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Community Banking

Remarks by

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at

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It is a pleasure to speak at the Federal Deposit Insurance Corporation's (FDIC) conference on the future of community banking. This conference is indeed an important and timely one. Community banks make a critical contribution to the prosperity of both their localities and the nation as a whole, which is why we at the Federal Reserve and the other banking agencies are acutely interested in their long-term strength and viability.[1]

Today I will discuss the role community banking organizations play in supporting the health of our economy, as well as some of the challenges they face. Because we greatly value our ongoing dialogue with community banks, I will also speak about the Federal Reserve's efforts to improve our understanding of the pressures affecting community banks and to foster constructive supervisory relationships.

The Role of Community Banks in a Challenging Economy

Although community banks provide a wide range of services for their customers, their primary activities revolve around the traditional banking model--specifically, taking short-term deposits to fund longer-term investments, such as small business, agricultural, or commercial real estate loans. Accordingly, risks at community banks tend to arise from their lending, in the form of credit risk, interest rate risk, or concentration risk, rather than from the trading, market-making, and investment banking activities associated with the largest banks. However, by taking on and managing the risks of local lending, which larger banks may be unwilling or unable to do, community banks help keep their local economies vibrant and growing. Importantly, community banks are well positioned to go beyond the standardized credit models used by larger banks and consider a range of

[1] For purposes of these remarks, the terms "community bank" and "community banking organization" will be used interchangeably to refer to both banks and bank holding companies with total consolidated assets of $10 billion or less.

factors when making credit decisions. In particular, they often respond with greater agility to lending requests than their national competitors because of their detailed knowledge of the needs of their customers and their close ties to the communities they serve.

While community banks have certain natural advantages, they also face an array of challenges, stemming from both the current economy and, to some extent, from their business model. The close ties of community banks to local economies is a source of strength, as I mentioned, but those close linkages have drawbacks as well, most notably the resulting concentration of exposures to those same local economies. Strong community banks take measures to counteract this risk, but it is not possible to fully manage it away. Thus, the fortunes of communities and their banks tend to rise and fall together. Community banks must also manage concentration risks arising from their specialization in certain categories of lending. For example, larger banks have used their scale to gain a pricing advantage over community banks in volume-driven businesses such as consumer lending. This strategy, in turn, has exacerbated a long-standing trend toward a greater concentration of community bank lending in certain areas less dependent on volume, such as loans secured by commercial real estate. Community banks will need to continue their ongoing efforts to prudently diversify their revenue sources.

Like larger banks, community banks are also being affected by the state of the national economy. Despite some recent signs of improvement, the recovery has been frustratingly slow, constraining opportunities for profitable lending. As I will discuss later, actual and prospective changes in the regulatory landscape have also raised concerns among community bankers. These headwinds notwithstanding, measures of the financial condition of community banks appear to have strengthened somewhat, suggesting that, for the most part, the industry is meeting its challenges. Profits of smaller banks have risen for the past several quarters. Although the ratios of nonperforming assets remain high in many cases, asset quality appears to be stabilizing, and bank provisions for loan losses are decreasing. In addition, capital ratios are steadily improving at community banks, in part due to increases in retained earnings and a greater ability to raise new capital.

Let me take this opportunity to mention one concern that is of particular relevance to the Federal Reserve: A common complaint on the part of some community bankers is that very low interest rates hurt their profitability by squeezing net interest margins. Since the onset of the financial crisis, the Federal Reserve's monetary policy has been accommodative, as you know. In particular, the federal funds target rate, which stood at 5-1/4 percent in mid-2007, was lowered to a range of 0 to 1/4 percent by the end of 2008 and has since remained at that level. Although these policies do not seem to have led to much change in aggregate measures of net interest margins, at least thus far, we continue to hear that many banks are feeling pressures from this source.

The effects of the configuration of interest rates on banks and other financial institutions are certainly part of the discussion when we strive to determine the appropriate monetary policy. Several points should be made, though. First, it is true that the difference between the yield on safe assets such as Treasury securities and the rate paid on deposits is currently relatively low. However, banks' net interest margins also depend importantly on the difference between the return on the loans the banks make and the return on their alternative investments in safe assets. When loan demand is weak, forcing banks to hold low-return safe assets instead of lending, net interest margins suffer. The purpose of the Federal Reserve's policy of low interest rates is to speed the economic recovery, which will increase loan demand and opportunities for profitable lending, among many other benefits, and thus, ultimately, lead to higher net interest margins. In short, it is necessary to set the negative effects on net interest margins against the positive effects of a strengthening economic and lending environment. Moreover, the benefits of a stronger economy for the performance of existing assets should also be taken into account; as you know, delinquencies decline as the economy improves. Putting all these considerations together, in the longer term the overall effect on bank profitability of an appropriately accommodative monetary policy is almost certainly positive.

Outreach and Communication with Community Banks

I think we would all agree that two-way communication between regulators and community banks is critical. The Fed and other bank supervisors, at both the state and federal levels, must clearly communicate their supervisory policies and expectations to banks, but they also must listen to and understand banks' concerns. For the Federal Reserve in particular, community banks not only provide insights into their industry, but they are also an unmatched source of crucial grassroots information about developments in the economy as a whole, which is necessary for effective monetary policy.

At the Federal Reserve, we pursue our dialogue with community bankers through many channels. One such channel is the recently established Community Depository

Institutions Advisory Council (CDIAC).[2] The council's membership is drawn from smaller banks, credit unions, and savings associations. Each of the 12 Reserve Banks around the country has a local advisory council, and one representative from each local council serves on the national council that meets with the Board in Washington twice a year. These meetings allow the Federal Reserve Board to hear directly from community bankers about supervisory and regulatory issues that affect their institutions as well as about local economic trends.

At a recent meeting, for example, one of our CDIAC members asked us to be clearer about whether particular rules and guidance apply to community banks. Having heard from this banker as well as others, we are now working to more explicitly indicate which banks will be affected when we issue new regulatory proposals, final rules, or regulatory guidance. As a first step in this effort, when issuing supervisory letters, we have begun to state specifically if and how new guidance will apply to community banks.[3] Although this change seems relatively simple, we hope it will help banks avoid allocating precious resources to poring over supervisory guidance that does not apply to them. We also hope that it will provide greater clarification to our examiners, who are on the frontline fielding questions from bankers and working closely with their state regulatory counterparts.

In addition to the advisory council, the Board last year established a special supervision subcommittee to more effectively address community banking issues.

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[2] For more information, see the Federal Reserve Board's webpage "Community Depository Institutions Advisory Council" available at www.federalreserve.gov/aboutthefed/cdiac.htm.
[3] See, for example, Board of Governors of the Federal Reserve System (2012), "Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit," Supervision and Regulation Letter SR 12-3 (January 31), www.federalreserve.gov/bankinforeg/srletters/sr1203.htm.

Because of their professional backgrounds in community banking and bank supervision, I asked Governors Elizabeth Duke and Sarah Bloom Raskin to serve on this subcommittee. Its primary role is to improve our understanding of community and regional banking conditions and to review policy proposals for their potential effect on the safety and soundness of, and the regulatory costs imposed on, community and regional institutions.[4] Governors Duke and Raskin are also keenly interested in how our policies could affect the availability of credit to sound borrowers, and their unique experiences and perspectives have contributed to the Board's understanding of the issues that community bankers care most about.

We have other contacts with community banks that have proved valuable. For quite a few years, the Reserve Banks have maintained local training and outreach programs for banks. More recently, several of these programs have been expanded nationally. For example, the Federal Reserve Bank of St. Louis organizes national "Ask the Fed" calls to provide bankers with an opportunity to hear Federal Reserve staff discuss recent policy initiatives and issues that examiners are encountering in the field. In addition, the Federal Reserve Bank of San Francisco hosts consumer compliance webinars, and the Federal Reserve Bank of Philadelphia publishes a quarterly overview of consumer compliance issues that allows Federal Reserve staff to address questions from banks.[5] We are exploring options for building on these initiatives.

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[4] For the purposes of the Federal Reserve's supervisory programs, regional banking organizations generally are considered to be those banks and bank holding companies (including savings and loan holding companies) with total consolidated assets between $10 billion and $50 billion.

[5] For archived webinars and publications as well as announcements about future events, see the Federal Reserve Bank of Philadelphia's webpage "Consumer Compliance Outlook" available at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook.

Research by economists throughout the Federal Reserve System is another means of gaining a better understanding not only about current conditions in community banking, but also about the more fundamental forces that drive their profitability and lending. Our researchers have looked at such topics as the use of credit scoring in small business lending, the willingness and ability of community banks to lend to small businesses that have lost access to lending from large banks, and the determinants of community bank performance both before and during the recent financial crisis--and the extent to which these determinants were under the control of bank managers.[6] Our hope is that this focused research effort not only will hone our understanding of the key role that community banks play in the U.S. economy, but also will help us to more effectively supervise these banks. With that, let me shift to some supervisory and regulatory matters that are on the minds of both supervisors and bankers.

The Supervision of Community Banks

Unlike most other businesses, banks are subject to rigorous examination and supervision to assess their safety and soundness, their ability to withstand risks, and their compliance with a variety of laws.[7] At community banks, these examinations involve off-site analyses and on-site visits by teams of examiners, exit meetings between

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[6] The use of credit scoring in small business lending is discussed in Allen Berger, Adrian Cowan, and Scott Frame (2011), "The Surprising Use of Credit Scoring in Small Business Lending by Community Banks and the Attendant Effects on Credit Availability, Risk, and Profitability," *Journal of Financial Services Research*, vol. 39 (April), pp. 1-17; the topic of community banks that lend to small businesses is discussed in Jihye Jeon, Judit Montoriol-Garriga, Robert K. Triest, and J. Christina Wang (2010), "Evidence of a Credit Crunch? Results from the 2010 Survey of First District Community Banks," Federal Reserve Bank of Boston, *Public Policy Briefs,* no. 10-3 (September), www.bos.frb.org/economic/ppb/2010/ppb103.pdf; and the determinants of community bank performance are discussed in Dean F. Amel and Robin A. Prager (2010), "Performance of Community Banks in Good Times and Bad Times," unpublished paper, Board of Governors of the Federal Reserve System, Division of Research and Statistics, May.

[7] Examinations typically occur annually but may take place more or less frequently depending on the size and condition of the banking organization. The Federal Reserve maintains a full-time, on-site presence at the largest banking organizations.

examiners and senior bank managers to discuss examination results, and written reports with narratives and metrics describing the examiners' findings. If necessary, of course, examiners may require actions by the bank to remedy specific problems.

These examinations, in combination with work we undertake between examinations, are critical for promoting safety and soundness while enhancing our understanding of the condition of individual banks and the banking system as a whole. We know, however, that supervision imposes costs on institutions. In particular, we recognize that new regulations and supervisory requirements may impose disproportionate costs on community banks, which have smaller staffs and less-elaborate information systems than larger banking organizations. Thus, we take quite seriously the importance of evaluating the costs and benefits of new rules.

As I have noted, the comparative advantage of community bankers is that they know and work with their communities and customers in ways that may not be possible for larger, more distant institutions. We tailor our examination and supervision to the size, complexity, risk profile, and business model of each institution. For community banks in particular, our examiners are expected to take local market conditions into account when assessing a bank's management and credit decisions. The Federal Reserve's decentralized structure, in which supervision is conducted through 12 regional Reserve Banks, helps facilitate our understanding of local economies, as does our ongoing coordination with state banking regulators. This connection to Main Street is vitally important to fulfilling both our supervisory and monetary policy responsibilities.

Bank supervision requires a delicate balance--particularly now. The weak economy, together with loose lending standards in the past, has put pressure on the entire banking industry, including community banks. To protect banks from a possible race to the bottom and new problems down the road, and to safeguard the Deposit Insurance Fund, supervisors must insist on high standards for lending, risk management, and governance. At the same time, it is important for banks, for their communities, and for the national economy that banks lend to creditworthy borrowers. Lending to creditworthy borrowers, after all, is how banks earn profits. Getting that balance right is not always easy, but it is of utmost importance.

Regulatory Challenges for Community Banking

Community bankers tell us repeatedly that they are concerned about the changing regulatory environment. They touch on a number of areas, but one particular worry is the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

It is important to emphasize that the Congress enacted the Dodd-Frank Act largely in response to the "too big to fail" problem, and that most of its provisions apply only, or principally, to the largest, most complex, and internationally active banks. To mitigate the threat to financial stability posed by systemically important financial firms, the act required the Federal Reserve to implement enhanced prudential standards to regulate these firms. The Board in December requested comment on proposed rules for systemically important firms, including stronger capital, leverage, liquidity, and risk-management requirements. Other aspects of the proposed rules are single-counterparty credit limits and requirements to periodically produce resolution plans (known as living wills) and to conduct stress tests.[8] The proposed rules, in conjunction with other elements of the Dodd-Frank Act, are designed to make these firms safer and to force large firms to take into account the costs that their potential failure could impose on the broader financial system.

These new standards are not meant to apply to, and clearly would not be appropriate for, community banks. Indeed, the Dodd-Frank Act explicitly exempts community banks from these new enhanced standards. Community banks express concern that the more stringent requirements for larger institutions will eventually find their way to smaller firms; that, however, is not our intent, and we will work to ensure that it does not happen. An example that predates the Dodd-Frank Act is the interagency guidance issued in June 2010 covering incentive compensation.[9] In that guidance, we were careful to note simplified expectations for community banks that did not make extensive use of incentive compensation. We intend to continue this practice for other policies and guidance and to continue to speak with community bankers to respond to their questions and concerns and to clarify our supervisory expectations.

Given the ongoing supervisory and regulatory changes, the Board and its senior-level staff members have made it a priority to work with other regulators to increase the coordination and consistency of regulation across a banking industry that has multiple regulators and charters. We regularly consult on these matters with the Consumer Financial Protection Bureau, the Securities and Exchange Commission, and other

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[8] See Board of Governors of the Federal Reserve System (2011), "Federal Reserve Board Proposes Steps to Strengthen Regulation and Supervision of Large Bank Holding Companies and Systemically Important Nonbank Financial Firms," press release, December 20, www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm.

[9] See Board of Governors of the Federal Reserve System (2010), "Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation," joint press release, June 21, www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm.

agencies.[10] The new Financial Stability Oversight Council also provides a forum for agencies to discuss the coordination of policies and initiatives. It is important that we at the Federal Reserve continue to work closely with other agencies on supervisory matters, particularly in cases in which a common regulatory approach across agencies and across banking organizations with different charters has the potential to reduce compliance costs and risks.

One of the areas where communication between banks and examiners is especially important is in the ongoing supervisory process. We conduct extensive training for our examiners, perform internal reviews and studies to ensure that the examiners are properly interpreting supervisory guidance, and stress that a main goal of supervision is to help bankers sustain sound lending and risk-management practices. We emphasize that open dialogue with bank management is an essential component of effective supervision.

Although we hope that bankers are able to resolve all examination issues through discussion with the examiner-in-charge or Reserve Bank management, it is inevitable that examiners and bankers will sometimes differ over examination findings despite our best efforts. For those cases, the Federal Reserve has a robust appeals process, as well as an independent ombudsman, to provide institutions with a fair and thorough review of complaints.[11] A banking organization's board or management may appeal any material

[10] See Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency (2011), "Agencies Issue Statement to Clarify Supervisory and Enforcement Responsibilities for Federal Consumer Financial Laws," joint press release, November 17, www.federalreserve.gov/newsevents/press/bcreg/20111117a.htm.
[11] For more information regarding the appeals process, see Board of Governors of the Federal Reserve System (1995), "Section 309 of the Riegle Community Development and Regulatory Improvement Act of

supervisory determination to a review panel composed of Reserve Bank staff that were not involved in the original supervisory determination and that were selected after consultation with staff at the Board in Washington. Bank managers may submit relevant information to this panel in writing and may appear in person.

If the bank's managers or board believe this panel's decision did not address their concerns in a satisfactory manner, the bank may make a second appeal to the president of the relevant Reserve Bank. A third review--undertaken by the member of the Board of Governors with oversight responsibility for the Federal Reserve's banking supervision, who at present is Governor Tarullo--can be requested if the institution is still not satisfied that its concerns have been addressed.

The Federal Reserve's ombudsman mediates complaints, facilitates appeals, and, where appropriate, refers matters to committees of the Board.[12] We are working to increase awareness of the ombudsman's office and encouraging bankers to use the ombudsman for matters that cannot be resolved at the local level. Importantly, the ombudsman reaches out to every institution that has filed an appeal within six months after the appeal has been decided to ensure that no retaliation or other unjustified reactions have taken place. The ombudsman has broad authority to investigate claims of retaliation, and, when appropriate, will report complaints to the Board. The Board will not tolerate retaliation against banking organizations that file appeals or raise concerns about the supervisory process. Beyond simple fairness, hearing concerns from banks

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1994, Intra-Agency Appeals Process," Supervision and Regulation Letter SR 95-18 (March 28), www.federalreserve.gov/boarddocs/srletters/1995/sr9518.htm.

[12] For information regarding the role of the ombudsman, see the Federal Reserve Board's webpage "Ombudsman for the Federal Reserve System" available at www.federalreserve.gov/aboutthefed/ombudsman.htm. For more information regarding the appeals process, see Board of Governors, "Section 309" (see note 12).

about supervisory practices gives us extremely valuable feedback that will help us improve supervision and better understand the issues that banks and examiners confront in the field.

Conclusion

To conclude, I would like to reemphasize the importance that my colleagues on the Board and I place on the Federal Reserve's relationship with community banks. The Fed is committed to fair, consistent, and informed examinations that take into account the size, complexity, and individual circumstances of each bank we oversee. We will continue to rely on the many channels of communication I discussed today to improve our supervision, and we will do all we can to eliminate unnecessary costs. By engaging in a constant dialogue with community banks through various communication channels and through the examination process, the Federal Reserve is able to collect important information about local economies and better inform banks about the applicability and expectations of new rules and regulations intended to help keep them safe and sound. Despite economic uncertainties, the condition of community banks is improving, which is reassuring given their undeniable importance to the health of our nation's economy.

My thanks to the FDIC and Marty Gruenberg for convening this important conference.