

Key Takeaways for Regional and Community Banks from the Federal Reserve's April 2021 Supervision and Regulation Report

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Twice a year — once in the spring and then again at the end of the year — the Board of Governors of the Federal Reserve System (Federal Reserve) publishes a report on banking conditions in the United States. Typically, the spring report summarizes the Federal Reserve's supervisory and regulatory posture for the next twelve months and is released to coincide with testimony by the Federal Reserve's vice chair for supervision before Congress. As such, the report serves as a good barometer for the Federal Reserve's perspective on three key areas: (1) banking system conditions, (2) regulatory developments, and (3) the supervisory environment. On April 30, the Federal Reserve released its [2021 Supervision and Regulation Spring Report](#). Below is a brief summary of the portions of the Federal Reserve's 2021 Spring Report that are of special importance for regional and community bankers.

Banking System Conditions

The pandemic continues to present challenges for families and businesses nationwide, regardless of geography or economic sector. But, as we regain our balance at the end of COVID-19's first year, it is clear that regional and community banking organizations have played a critical role in supporting customers and the broader economy. This is due in large part to the financial skill and operational resilience of the American banking system. Several factors identified by the Federal Reserve reflect our banking system's key strengths as of the second quarter of 2021:

- Capital and liquidity positions remain robust, with capital ratios well above regulatory minimums and significant deposit growth providing a buffer to absorb losses and support continued lending.
- Rapid investment in and deployment of technology has helped regional and community banks continue to engage with customers in a remote, digital environment.
- Profitability — measured by return on equity (ROE) and return on average assets (ROAA) — has rebounded to pre-COVID-19 levels.
- Bank involvement in the Small Business Administration's Paycheck Protection Program (PPP) has played a vital role in sustaining main street businesses.

Despite these strengths, however, the Federal Reserve is careful not to declare the economic recovery complete. Several unresolved issues give the Federal Reserve cause for concern, including:

- Overall bank lending activity remains low, with reduced demand and tighter lending standards, particularly at smaller banks (notwithstanding the success of the PPP).
- Net interest margin declined sharply in the first three quarters of 2020 and only recovered slightly by year-end 2020.
- Borrower delinquency rates slightly increased, and loan modification activity continues — particularly in residential and commercial real estate — despite the flexibility afforded by banking regulators.
- Expanded reliance on technology has presented a corresponding increase in cybersecurity vulnerability, which affects all banks regardless of asset size or technical sophistication.

Regulatory Developments

During the first year of the pandemic, the Federal Reserve issued 60 notices of proposed or final rules and statements on policy actions to support the economic recovery. The Federal Reserve also worked to improve regulatory transparency and efficiency and cooperation with other financial regulators — particularly in its approach to new risks related to operational resilience and the supervision of new technology (such as artificial intelligence or AI).

Since the onset of the pandemic in early 2020, many regional and community bank balance sheets have grown unexpectedly, which — absent intervention — would subject those banks to new and unfamiliar regulatory requirements. To support operational resilience during this time, the Federal Reserve — along with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency — granted temporary regulatory relief to address the consequences of the unanticipated asset growth, providing banks with time to reduce assets or prepare for new regulatory and reporting standards.

At the same time, the banking industry continues to explore AI in a number of technology-intensive areas, including fraud monitoring, customer service, and loan underwriting. In response, the Federal Reserve and its sister financial regulators have engaged with supervised financial institutions to gather information on the risk management of AI applications in financial services, including the potential for a lack of transparency in AI models, the use of data in AI applications, cybersecurity risks, and fair lending considerations. In the coming months, the Federal Reserve intends to use this information to determine whether additional clarity around supervisory expectations on the use of technology is warranted.

The Supervisory Environment

Because the Federal Reserve's supervisory approach and priorities differ depending on the size a supervised bank, the report distinguishes between large financial institutions, on the one hand, and regional and community banks, on the other. Generally speaking, community banking organizations (CBOs) have less than \$10 billion in

total assets, whereas regional banking organizations (RBOs) have total assets between \$10 billion and \$100 billion, and large financial institutions have total assets of \$100 billion or more. With that framework in mind, the Federal Reserve highlighted the following points for 2021's supervisory environment with respect to CBOs and RBOs:

- Although CBOs and RBOs present stable operational and credit conditions, they continue to face uncertainty about the future performance of loans to industries and businesses most affected by the pandemic.
- The number of CBOs and RBOs reporting losses has declined throughout the past twelve months and, at the same time, CBOs and RBOs report generally stable or increasing liquidity levels and lower reliance on noncore funding.
- The importance of sound risk management of third-party risk exposure is expected to increase as CBOs and RBOs increase their reliance on third-party technology service providers to service customers in an increasingly more remote, digital environment.
- Because many CBOs and RBOs project flat or minimal loan growth in 2021 (with evident credit risks in borrowers adversely affected by the pandemic, such as commercial real estate), banks should expect the Federal Reserve to closely monitor loan concentrations.

In addition, the Federal Reserve outlines the following categories of supervisory priorities for CBOs and RBOs over the next twelve months:

- **Overall:** (1) capital and liquidity resiliency and (2) risk-identification and management practices.
- **Credit Risk:** (1) loan modifications; (2) high-risk loan portfolios (commercial real estate loan portfolios and loans to borrowers in COVID-19-sensitive industries); (3) underwriting practices and asset growth; and (4) reserve practices and levels.
- **Capital:** (1) planning, projections, needs, and vulnerabilities; (2) capital actions; and (3) earnings assessment.
- **Operational Risk:** (1) business and operational continuity and (2) information technology and cybersecurity.

The COVID-19 pandemic has changed many aspects of the way banks, businesses, and consumers work and use financial products and services. The economic recovery is not complete, but conditions are improving — primarily because the pandemic has affirmed the values and priorities that undergird the American banking system. As the 2021 Spring Report makes clear, the Federal Reserve will continue to closely support and monitor risk exposures, credit performance, and operations as the banking industry makes its way through this unique and demanding time.

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