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Market Threats to and Resilience of Community Banks



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I am not surprised when I hear claims that a new intermediary will spell the end of community banks. Nor am I surprised when new evidence emerges that reinforces the vital role that community banks play. This push and pull has been a regular feature of the bank policy environment.

This discussion—about the market threats to and resilience of community banks—recently took place at the Federal Reserve and Conference of State Banking Supervisors (CSBS) annual research conference on community banks. Specifically, it occurred in a session on small business lending by community banks, a panel on which I had the honor of participating.

The joint research conference is a great event, which I will describe briefly next. I will then put new research on novel competition that community banks face and support for the continued importance of community banks in a context of the early 1990s, a period when banks were supposedly “dying.” Available evidence suggests resilience in the future of small banks in the face of serious competitive threats. That said, weaknesses in existing data challenge researchers’ ability to determine the strength of the community bank model—especially in light of new markets and firms. I conclude this article with a call for new data.

Federal Reserve and CSBS Community Bank Research Conference

The Federal Reserve and CSBS have now sponsored a research conference on community banks for the past three years. The conference has done an excellent job in spotlighting important new analysis on community banks, encouraging analysts to conduct new work and bringing together bankers, researchers and bank supervisors to discuss the key issues of the day. Indeed, the mix of attendees and community bank discussion topics makes the event unique. In this article, I will summarize key points from one panel from the conference, but I strongly encourage you to view all the conference materials from the event website.¹

I got to chair the first panel of the conference, which concerned small business lending by community banks. This topic is a particularly good kickoff, as knowledge-based small business lending of community banks epitomizes what makes their business model valuable to the American economy. But the four papers in the panel raised the critical question: Does that special intermediary role for community banks still hold? I will highlight a few reasons why the question is particularly relevant today. First, increasing regulatory costs could make a higher-touch lending approach less viable. Second, traditional competitors for community

continued on page 3

SAFETY & SOUNDNESS UPDATE

5 Things — *A Nontechnical Approach to Cybersecurity Risk Management and the FFIEC CAT*

By Jerome Combs, Supervisory Examiner

The Federal Financial Institutions Examination Council (FFIEC) released the Cybersecurity Assessment Tool (CAT) in June 2015.¹ The banking agencies developed this tool to help institutions identify their cybersecurity risks and determine their preparedness. This article provides a basic overview to the two parts of the CAT and focuses on five data questions that can improve cybersecurity risk management awareness.

A few definitions before I cover the details: Cybersecurity is a subset of information security; the practice of defending data/information (electronic or physical) from unauthorized access, use, disclosure, disruption, modification, perusal, inspection, recording or destruction.² Confidentiality, integrity and availability of data are critical, especially sensitive and private data. Understanding key aspects of managing data helps build effective cybersecurity risk management.

The CAT

The CAT contains two parts. The first measures an institution’s Inherent Risk Profile while the second helps assess Cybersecurity Maturity. The CAT results help an institution’s board and management determine if cybersecurity inherent risk and preparedness are aligned well and, if not, where additional action may be needed.

continued on page 2

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The CAT Inherent Risk Profile provides a framework to measure an institution's operating environment within five categories. The framework provides various examples of products, services or operating considerations within each category. Risk in each category is rated on a five-point scale from least to most risky, depending on the activity level. The five categories include:

1. Technologies and Connection Types
2. Delivery Channels
3. Online/Mobile Products and Technology Services
4. Organizational Characteristics
5. External Threats

The Cybersecurity Maturity portion of the CAT identifies a range of controls and activities that help define an institution's preparedness. Risk management levels are also on a five-point scale, ranging from baseline to innovative. Cybersecurity Maturity includes statements and assessment factors to determine how an institution's behaviors, practices and processes support cybersecurity preparedness within the following five domains:

1. Cyber Risk Management and Oversight
2. Threat Intelligence and Collaboration
3. Cybersecurity Controls
4. External Dependency Management
5. Cyber Incident Management and Resilience

Five Questions

The CAT can seem daunting, particularly to community banks. While not a substitute for the CAT, addressing the following five data-related questions can assist management when evaluating the bank's inherent risk and preparedness. Indeed, there is a strong connection between these simple questions and the CAT, a point I support with specific examples below.

1. Where are the data?

Knowing where data are located helps to assess what controls are needed. The

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answer serves to identify where sensitive, private data are located whether data are in motion or at rest. Understanding and addressing the five categories within the Inherent Risk Profile helps an institution to better understand the activities, services and products that influence the movement and locations of sensitive, private data and associated risks and threats.

2. Who owns the data?

Identifying data owners will help establish ownership, authority, responsibility and accountability over data and related processes, policy, hardware, software, reporting, logging and monitoring. Banks can use the categories of the Inherent Risk Profile to determine where in the organization's operating environment ownership lies. An institution will begin to align with the baseline level of several Cybersecurity Maturity domains and, maybe at a more sophisticated level, by knowing who owns the data.

3. What Information Technology (IT) control framework do you believe in?

Cybersecurity controls are more effective when an IT governance and information security control framework is in place. Individual controls are often designed to act together to increase effective protection. A framework is a system of such controls. Frameworks can enable an organization to manage security controls across different types of assets with consistency. Adopting and aligning with a framework can demonstrate preparedness and can help to reduce an organization's cybersecurity risk characteristics. Several examples are noted in the footnotes to the right.³⁴⁵⁶⁷

4. What does "normal" look like?

"Normal" refers to baseline operations of a network. The Inherent Risk Profile helps

to identify the strengths or weaknesses of processes that allow an organization to monitor critical IT operations and processes. Knowing what "normal" operating activity looks like using audit, logging and monitoring tools helps to identify unusual or suspicious activity and supports Cybersecurity Maturity.

5. How do you know?

Threat awareness and processes that provide timely and accurate feedback to management about the implementation of controls and their effectiveness are critical components to preparedness. The Inherent Risk Profile should identify threat awareness activities, feedback mechanisms such as scanning, reporting and monitoring tools and audit controls. Effective implementation of these processes supports cyber risk management and oversight.

Management can begin to more fully understand the institution's overall cybersecurity inherent risk profile and maturity level in each Cybersecurity Maturity domain by using the CAT and asking and answering the five data questions.

¹ FFIEC Cybersecurity Assessment Tool, *Overview for Chief Executive Officers and Boards of Directors*, June 2015, www.ffiec.gov/cyberassessmenttool.htm

² Wikipedia, September 29, 2015, en.wikipedia.org/wiki/Information_security

³ www.isaca.org/cobit/pages/default.aspx

⁴ www.nist.gov/cyberframework/; The CAT is mapped to the NIST Cybersecurity Framework – Appendix B: *Mapping Cybersecurity Assessment Tool to the NIST Cybersecurity Framework*; www.ffiec.gov/pdf/cybersecurity/FFIEC_CAT_App_B_Map_to_NIST_CSF_June_2015_PDF4.pdf

⁵ www.iso.org/iso/home/standards/management-standards/iso27001.htm; http://www.iso.org/iso/catalogue_detail?csnumber=54533

⁶ www.owasp.org/index.php/Main_Page

⁷ www.counciloncybersecurity.org/critical-controls/

banks using current technology seem particularly potent. Third, and perhaps most importantly, innovations in technology create new competitors from existing firms and new entrants, such as so-called “fin tech” or “market place” small business lenders.

The Prior Market Threat/Resilience Debate

Researchers’ concern about the viability of banks and their potential demise is a familiar story for those at the Minneapolis Fed, and this history helped me understand the current situation and research. In 1994, the Minneapolis Fed published an article by John Boyd and Mark Gertler (BG) called “Are Banks Dead? Or Are the Reports Greatly Exaggerated?” and I wrote an update to the BG analysis in 2007 with Mark Lueck.²

BG’s analysis responded to concerns that banks were going to lose market share to alternative providers of liquidity and credit. The source of the concern should sound familiar: the perceived crushing burden of regulation and new competitors that arose due to advances in information and financial technology. BG noted that several standard metrics showed a big decline in the role of banks in financial intermediation. They argued that the decline mattered because of the unique role that banks play in the economy with the provision of credit to small business serving as a primary example. BG concluded, however, that standard data were not sufficient to identify the actual role banks played. They argued that accounting for the full set of activities of banks, such as so-called off balance sheet activities, confirmed the importance of banks.

I updated BG’s work in 2007 with a colleague because of concern that bank disintermediation by new competitors had resurfaced. In short, we produced roughly the same results as BG. However, we pointed out that the data limitations in our analysis were severe. The data to determine exactly what role banks play in intermediation do not really exist, particularly when new lenders enter the scene.

This history anticipates the research on community bank small business lending presented at the conference. One paper—by Julapa Jagtiani and Cathy Lemieux—pointed to a variety of data showing community bank relative share or position in small business lending had been declining for some time.³ The authors point to changes in lending technology in the current period as a potential accelerant to the decline. This paper is more in the “banks are dying” camp—to use the BG terms—than not.

Two other papers—by Berger et al. and Black and Kowalik—find that the role of community banks in small business lending remained strong; these papers answer “no” to the question of bank death.⁴ Berger et al. argue that better data and analysis allow them to identify a continued critical role for community banks in small business lending, particularly during times of stress. Black and Kowalik develop a model suggesting that small banks’ role in small business lending remains relevant, and they provide some preliminary data consistent with that.

So these three papers relitigate in some sense the original questions and answers that BG posed.

The final paper—Morris et al.—also focuses on the important competition that small banks face in their small business lending, in this case from the Farm Credit System (FCS).⁵ Unfortunately, current data do not readily allow policymakers to determine the level of competition that the FCS presents to banks. This paper helps reinforce a major conclusion of our update to BG: the data to quantify the role of banks in lending and other activities are weak. Specifically, data from lenders on their small business lending have important weaknesses or are nonexistent. Data from small firms on their borrowing have similar problems.

Calling for more data collection at a time when interested parties want to cut back on that effort seems particularly ill-advised. But the research conference has shown the value of applying strong analytics and solid data to community bank issues. In particular, analysis presented at the conference has shown the social and economic gains to community banking. Such work can then motivate changes to public policy to maintain the value of community banking. Better data on small business loan markets would illuminate the important role that community banks play now and could play in the future.

¹ The agenda and materials are available at www.communitybanking.org/

² See www.minneapolisfed.org/research/qr/qr1831.pdf for the Boyd and Gertler article and www.minneapolisfed.org/publications/the-region/are-banks-really-dying-this-time for the Feldman and Lueck update.

³ www.communitybanking.org/documents/Session1_Paper2_Lemieux.pdf

⁴ See www.cicfconf.org/sites/default/files/paper_784.pdf for the Berger et al. paper and <https://iaes.confex.com/iaes/80am/webprogram/Paper12090.html> for the Black and Kowalik paper.

⁵ See www.communitybanking.org/documents/Session1_Paper4_Morris.pdf.

SAFETY & SOUNDNESS UPDATE

Risk List—2015

Previous *Banking in the Ninth* articles discussed the Federal Reserve Bank of Minneapolis’ semiannual process for identifying high or emerging risks facing Ninth District financial institutions. The most recent list identifies

cybersecurity as the most significant risk facing Ninth District institutions. Other key risks include strategic risk, agriculture credit risk and interest rate risk. You can find the full list, including key action steps for banks and holding companies for the identified risks, at <https://www.minneapolisfed.org/banking/for-banks/risk-list/2015-risk-list>.

Have we captured the risks your bank is facing? Are there other actions we should take to ensure that banks are appropriately managing these risks? Let us know what you think by emailing us at mpls.src.outreach@mpls.frb.org.

Mortgage Loans with Balloon Payments

By Catherine Minor, Senior Examiner

Findings from recent exams suggest that banks may not fully understand Regulation Z's ability-to-repay (ATR) rules regarding balloon payments. These rules are relevant for Ninth District banks that continue to originate mortgage loans with balloon payments, particularly because recent regulatory changes affect the qualified mortgage options for small creditors. In this update, we address typical errors by clarifying the ATR requirements applicable to balloon payment loans.

Balloon Payment Mortgage Loans

Regulation Z requires banks to evaluate the applicant's ATR on most mortgage loans, including mortgage loans with a balloon payment (a payment more than two times the regular periodic payment). Most applicants cannot meet the ATR requirement when the creditor includes the balloon payment in the assessment. Specifically, the borrower does not have the income necessary to cover the payments that result when the balloon payment is included in the calculation. Banks have limited alternatives in this situation. Creditors that originate balloon loans must meet certain criteria in Regulation Z to exclude the balloon payment from the ATR calculation. Examiners identified several instances where banks did not follow these criteria as intended. We detail these cases to help creditors avoid making similar errors.

ATR Determination on Balloon Payment Loans

Non-qualified mortgage loans. Some lenders set up balloon payment loans with terms that were too short to allow them to exclude the balloon payment from the ATR calculation. All creditors may determine an applicant's ATR on a mortgage loan with a balloon payment by using only the monthly periodic payment. Creditors can use this calculation method if the loan term is at least 60 months from the first payment. Typically, loans eligible for this calculation method have loan terms of 61 or 62 months depending on the number of days until the first payment is due. This option is not available for higher-priced loans.¹

Qualified mortgage loans. Some lenders intended to meet the balloon payment qualified mortgage (BPQM) standard, which includes requirements for both the creditor and the loan, but did not meet all the qualification criteria. Only small creditors may originate one of the BPQMs described below. Effective January 1, 2016, a creditor must meet the following criteria to be considered a small creditor:

1. Together with its affiliates, originated 2,000 or fewer first-lien, covered transactions² during the last year (not including portfolio loans) and
2. Had assets less than \$2.060 billion as of the end of the preceding year (affiliate assets are included in this total if the affiliate regularly extends covered first-lien residential loans), or

3. If the application is received between January 1 and April 1 of the current year, had assets less than \$2.060 billion as of the end of either of the two preceding years.

Permanent balloon payment qualified mortgage. Small creditors that primarily lend in rural or underserved areas are eligible for the permanent BPQM, which allows them to exclude the balloon payment in the ATR calculation. Effective January 1, 2016, the lender must have extended more than 50 percent of its first-lien covered transactions on properties located in rural or underserved areas during the preceding calendar year. Previously, a lender could meet this test if 50 percent of its lending in any one of the preceding three years was in rural or underserved areas. A rural area can be either a county defined as rural or a census tract not in an urban area as defined by the U.S. Census Bureau.

Temporary balloon payment qualified mortgage. All small creditors, regardless of the locations of their loans, are eligible to originate the temporary BPQM until it expires on April 1, 2016. After that date, the rural and underserved standard must be met for lenders to be eligible for the permanent BPQM standard.

The loan must also meet all of the following requirements in order to be a BPQM:

1. Have a term between five and 30 years.
2. Have a fixed interest rate.
3. Have substantially equal payments (other than the balloon payment) that do not result in negative amortization and are based on an amortization period of 30 years or less.
4. Be held in portfolio for three years after origination.
5. Have points and fees within the specified limits for qualified mortgages.

Suggested Actions

Lenders that choose to originate adjustable rate mortgages (ARMs) rather than balloon loans should continue to follow the applicable ATR requirements of Regulation Z, regardless of creditor size or location of lending. Lenders that originate balloon loans should ensure that these loans meet either the ATR requirements for non-qualified mortgages or the standards for BPQMs, including evaluating whether the bank will meet the small creditor and rural and underserved standards for any applications received on or before April 1, 2016.

Final Rule

The CFPB issued rule amendments on October 2, 2015. The rule is available at www.federalregister.gov/articles/2015/10/02/2015-24362/amendments-relating-to-small-creditors-and-rural-or-underserved-areas-under-the-truth-in-lending-act.

¹ A higher-priced loan has an annual percentage rate that exceeds the average rate offered to prime borrowers by more than 1.5 percentage points in the case of a first lien and by more than 3.5 for a subordinate lien. For example, a first-lien loan originated in August 2015 with a rate of about 5.5 percent or higher is higher-priced.

² 1026.43(b)(1) A covered transaction is a closed-end, consumer credit transaction secured by a dwelling other than a reverse mortgage, a temporary loan, or a loan secured by an interest in a timeshare.