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Preserving a Central Role for Community Banking

Remarks by

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at

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I'm glad once again to be able to meet with and speak to the Independent Community Bankers of America. I greatly value the chance to hear directly from you about the challenges you are facing today. As everyone in this audience knows, those challenges are daunting indeed, and they go far beyond parochial concerns. Communities all over America are trying to cope with the economic consequences of the most severe financial crisis since the Great Depression--high unemployment, lost incomes and wealth, home foreclosures, strained fiscal budgets, and uncertainty about the future. Because community banks are integral to local economies, you have been on the front line, so to speak, deeply engaged in confronting those problems and uncertainties. Your commitment to your communities, including your willingness to provide credit and services supporting small businesses, home purchases, and commercial development, is reason to be optimistic about our nation's ability to meet the current challenges and return to economic health.

One of America's economic strengths is its relatively greater reliance on bottom-up rather than top-down growth and development, in which individual creativity, local knowledge, and the trust born of longstanding relationships help foster economic creativity and progress. Of course, it is precisely the ability to foster bottom-up growth, building on local knowledge and relationships, that sets community banks apart from other financial institutions. It is important for our economic health to maintain a diverse and resilient financial system in which community banks play an important role.

As the crisis has shown, one of the greatest threats to the diversity and efficiency of our financial system is the pernicious problem of financial institutions that are deemed "too big to fail." I will spend some time today discussing the efforts the Federal Reserve

and other policymakers are making to put an end to the too-big-to-fail problem and thus help foster effective competition in financial services. I also want to speak today about the links between your institutions and mine. The Federal Reserve has always had a special relationship with community banks. As we turn from crisis management to supporting the economic recovery, that relationship will become more important than ever.

Toward a More Competitive, Efficient, and Innovative Financial System

The United States has a financial system that is remarkably multifaceted and diverse. Some countries rely heavily on a few large banks to provide credit and financial services; our system, in contrast, includes financial institutions of all sizes, with a wide range of charters and missions. We also rely more than any other country on an array of specialized financial markets to allocate credit and help diversify risks. Our system is complex, but I think that for the most part its variety is an important strength. We have many, many ways to connect borrowers and savers in the United States, and directing saving to the most productive channels is an essential prerequisite to a successful economy.

That said, for the financial system to do its job well, it must be an impartial and efficient arbiter of credit flows. In a market economy, that result is best achieved through open competition on a level playing field, a framework that provides choices to consumers and borrowers and gives the most innovative and efficient firms the chance to succeed and grow. Unfortunately, our financial system today falls substantially short of that competitive ideal.

Among the most serious and most insidious barriers to competition in financial services is the too-big-to-fail problem. Like all of you, I remember well the frightening weeks in the fall of 2008, when the failure or near-failure of several large, complex, and interconnected firms shook the financial markets and our economy to their foundations. Extraordinary efforts by the Federal Reserve, the Treasury, the Federal Deposit Insurance Corporation (FDIC), and other agencies, together with similar actions by our counterparts in other countries, narrowly averted a global financial collapse. Even with those extraordinary actions, the economic costs of the crisis have been very severe; but I have little doubt that, had the global financial system disintegrated, the effects on asset values, credit availability, and confidence would have resulted in a far deeper and longer-lasting economic contraction. It is unconscionable that the fate of the world economy should be so closely tied to the fortunes of a relatively small number of giant financial firms. If we achieve nothing else in the wake of the crisis, we must ensure that we never again face such a situation.

The costs to all of us of having firms deemed too big to fail were stunningly evident during the days in which the financial system teetered near collapse. But the existence of too-big-to-fail firms also imposes heavy costs on our financial system even in more placid times. Perhaps most important, if a firm is publicly perceived as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better terms than the

quality or riskiness of their business would merit and giving them incentives to take on excessive risks.

Having institutions that are too big to fail also creates competitive inequities that may prevent our most productive and innovative firms from prospering. In an environment of fair competition, smaller firms should have a chance to outperform larger companies. By the same token, firms that do not make the grade should exit, freeing up resources for other uses. Our economy is not static, and our banking system should not be static either.

In short, to have a competitive, vital, and innovative financial system in which market discipline encourages efficiency and controls risk, including risks to the system as a whole, we have to end the too-big-to-fail problem once and for all. But how can that be done? Some proposals have been made to limit the scope and activities of financial institutions, and I think a number of those ideas are worth careful consideration. Certainly, supervisors should be empowered to limit the involvement of firms in inappropriately risky activities. But even if such proposals are implemented, our technologically sophisticated and globalized economy will still need large, complex, and internationally active financial firms to meet the needs of multinational firms, to facilitate international flows of goods and capital, and to take advantage of economies of scale and scope. The unavoidable challenge is to make sure that size, complexity, and interconnectedness do not insulate such firms from market discipline, potentially making them ticking time bombs inside our financial system.

To address the too-big-to-fail problem, the Federal Reserve favors a three-part approach. First, we and our colleagues at other supervisory agencies must continue to

develop and implement significantly tougher rules and oversight that serve to reduce the risks that large, complex firms present to the financial system. Events of the past several years clearly demonstrate that all large, complex financial institutions, not just bank holding companies, must be subject to strong regulation and consolidated supervision. Moreover, the crisis has shown that supervisors must take account of potential risks to the financial system as a whole, and not just those to individual firms in isolation. Implementing supervision in a way that seeks to identify systemic risks as well as risks to individual institutions is a difficult challenge, but the fact is that the traditional approach of focusing narrowly on individual firms did not succeed in preventing this crisis and likely would not succeed in the future. Consequently, we at the Federal Reserve have been working with international colleagues to require that the most systemically critical firms increase their holdings of capital and liquidity and improve their risk management; and we are overhauling our supervisory framework for the largest institutions, both to improve the effectiveness of consolidated supervision and to incorporate in our oversight a more comprehensive, systemic perspective.

The second component of the strategy to end too-big-to-fail is to increase the resilience of the financial system itself, to reduce the potential damage from a systemic event like the failure of a major firm. For example, the Federal Reserve has been leading collaborative efforts to improve the clearing and settlement of credit default swaps and other derivatives and to enhance the stability of markets for repurchase agreements. Limiting the fallout from the failure of a major firm is not only directly beneficial in a crisis, it also helps to reduce the too-big-to-fail problem, because the government has

much less reason to intervene if it believes that the financial system is resilient enough to handle a significant failure without excessive disruption.

Third, because government oversight alone will never be sufficient to anticipate all risks, increasing market discipline is an essential piece of any strategy for combating too-big-to-fail. To create real market discipline for the largest firms, market participants must be convinced that if one of these firms is unable to meet its obligations, its shareholders, creditors, and counterparties will not be protected from losses by government action. To make such a threat credible, we need a new legal framework that will allow the government to wind down a failing, systemically critical firm without doing serious damage to the broader financial system. In other words, we need an alternative for resolving failing firms that is neither a disorderly bankruptcy nor a bailout.

A prototype for such a framework already exists--namely, the rules set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991 for dealing with a failing bank. As the FDIC is now able to do with a failing bank, the government should, under appropriate circumstances and with appropriate safeguards, be able to seize and wind down a failing, systemically critical firm. Institutions should not be permitted to receive assistance while open, but authorities must be empowered to sell, merge, or break up an institution as necessary to avoid a disorderly unraveling that threatens the financial system as a whole. The resolution agency should not be allowed to protect shareholders and other capital providers and it should have clear authority to impose losses on debt holders, override contracts, and replace managers and directors as appropriate. If, in the end, funds must be injected to resolve a systemically critical institution safely, the

ultimate cost must not fall on taxpayers or small financial institutions, but on those institutions that are the source of the too-big-to-fail problem.

I don't want to understate the difficulties of creating an effective resolution framework for large, interconnected firms. Such firms can be extraordinarily complex, both in terms of their legal structure and in the range and sophistication of their activities. The resolution of large institutions whose operations span many countries poses particular challenges, as legal frameworks vary across countries, and the authorities in each country naturally seek to protect the interests of depositors and creditors in their own jurisdictions. We must also recognize that such resolutions might well take place in the context of a broader crisis, in which the government might be forced to address problems at multiple firms simultaneously. Careful planning is therefore essential. An idea worth exploring is to require firms to develop and maintain a so-called living will, which will help firms and regulators identify ways to simplify and untangle the firm before a crisis occurs.¹

The Federal Reserve and Community Banks

The Federal Reserve and community banks have much in common beyond our mutual concerns about the too-big-to-fail problem. Our interest in community banks has its roots in the founding of the Federal Reserve in 1913, nearly a century ago. President Woodrow Wilson and the other founders of the Fed, taking note of two previous failed attempts to establish a U.S. central bank, intentionally avoided creating a single, monolithic institution located in Washington or New York. Instead, they established a system of 12 Reserve Banks located in major cities around the country. (It was a federal

¹ See Daniel K. Tarullo (2009), "Supervising and Resolving Large Financial Institutions," speech delivered at the Institute of International Bankers Conference on Cross-Border Insolvency Issues, New York, N.Y., November 10, www.federalreserve.gov/newsevents/speech/tarullo20091110a.htm.

system--hence the term, "Federal Reserve.") Why was America's central bank given this unique structure? The reason was to provide legitimacy and a broad geographic presence across the nation for an institution that often has to make difficult decisions. Over time, this structure has provided the Federal Reserve with grassroots connections, local insights, and diverse perspectives that few other federal institutions enjoy.

We are always looking for opportunities to interact with and learn from community bankers. Events like this one are an important venue for exchanging ideas, as I've mentioned, but there are many others. For example, community bankers sit on our Federal Advisory Council, which meets with the Board of Governors for three mornings each year to discuss developments in the economy and in the banking industry. We meet on a similar schedule with a second official council, the Thrift Institutions Advisory Council, which brings together thrifts, saving banks, and a variety of other depository institutions, most of them smaller, from around the country. In addition, community bankers sit on the boards and the advisory councils of the Fed's 12 regional Reserve Banks and 24 Reserve Bank branches. Both the Board and the Reserve Banks organize regular meetings involving community banks and a range of other participants. For example, the Reserve Banks are meeting with community bankers, community development organizations, and other stakeholders to discuss barriers to and opportunities for extending credit to small businesses.

Of course, many of our regular interactions with community banks arise from our oversight of bank holding companies and state-chartered banks that choose to join the Federal Reserve System. This supervision is guided by the Board, but conducted day-to-day by the Reserve Banks and their examiners, many of whom have lived and worked

within the Districts they serve for many years. We believe this approach ensures that Federal Reserve supervision of community banks is consistent and disciplined but also reflects a local perspective that can take account of differences in regional economic conditions. For example, in the Midwest, where many community banks specialize in agricultural lending, Federal Reserve examiners maintain a special expertise in the agricultural economy and the associated lending practices. They also draw frequently on the expertise of regional and agricultural economists in the Districts to maintain an up-to-date understanding of local conditions. So while many bankers tell us that Federal Reserve examiners are analytical and tough, few tell us that they are unfair or uninformed about what's going on in the local economy. We believe that this kind of response speaks to the effectiveness of our supervisory program for community banks, and we take pride in the professionalism and quality of our community bank examiners.

One particularly valuable aspect of our federal structure is that, over the years, it has provided policymakers in Washington with a way to keep in close touch with the continent-spanning, highly varied economy of the United States. When I attend board of directors meetings at regional Reserve Banks, which I do regularly, one of the most interesting portions is the go-round, during which each director provides his or her perspective on local economic developments. Quite often, the directors who are community bankers provide some of the most valuable contributions. That fact should not be surprising. By their nature, community banks interact with many parts of the area economy--consumers, small businesses, large businesses, real estate developers, even local governments. This breadth of vision, together with a good sense of the underlying economic forces at work in each locality, gives community bankers a unique perspective

on the developments in their part of the country. When the Fed analyzes economic developments, of necessity we rely on official economic data to identify broad national trends. However, the official data often mask the diversity of the U.S. economy; moreover, the data are inherently backward-looking, telling us what happened in the past quarter or year. In contrast, the grass-roots information that we obtain from community bankers and the other community and business leaders who serve as Reserve Bank directors provides a forward-looking perspective on economic developments and concerns, as well as a level of detail and qualitative insight that is often lost in the aggregate numbers.

Our contacts with community bankers also provide critical insights into the state of our nation's banks. Because of the remarkable diversity of the U.S. financial system, a supervisory agency that focused only on the largest banking institutions, without knowledge of community banks, would get a limited and potentially distorted picture of what was happening in our banking system as a whole. Close connections with community bankers enable the Federal Reserve to better understand the full range of financial concerns and risks facing the country, such as the current difficult problems in commercial real estate lending and the impediments to small business lending. For example, recent patterns in commercial loan growth are very different at large and small banks, and our links to community bankers help us to better understand these trends. The community banking perspective is also critical as we try to assess the burden and effectiveness of financial regulation.

As a group, community banks are also important to the nation's financial stability, a particular focus and responsibility of the Federal Reserve. Although it was not the case

in the current crisis, instability can be generated by small institutions as well as by large ones--as occurred in the Great Depression or in the thrift crisis, to cite two particularly dramatic examples. Additionally, as a lender through our discount window to community banks and other depository institutions, we rely on information and expertise obtained from our supervisory responsibilities to lend safely, particularly in times of stress.

For all these reasons, our supervisory relationships with the state-chartered banks that have joined the Federal Reserve System are immensely valuable, as is the range of contacts we have with community banks.

Conclusion

I know that community banks, with their special strengths, can flourish in a system that provides fair competition; indeed, many of you have stepped up during a difficult time to provide credit to support the economic recovery. To create a more competitive system, as well as a safer one, we need to end the too-big-to-fail problem once and for all. We will continue to focus on this issue, and we welcome constructive ideas from all quarters.

We at the Federal Reserve look forward to maintaining our long-standing relationships with community bankers. You bring us insights into the banking industry and the economy that we can obtain nowhere else. And as the recovery progresses, we expect that you will continue to aid the nation's return to prosperity by making good loans to creditworthy borrowers in your communities. We want to continue to work with you to help you play this important role. In doing so, together we will help ensure a bright future both for our economy and for community banking.