Meeting Between the Board of Governors and
the Community Depository Institutions Advisory Council
November 8, 2013

Board members: Chairman Ben Bernanke, Governor Daniel Tarullo, Governor Sarah Bloom Raskin, Governor Jeremy Stein, and Governor Jerome Powell

Federal Reserve staff: Susan Foley, Robert Frierson, Robin Prager, Louise Roseman, William Treacy, Jon Hiratsuka, Lanette Meister, Wanda Quick, Shahera Williams, William Tiernay (Federal Reserve Board); Erien Terry (Federal Reserve Bank of Atlanta)

Council Members: Chandler J. Howard, Michael J. Castellana, Dennis D. Cirucci, Eddie Steiner, Charles H. Majors, Claire W. Tucker, Timothy G. Marshall, Glenn D. Barks, Brian L. Johnson, John B. Dicus, Drake Mills, John V. Evans Jr. (Community Depository Institutions Advisory Council); Robert R. Davis (Consultant)

Summary: The Federal Reserve Board and staff met with the Community Depository Institutions Advisory Council ("the Council"), an advisory group established by the Board to provide input about the economy, lending conditions, and other issues of interest to community depository institutions. One representative from each of the local advisory councils at the twelve Federal Reserve Banks is selected to serve on the Council, which meets twice a year.

The Council discussed regulatory matters and the future of banking, including how recent changes in the regulatory landscape were affecting community depository institutions' ability to continue providing services to their customers. The Council also expressed concerns about regulatory burdens resulting from the Dodd-Frank Act, including the implementation of provisions such as the Volcker Rule (Docket No. R-1432).

The information collected from the Council at the meeting is attached. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Regulatory Matters and the Future of Banking:

How are recent changes in the regulatory landscape affecting community depository institutions' ability to continue to provide services to their customers?

It is well known that lending by community institutions is essential to job creation and supporting the small business sector in a recovering economy. However, a community institution's benefit to the community is not limited to supplying banking services. They also fill an important role within community life. Often community institutions are the only reliable source of charitable support in the form of monetary donations and volunteers. An unintended and artificial contraction of community banking institutions will not only dramatically reduce the nation's economic diversity and growth but also harm the well-being and viability of the communities that depend on them.

Increasing regulatory burden and resulting constriction of traditional banking services caused the Council to question the future of community banking institutions as a value proposition. If the viability of community financial institutions is limited or reduced, so too will be the value they bring to the community-at-large. The focus of resources on compliance and examination results in less focus on growing the business, serving the customer, expanding products, and being active in the community.

The Council continues to voice its concern about the volume of overwhelming new rules and the high cost of compliance, particularly those caused by the new mortgage rules. In direct response to the new QM and Ability to Repay (ATR) rules, several Council members indicated that community institutions will be significantly restricting – or terminating – their traditional business focus on consumer lending and residential mortgages, due to the lack of clarity surrounding the consumer protection rules and fair lending expectations. Moreover, the impact of the QM rule makes it exceedingly difficult to serve first-time homebuyers or those with significant student loan debt. With the risks of non-QM loans not yet understood, community institutions are much less likely to make non-QM loans to potentially good borrowers. Rather, the Council recounted that many community institutions are tightening underwriting beyond the QM standards to ensure a non-QM loan is not made by mistake. The unintended consequence of the rule remains that qualified borrowers who should get a loan will be unable to get funding. When a mortgage loan is made, the Council questioned the ability and supervisory expectation to document a borrower's ATR. Must a bank use information gleaned from other sources to determine ATR? For example, a borrower reveals in a casual conversation with a loan officer an expected upcoming life event that could have significant impacts on ATR for borrowers on the edge of qualifying. The expected level of scrutiny of customer information, customer expectations of privacy, and needed evidentiary threshold to withstand litigation is yet untested. How much is enough?

Among institutions that are exiting the mortgage business or exiting temporarily until the risks are understood, several Council members expressed hesitation at making an exception to accommodate the credit needs of known customers. A violation arising from a manual or infrequent loan origination process may carry too high a risk to a bank's reputation.

Several Council members addressed the difficulty caused by an extended QM rule-writing period and a rushed implementation schedule. Community institutions rely on automated systems provided and maintained by third-party service providers. When final regulations arrive late and implementation periods are not extended, the computerized systems used by community institutions cannot be updated in time. Council members reported systems not yet delivered or still in the testing phase and unreliable in calculating the QM thresholds. For those institutions electing to use manual processing until systems are ready, the process will be dramatically slower, and as a result, the number of loans processed will be restricted.

In addition to the QM rules, the Council discussed the cumulative impacts of other recent regulation on the decision to move away from mortgage lending. The new PMI treatment obligates a bank to cancel PMI insurance upon obtaining 78 percent of appraised value, not 78 percent of original value. Unfortunately, the rule does not address a bank's safety and soundness concern when the loan is underwater or the borrower has a history of delinquency. Also, the Basel III capital rule's treatment of mortgage servicing assets creates additional costs for community institutions with an active mortgage business. In a stagnant economic environment with flat yield curves, few community institutions are in a position to take on even incremental costs associated with residential mortgages.

The Council continues to focus on the negative impact of compliance costs on a bank's efficiency ratio. Dodd-Frank implementation has forced community institutions to increase significantly the number of full-time employees focused on compliance. These expenditures have no business development function; they are not offset by loan growth or increased product sales. Rather, compliance burden increases costs and reduces a bank's performance statistics. The Council repeatedly discussed the search for a "new normal" as a trend in rising compliance costs causes efficiency ratios to decrease significantly across the industry. These costs, as reflected in lower ratios and earnings, may severely impair the ability to maintain, grow, or attract the capital needed to continue operations.

What has been the effect on the industry generally?

The immediate effect on the industry is restricted or discontinuation of specific products or business lines. As compliance costs increase, efficiency ratios will continue to rise, making investment more difficult to attract. The restrictions on compensation and compliance workload also make it difficult to attract and retain good talent. Employees are easily attracted to positions outside of banking (or within the less-regulated shadow banking market) with higher compensation and less risk.

Over the longer term, institution portfolios may become more concentrated and less diverse, with the correlating decrease in safety and soundness.

Volcker Rule – Community Bank Issues

Rather than applying only to the largest banks, the Volcker Rule applies to *all* banks *regardless of size or activity*. Therefore, every community bank will be required to read and understand the

Volcker Rule and adapt the bank's compliance program to the Volcker Rule's requirements. Instead of defining what is prohibited, the agencies have tried to carve out permitted activities. It is not readily apparent, however, what is permissible versus impermissible trading and investment activity. Community banks therefore will be forced to allocate precious resources not to customer service but to puzzling through regulatory requirements.