For release on delivery
Noon EDT (9:00 a.m. local time)
March 23, 2011

Community Banking in a Period of Recovery and Change

Remarks by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

at the

Independent Community Bankers of America National Convention

San Diego, California

March 23, 2011

It's a pleasure to have the opportunity to speak once again before the Independent Community Bankers of America (ICBA). This is the sixth consecutive year that I've met with you at this event, and the themes of my remarks over the years tell a story not only about the financial and economic upheaval that we have all experienced, but also about some of the very difficult issues that continue to confront both bankers and policymakers today. Back in 2006, less than two months after I started as Chairman, I spoke to you about the strong performance of community banks as well as about some important longer-term challenges. In subsequent years, my remarks touched on the need to strengthen regulation and supervision of Fannie Mae and Freddie Mac, approaches to reducing preventable mortgage foreclosures, community banking and the financial crisis, and then last year, the need to address the problem of financial institutions that are "too big to fail." My themes today are the vital role that community banks need to play in the economic recovery, the value that the Federal Reserve places on insights from community banks, and the evolving regulatory environment.

Community Banks and the Economic Recovery

To me, the title of the 2009 ICBA annual report, *Empowering Main Street*, is a concise and accurate description of the critical role that community banks play in the U.S. economy. Community bankers live and work where they do business, and their institutions have deep roots, sometimes established over several generations. They know their customers and the local economy. Relationship banking is therefore at the core of community banking. The largest banks typically rely heavily on statistical models to assess borrowers' capital, collateral, and capacity to repay, and those approaches can add value, but banks whose headquarters and key decisionmakers are hundreds or thousands of miles away inevitably lack the in-depth local knowledge that community banks use to assess character and conditions when making credit decisions. This advantage for community banks is fundamental to their effectiveness and cannot be matched by models or algorithms, no matter how sophisticated. The IBM computer program Watson may play a mean game of Jeopardy, but I would not trust it to judge the creditworthiness of a fledgling local business or to build longstanding personal relationships with customers and borrowers.

Given the important role that community banks play in their local economies, we at the Federal Reserve are keenly interested in their health and their collective future. Local communities, ranging from small towns to urban neighborhoods, are the foundation of the U.S. economy and communities need community banks to help them grow and prosper. As I'm sure you are all too aware, the financial crisis and its aftermath have hit some community banks especially hard, and those institutions will continue to need time to repair their balance sheets. Although we are not yet where we would like to be, the good news is that many community banks are recovering and reporting stronger performance.

Indeed, despite some of the worst economic conditions since the Great Depression and their own strained balance sheets, community banks have already been doing their part to meet the credit needs of their customers, notably including small business customers. We have been spending a lot of time at the Federal Reserve trying to understand and promote lending to small businesses, and one of the interesting things we have found is that while small business lending contracted overall from mid-2008 through 2010, this contraction was not uniform. In fact, a majority of the smallest banks (in this case, those with assets of $250 million or less) actually increased their small business lending during this period. And while banks with assets between $250 million and $1 billion showed a slight decline in small business lending over this period, the contraction was not nearly as sharp as it was for the largest banks. This hard evidence underscores the important benefits of relationship banking, particularly in periods of unusual economic and financial stress.

Community Banks and the Federal Reserve

You may recall that in my remarks to this group last year, I noted that the decentralized structure of the Federal Reserve System, with 12 Reserve Banks and 24 branches located in cities across the country, was designed to ensure that local insights and information would be incorporated in the deliberations of both the Board and the Federal Open Market Committee. During the debates leading up to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, we emphasized that our supervisory responsibility for state-chartered banks that are members of the Federal Reserve System and bank holding companies of all sizes not only provides valuable economic information at the grass-roots level that would be very difficult to replace, it also gives us a fuller picture of the nation's financial system. At the same time, the range of expertise that the Federal Reserve develops in making monetary policy and in its engagement with the financial system allows us to bring unique insights and value-added to our supervisory activities. Fortunately, the Congress decided to preserve the Federal Reserve's existing supervisory authority over smaller as well as larger banking organizations. It also broadened the Federal Reserve's connections to Main Street by adding hundreds of thrift holding companies to the institutions we supervise. We are delighted that, through our supervision, our gathering of economic intelligence, and the activities of our community affairs departments around the country, we will be able to remain fully engaged with grass-roots America.

The Federal Reserve has undertaken several recent initiatives to enhance our interactions with community banks and ensure that we fully take their perspectives and unique characteristics into account in our policymaking. First, for many years, the Board has had a committee of

Governors that provides oversight on bank supervisory and regulatory matters. Although many of this committee's efforts in the wake of the financial crisis have understandably been focused on the largest and most complex banking organizations, the Board believes that it is important to sharpen our focus on smaller banking organizations as well. As a result, we recently established a special supervision subcommittee that focuses on community banks and smaller regional institutions. This subcommittee is chaired by a former longtime community banker, Governor Betsy Duke, and also includes a former state banking commissioner, Governor Sarah Bloom Raskin.

The subcommittee provides leadership and oversight on a variety of matters related specifically to our supervision of community and smaller regional banks.[1] In particular, the subcommittee is reviewing new policy proposals through the lens of the effect those proposals could have on smaller institutions, both in terms of safety and soundness and potential regulatory burden. Among other things, the subcommittee also monitors the Federal Reserve's working relationship with state banking supervisors, which is particularly important because we share with them supervisory responsibility for state member banks.

We have also undertaken an initiative to solicit feedback from community banks on a more regular basis. In October, the Board announced that it would form a Community Depository Institutions Advisory Council to provide insight and information on the economy, lending conditions, and other issues of interest to community banks.[2] To make this council as representative as possible, each of the 12 Reserve Banks now has its own local advisory council comprising representatives from banks, thrift institutions, and credit unions; one member from

[1] For supervisory purposes, the Federal Reserve generally considers banking organizations with assets of $10 billion or less to be community banking organizations and those with assets between $10 billion and $50 billion to be regional banking organizations.

[2] This group replaces the former Thrift Institution Advisory Council, which provided the Board with useful information from the perspective of thrift institutions and credit unions.

each local council serves on the national council that will meet with the Board twice a year in Washington. Local meetings have already begun, and the first meeting of the national council with the Board will take place soon. Personally, I am looking forward to hearing more from community bankers about issues ranging from their local economies to regulatory reform.

Community Banks and Regulatory Reform

As you know, a key challenge for community banks in the years ahead will be to adapt to the changing regulatory environment, particularly the regulatory reforms contained in the Dodd-Frank Act, as well as the changes that will be associated with the Basel III reforms. We are certainly aware of and appreciate the concerns that community banks have about these regulatory changes, and, as I have just described, we have stepped up our efforts to understand those concerns and to respond to them as appropriate. I think it is worth emphasizing that the changes we will be seeing in the financial regulatory architecture are principally directed at our largest and most complex financial firms, including nonbanks. Consequently, one benefit of the reforms should be the creation of a more level playing field for financial institutions of all sizes.

Focusing reform on our largest, most complex financial firms makes sense. The recent financial crisis highlighted the fact that some financial firms had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability. The sudden collapses of major financial firms were among the most destabilizing events of the crisis. The crisis also demonstrated the inadequacy of the existing framework for supervising, regulating, and otherwise constraining the risks of major financial firms as well as of the toolkit the government had at the time to manage their failure.

As I discussed with you at last year’s meeting, a major thrust of the Dodd-Frank Act is addressing the too-big-to-fail problem and mitigating the threat to financial stability posed by systemically important financial firms. The too-big-to-fail problem is a pernicious one that has a number of substantial harmful effects. Critically, it reduces the incentives of shareholders, creditors, and counterparties of such firms to discipline excessive risk-taking. And it produces competitive distortions by enabling firms with large systemic footprints to fund themselves more cheaply than other firms because of the implicit subsidy of too-big-to-fail status. This competitive distortion is not only unfair to smaller firms and damaging to competition today, but it also spurs further growth by the largest firms and more consolidation and concentration in the financial industry. A financial system dominated by too-big-to-fail firms cannot be a healthy financial system.

The act addresses the too-big-to-fail problem with a multi-pronged approach. Under it, we are developing more-stringent prudential standards for banking firms with assets greater than $50 billion and all nonbank financial firms designated as systemically important by the Financial Stability Oversight Council. These more-stringent standards will include stronger capital and leverage requirements, liquidity requirements, and single-counterparty credit limits, as well as requirements to periodically produce resolution plans and conduct stress tests. Our goal is to produce a well-integrated set of rules that meaningfully reduces the probability of failure of our largest, most complex financial firms and that minimizes the losses to the financial system and the economy if such a firm should fail. In doing so, we aim to force these firms to take into account the costs that they impose on the broader financial system, soak up the implicit subsidy these firms enjoy due to market perceptions of their systemic importance, and give the firms regulatory incentives to shrink their systemic footprint.

Complementing these efforts, the Federal Reserve has been working for some time with other regulatory agencies and central banks around the world to design and implement a stronger set of prudential requirements for large, internationally active banking firms. These efforts include the agreements reached in December on the major elements of the new Basel III prudential framework for large, globally active banks. Basel III should make the financial system more stable and reduce the likelihood of future financial crises by requiring large banks to hold more and better-quality capital and more-robust liquidity buffers. A more stable financial system will benefit all banking institutions and, of course, our economy as a whole. We are working to adopt the Basel III framework in the United States in a timely manner.

A central issue that we and the other banking agencies face in implementing Basel III in the United States is deciding how these capital rules will be applied for banks that are not systemic or internationally active. We recognize the importance of striking the right balance between promoting safety and soundness throughout the banking system and keeping the compliance costs for smaller banking firms as low as possible. Also, to minimize the impact of the new capital rules on credit availability while the global economy is still recovering, we and our international colleagues have agreed to allow long transition periods for the implementation of the new standards.

In addition to stricter regulation and supervision of large financial firms, the Dodd-Frank Act places new checks on the growth by acquisition of our major financial firms. It expands current restraints on acquisitions by bank holding companies to include a broader range of acquired firms (not just banks) and a broader range of liabilities (not just deposits). This expansion reflects a financial system that has changed in important ways since 1994, when the Congress first adopted concentration limits for banks and bank holding companies.

The act also imposes new restrictions on the capital markets activities of banking firms--restrictions that will disproportionately affect the structure and profitability of the largest banking firms. For example, the so-called Volcker rule will restrict the ability of banking firms to engage in proprietary trading of securities and derivatives and to invest in or sponsor private investment funds.

Among the most important aspects of act are the measures that it authorizes to reduce the financial and economic effects of the failure of large firms. A clear lesson of the past few years is that the government must not be forced to choose between bailing out a systemically important firm and having it fail in a disorderly and disruptive manner. Instead, we need the tools to resolve a failing firm in a manner that preserves market discipline--by ensuring that shareholders and creditors incur losses and that culpable managers are replaced--and that at the same time cushions the broader financial system from the possibly destabilizing effects of the firm's collapse. Of course, such a framework has been in place for banks for several decades now, as you know. The Dodd-Frank Act creates an analogous framework for systemically important nonbank financial firms, including bank holding companies. Resolving a large, multinational financial firm safely will likely always be a difficult challenge, and a great deal of work remains to be done to make these new authorities fully effective. Ultimately, though, these changes will mitigate moral hazard in our financial system by reducing expectations of government support by the creditors and counterparties of large firms. Taken together, the measures I have described should give us a financial system that is safer, more efficient, and more equitable.

In short, two key objectives of financial regulatory reform are, first, addressing the problems that emerged in the largest, most complex financial firms during the crisis and, second, creating a better balance with respect to regulation and oversight between banks and nonbank financial firms. The Federal Reserve believes that these are the right goals for reform. We are committed to working with the other U.S. financial regulatory agencies to implement the act and related reforms in a manner that both achieves the law's key objectives and appropriately takes into account the risk profiles and business models of smaller banking firms, including community banks.

Before I conclude my remarks, let me say a few words about the transfer of thrift holding company supervisory authority to the Federal Reserve. We have been working closely with the Office of Thrift Supervision, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation to make this transfer as smooth as possible, and progress so far has been good. The Federal Reserve believes that any company that controls a depository institution should be held to appropriate prudential standards, including those for capital, liquidity, and risk management. As such, we intend to create an oversight regime for thrift holding companies that is consistent with, and is as rigorous as, the supervisory regime we apply to bank holding companies. That said, we appreciate that thrift and bank holding companies differ in important ways, play different roles in our economy, and will remain governed by different statutes. We will be mindful of these differences and of the unique characteristics of the thrift industry as we develop our supervisory approach to thrift holding companies.

Conclusion

My colleague, Governor Duke, recently told our examiners that "community bankers are creative, committed, stubborn, and resilient." I know she won't mind my repeating that sentiment here, and I'm sure most of the community bankers in this room would wear those words as a badge of honor. Community banks face substantial challenges in the months and years to come, including still-difficult economic conditions, continued uncertainties in real estate and other key markets, and a changing regulatory environment. But community banks have faced difficult times before, and the industry has remained vibrant and resilient. I am confident that community banking will successfully navigate these new challenges as well. Thank you for what you do every day to meet the needs of your communities and to help our economy grow stronger.