

# COMMUNITY BANKING CONNECTIONS<sup>®</sup>

A SUPERVISION AND REGULATION PUBLICATION

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## VIEW FROM THE DISTRICT

*A Fifth District Perspective — Richmond*

### Managing Risks of Commercial Real Estate Concentrations

*by Jennifer Burns, Executive Vice President, Supervision, Regulation and Credit, Federal Reserve Bank of Richmond*

In the Fifth District of the Federal Reserve System, commercial real estate (CRE) exposures have long been top of mind. As is the case in many regions across our country, CRE lending is and has been a significant strategic focus for many



Jennifer Burns

CRE lending began to emerge.

As bank supervisors, we understand that the business models of many community banks<sup>1</sup> rely on CRE lending, and we appreciate the benefit that bank lending provides to the economic activity in their communities. Our objective is to help bank leaders develop and implement risk management and capital planning practices that support well-informed decision-making and an ability to balance risk-taking with

banks. During and right after the Great Recession, CRE exposures on banks' balance sheets declined because older, nonperforming loans were charged off, and there was a lack of demand for new CRE loans from qualified borrowers. In 2013, exposures began to grow again, concentrations began to build, and trends that signaled an increasing risk appetite for

safety and soundness. Along those lines, in this article, I will share trends that are heightening the supervisory focus on CRE lending practices, including anecdotal risk management observations from examinations. I will highlight potential consequences of high CRE concentrations as evidenced from the last recession and provide some CRE loss rate trends that may offer new insight into risk management considerations. Finally, I will share results and best practices from two horizontal supervisory reviews of banks' risk management practices completed last year as well as some observations on the current state of capital planning in our District. My hope is that this information helps you as your bank contemplates a strategy for and management of CRE exposures.

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<sup>1</sup> Community banks include state member banks, state nonmember banks, and national banks with assets less than \$10 billion.

# Economic Growth and Regulatory Paperwork Reduction Act Review

by Staff from the Divisions of Supervision and Regulation, Consumer and Community Affairs, and Legal at the Board of Governors of the Federal Reserve System

The Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) requires the federal banking agencies<sup>1</sup> and the Federal Financial Institutions Examination Council (FFIEC) to perform a review of their regulations every 10 years. The purpose of the review is to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions.

Much has happened since the first EGRPRA report was sent to Congress in November 2007. The country suffered a financial crisis that destabilized the U.S. economy and weakened banks, resulting in hardships for the people and communities served by banks. The legislative and regulatory responses to the crisis were many, imposing measures designed to strengthen banks and to diminish the likelihood of future crises. As a result of those efforts, the banking system is indeed safer and stronger than it was before the crisis. The most recent EGRPRA report was sent to Congress in March 2017 and included the agencies' assessment

of existing regulations placed on banks, including the newest regulations.<sup>2</sup> A particular focus of the most recent EGRPRA review was the effect of regulations on smaller institutions, such as community banks and savings associations.

## EGRPRA Review Process

As part of this EGRPRA review, the agencies published four *Federal Register* notices and held six outreach meetings throughout the country to solicit comment from the public on the agencies' regulations. In response, bankers, consumer and community groups, and other interested persons submitted more than 230 written comments and voiced more than 120 oral comments at the outreach meetings addressing concerns about the agencies' regulations.<sup>3</sup> Many themes have emerged from the comments, including several of particular interest to community banks:

- Bankers recommended the agencies reevaluate the various thresholds and limits imposed by regulations that may constrain community banks and their lending activities.

<sup>1</sup> The federal banking agencies are the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, together "agencies." The National Credit Union Administration (NCUA), which is not subject to EGRPRA, conducted a separate review of its own regulations concurrently with the EGRPRA process. The NCUA's report on its review follows the interagency report.

<sup>2</sup> See the "Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act," available at [www.ffiec.gov/pdf/2017\\_FFIEC\\_EGRPRA\\_Joint-Report\\_to\\_Congress.pdf](http://www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf).

<sup>3</sup> See <http://egrpra.ffiec.gov/> for further information on the EGRPRA process.

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- Bankers recommended the agencies reevaluate the regulatory requirement to obtain an appraisal on small dollar real estate loans, particularly in rural areas.
- A number of community bankers recommended reducing the volume of information required in the quarterly filings of the Consolidated Reports of Condition and Income (Call Report).
- Bankers asked the agencies to review the statutorily mandated safety and soundness examination frequency for banks, which varies based on a bank's asset size and condition, as a way to reduce the frequency of on-site examinations.
- Bankers indicated that they would welcome guidance to assist them in meeting their compliance obligations under the Bank Secrecy Act (BSA) and anti-money laundering rules in more cost-effective ways.
- Bankers commented that some longstanding interagency guidance may now be outdated and warrant a fresh look and revision.

## Interagency Initiatives

The issues raised by the commenters as well as the agencies' responses were summarized in the EGRPRA report. The report highlights the agencies' response to the six topics that received the most comments: (1) regulatory capital, (2) the Call Report, (3) appraisals, (4) the frequency of safety and soundness examinations, (5) the Community Reinvestment Act (CRA), and (6) the BSA and anti-money laundering rules. The agencies also received comments on other interagency regulations and on each agency's own regulations.

## Regulatory Capital

*Simplifying the Regulatory Capital Rules.* The agencies recently proposed a rule intended to simplify several requirements in the agencies' regulatory capital rule.<sup>4</sup> Specifically, the proposed rule would simplify the capital treatment for certain acquisition, development, and construction loans; mortgage servicing assets; certain deferred tax assets; investments in the capital instruments of unconsolidated financial institutions; and minority interest. The proposed rule is consistent with the EGRPRA report in which the agencies committed to meaningfully reducing the regulatory burden, especially on community banking organizations, while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system.

## Call Report

*Reduced Regulatory Reporting Requirements with the Introduction of a Small Bank Call Report.* In December 2016, the agencies

finalized a new, streamlined FFIEC 051 Call Report for institutions with domestic offices only and less than \$1 billion in total assets. This new Call Report, which took effect on March 31, 2017, reduces the length of the Call Report from 85 pages to 61 pages and removes approximately 40 percent of the data items included in the FFIEC 041 Call Report.

*Further Simplifying the Call Report.* Staffs of the agencies have completed or started work on other Call Report revisions, including: (1) completing limited reductions to the Call Report, which were finalized in July 2016 and effective in September 2016 and March 2017; (2) completing the required review this year<sup>5</sup> of existing Call Report data items; (3) proposing further burden-reducing changes to the FFIEC 051 and other burden-reducing Call Report changes for larger institutions; and (4) continuing industry outreach and training.

## Appraisals

*Raising the Appraisal Threshold for Commercial Real Estate Loans.* The agencies issued a notice of proposed rulemaking to increase the threshold for requiring an appraisal on commercial real estate loans from \$250,000 to \$400,000, in a manner consistent with safety and soundness.<sup>6</sup> As part of that proposal, the agencies solicited comments on whether the current \$250,000 threshold for residential real estate loans should be raised and what factors should be considered in assessing the threshold amount for these loans.<sup>7</sup> The proposal also asked for information about the appropriateness of increasing the existing \$1 million threshold for real estate-secured business loans. The comment period for the proposal ended on September 29, 2017, and the staffs of the agencies are now reviewing the comments on the proposal in the development of a final rule.

*Addressing Appraiser Shortages in Rural Areas.* The agencies issued an advisory<sup>8</sup> to regulated entities, highlighting two

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<sup>4</sup> The press release announcing the proposal is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20170927a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20170927a.htm).

<sup>5</sup> This review is mandated by section 604 of the Financial Services Regulatory Relief Act of 2006 (12 U.S.C. 1817(a)(11)).

<sup>6</sup> The press release announcing the proposal is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20170719a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20170719a.htm).

<sup>7</sup> In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, the agencies are required to receive the concurrence of the Consumer Financial Protection Bureau to change the current \$250,000 threshold above which an appraisal is required for a residential mortgage.

<sup>8</sup> See Supervision and Regulation (SR) letter 17-4, "Interagency Advisory on the Availability of Appraisers," available at [www.federalreserve.gov/supervisionreg/srletters/sr1704.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1704.htm). This advisory applies to state member banks and bank holding companies and their nonbank subsidiaries; it does not apply to savings and loan holding companies.

# Banks Are Becoming More Efficient — Is That Good or Bad?

by Wallace Young, Director, Risk Coordination Unit, and Alex Lightfoot, Senior Risk Specialist, Federal Reserve Bank of San Francisco

Although the extended low interest rate environment has made it challenging for many banks to improve profitability, net income in the banking industry is rising, largely because of efficiency gains. At many banks across the nation, overhead expenses (otherwise known as noninterest expenses) are increasing but at a much slower pace than total assets. For example, average noninterest expenses as a percentage of average assets at small community banks across the nation (those with total assets below \$1 billion) have slowly declined from 3.09 percent at December 31, 2013, to 3.02 percent at December 31, 2016, a drop of 7 basis points (Figure 1). For larger banks, the decline is much more noticeable; since year-end 2013, noninterest expenses as a percentage of average assets have declined 36 basis points at larger community banks (with total assets between \$1 billion and \$10 billion) and 37 basis points at banks with assets above \$10 billion.<sup>1</sup>

These declines may not seem that significant, but over this same period, return on average assets (ROAA) at banks across the nation has actually decreased slightly by 5 basis points, as net interest margins (NIMs), net interest income as a percentage of average assets, have hovered in a very tight range for most institutions. In this low interest rate environment, banks face challenges to further improve core earnings; therefore, even a modest reduction in overhead expenses will likely have a material impact on a bank's profitability.

<sup>1</sup> The data were obtained from the aggregate reports developed by the Surveillance staff at the Board of Governors of the Federal Reserve System using the Consolidated Reports of Condition and Income (Call Report).

The fact that the industry is operating more efficiently is a positive development. However, it is somewhat surprising that some banks are able to boost efficiency at a time when operating and information security costs are reportedly rising, which raises the following question: Can a bank be too efficient? Some minimal level of overhead is necessary to ensure that the institution is devoting sufficient resources to all the various operations across the organization, including its administrative, human resources, compliance, and audit functions.

With this in mind, this article explores the improving efficiency trend to uncover some ways that banks are becoming more efficient and highlights a number of issues that bank management teams should consider as they balance a desire to operate more efficiently against the need to devote appropriate resources to all functions in the organization.

## Why (and How) Are Banks Becoming More Efficient?

The motivation to improve efficiency is not unique to the banking industry. Most companies are regularly looking for

Figure 1: Noninterest Expenses to Average Assets

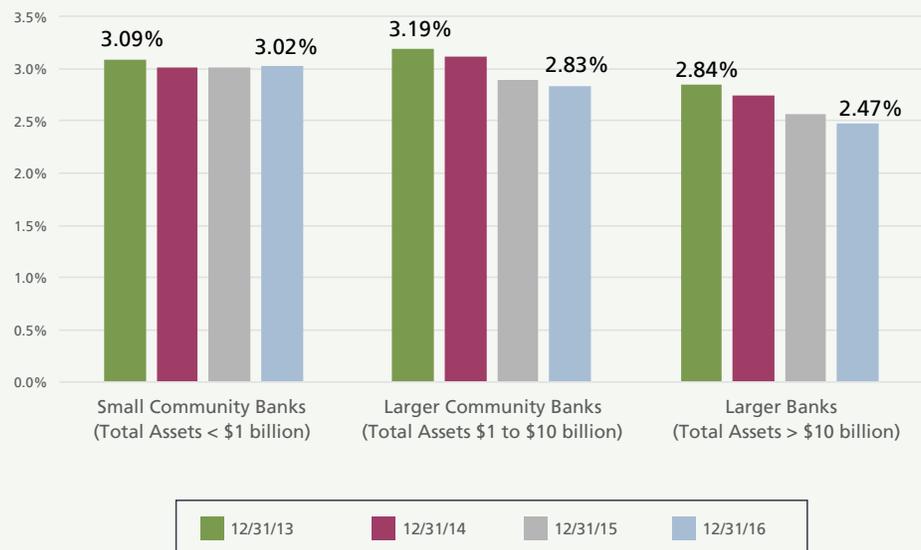
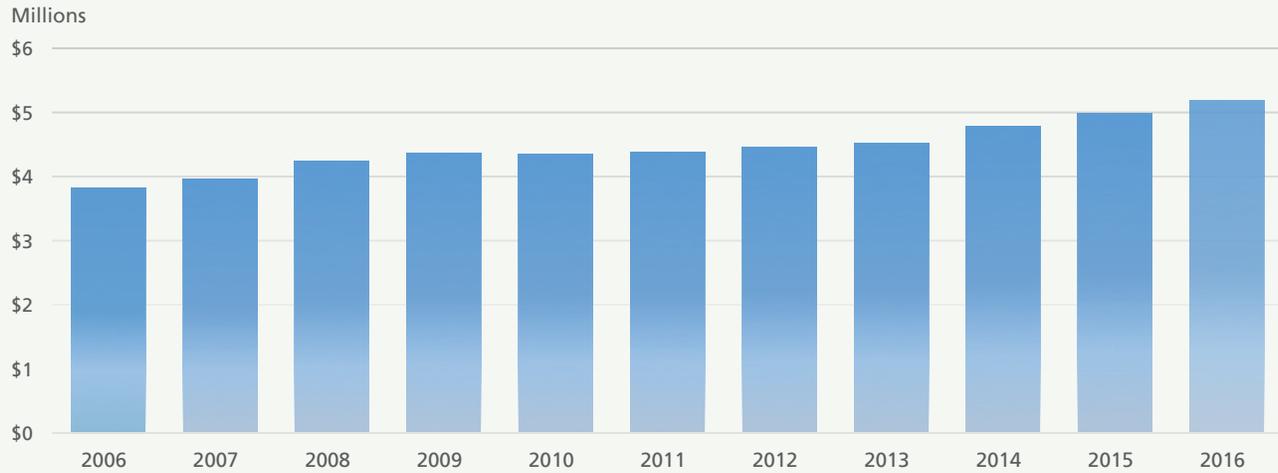


Figure 2: Assets Per Employee Across All Community Banks (Aggregate Data)



ways to operate more efficiently, as more efficient businesses are often more profitable and better positioned to generate higher returns for their owners. More often than not, technological advancements enable businesses to operate more efficiently. Certainly, the banking industry has seen numerous technological advancements over the past several decades, such as the advent of the computer itself, the invention of the automated teller machine (ATM), the evolution in electronic payments, and the proliferation of online banking. Many of these technological advancements not only make banking more convenient for the consumer, but they also allow banks to build a much larger organization with relatively fewer staff, branches, and support offices. For example, over the past several years, a big shift has been seen in how customers interact with their banks. Although many bank customers may not want to see their local branches close, most are less inclined to visit a bank branch to conduct banking activities. As a result, banks need fewer branches and, correspondingly, fewer employees and physical assets such as copy machines, file cabinets, and office furniture. In fact, the number of bank branches in the U.S. has declined by 6 percent since 2009, and there is speculation that banks can do even more trimming as customers continue to embrace online and mobile banking services.<sup>2</sup>

In the meantime, as credit quality across the industry continues to improve, there are fewer problem assets that need to be worked out. This has led to a natural decline in operating

expenses (e.g., legal expenses), as fewer problem assets mean that there is less need to engage legal counsel to assist with document review and various legal filings. Also, over the past several years, there have been advancements in risk management techniques that have helped management teams manage even larger and more complex organizations. For example, advancements in data analytics allow bank management teams to develop and analyze increasing amounts of data, which result in the need for fewer staff or management to oversee the staff.

So, there are several reasons to explain why banks are becoming more efficient; however, it is also possible that bank management teams are more inclined to seek out improvements in efficiency as a way to boost net income during this extended period of very low interest rates. Despite robust loan growth over the past several years, bank management teams have found it difficult to improve NIMs and may face increased pressure to reduce operating expenses.

Whatever the motivation, many institutions are seeking outright cuts to employee count, while others are tightly controlling personnel and other operating expenses to lag asset growth. One measure that highlights this trend is the growth in overhead expenses against asset growth. This can be highlighted in the continuously rising number of assets per employee (Figure 2). Closely managing employee count appears to be a common (and even obvious) method for improving efficiency, but asking staff to do more with less puts additional pressure on bank staff. Meanwhile, bank

<sup>2</sup> Dan Freed, "Bank Customers Don't Want Their Local Branches to Close," *Money Magazine*, August 22, 2016.

# Denver Cybersecurity Conference Reminds Bankers to Be Vigilant

by Brian Brown, Senior Examiner, Federal Reserve Bank of Kansas City

The 2nd Annual Denver Cybersecurity Conference, featuring presentations from federal law enforcement agents, bank officers, and bank regulatory professionals, took place at the Denver Branch of the Federal Reserve Bank of Kansas City on December 14, 2016. The conference was cosponsored by the Federal Reserve Bank of Kansas City, the Federal Bureau of Investigation (FBI), the U.S. Secret Service, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Colorado Division of Banking. More than 60 bankers and regulators attended the conference.

The conference presenters shared their real-world cybersecurity experiences with attendees. They discussed how current cybersecurity risks are escalating and made recommendations for preventing and responding to these risks. The consensus was that cybersecurity threats continue to pose increased risks that require the collective efforts of bankers, law enforcement agents, and regulators to effectively combat the danger to the banking industry.

The law enforcement panel opened the conference and confirmed that cybersecurity risks remain a top threat to businesses and the government. The federal law enforcement representatives explained that criminal actors, a majority of whom are located outside of the United States, are stealing funds by executing various types of financial fraud schemes. The presenters gave attendees an overview of the different types of cyber-related fraud being perpetrated and provided information on how to effectively deal with these issues.

## Topics Discussed During the Conference

In the first session, the panel provided information about e-mail spoofing, the Financial Fraud Kill Chain, and ransomware. The second session included a panel of bank professionals who discussed cybersecurity threats identified during their day-to-day operations. The panelists shared examples of internal and external threats along with the best practices for remediation. The final session of the conference included a panel of representatives from bank regulatory agencies. The panelists summarized current examination findings and answered participants' questions.

The following topics were discussed as the various experts shared their thoughts and concerns.

### Wire Fraud

All three panels addressed the subject of wire fraud. Various panelists pointed out that criminals will use a spoofed e-mail<sup>1</sup> to obtain customer information or to take over the e-mail accounts of customers or bank executives. Once criminals have the customer's information or have compromised an e-mail account, they can originate fake wire transfer requests or initiate other types of money transfers from the bank. These fraudulent transactions often occur on a Friday afternoon to instill a sense of urgency and to limit the bank's ability to recover the fraudulent wire transfer. As soon as wire fraud is suspected, the bank should follow its usual procedures for recalling the fraudulent funds, which involve quickly notifying the receiving bank.

Law enforcement agents who were on the panel indicated that they can help bankers attempt to recover large international wire transfers by using the Financial Fraud Kill Chain (FFKC).<sup>2</sup> The FFKC can be initiated if the victim is located in the United States, the fraudulent wire transfer is international, the transfer is greater than or equal to \$50,000, the transfer has occurred within the past 72 hours, and a recall notice<sup>3</sup> has been issued by the Society for Worldwide Interbank Financial Telecommunication (SWIFT). U.S. law enforcement agents use their relationships with law enforcement

<sup>1</sup> In e-mail spoofing, the header of the e-mail has been manipulated to make the message look as if it is being sent from a legitimate source or from a source other than the sender.

<sup>2</sup> See Federal Bureau of Investigation, Financial Fraud Kill Chain, January 11, 2016, available at <https://tinyurl.com/y8dxwrno>.

<sup>3</sup> Recall notices are initiated by the sending bank when it wants to recall a wire. The wire can sometimes be canceled, depending on the time it was received. The receiving bank has to obtain the recall notice before the money is withdrawn from the account into which the wire funds were deposited. The receiving bank can only send the money back if it has not been withdrawn by the perpetrator. See Independent Bankers Bank Association of Texas, Operations, Wire Transfer: Recall of Wire by Originator, available at <https://tinyurl.com/y7ypmbk9>.

agents in other countries to help recover illegally obtained funds. Although not all countries cooperate with U.S. law enforcement agents, the panelists indicated the success rate was fairly good.

Conference participants also expressed concern about the lack of adequate controls over wire transfers. Panelists recommended that written procedures specify the processing protocol for incoming and outgoing wire transfers, the protocol for posting and balancing entry procedures, and employees' responsibilities for implementing these policies. The processing of wire transfers should be performed under dual control, and the bank staff who are allowed to send or approve wires should have preset approval limits. Customers who frequently request wire transfers should be required to sign wire transfer agreements, and callback procedures should be established for wire transfers over a certain dollar threshold.<sup>4</sup>

### Ransomware

The law enforcement panel indicated that the number of victims and the dollar volume of losses caused by ransomware continue to increase. Criminals use ransomware to encrypt data on an infected computer until the user pays a ransom to the originator of the malware. After the ransom is paid, the originator may or may not give the user a key to unlock the information. More than 200 variations of ransomware are currently estimated to exist, and cybercriminals are constantly developing new versions. The FBI has seen 35 to 38 new variants in as few as two months. The FBI also estimated that only about one-third of ransomware victims report the crime to law enforcement. The reasons for not reporting these crimes are varied but seem centered around reputational risk. The figure to the right details the stages of ransomware.

To hide the origin of the e-mail that delivered the ransomware, criminals use a process called onion routing.<sup>5</sup> The criminal typically asks for the payment to be made in some form of electronic currency so that it is difficult to track the

<sup>4</sup> *Community Banking Connections* published an article titled "Managing the Risk of Unauthorized Payments from Business Bank Accounts" in the Second Quarter 2015 issue that discusses ways to mitigate the risk of wire fraud. This article is available at [www.cbefrs.org/articles/2015/q2/managing-the-risk-of-unauthorized-payments](http://www.cbefrs.org/articles/2015/q2/managing-the-risk-of-unauthorized-payments).

<sup>5</sup> Onion routing simply means that messages with several layers of encryption, like the layers of an onion, are anonymously routed. For more information about onion routing, see Marc O'Morain, Vladislav Titov, and Wendy Verbuggen, "Onion Routing for Anonymous Communications," available at <https://tinyurl.com/ybcyvllu>.

## The Four Stages of a Ransomware Attack\*

1 Ransomware is installed on the victim's computer, often through an attachment in a phishing e-mail.

2 The ransomware contacts the criminal to get a code to encrypt the information.

3 The code begins encrypting the victim's files.

4 The victim receives a message demanding some form of payment within a specified time frame.

\*For more information, see the Anatomy of a Crypto-Ransomware Attack, available at <https://tinyurl.com/y9p6oha4>.

funds. Ransomware has various names, including CryptoWall, CTB Locker, TeslaCrypt, MSIL/Samas.A, and Locky. While the most prevalent victims are hospitals and government networks, banks are also targeted.

Bank management can protect their institutions from ransomware by:

- focusing on staff awareness and training;
- regularly updating software patches;
- automatically updating antivirus and malware software;
- managing privileged administrator accounts;
- implementing the principle of least privilege (giving bank staff the minimal level of access that they need to perform their jobs);
- having robust backup and restore procedures; and
- implementing software installation restriction policies.

Federal law enforcement does not condone paying the ransom because it encourages criminals and funds illegal activity.

### Phishing

One of the banker panelists estimated that approximately 91

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# Managing Risks of Commercial Real Estate Concentrations

*continued from page 1*

## Ongoing Surveillance to Spot Trends

Given the prominence of CRE lending in community banking, the Board of Governors of the Federal Reserve System and other federal banking agencies perform ongoing surveillance of individual banks, bank holding companies, and the industry to identify early signs of increasing risks. The agencies look for trends in Call Report data and other regulatory information, including reports of examination and outreach discussions. This information informs our thinking on what risk areas require more attention, where to perform horizontal reviews to gain a broad perspective on the issues, and how to adjust examiner training programs to prepare examiners for conversations with bankers. These trends also help us focus our surveillance, outreach, and training approaches to identify growing risk factors far enough in advance to provide timely and meaningful insights into the banking system.

## Focus on Existing Guidance

When the agencies conducted their surveillance activities during 2014 and 2015, they saw trends that indicated that CRE risk appetite and risk levels were rising. In response, at the end of 2015, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency issued the “Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending.”<sup>2</sup>

This interagency guidance noted “substantial growth in many CRE asset and lending markets, increased competitive pressures, and an easing of CRE underwriting standards.” Importantly, the guidance did not lay out any new risk management requirements or supervisory criteria related to CRE lending. Rather, the guidance reiterated the need for strong risk management practices related to managing CRE credit concentrations and compliance with existing CRE guidance.

Specifically, the agencies reiterated the need for strong risk management practices to comply with Supervision and Regulation (SR) letter 07-1, “Interagency Guidance on

Concentrations in Commercial Real Estate.”<sup>3</sup> This guidance does not set limits on the size of CRE concentrations but instead highlights strong risk management practices that are necessary for a bank with a high CRE credit concentration. Further, the guidance outlines supervisory screening criteria for concentration levels and a growth percentage for a portion of CRE loans that may potentially expose an institution to significant risk.<sup>4</sup>

## Trends from a Historically High CRE District

Prior to the economic crisis, the Fifth District experienced rapid CRE loan growth. By 2008, the average annual growth in concentrations in total CRE exposure for banks was 36 percent. Two-thirds of the community banks in the Fifth District reported positive CRE concentration growth, and a quarter reported CRE concentration growth greater than 50 percent.

Total CRE growth rates for Fifth District banks dropped rapidly in 2009 and did not become positive again until 2013. By 2016, average annual CRE loan growth for Fifth District community banks had rebounded to about 10 percent, outpacing total average annual loan growth of 9 percent. The construction and land development (CLD) segment grew at an average rate of 14 percent, the highest growth in that sector since 2009.

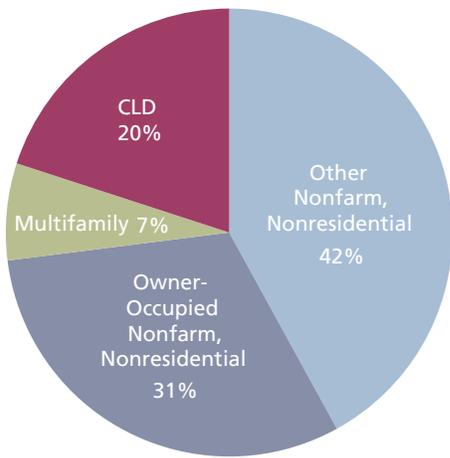
Nationwide, multifamily lending has experienced the highest growth rates since the crisis. However, as depicted in Figure 1, for community banks in the Fifth District, the concentration in that sector is not nearly as large as owner-occupied nonfarm, nonresidential or as other (nonowner-occupied) nonfarm, nonresidential CRE segments. So admittedly, we are more interested in those trends, including positive concentration growth in total

<sup>2</sup> See Supervision and Regulation (SR) letter 15-17, “Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending,” available at [www.federalreserve.gov/supervisionreg/srletters/sr1517.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1517.htm).

<sup>3</sup> See SR letter 07-1, “Interagency Guidance on Concentrations in Commercial Real Estate,” available at [www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm](http://www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm).

<sup>4</sup> The criteria for SR letter 07-1 are as follows: (1) total reported loans for construction and land development (CLD) and other land represent 100 percent or more of the institution’s total capital; or (2) total CRE loans (including loans for nonfarm, nonresidential, nonowner-occupied CRE, CLD, other land, and multifamily properties as well as CRE loans not secured by real estate) represent 300 percent or more of an institution’s total capital, and the outstanding balance of the CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

**Figure 1: Aggregate CRE Loan Portfolio Composition as of Year-End 2016 (Fifth District Community Banks)**



CRE loans by community banks, as depicted in Figure 2, and the increasing number of institutions identified as potentially exposed to high CRE concentration risk.

**Potential Consequences of High Concentrations**

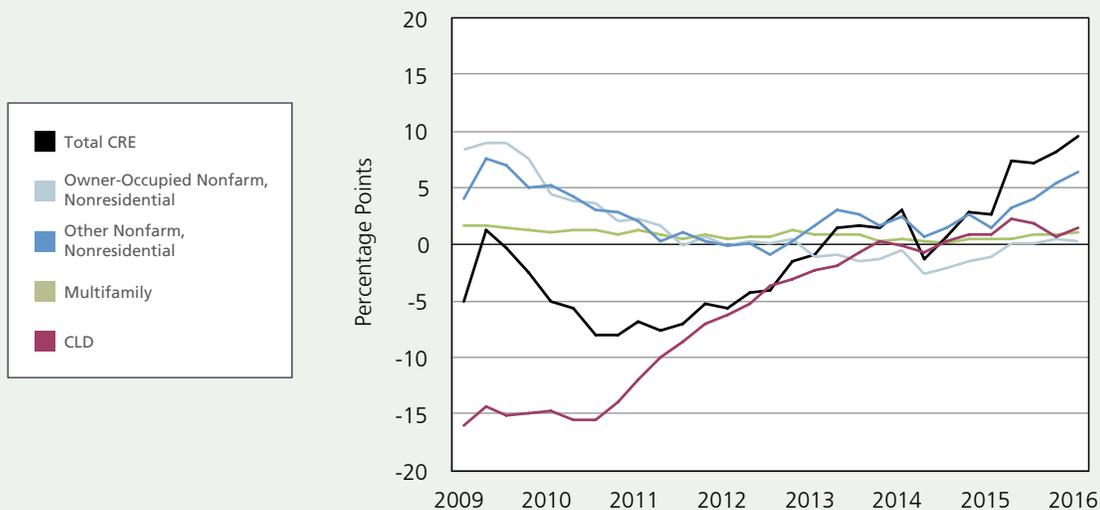
An analysis of community bank losses following the recent financial crisis showed that the concentration criteria out-

lined in SR letter 07-1 did indeed prove indicative of higher default risk and greater financial stress during the crisis. A 2013 national study validated the relationship between high CRE concentrations and negative impacts to banks during the financial crisis.<sup>5</sup> That study found that “during the three-year economic downturn, banks with high CRE concentration levels proved to be far more susceptible to failure” and that “banks that exceeded the supervisory criteria on CRE concentrations tended to experience greater deterioration in condition as assessed by market participants.” In fact, the study found that “among banks that exceeded both supervisory criteria, 23 percent failed during the three-year economic downturn, compared with 0.5 percent of banks for which neither of the criteria was exceeded.”

CRE concentrations at community banks nationwide fell after the financial crisis, owing partly to large losses but also because of a lack of demand and/or sufficiently qualified borrowers to replace CRE loans that were paying down. During this period, we also observed boards of directors opting to add CRE concentration limits or reduce existing limits to levels at or below the criteria outlined in SR letter 07-1. While in December 2008, 52 percent of the Fifth District community

<sup>5</sup> Keith Friend, Harry Glenos, and Joseph B. Nichols, “An Analysis of the Impact of the Commercial Real Estate Concentration Guidance,” April 2013, available at [www.federalreserve.gov/bankinforeg/cre-20130403a.pdf](http://www.federalreserve.gov/bankinforeg/cre-20130403a.pdf).

**Figure 2: Average Annual Concentration Growth (Fifth District Community Banks)\***



\* All lines below the horizontal line at “0” reflect percentage declines in those sectors’ concentration levels within the District.

banks exceeded one or more of the criteria and 8 percent were nearing the criteria, the percentage of banks that exceeded or were near the CRE limits fell significantly over the next five years. By the end of 2013, the percentage exceeding one or more of the criteria had fallen to 13 percent, while another 11 percent were nearing the criteria. However, starting in 2014, we noticed a slight uptick in those percentages, and, by year-end 2016, 14 percent of the community banks in the Fifth District exceeded the criteria, and another 12 percent were nearing the criteria.

### Owner-Occupied: Not as “Safe” as We Once Thought

Historically, loss rates associated with owner-occupied CRE loans were believed to be much lower than with other types of CRE loans. The rationale was that the cash flow from ongoing operations and activities conducted by the borrower (or an affiliate of the borrower) who owned the property is both the primary payment source of the loan and the livelihood of the borrower. In fact, owner-occupied loss rates were not tracked separately in the Call Report until after the issuance of SR letter 07-1, which excluded supervisory screening criteria for this subset of CRE loans. Similarly, we have rarely encountered banks in which the boards of directors have established concentration limits for the owner-occupied CRE sector. In fact, since the financial crisis, many boards and senior management teams have pursued growth in this segment. In the Fifth District, owner-occupied CRE credit concentrations grew at a higher rate than most other CRE loan segments from 2009 to 2012 and only recently have declined, as growth in other CRE loan segments has started to gain some momentum. As a result, we are seeing owner-occupied CRE credit levels that are quite high in relation to capital.

In studying CRE loss patterns for Fifth District banks during the last recession, the pattern that emerged contradicted historically perceived norms. As depicted in Figure 3, the trend line for net charge-off rates of owner-occupied CRE loans was very similar to the trend line for nonowner-occupied charge-off rates for much of the studied period.<sup>6</sup> A study on nationwide default rates submitted for the Community Banking in the 21st Century research and policy conference noted similar results.<sup>7</sup>

<sup>6</sup> The loss rates for “nonowner-occupied nonfarm nonres” do not include losses for CLD loans or multifamily loans.

<sup>7</sup> Julie Stackhouse, “Community Bank Research Conference Looks at the Changing Nature of Competition,” *Community Banking Connections*, First Issue 2016, available at [www.cbcrfs.org/articles/2016/i1/view-from-the-district](http://www.cbcrfs.org/articles/2016/i1/view-from-the-district).

The trends in Figure 3, including the unexpected charge-off results for owner-occupied CRE, are a reminder that risks may manifest in unpredictable ways. This underscores the benefits of strong risk management, including consideration of expected and unexpected losses in all portfolios under various stress scenarios.

### Insights from CRE Stress Testing

Stress testing of asset concentrations is one way to develop a fuller understanding of the risks and losses that might occur during a downturn. Evaluating the potential effect of stressful conditions on a specific loan portfolio provides bank management and board members with additional information as they determine the level of capital needed to protect the bank from losses in that portfolio.

This is why SR letter 07-1 establishes the expectation that banks with CRE credit concentrations conduct portfolio stress testing. As with most supervisory expectations, the sophistication of the testing should be consistent with the size and complexity of the CRE credit portfolio, including the level and nature of the concentration. What this means exactly can be difficult to tease out, so please take time to discuss this with supervisors at your Reserve Bank.

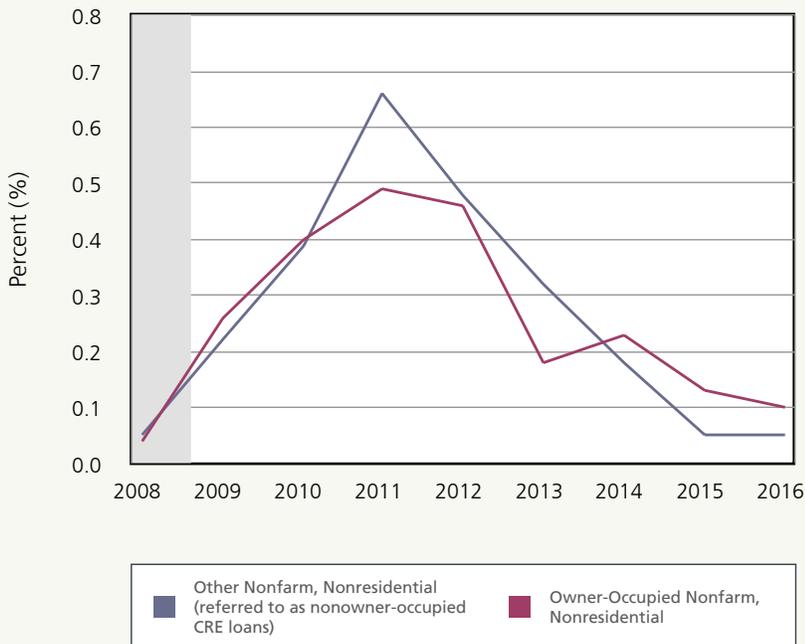
During 2016, we performed a horizontal review at banks with high CRE loan concentrations, focusing on their stress testing practices. We wanted to compare and contrast the portfolio-level stress testing methodologies that banks use to quantify impacts of changing economic conditions on asset quality, earnings, and capital.

We found that all banks were making efforts to implement sound practices. That said, and given the nascence of stress testing practices, it is not surprising that we found opportunities to make practices more responsive to risks at many of the banks. These reviews have helped us identify a number of best practices:

- Consideration should be given to the CLD portfolio when developing various adverse scenarios and relevant loss rates.<sup>8</sup>
- Assumptions for inputs such as changes in borrower income and collateral values should be severe enough to provide management with useful information about vulnerabilities. In fact, management may wish to run

<sup>8</sup> During the recent financial crisis, the average net charge-off rate for CLD loans in Fifth District community banks peaked at 2.8 percent, which was more than double the peak charge-off rates experienced in the other CRE loan segments.

**Figure 3: Average Net Charge-Off Rates (Fifth District Community Banks)**



multiple scenarios to understand the spectrum of potential outcomes. For example, a bank might link scenarios directly to changes in economic conditions, new strategic directions, and shocks to collateral values.

- While a good starting point may be using a bank’s charge-off rates experienced in the last recession, varying these assumptions can provide valuable insight to potential losses in the portfolio should the next recession play out differently.
- After completing a stress test, results should influence both capital and strategic planning. In fact, for maximum benefit, bank management should ensure that stress testing scenarios change over time to stay in sync with the bank’s current strategic plan.
- Finally, it is important to perform independent validation of models to ensure quality results.

Many of the CRE stress tests we see in the Fifth District were developed and implemented after the financial crisis, so they have not been “tested” against an actual downturn. This disadvantage points to the importance of varying your stress test assumptions over time to identify a range of possible losses that your bank may need to absorb. Stress testing should include both high- and low-probability scenarios. The level of sophis-

tication of a bank’s stress testing practices and analysis should be consistent with its size, complexity, and risk characteristics of its CRE loan portfolio. Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings.

### Understanding Current Underwriting Standards

In addition to building our knowledge of stress testing practices, we completed a horizontal review in 2016 to identify trends in banks’ underwriting standards. Anecdotally, bankers stated that underwriting standards were loosening for high-quality borrowers because of intense lender competition. Examiners found that boards were approving loans with concessions to maintain or increase high-quality, in-market relationships. For example, examiners were

noting increasing trends in the type and number of underwriting exceptions to internal bank policy guidelines identified in bankers’ management information system reports.

Not surprisingly, the underwriting horizontal review pointed to growth in concessions and terms outside of bank policy limits. Some concession examples included lower equity requirements, extended fixed interest rate periods, longer amortization and interest-only periods, interest-only extensions, lower debt service requirements, higher loan-to-value ratios, and nonrecourse terms for loans in which recourse is generally required by the bank’s policy. For bank supervisors, the trend in concessions is concerning because borrower guarantees and covenants influence when and how borrowers and bankers work together if issues arise.

Throughout the recent financial crisis, the presence of guarantees compelled problem borrowers to work closely with lenders. Borrowers simply did not walk away as they may have done otherwise. Also, in instances when affirmative and negative covenants were included in loan agreements and monitored closely, borrowers and bank management were able to begin working together earlier — and take action sooner — as problems were emerging. These protection mechanisms

proved very helpful during the last recession and should prove helpful in future economic downturns.

Most bank boards have approved underwriting policies under the expectation that exceptions will be “one-off” and amount to just a few. However, during intensely competitive periods, boards may want to consider setting limits on prevalent policy exceptions and establishing mitigating factor requirements for some exceptions. Additionally, when there is a significant volume of loans with underwriting exceptions, bank management may wish to incorporate these mitigating factor exception requirements into CRE concentration stress analyses to understand implications for potential loss and, by extension, capital adequacy.

We did not focus on loan pricing concessions in our horizontal review and, thus, have no empirical results to share. Certainly, low market rates breed low loan rates and borrower requests for longer terms. We have heard repeatedly from bankers that they “don’t know how the competition is making any money at the rates and terms they’re offering.” Bank supervisors expect and anticipate that bank management is carefully considering risk when setting pricing, as intense competition on price may lead to underpricing and overextension of credit to weaker borrowers.<sup>9</sup>

### Capital Planning Is Paramount to Managing Risk

In 2013, I wrote a View from the District article on capital planning.<sup>10</sup> That article highlighted a message we continue to emphasize today: Risk management, including board attention, cannot fully anticipate and sufficiently reduce high levels of concentration risk. Effective capital planning is paramount to managing risk associated with any asset concentration.

Over the past several years, Fifth District community bankers have significantly improved their banks’ capital planning processes. We see many capital plans that now include a risk assessment process that identifies all necessary elements in setting target capital levels, early warning triggers to alert management to increasing risks, and reasonable action plans with timetables to restore capital to satisfactory levels. Bank

<sup>9</sup> John Barrickman, New Horizons Financial Group, “Best Practices in Credit Risk Management,” provided to students at the Pacific Coast Graduate School of Banking, 2011.

<sup>10</sup> Jennifer Burns, “Capital Planning: Not Just for Troubled Times,” *Community Banking Connections*, Third Quarter 2013, available at [www.cbcfrs.org/articles/2013/Q3/Capital-Planning-Not-Just-for-Troubled-Times](http://www.cbcfrs.org/articles/2013/Q3/Capital-Planning-Not-Just-for-Troubled-Times).

boards have also begun to align their banks’ capital planning processes with the strategic planning processes, and some are incorporating the insights from stress tests in setting their capital targets. If you are planning a strategic increase in concentration levels, it is also a good time to review your capital plan to ensure it will cover your projected concentration growth. We welcome these improvements and encourage bank management to take these actions if they have not already done so. Doing so will ensure that capital levels remain commensurate with a bank’s current and projected risk profile.

### Balancing the Business

Just as you look for trends within your market to help grow your business, we look for trends to understand how your bank is navigating market changes and maintaining sound operations. CRE lending has begun heating up in the Fifth District, so it is likely happening in other places across the country. As part of that increased activity and competition, we are seeing more and more exceptions in underwriting standards. As I pointed out, recent interagency guidance has not called for any new risk management requirements or supervisory criteria. Instead, it is reinforcing the need for strong risk management practices that align with prior guidance and the size and complexity of a bank’s concentration risk. Through our horizontal stress scenario research, we have seen that regularly running a number of scenarios on high-concentration portfolios — and even ones that are nearing those ratios — can help you improve your capital planning and risk management activities. I look forward to continuing the conversation with bankers in our District regarding some of the trends and best practices we are seeing. ■

*The author would like to thank Sue Werner, James Dail, Hamilton Holloway, and Lauren Ware, all from the Federal Reserve Bank of Richmond, for their contributions to this article.*

**Editor’s Note** — *Since this article was penned, Jennifer Burns was appointed by the Board of Governors of the Federal Reserve System as deputy director for the Large Institution Supervision Coordination Committee (LISCC) group where she is playing a significant strategic leadership role providing oversight and guidance to the Board’s Division of Supervision and Regulation and LISCC group, primarily focusing on the supervision of systemically important financial institutions. Jennifer joined the Federal Reserve Bank of Richmond in 1991 and had led the Supervision, Regulation and Credit Department since 2010. Although she remains an integral part of the Federal Reserve, she will be missed at the Richmond Fed for her engagement, intellect, and commitment to a safe and sound banking system.*

# Economic Growth and Regulatory Paperwork Reduction Act Review *continued from page 3*

options designed to help insured depository institutions and bank holding companies that lend in areas experiencing a shortage of appraisers. The first option, temporary practice permits, allows appraisers credentialed in one state to provide their services on a temporary basis in another state experiencing a shortage of appraisers, subject to state law. The second option, temporary waivers, sets aside requirements relating to the certification or licensing of individuals to perform appraisals in states or geographic political subdivisions when it is determined that there is a scarcity of state certified or licensed appraisers, leading to significant delays in obtaining an appraisal. The agencies will also work to streamline the process for granting temporary waiver requests.<sup>9</sup>

*Clarified the Use of Evaluations Versus Appraisals.* To clarify current supervisory expectations regarding evaluations, particularly in response to commenters in rural areas, in March 2016, the agencies issued an interagency advisory on when evaluations can be performed in lieu of appraisals, including when transactions fall below the dollar thresholds set forth in the agencies' appraisal regulations.<sup>10</sup>

## Frequency of Examinations

*Reduced the Full Scope, On-Site Safety and Soundness Examination Frequency for Certain Qualifying Institutions.* The agencies increased the number of small banks and savings associations that can qualify for an 18-month, rather than a 12-month, examination cycle. As a result, approximately 83 percent of all insured depository institutions would qualify for an 18-month examination cycle.<sup>11</sup>

<sup>9</sup> Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 allows the FFIEC Appraisal Subcommittee, after finding that there is a shortage of appraisers leading to significant delays and with the approval of the FFIEC, to grant temporary waivers of any requirement relating to certification or licensing of a person to perform appraisals under Title XI.

<sup>10</sup> See SR letter 16-5, "Interagency Advisory on the Use of Evaluations in Real Estate-Related Financial Transactions," available at [www.federalreserve.gov/supervisionreg/srletters/sr1605.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1605.htm).

<sup>11</sup> See SR letter 17-2, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations," available at [www.federalreserve.gov/supervisionreg/srletters/sr1702.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1702.htm).

## Community Reinvestment Act

*Completed the Interagency Questions and Answers (Q&As) Regarding Community Investment.* The agencies have revised the CRA Q&As, which are the primary vehicle for CRA policy guidance, twice in the past five years. The 2013 revisions clarified how the agencies consider community development activities that benefit a broader statewide or regional area that includes an institution's geographic assessment area.<sup>12</sup> In 2016, further revisions were adopted to the Q&As that address the availability and effectiveness of alternative delivery systems in reaching low- or moderate-income individuals and geographies under the retail service test as well as innovative and flexible lending practices and community development-related issues, including clarifying the activities considered to meet the purpose test for qualifying economic development activities.<sup>13</sup> The agencies are also working together to update interagency examination procedures and make other process improvements. The agencies plan to conduct interagency examiner training to ensure that these policies are applied consistently across the agencies.

## Bank Secrecy Act

*Reduced Frequency of BSA Reviews for Certain Qualifying Institutions.* The change to allow more small banks and savings associations to be eligible for 18-month, rather than 12-month, examination cycles will also result in less frequent BSA reviews.

*Referred Bank Secrecy Act and Anti-money Laundering Comments.* The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury, is the delegated administrator of the BSA and issues the regulations and interpretive guidance. FinCEN is the federal agency responsible for making any changes related to the Currency Transaction Report (CTR) as that is a FinCEN regulation. Changes to Suspicious Activity Report (SAR) requirements would require a joint effort by FinCEN and the agencies, with changes to both FinCEN's and the agencies' regulations. The agencies provided FinCEN with the EGRPRA comments, and FinCEN provided a response, which is included in the

<sup>12</sup> See 78 Fed. Reg. 69671 (November 20, 2013).

<sup>13</sup> See 81 Fed. Reg. 48506 (July 25, 2016).

report as Appendix 5. FinCEN indicated in its response that information in the CTR and SAR reports provides invaluable information to law enforcement agencies, and those agencies affirmed that the current CTR and SAR thresholds are appropriate and should not be raised.

## Interagency Initiative to Review the Examination Process

The agencies are aware that outdated and unnecessary supervisory requirements do not emanate only from statutes and regulations but often come from the agencies' processes and procedures related to their examination and supervisory oversight responsibilities. To that end, the agencies are conducting a joint review of the examination process, examination report format, and examination report preparation process to identify further opportunities to minimize the burden to bank management where possible, principally by rethinking traditional processes and making better use of technology. The agencies are also reviewing interagency guidance to update and streamline guidance to reflect current banking practices and risks.

## Federal Reserve Initiatives

In addition to the joint interagency actions, the Federal Reserve Board has taken additional actions unilaterally to provide regulatory relief on issues that emanate from Board regulations, policies, and practices, including the following:

- Refocusing the holding company inspection process to alleviate unnecessary supervisory oversight by issuing guidance and procedures to ensure Federal Reserve examiners do not duplicate the work of other state and federal regulators when supervising holding companies with assets less than \$50 billion.<sup>14</sup>
- Responding to industry concerns about the disruption caused by large on-site examination teams by providing community and regional banks with the option of having the loan review portion of the examination — the most labor-intensive part of exams — conducted off-site. The Federal Reserve is also conducting other aspects of the examination off-site whenever possible.<sup>15</sup>
- Addressing concerns about unreasonable demands on

<sup>14</sup> See SR letter 16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less Than \$50 Billion," available at [www.federalreserve.gov/supervisionreg/srletters/sr1604.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1604.htm).

<sup>15</sup> See SR letter 16-8, "Off-Site Review of Loan Files," available at [www.federalreserve.gov/supervisionreg/srletters/sr1608.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1608.htm).

boards of directors by clarifying expectations for boards of directors in relation to senior management in revised risk management guidance for supervised institutions with total consolidated assets less than \$50 billion.<sup>16</sup>

- Improving the rigor and accuracy of off-site financial screening to help reduce examination time for well-managed, low-risk community banks and in turn focus more time on higher-risk institutions. As part of this effort, the Federal Reserve streamlined procedures applicable to low-risk banks for key aspects of the examination process. The Federal Reserve is extending this effort to the remaining examination procedures.
- Implementing a revised consumer compliance examination frequency policy to lengthen the time frame between on-site consumer compliance and CRA examinations for many community banks with less than \$1 billion in total consolidated assets.<sup>17</sup> The Board adopted a new consumer compliance examination framework for community banks at the same time.<sup>18</sup> The new framework more explicitly bases examination intensity on the individual community bank's risk profile, weighed against the effectiveness of the bank's compliance controls.

For a comprehensive list of Board actions taken to provide regulatory relief, please refer to the EGRPRA report.

## Conclusion

The initiatives identified in the EGRPRA report are part of an ongoing effort by the agencies to provide regulatory relief, especially for community banks. The Federal Reserve will continue to engage in dialogue with the banking industry to better understand which requirements may be outdated or unnecessary. The Federal Reserve is also committed to identifying ways to provide relief, especially for community banks, on issues that emanate from Board regulations, policies, and practices, balanced against the need to ensure the safety and soundness of banks. ■

*The Community Banking Connections Advisory Board would like to thank Jinai Holmes for coordinating the writing of this article.*

<sup>16</sup> See SR letter 16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less Than \$50 Billion," available at [www.federalreserve.gov/supervisionreg/srletters/sr1611.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1611.htm).

<sup>17</sup> See Consumer Affairs (CA) letter 13-20, "Consumer Compliance and Community Reinvestment Act (CRA) Examination Frequency Policy," available at [www.federalreserve.gov/bankinforeg/caletters/caltr1320.htm](http://www.federalreserve.gov/bankinforeg/caletters/caltr1320.htm).

<sup>18</sup> See CA letter 13-19 "Community Bank Risk-Focused Consumer Compliance Supervision Program," available at [www.federalreserve.gov/bankinforeg/caletters/caltr1319.htm](http://www.federalreserve.gov/bankinforeg/caletters/caltr1319.htm).

# Banks Are Becoming More Efficient — Is That Good or Bad?

*continued from page 5*

management teams become more reliant on relatively fewer staff to perform day-to-day activities and to ensure proper internal controls are followed.

## To What Extent Is Improving Efficiency Leading to Stronger Net Income?

After several years of consistent improvement, net income (as measured by pretax ROAA) at all community banks has slowed to varying degrees. At small community banks, pretax ROAA has increased from 1.09 percent at year-end 2013 to 1.28 percent at year-end 2016. However, at larger community banks, ROAA has actually declined nominally, from 1.54 percent to 1.51 percent over this same period. Meanwhile, over this period, NIMs actually declined for both groups of community banks, from 3.69 percent to 3.66 percent at small community banks and from 4.00 percent to 3.61 percent at larger community banks.<sup>3</sup>

Therefore, the improvement in pretax ROAA over this period was not driven by improvement in core earnings. Instead, the stronger earnings performance at these banks was due to lower credit-related costs (provisions for loan and lease losses) and/or operating expenses (noninterest expenses). Provisions for loan and lease losses declined modestly at small community banks, from 0.18 percent of average assets at year-end 2013 to 0.13 percent at year-end 2016. Provisions for loan and lease losses increased slightly at banks with total assets of \$1 billion to \$10 billion, from 0.21 percent at year-end 2013 to 0.26 percent at year-end 2016. However, noninterest expenses declined more significantly over this period, particularly for larger community banks. As previously mentioned, at small community banks, the decline in noninterest expenses over this period equaled 7 basis points, but it was much more meaningful at the larger community banks (36 basis points), indicating that net income, particularly at larger banks, was driven primarily by a decrease in operating expenses.<sup>4</sup>

<sup>3</sup> Data obtained from the Call Report.

<sup>4</sup> Data obtained from the Call Report.

## What Concerns Arise When Banks Become More Efficient?

While there are several benefits to banks becoming more efficient, a strategic decision to make an organization more efficient, if not managed appropriately, could hurt the financial health of the institution in the long run. If bank management chooses to improve efficiency by cutting staff or limiting the growth in employee count as the balance sheet grows, it may quickly encounter internal control challenges or other operational breakdowns. For instance, if resources in the bank's internal loan review department do not increase in line with loan growth, internal loan review staff could quickly become overwhelmed, and a previously effective operation could become ineffective.

One common metric that is used to measure and monitor an institution's overall efficiency is the efficiency ratio (total noninterest expenses divided by the sum of noninterest and net interest income). The lower this ratio, the more efficient the organization is when compared with other institutions.

## What Could Go Wrong?

One institution that was experiencing significant asset growth soon found that its Bank Secrecy Act (BSA) compliance team was overworked and too thinly staffed to ensure its BSA compliance program was working appropriately. The bank, which previously had a satisfactory BSA compliance program, learned that it was no longer in full compliance with the BSA. The management team was slow to recognize that as the institution quickly grew so too did its BSA risk profile. This unanticipated development required the institution's management team to quickly shift gears, slow down its expansionary plans, and focus on hiring additional BSA staff to address the backlog of work and implement the program enhancements necessary to ensure that the program was appropriately scaled to handle the increased risk profile.

Concerns arise when a low efficiency ratio is driven by the numerator rather than the denominator. Put differently, a low efficiency ratio that is the result of declining and/or lower overhead expense (the numerator) will be viewed with more concern by regulatory authorities than a low ratio that is the result of relatively larger levels of noninterest or net interest income (the denominator).

Over the past several years, the overall efficiency ratio for the banking industry actually has not moved much. However, there does appear to be a widening range of ratios, and there is a pronounced decline in efficiency ratios for banks in certain markets. For example, for banks in the Federal Reserve's Twelfth District, the aggregate efficiency ratio of 56 percent is nearly 5.5 percentage points lower than the aggregate efficiency ratio for all banks nationwide. Moreover, there are several institutions in the Twelfth District that now have extremely low efficiency ratios, with some still moving downward and approaching the 40 percent level.<sup>5</sup> Further, many of these ratios are indeed driven by lower overhead expenses, which could draw some regulatory attention, particularly if these same institutions also have internal audit or other internal control deficiencies. In fact, in the Twelfth District, there has been a rise in the number of banks that have internal audit program deficiencies.

### What Should Bank Management Teams Keep in Mind?

In the current low interest rate environment, it is especially important that bank management teams pay particular attention to operating expenses and promote efficient operations. However, short-term profits should not come at the expense of long-term viability. Bank management teams also need to ensure that the institution is appropriately staffed and that sufficient resources are in place to effectively manage all areas of the institution's operations. As an institution grows in size and complexity, it will naturally require more resources to manage increasing risks. The difficult part of the process is determining just how many additional resources are necessary. With that in mind, as bank management teams focus attention on increasing profits, they should consider the following:

- **Incorporate staffing and resource needs into the strategic planning process.** Boards of directors and bank management teams at most banks already develop an

annual strategic plan that is used to guide their organizations' operations. The strategic planning process used by a bank is going to vary widely given the bank's size, complexity, and type of operations, but often these plans are developed by simply incorporating new growth targets for the bank's various lines of business and areas of operations. On the expense side, very high-level targets will often be established (e.g., "personnel expense will grow 5 percent over the next 12 months" or "personnel expense will decline 5 percent"). While there may be some good rationale for determining these growth rates, it is still a top-down approach, and it may not be clear whether that specific level of personnel expense is appropriate for the bank's business model and type of operations.

- **Incorporate efficiency metrics into peer analysis.** Similarly, most bank management teams already conduct some form of peer analysis to see how their bank's performance compares with that of a designated peer group. This peer analysis should incorporate efficiency metrics. Peer analysis is useful; it can help management teams identify areas in which the bank is performing not as well as or much better than its peers. Efficiency metrics such as the efficiency ratio, overhead expense to average assets, and average personnel expense per employee (all of which are available in the Federal Financial Institutions Examination Council Uniform Bank Performance Report<sup>6</sup>) can show how the bank is financing its operations relative to its peers. Operating expenses that are substantially lower than those of its peers (factoring in variances in business models) should be viewed as a red flag and investigated by the management team.
- **Monitor root causes of operational breakdowns.** From time to time, even the best-run organization will have some breakdown in its operations, internal controls, or compliance programs, and even the best organization will receive an occasional adverse audit finding. These things happen despite the best intentions and sound risk management programs. As gaps are identified, bank management teams should focus their attention on root causes. When the root causes point to a theme of inadequate staffing, resources, or expertise in different areas of bank operations, this could be a signal that the bank is not devoting sufficient resources to its various operational functions.

<sup>5</sup> Data obtained from the Call Report.

<sup>6</sup> See the Uniform Bank Performance Report, available at [www.ffiec.gov/UBPR.htm](http://www.ffiec.gov/UBPR.htm).

## Bringing It Home

To close, it is important to reinforce the point that efficiency is good. Any organization will be more successful if it closely manages its growth and expenses. On that note, management teams should not be so focused on profitability metrics that they forget about the need to maintain appropriate internal controls, audit functions, and compliance programs, especially as the institution grows in size, complexity, and/or risk profile. At times, it may be totally appropriate to make some tough

decisions and sacrifice current income for long-term profitability to staff-up an important operational function in order to better position the institution to manage its risk for the long term. ■

# Denver Cybersecurity Conference Reminds Bankers to Be Vigilant *continued from page 7*

percent of cyberattacks originate through phishing e-mails and other methods of social engineering. Bankers were encouraged to conduct vulnerability and social engineering tests on a regular basis to reduce the chances of employees unknowingly clicking on an infected e-mail. Employees subject to the test should not know when a social engineering test is going to be conducted to avoid skewing the test results.

### Friendly Fraud

Another banker panelist estimated that 70 percent to 80 percent of credit card fraud is the result of “friendly fraud.” Friendly fraud occurs when a product is purchased from an online store, but after the customer receives the product, he or she tells the credit card company to reverse the charge because the merchandise wasn’t received. The card issuer, such as VISA or MasterCard, will then cancel the transaction and give the person who initiated the purchase his or her money back. In the end, the consumer obtains a refund from the credit card company but also keeps the product. Ultimately, the loss has to be absorbed by either the bank or the merchant.<sup>6</sup>

<sup>6</sup> See David Lott, “Friendly Fraud: Nothing to Smile About (Part 1),” Federal Reserve Bank of Atlanta, 2015, available at <http://takeonpayments.frbatlanta.org/2015/07/friendly-fraud-nothing-to-smile-about-part-1.html>.

### Printed Documents

The banking panel reminded attendees that printed documents with sensitive or confidential customer information (for example, a customer’s loan file or credit card application) are difficult to secure because they can be easily misplaced. Both bank staff and customers were encouraged not to print documents unless absolutely necessary. A significant problem noted with regard to printed material is that organizations do not know if a printed document has been lost.

### Internet of Things

Bankers reminded attendees that the Internet of Things (IoT) poses new threats. The IoT refers to mechanical devices connected to the Internet, such as video cameras and home thermostats.<sup>7</sup> If not adequately secured and protected, these Internet-connected devices can expose organizations and individuals to security risks. One panelist gave an example of a security camera that, when connected to the network, immediately started attempting to send messages to China. Bank management should monitor devices that seem harmless, such as photocopiers, because the information accessed or stored on these devices can possibly be compromised.

<sup>7</sup> See Jacob Morgan, “A Simple Explanation of ‘The Internet of Things,’” *Forbes*, May 13, 2014, available at <https://tinyurl.com/yabtdfzv>.

### **Anomaly Detection**

The banker panel indicated that banks have the ability to observe customers' normal patterns of performing transactions and, based on these data, are able to develop a baseline of customers' behavior. This baseline helps banks to more quickly identify behavioral anomalies that may indicate incidents of fraud. Banks can use anomaly detection software to help create and monitor baseline behavioral patterns. Incident response program flow charts detailing the steps the bank will take during a cybersecurity event should also be developed and regularly tested.

### **Employee Training**

Employees who are trained to identify fraud are a bank's greatest resource. The conference participants agreed that, to promote the effectiveness of training, banks need to make fraud detection training fun and competitive to keep employees engaged. One-time training events were seen to effectively change behavior for only two to three months; therefore, regularly repeating the training was encouraged. Employees need to feel that they are part of the solution.

### **Threat Intelligence**

The bank's cybersecurity experts should monitor threat intelligence and should provide related information to the bank's board of directors, staff, and customers when appropriate. Banks should discern between minor and significant threats and should educate bank staff and customers about these threats so that they can be readily identified and reported to management.

### **Data Leakage**

Data leakage occurs when unauthorized parties obtain sensitive data through either malicious intent or an inadvertent mistake by an employee. Panelists recommended various steps to assist with data loss prevention, including shutting off USB ports and filtering out the content of outgoing messages. Shutting off USB ports prevents the downloading of sensitive or confidential information to USB flash memory sticks. Filtering content out of outgoing messages can be done through a program that screens outgoing e-mails for sensitive information and prevents the sending of an e-mail with sensitive information.

### **User Groups**

Banks' information technology and cybersecurity experts were encouraged to be involved in the user groups of critical

software vendors. User group meetings offer an opportunity for software users to discuss their cybersecurity concerns and to share those concerns with the vendor.

### **User Access Levels**

Management should closely monitor user access levels to ensure bank employees have no more access rights to information and systems than required to do their jobs. This is known as the principle of least privilege. For example, a bank's senior management should not have administrative access to critical systems because these individuals are often targeted by hackers. If a bank senior officer has administrative access and that access is stolen, the hackers will be able to make unrestricted, potentially adverse, system-wide changes to the bank's critical systems.

### **A Bank's Board of Directors**

While not a regulatory requirement, conference panelists suggested that a bank's board of directors take time to discuss cybersecurity issues at every board meeting and seek to understand the issues. Discussions should cover topics such as the different types of cybersecurity breaches and the potential harm of such breaches to the bank; the board's role in overseeing cybersecurity and providing risk oversight; the importance of having a cybersecurity framework for the bank; the bank's efforts to prepare for cybersecurity incidents; and measures to take to prevent an incident as well as possible responses to a breach.

### **Conclusions**

The general consensus of the conference participants is that banks need to take measures to improve the protection of their information and systems. In addition to establishing processes to identify and manage cyberthreats, as discussed in this article, bankers should also (1) maintain an inventory of their information technology assets and systems, (2) develop a program for promoting customer awareness about how to protect personal and bank information, (3) develop processes for monitoring critical third-party interconnectedness and resilience plans, and (4) maintain and periodically test an incident response plan to address cybersecurity breaches as well as testing of the plan.<sup>8</sup> ■

<sup>8</sup> The FFIEC IT Exam Handbook InfoBase, which is available at <http://ithandbook.ffiec.gov/it-booklets.aspx>, provides additional information. See also Brian Bettel, "Less Risky Business: An Overview of a New Cybersecurity Assessment Tool," *Community Banking Connections*, Second Issue 2016, available at [www.cbefrs.org/articles/2016/i2/less-risky-business](http://www.cbefrs.org/articles/2016/i2/less-risky-business), and Qing Liu and Sebastiaan Gybels, "Cybersecurity: Part 2 — Cyber-Related Assessment and Controls," *Community Banking Connections*, Third/Fourth Quarter 2014, available at [www.cbefrs.org/articles/2014/q3-q4/cybersecurity-part-two](http://www.cbefrs.org/articles/2014/q3-q4/cybersecurity-part-two).

## D.C. UPDATES

Governor Lael Brainard gave a speech at the Northwestern Kellogg Public–Private Interface Conference on “New Developments in Consumer Finance: Research and Practice” in Evanston, IL, on April 28, 2017. Her speech on “Where Do Banks Fit in the Fintech Stack?” is available at [www.federalreserve.gov/newsevents/speech/brainard20170428a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20170428a.htm).

Governor Jerome H. Powell gave welcoming remarks at “Expanding the Impact: Increasing Capacity and Influence,” the 2017 Interagency Minority Depository Institution and Community Development Financial Institution Bank National Conference in Los Angeles on April 5, 2017. His remarks are available at [www.federalreserve.gov/newsevents/speech/powell20170405a.htm](http://www.federalreserve.gov/newsevents/speech/powell20170405a.htm).

Governor Daniel K. Tarullo offered some departing thoughts at the Woodrow Wilson School at Princeton University in Princeton, NJ, on April 4, 2017. Governor

Tarullo submitted his resignation on February 10, 2017, as a member of the Board of Governors of the Federal Reserve System, effective on April 5, 2017. He had been a member of the Board since January 28, 2009, and served as the chair of the Board’s Committee on Supervision and Regulation. Governor Tarullo’s remarks are available at [www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm](http://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm), and the press release announcing his resignation is available at [www.federalreserve.gov/newsevents/pressreleases/other20170210a.htm](http://www.federalreserve.gov/newsevents/pressreleases/other20170210a.htm).

Governor Powell gave a speech at “Blockchain: The Future of Finance and Capital Markets?” at the Yale Law School Center for the Study of Corporate Law in New Haven, CT, on March 3, 2017. His speech on “Innovation, Technology, and the Payments Systems” is available at [www.federalreserve.gov/newsevents/speech/powell20170303a.htm](http://www.federalreserve.gov/newsevents/speech/powell20170303a.htm).

For more recent news, visit the Board’s website at [www.federalreserve.gov/newsevents.htm](http://www.federalreserve.gov/newsevents.htm).

## REGULATORY RECAP

### Supervision & Regulation (SR) & Consumer Affairs (CA) Letters

The following SR and CA letters that have been published since the last issue (and are listed by most current) apply to community banking organizations. Letters that contain confidential supervisory information are not included. All SR letters are available by year at [www.federalreserve.gov/bankinforeg/srletters/srletters.htm](http://www.federalreserve.gov/bankinforeg/srletters/srletters.htm) and by topic at [www.federalreserve.gov/bankinforeg/topics/topics.htm](http://www.federalreserve.gov/bankinforeg/topics/topics.htm). A complete list of CA letters can be found at [www.federalreserve.gov/bankinforeg/caletters/caletters.htm](http://www.federalreserve.gov/bankinforeg/caletters/caletters.htm).

- SR Letter 17-8 Frequently Asked Questions on the Current Expected Credit Losses Methodology (CECL)
- SR Letter 17-7 Regulatory Capital Treatment of Certain Centrally Cleared Derivative Contracts Under the Board’s Capital Rule
- SR Letter 17-5 Procedures for a Banking Entity to Request an Extension of the One-Year Seeding Period for a Covered Fund
- SR Letter 17-4 Interagency Advisory on the Availability of Appraisers
- CA Letter 17-2 Revised Interagency Home Mortgage Disclosure Act Sampling, Verification, and Resubmission Procedures

# Connect with Us

What banking topics concern you most? What aspects of the supervisory process or the rules and guidance that apply to community banks would you like to see clarified? What topics would you like to see covered in upcoming issues of *Community Banking Connections*?

With each issue of *Community Banking Connections*, we aim to highlight the supervisory and regulatory matters that affect you and your banking institution the most, providing examples from the field, explanations of supervisory policies and guidance, and more. We encourage you to contact us with any ideas for articles so that we can continue to provide you with topical and valuable information.

Please direct any comments and suggestions to [www.cbcrfs.org/feedback.cfm](http://www.cbcrfs.org/feedback.cfm), or send an e-mail to [editor@communitybankingconnections.org](mailto:editor@communitybankingconnections.org).

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A SUPERVISION AND REGULATION PUBLICATION

Second Issue 2017

VIEW FROM THE DISTRICT  
A Fifth District Perspective — Richmond



### Managing Risks of Commercial Real Estate Concentrations

by Jennifer Burns, Executive Vice President, Supervision, Regulation and Credit, Federal Reserve Bank of Richmond

In the Fifth District of the Federal Reserve System, commercial real estate (CRE) exposures have long been top of mind. As is the case in many regions across our country, CRE lending is and has been a significant strategic focus for many banks. Given a dearth of demand from qualified borrowers and significant change-offs, CRE exposure declined during and after the Great Recession. In 2013, exposures began to grow again, concentrations began to build, and trends that signaled an increasing risk appetite for CRE lending began to emerge.



Jennifer Burns

As bank supervisors, we understand that the business models of many community banks<sup>1</sup> rely on CRE lending, and we appreciate the benefit that bank lending provides to the economic activity in their communities. Our objective is to help bank leaders develop and implement risk management and capital planning practices that support well-informed decision-making and an ability to balance risk-taking with safety and soundness. Along those lines, in this article, I will share trends that are heightening supervisory focus on CRE lending practices, including anecdotal risk management observations from examinations. I will highlight potential consequences of high CRE concentrations as evidenced from the last recession and provide some CRE loss rate trends that may offer new insight into risk management considerations. Finally, I will share results and best practices from two horizontal supervisory reviews of banks' risk management practices completed last year as well as some observations on the current state of capital planning in our District. My hope is that this information helps you as your bank contemplates a strategy for and management of CRE exposures.

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<sup>1</sup> Community banks include state member banks, state nonmember banks, and national banks with assets less than \$10 billion.

## CECL Corner Coming Soon

Do you have questions about the current expected credit loss (CECL) model? If so, look for more information in the new CECL Corner that will be featured in future issues of *Community Banking Connections*.

Scan with your smartphone or tablet to access *Community Banking Connections* online.

