, assistant vice president, Federal Reserve Bank of Chicago; Hilario Gonzalez, assistant regional director, CFPB; Teresa Sabanty, deputy regional director, FDIC; and Sheila Steck, compliance officer, OCC.

Sabanty introduced the Uniform Interagency Consumer Compliance Rating System[21] by stating that it was designed to align with the existing risk-focused, tailored-examination approach—rather than to establish a new set of standards. Panelists agreed that the updated rating system has not resulted in a noticeable adverse shift in consumer compliance ratings and the feedback from bankers has largely been positive, particularly regarding the framework's transparency. A notable change from the prior ratings approach is the formal consideration of consumer complaints. Panelists stressed that banks need oversight and reporting systems in place to ensure consumer complaints are properly addressed and patterns of complaints are investigated. When assessing an institution's approach under the new rating system, Frenchak noted, examiners consider the organizational structure and how compliance functions are involved in significant business decisions. Steck added that compliance personnel should typically be included in the vetting of any third-party compliance providers. Integrating regulatory compliance into an organization's culture can help reduce or eliminate regulatory concerns, legal liabilities, and reputational risk.

The 13th annual Community Bankers Symposium will be held at the Chicago Fed on November 16, 2018.

The panelists referenced the use of new reporting requirements under the Home Mortgage Disclosure Act (HMDA),[22] with Sabanty commenting that the data will continue to be used primarily for analysis in Community Reinvestment Act (CRA)[23] and fair lending reviews. The new data fields should provide greater clarity in assessing institutions' lending patterns. Steck urged bankers to be proactive in developing processes to meet the new reporting requirements consistently and accurately, and Sabanty recommended bankers conduct internal analysis of HMDA data to proactively identify trends and potential lending risks. Panelists noted several specific risks related to fair lending requirements, including obtaining spousal signatures without evidence of joint intent, overlooking population shifts within existing markets, and neglecting diversity in advertising messages.

The panel closed with some observations about UDAAP risks. All panelists stressed the importance of ensuring that disclosures for products and services are consistent with what customers actually receive. The group discussed various scenarios that could expose an institution to regulatory scrutiny; one type involved bank-assessed fees that trigger additional fees (i.e., "fee on fee" scenarios). The panelists also discussed other practices that could increase UDAAP-related risk, including conversions of and updates to the core banking software system and mergers and acquisition activity, all of which often involve the integration or consolidation of products and services.

Conclusion

Blake Paulson, deputy comptroller, OCC, concluded the conference with some takeaways from the OCC's most recent *Semiannual Risk Perspective*,[24] a report identifying specific areas of concern, including strategic, credit, operational, and compliance risks. In attempting to address these risk exposures, agencies are paying closer attention to succession planning, the growing appetite for multifamily and retail commercial real estate lending, agricultural lending concentrations, and cybersecurity. Paulson expressed optimism about the future of community banking, highlighting the ongoing regulatory relief efforts and ways agencies are sharpening the regulatory framework to better benefit consumers, banks, and the broader economy. Paulson indicated that examiners and regulators are available as informational resources, and encouraged bankers to reach out at any point for guidance. Regulators and banks should remain adaptable to changes in the economy, he said, while continuing to operate in a sound manner.

This article provides an overview of the 2017 conference, and is not intended to be an exhaustive account of the event's speeches and panel discussions. We encourage interested readers to consider attending the next symposium, which will be held at the Chicago Fed on November 16, 2018. More details will be posted on the Chicago Fed's website[25] 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] Ombudsmen are officials appointed by the banking agencies to independently investigate complaints of maladministration, especially that of regulatory and supervisory authorities. Further details on the Federal Reserve's ombudsman is available online, https://www.federalreserve.gov/aboutthefed/ombudsman.htm.

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

[4] In January 2012, the FOMC set 2% inflation—measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE)—as the explicit inflation target consistent with the Fed's price stability mandate; see the press release, https://www.federalreserve.gov/newsevents/pressreleases/monetary20120125c.htm.

[5] For more on Evans's concerns about persistent low inflation and the public's perception of 2% inflation as a ceiling instead of a symmetric target, see his November 15, 2017, speech, https://www.chicagofed.org/publications/speeches/2017/11-15-2017-low-inflation-and-symmetry-of-two-percent-target-charles-evans-london-ubs.

[6] Available online, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170927a.htm.

[7] Available online, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170719a.htm.

[8] Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1609.pdf.

[9] Available online, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20150409a.htm.

[10] Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1704.htm.

[11] More details on the difference between regulation and supervision according to the Fed are available online, https://www.federalreserve.gov/aboutthefed/files/pf_5.pdf.

[12] Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1608.htm.

[13] Available online, https://www.federalreserve.gov/boarddocs/press/general/2001/20010511/attachment.pdf.

[14] See the FDIC rules and regulations, section 337.6, https://www.fdic.gov/regulations/laws/rules/2000-5900.html#fdic2000part337.6.

[15] Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1612.htm.

[16] Available online, https://www.federalreserve.gov/supervisionreg/srletters/sr1708.htm.

[17] Available online, https://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.

[18]More on the federal funds rate is available online, https://www.chicagofed.org/research/dual-mandate/the-federal-funds-rate.

[19]More on the federal fair lending laws is available online, https://www.occ.treas.gov/topics/consumer-protection/fair-lending/index-fair-lending.html.

[20]Available online, https://www.cfpaguide.com/portalresource/Manual%20-%20UDAAP.pdf.

[21]Available online, https://www.federalreserve.gov/supervisionreg/caletters/caltr1608.htm.

[22]Available online, https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/regulation-c-home-mortgage-disclosure-act/.

[23]CRA details are available online, https://www.ffiec.gov/cra/.

[24]Available online, https://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2017.pdf.

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

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â€œHeadwindsâ€ and â€œtailwindsâ€ are both ways of describing extrinsic or macro phenomena that affect a business in its operation or performance. * Headwinds make things worse for a business. For example, if a global economic depression reduces consume...Â Headwinds make things worse for a business. For example, if a global economic depression reduces consumer spending, that might constitute a headwind for a movie theater chain or a clothing retailer. Nothing the companies have done is responsible for the likely decline in their sales or traffic, and little the can do will reverse it without painful costs (e.g. to their margins if they reduce prices). Tailwinds make things better! Winds here bring change, and opportunity. Historically, they blew ships to its port. These resupplied while waiting for the Monsoon to pass, for the seasons to change.Â Regulation may not be able to fully redress these downsides. A digital currency could offer advantages, as a backup means of payment. And it could boost competition by offering a low-cost and efficient alternativeâ€”as did its grandfather, the old reliable paper note.Â Lest we remain the last leaf on a dead branch, the others having decided to fly with the wind. In the world of Fintech, we need to harness change so it is fair, safe, efficient, and dynamic. That was the goal of the Bali Fintech Agenda launched by the IMF and World Bank last October. When the winds of change pick up, what will guide us in our journey? If the wind is at your back (tailwind), that will help you move forward more quickly. If you are moving into a headwind, that will only make progress more difficult. ï»¿ Share. Improve this answer. Follow. edited Jun 18 '12 at 18:35. answered Jun 14 '12 at 13:56. Robert CartainoRobert Cartaino.Â So headwinds are negative. Tailwinds are the opposite and help to increase growth of an economy. ï»¿ Share. Improve this answer. Follow. answered Jun 12 '12 at 18:45. Dave HaighDave Haigh. 14122 bronze badges.