Banking
IN THE NINTH
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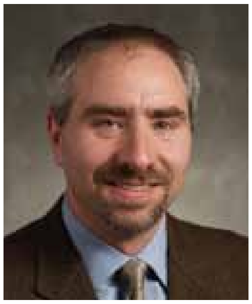
NINTH DISTRICT HIGHLIGHTS

The Value of Analytical Research on Community Banking


Ron Feldman

In this quarter's edition of *Banking in the Ninth,* I explain why conducting, and encouraging others to conduct, analytical research on community banking is a high value proposition for the Federal Reserve and others. There are two reasons. First, community banks are important to the economy. Second, government regulation and supervision have an effect on these firms. Both justify understanding community bank activity and the interaction between this activity and the rest of the economy. These reasons motivate analysis we have conducted at the Federal Reserve Bank of Minneapolis on community banking topics, which I describe below.

Why Analytical Research on Community Banking Is High Value

There is no end to the number of interesting topics to research, particularly for an employee of the Federal Reserve, where our direct responsibilities concern, for example, the financial sector, payments and the performance of the economy. Our analytical resources to conduct research are finite, however. The question could arise then, why should community banking make it to the list of high priority topics deserving analytical research?

The first reason concerns the economic role of community banks. These financial institutions typically focus on providing credit to borrowers who, because of their size, activity or location, are relatively costly for an outside firm to evaluate. Community banks have the skills and knowledge to conduct such evaluations and provide credit when other financial institutions might not at "reasonable" terms, conditions and prices. The individuals and businesses receiving such credit produce valuable output with employment—a key focus of the Federal Reserve—typically being a critical input to such production. Less credit to such entities often means less output.

The second reason arises from the supervisory and regulatory authority of the Federal Reserve along with other federal and state agencies. These agencies of the government have a profound effect on the activity of community banks via their oversight capacity. These activities create public and private benefit for society, but also public and private costs. The key to good policy is ensuring that the benefits exceed the costs. Making a determination that government action generates net benefits requires an analytical understanding of the role and activity of community banks. Analytical research is critical for establishing the baseline against which a review of government regulation and supervision of community banks should occur.

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SAFETY & SOUNDNESS UPDATE

Underwriting Standards—Lessons From the Past

Lending involves risk; sound underwriting insulates financial institutions from excessive risks that lead to increased credit losses. History shows that lending and correspondingly, underwriting standards are generally pro-cyclical. As competitive pressures increase for loan growth, banks may be enticed to ease underwriting standards to expand the loan portfolio in order to generate earnings. As conditions begin to deteriorate, this easing of underwriting standards, if carried too far, causes banks to face increased risk that is followed by rising losses and, an eventual tightening of underwriting standards.

The Federal Reserve Board's April 2014 "Senior Loan Officer Opinion Survey on Bank Lending Practices" (http://www.federalreserve.gov/boarddocs/snloansurvey/201405/default.htm) provides support that institutions, particularly large banks, are again easing credit standards in response to competitive pressure. Survey data indicates that easing was predominant in the administration of pricing, loan covenants, and credit line size. Anecdotal comments from community bank supervisors in the Ninth District also suggest banks feel competitive pressure to ease their underwriting. We hear from banks that they are currently turning down deals but warning that they cannot keep up that practice forever. Thus, it seems timely to again emphasize the importance of proper underwriting and risk management practices, particularly as the lessons of the most recent financial crisis become more remote.

Consistently sound underwriting is essential to

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maintaining safety and soundness of financial institutions. This principle is not new and was previously communicated in SR letters 95-36 and 98-18 nearly two decades ago.

These supervision letters encouraged banks to exercise sound underwriting practices despite competitive pressure. The recent adjustments to ease standards may be appropriate if done prudently by banks that had significantly tightened credit standards in response to serious credit problems and weak banking conditions. In 1995,SR letter 95-36 noted, "In today's intensely competitive lending markets, however, there is the potential that some banks may be relaxing, or be inclined to relax, lending terms and conditions beyond prudent bounds in efforts to obtain new customers or retain existing customers." Is this déjà vu all over again?

SR 95-36 notes that the decision to alter lending terms and standards (and risk-taking) can result from board and senior management decisions to adjust policies and procedures. Alternatively, these changes may reflect more subtle revisions resulting from how policies and procedures are applied in practice. Nevertheless, either process must include appropriate risk management to ensure that all credit risks are properly identified, monitored, and controlled, and that loan pricing, terms, or other safeguards against non-performance are consistent with the level of risk taken. Just as bank senior managers and boards must be aware of changes in policies and practices, we expect examiners to be alert to changes in loan policies and credit underwriting terms and conditions and to discuss their findings with bank management and, if necessary, the board of directors. In the last crisis both bankers and examiners who did not keep routine track of small relaxations of terms, conditions, and pricing were surprised at how incremental changes added up to a substantive decline in underwriting standards over time.

In a 1998 study of observed lending practices, SR 98-18 highlights six core elements to maintain strong credit discipline and assure that credit decisions are well-informed, balanced, and prudent. Those practices include:

1. Formal credit policies that communicate the bank's risk appetite and provide specific guidance and measurement standards along with a consistent process for approving and monitoring exceptions.
2. Formal credit approval processes that are independent of line lending functions.
3. Standardized loan approval documents that promote consistent financial analysis, collateral valuation, guarantor support, and covenant provisions.
4. Use of forward-looking tools to assess projections and various scenarios that focus on key determinants of performance.
5. Risk rating systems that accurately assess quantitative and qualitative considerations to evaluate credit risk at inception and during the life of the loan.
6. Management and lender information systems that support the approval process and on-going monitoring of portfolio composition and risk positions.

The current competitive banking market is placing pressure on banks to ease credit standards. As market and economic conditions continue to stabilize, additional pressures to ease standards are likely. While not new, prudent lending practices that are supported by a robust risk management programs should be integral for any decision to ease standards. The old adage that" bad loans are made during good times", coupled with the adage, "those that forget the past are doomed to repeat it," should be appropriately considered when evaluating a decision to ease credit standards.

[1] Bank Lending Terms and Standards (June 19, 1995) (http://www.federalreserve.gov/boarddocs/srletters/1995/sr9536.htm)

[2] Lending Standards for Commercial Loans (June 23, 1998) (http://www.federalreserve.gov/boarddocs/srletters/1998/SR9818.HTM)

CREDIT and PAYMENT SYSTEM RISK UPDATE

New Collateral Margins Table

On June 3, 2014, the Federal Reserve announced new collateral margins for discount window lending and payments system risk purposes. The new margins are effective July 1, 2014, and are available at frbdiscountwindow.org. In general, aggregate collateral values are slightly lower and the collateral value of loans is affected more than securities under the new margins. Of course, the exact effect of the change in margins on a depository institution depends on the specific type of collateral it pledges.

In the rest of the article, we describe the rationale for the change, the general nature and effects of the change and our plans for working with institutions on the transition.

The rationale for the change in margins is straightforward. As is the case for any lender, the taking of collateral is a central element of the Federal Reserve's credit risk management practices. To determine how much to lend against collateral, the Federal Reserve has to value the collateral and then determine how much of a margin or "haircut" it will apply to the collateral. The Federal Reserve regularly reviews how it makes those valuations and determines those haircuts. These reviews can lead to changes in Federal Reserve valuation approaches and in related policies.

The new collateral margins announced this month are the result of the Federal Reserve's periodic review of collateral valuation and margining practices, together with certain policy changes designed to add more granularity to determining lendable value for specifically

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Community banking research at the Federal Reserve Bank of Minneapolis, described below, is motivated by the factors just noted. More generally, such factors drive research across the Federal Reserve System and academia and were highlighted at the Community Bank Research Conference sponsored by the Federal Reserve and the Conference of State Banking Supervisors. Last year's conference brought together a wide range of interesting research on community banking, and I fully expect this year's conference in September 2014 to do the same.[1]

Federal Reserve Bank of Minneapolis Community Banking Research

Our recent analytical research has focused on two closely related concerns of community banks. The first concern is the increased costs facing community banks due to more intense supervision and regulation. The second concern is consolidation—specifically, the view that long-term consolidation in community banks will pick up because of the increased cost of regulation (which depresses returns in community banking).

A common feature of each project is providing a quantitative view on an issue often discussed in qualitative terms. Both pieces, along with our quarterly update on banking conditions, can be found at minneapolisfed.org/banking/communitybank/. Before describing the two efforts, I note that the Minneapolis Federal Reserve Bank has a particularly long history in analyzing a topic key to community banks, the so-called too-big-to-fail (TBTF) problem. (See this work at minneapolisfed.org/publications_papers/studies/tbtf/index.cfm.) One reason for our concern about TBTF is the advantage it provides systemically important firms relative to community banks.

Community Bank Regulatory Cost Analysis

In this project, we quantify the cost of increased regulation on community banks. We do so by modeling the impact of new regulatory costs, such as the hiring of additional staff, which result in higher total compensation and lower profitability. We then analyze the changes in the distribution of community bank profitability.

Our approach to analyzing potential costs of additional bank regulation has some advantages. In particular, the approach provides quantification of the issue in a simple, transparent and flexible way. Banks may respond to regulation by increasing training, by shifting staff to activities that generate less revenue or by doing nothing differently. In all cases, the bank's response will manifest itself in lower profits, as if the bank altered its head count.

In the analysis, we provided the following cost estimate for increased supervision/regulation under a baseline scenario with a fixed set of key assumptions and through cost estimates in which we vary the key assumptions from the baseline scenario. By way of example, we found that the median reduction in profitability for banks with less than $50 million in assets was 14 basis points if they have to increase staff by one half of a person; the reduction is 45 basis points if they increase staffing by two employees. The former increase in staff leads to an additional 6 percent of banks this size becoming unprofitable, while the latter increase leads to an additional 33 percent becoming unprofitable.

We also allow interested parties to customize key model inputs to tailor the simulation via a spreadsheet on our website.

Community Bank Consolidation Analysis

Observers argue that increased regulation and supervision added in response to the financial crisis will speed the decline of community banks. Determining if the rate of community bank consolidation is higher than it would have been absent this additional regulation requires a baseline estimate of community bank consolidation. A baseline estimate is particularly important because the number of community banks in the states of the Ninth Federal Reserve District, and the nation as a whole, has been in a steady rate of decline for several decades.

Our approach to analyzing potential costs of additional bank regulation has some advantages. In particular, the approach provides quantification of the issue in a simple, transparent and flexible way. Banks may respond to regulation by increasing training, by shifting staff to activities that generate less revenue or by doing nothing differently.

In this project, we used several simple methods to provide baseline estimates of community bank consolidation. We then compared actual consolidation against these baselines and updated our estimates quarterly to help determine if consolidation proceeds at a higher than expected rate. We continue to update our baseline estimates each quarter. So far we have not seen consolidation occurring at a faster rate than expected for states in the Ninth District or the nation. But such trends can change quickly. We will continue to monitor the historically expected and actual consolidation experiences of community banks.

Community banking analytical research has been and will continue to be a focus of mine and the Federal Reserve Bank of Minneapolis more generally. I welcome your feedback on the work we have done and suggestions for additional work you think merits analysis. Please provide any feedback you may have to Ron.Feldman@mpls.frb.org.

[1] Go to stlouisfed.org/banking/community-banking-conference/ to access the papers and proceedings from the 2013 conference. The 2014 conference is described at stlouisfed.org/banking/community-banking-conference-2014/

Unsolicited Access Devices

The Consumer Financial Protection Bureau's Regulation E—Electronic Fund Transfers Act limits the circumstances under which a financial institution may issue access devices, such as debit cards, to consumers. Examiners identified some errors at recent Federal Reserve consumer compliance examinations involving the issuance of unsolicited access devices. The errors occurred primarily because the bank did not realize its actions were covered by the requirements. In this update, we summarize the key points regarding unsolicited access device issuance.

What is an access device?
A well-recognized example of an access device is a debit card that enables a consumer to initiate point-of-sale transactions to his/her transaction account. As defined in Regulation E, an access device is a card, code or other means of access to a consumer's account that may be used by the consumer to initiate electronic fund transfers (EFTs). A less recognized example of an access device includes a personal identification number (PIN) used to access Internet banking or telephone banking services that enable the consumer to initiate transfers from an account.

What requirements apply to the unsolicited issuance of an access device?
A financial institution must follow specific requirements for unsolicited issuance of access devices. Unsolicited issuance refers to any circumstances other than when a customer requests the device or it is issued as a renewal of or a substitute for an existing device.

A bank may distribute an unsolicited access device to a consumer if the device is

1. not validated, meaning that it cannot be used to initiate an EFT;
2. accompanied by the explanation that it is not validated and how the consumer can safely dispose of it if not desired;
3. accompanied by complete disclosures explaining the consumer's rights and liabilities that will apply if the device is validated; and
4. validated only in response to the consumer's request, after the institution reasonably verifies the consumer's identity.

What is an example of unsolicited access device issuance?
A common unsolicited access device is allowing a consumer to use the last four digits of his/her social security number (SSN) for initial access to telephone banking or Internet banking, including the ability to initiate fund transfers. To meet Regulation E requirements, the consumer must not be able to use the PIN (in this case the last four digits of the SSN) to initiate a transfer until he/she has requested validation and received the required disclosures.

What risks exist concerning the issuance of unsolicited access devices?
The additional requirements applicable to unsolicited access devices serve to safeguard both the consumer and the bank from fraudulent transactions. Because the consumer is not expecting an unsolicited access device as he/she would in the case of a renewal, greater risk exists that the device will be used fraudulently. As a result, a consumer may only be held liable, within the limitations set by Regulation E, for unauthorized transfers involving an unsolicited access device if he/she requests validation. For more information on liability limits under Regulation E for unauthorized electronic fund transfers, refer to the fourth quarter 2012 Consumer Compliance Outlook article at philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2012/fourth-quarter/error-resolution-procedures-consumer-liability-limits-unauthorized-electronic-fund-transfers.cfm.

CREDIT AND PAYMENT SYSTEM RISK UPDATE *continued from page 2*

pledged assets. Overall, the new margins reflect data and methodological enhancements that better account for the differences in various risk characteristics across collateral types.

In terms of the changes, the collateral categories listed in the margins table have been adjusted slightly; however, no changes have been made to the range of assets accepted as eligible collateral. Institutions will note fewer group deposited loan categories on the new margin table. The Federal Reserve previously announced that all pledged loans must be submitted in the individual deposited loan format by year-end 2014, except for student loans and credit card receivables. Group deposited loan margins will no longer be published for loan categories that must be pledged as individual deposited loans.

The most significant changes reflected in the new margin table are (a) the introduction of separate margins for fixed-rate and floating-rate individually deposited loans and (b) the discontinuation of valuation floors (a policy that resulted in the collateral value of individually deposited loans being greater than or equal to that of group deposited loans). The pro forma outcome of applying the new margin table to pledged collateral across all Federal Reserve districts in May 2014 shows a modest reduction in lendable value. The effect on individual depository institutions will vary depending on the specific composition and characteristics of the collateral pledged (asset category, maturity, coupon, etc.).

Ahead of the implementation date, Reserve Banks will be reviewing the pro forma collateral positions of depository institutions that routinely borrow under the System's primary and seasonal lending programs and those institutions subject to payments system risk collateral requirements. The Minneapolis Federal Reserve Bank will be contacting select institutions, based on those reviews and on the absolute level of value change, during the month of June to discuss institution planned borrowing and collateral positions. Institutions can find more information regarding the new collateral margins within the Margin Announcement FAQs and the General Collateral FAQs located on the Discount Window & Payment System Risk website. Ninth District Institutions can also contact the Credit/PSR/Reserves section of the Division of Supervision, Regulation and Credit at 612-204-5855 or toll free at 877-837-8815.