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Creating a New Model for the Future of Supervision

Remarks by

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at the

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Good afternoon. I'm pleased to be able to join you again virtually for this year's *Community Banking in the 21st Century* research and policy conference. Although I think we would all prefer to be together in person, in the shadow of the St. Louis Arch, I'm optimistic that next year (which will be the 10th anniversary of the conference, by the way) will give us the opportunity to finally gather in person after a two-year hiatus.

For nine years, this conference, which brings together researchers, regulators, and community bankers, has enabled us to hear from top academics around the world who conduct research to help us better understand the community bank business model. It's not an accident that this conference is sponsored by three agencies involved in the supervision of banks—the Federal Reserve, the Conference of State Bank Supervisors, and the FDIC—as the work of this conference has informed, and will continue to inform, how we think about the supervision of our nation's community banks.

Our conference sponsors entered this partnership with the belief that what we learn here will deepen our understanding of the benefits of, and the challenges facing, the community bank business model, which, in turn, helps to make us better bank supervisors.

It's natural then to ask: What have we learned from this conference that is applicable today? What might we apply in the future to the supervision of community banks?

To answer that question, or quite frankly, to answer many questions that pertain to the regulation and supervision of banks, it's instructive to first go back a bit in history. In this case, I'd like to take you all the way back to. . .2019.

Seems like a lifetime ago.

Way back then, we were concerned about liquidity. Banks were concerned about a potential run-off of deposits as consumers found new, more technology-centric ways to manage their money, often outside of the insured banking system. Although we also saw a decline in technology costs that enabled banks of all sizes to offer a wider array of digital products and services to their customers, the innovation taking place outside the banking sector was often seen as outpacing the innovation in the banking sector.

Consumers seemed to increasingly weigh convenience over safety, as a number of non-banks increased their market share. To a lesser degree, but still concerning, was that of the convenience factor. It drove some small business borrowers to move away from lenders with whom they had longstanding relationships. In some cases, those borrowers were even willing to pay much more for credit for the sake of convenience. Unfortunately, some borrowers learned the hard way that convenience does not always outweigh a banking relationship—particularly when a business or community experiences a significant hardship such as a natural disaster.

I regularly heard stories of how small businesses that borrowed from an online lender were unable to reach anyone to discuss their situation during a crisis and ultimately had their loans called because of missing a payment. In these situations, I also heard stories of how the local community bank that understood the local situation and wanted to see the business and the community survive, would step in, and refinance the original loan to help the small business return to more normal operations.

I also heard about challenges with core processors and how legacy contracts and a lack of competition for core processing services was stifling innovation. We saw several fintechs become "mainstream" nationally, and we saw a proliferation of technology solutions targeted at helping community banks become nimbler in adding new products and services.

From a supervisory perspective, the Federal Reserve actively explored ways to reduce regulatory burden and provide greater transparency into the work of bank supervisors. Using research presented in prior years at this conference, we applied findings showing the disproportionate regulatory burden borne by our smallest institutions and looked across our processes to find ways to tailor our supervisory model to more accurately reflect the risk posed by these smaller financial institutions.

And then came March 2020 and the arrival of the COVID-19 pandemic in the U.S.

Despite the many choices consumers have for managing their money and purchases outside of the traditional banking system, we witnessed a systematic flight to the safety of FDIC-insured deposits in state or nationally chartered banks.

Specifically, total deposits at all FDIC-insured institutions increased by 22 percent when comparing deposit data from 2019 to 2020.[1] Small business lending also increased significantly. From the end of 2019 to the end of the second quarter of 2020 alone, small loans to businesses at community banks, a proxy for small business lending, increased by 39 percent.[2]

The Impact of the PPP during the Pandemic

One driver for the increase in small business lending was, of course, the Small Business Administration's Paycheck Protection Program or PPP. The PPP was funded

[1] FDIC Summary of Deposits (2019, 2020). Summary of Deposits is collected as of the second quarter each year.
[2] Consolidated Reports of Condition and Income (Call Reports).

by the U.S. Treasury Department through forgivable loans that enabled small businesses to maintain payroll, retain employees who may have been laid off in response to the social distancing protocols that went into effect in April 2020, or to cover other overhead costs.

To support the PPP, the Federal Reserve provided a liquidity backstop to PPP lenders through its Paycheck Protection Program Liquidity Facility or PPPLF. In recognition of the evolution in the banking landscape that I referenced a few moments ago, the PPPLF was designed to not only provide a liquidity backstop to banks and credit unions, but also to serve non-bank fintechs, community development financial institutions, and agricultural finance companies that participated in the PPP. Given the important role minority-owned banks play in the allocation of credit in their communities, the Federal Reserve also actively engaged minority depository institutions to ensure they had the tools they needed to benefit from the Fed's emergency liquidity programs.

To be sure, the PPP and the PPPLF will provide significant research material for years to come. I understand from reviewing the papers accepted into this year's proceedings that it has already driven the work of several economists you'll be hearing from over this two-day conference. In reviewing the data on these programs, however—and here I must credit the Federal Reserve Bank of New York's "Supervision Transformational Trends" program—we see that a substantial majority of PPP loans, nearly 73 percent, were made by insured depository institutions. These loans also accounted for nearly 90 percent of the aggregated loan amount for all PPP loans.

Getting a bit more granular, we can see that community banks made 32 percent of all PPP loans while large banks made 35 percent of all PPP loans, with credit unions and savings banks accounting for the rest of the loans made by banking institutions. Fintechs accounted for approximately 13 percent of all PPP loans and more than half of those were made as a result of a partner bank relationship.

A recent working paper from the National Bureau of Economic Research (NBER) offers additional detail on the roles these different types of lenders played in allocating credit through the PPP during the pandemic.[3] The authors found

- Community banks originated the majority of PPP loans when the program first launched, while large banks were the majority lender during the second phase of the program.[4]
- Community banks provided more loans to middle income borrowers while large banks provided more PPP loans to upper income borrowers.
- Community banks and large banks made loans to lower and moderate-income borrowers in approximately equal proportions.
- Fintech firms, on the other hand, made more loans in zip codes with fewer bank branches, lower incomes, and larger minority populations.[5]
- The authors also found that fintech lending, instead of taking market share from traditional banks, mostly expanded the overall supply of credit and other financial services.

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[3] Isil Erel and Jack Liebersohn, "Does FinTech Substitute for Banks? Evidence from the Paycheck Protection Program," NBER Working Paper 27659 (Cambridge: National Bureau of Economic Research, December 2020), https://www.nber.org/papers/w27659.
[4] It's important to note that the NBER paper uses $20 billion as the asset size threshold between large banks and small (community) banks. This is different than the $10 billion asset size threshold that was established via the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.
[5] In this study, lending by Minority Depository Institutions and Community Development Financial Institutions is included in the lending data for small (community) banks.

From my perspective, these findings offer evidence of the continuing importance of community banks to our economy during both "normal" times as well as during times of extreme financial stress. Or, to paraphrase Mark Twain, "reports of the demise of community banks are greatly exaggerated."

The NBER paper also highlights how new entrants to banking can meet an unmet need.

The experiences of banks and bank supervisors during the pandemic also offer insights into how we should think about the Federal Reserve's approach to supervision in the future. For the remainder of my talk, I will offer my thoughts on a key principle that I believe should guide our thinking: **The future of community banking and the future of banking supervision are deeply interconnected.**

My earlier comments should not be interpreted as suggesting that there aren't real challenges facing the community bank business model. But I am suggesting that new technologies, new entrants into banking, and changes in customer preferences that have led to predictions about the end of the community banking business model simply have not been substantiated.

If anything, this conference has highlighted that the diversity in business models of small financial institutions is an essential part of our economy. There is strength in being small that enables institutions to know their customers on a much deeper level. Small financial institutions can quickly customize products and services to address their customers' needs and, in some cases, they can leverage the flexibility of their business models to take advantage of new business opportunities. This flexibility allows banks to maintain strong relationships with customers—particularly those customers who don't fit a “typical” borrower profile. It also explains why community banks have a long history of providing essential financial services to households, small businesses, and small farms in communities across the country.

During the pandemic, I personally began speaking to the leaders of the more than 650 state member community banks in the Federal Reserve’s supervisory portfolio. The conversations to date have provided important regional insights and perspectives that can only be gleaned from leaders who know their markets and customers at a very deep level. While I heard that lobby traffic was down and that lending opportunities were not as robust as they once were, I mostly heard optimism. I heard that the value proposition of the traditional community bank was on full display in many communities, urban and rural. I heard that bank business customers needed bankers who truly knew them and their businesses, and who could work with them to provide the customized support they needed during that time of great uncertainty.

As banks changed to meet the challenges of the pandemic, we asked ourselves at the Federal Reserve, do bank supervisors need to change?

By necessity, the immediate answer, of course, was “yes.” The Federal Reserve did so by pausing all on-site exams and using technology that enabled us to remotely supervise the safety and soundness of our institutions as well as monitor their compliance with relevant consumer compliance laws and regulations. To be sure, we adjusted our supervisory expectations accordingly based on the guidance we were providing banks.

We also greatly expanded our outreach and engagement with financial institutions. We deployed the full range of communications tools that we’ve developed over many years to provide banks with real-time information on supervisory expectations as well as the emergency lending programs that were put in place to forestall any systematic deterioration in the health of our financial system.

As evidenced by the continued strength of bank balance sheets and the general absence of bank failures during the pandemic, I think we can confidently say that the actions of banks, bank supervisors, and policymakers during the pandemic allowed us to avoid the challenges that plagued our banking system during 2008 financial crisis. The pandemic heightened our awareness of this important linkage between banking and supervision.

Had we not tailored our supervisory approach during the pandemic, I believe the impact on our banks, our economy, and on consumers would have been much more severe.

From the beginning, we worked closely with our federal and state counterparts—many of whom are represented at this conference—to develop a sense of joint action and to agree to work together in a holistic way.

I knew from my experience as both a community banker and a state bank regulator, that we needed to avoid overreacting and instead approach supervision in a more measured way that allowed banks the flexibility to work with their customers. We needed to empower banks to manage those key relationships in their loan portfolios in a way that was beneficial to their customers without exposing the banks to risk.

What we saw, as a result of this approach, is that the industry made responsible decisions that kept credit flowing throughout the pandemic and enabled businesses across the U.S. to continue operating.

But the question remains: how should supervisors, and banking supervision itself, apply what we learned going forward? During the pandemic, we changed our supervisory approaches based on necessity, but now we need to look ahead and make sure that we're adjusting our supervisory model in ways that allow banks greater flexibility to innovate to compete in today's quickly evolving banking environment—without sacrificing important consumer protections or the health and safety of our banking system.

The Future of Supervision

To start, we must acknowledge the interconnectedness of the future of banking and the future of bank supervision. Supervision has to evolve because the banking industry is evolving. Available technology, analytical capabilities, and customer and workforce preferences are driving this evolution in how financial sector products and services are delivered. We recognize that our workforce, processes, and technology must align with these changes to ensure that an effective, transparent, and timely supervision program is maintained.

Therefore, the Federal Reserve is embarking on an initiative to investigate the implications of these changes for the Federal Reserve's Supervision function.[6]

The goal of this initiative is to ensure our supervisory approaches accommodate a much broader range of activities while ensuring we don't create an unlevel playing field with unfair advantages, or unfair disadvantages, for some types of firms versus others.

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[6] The scope includes execution of safety and soundness and consumer compliance supervision, risk identification, and analytical activities. The scope excludes other System Supervision activities, such as training, applications, enforcement, and policymaking.

This will include investigating technology and innovative business practices that increase our agility and efficiency.

Innovation is a way of life for banks, it should be for supervisors as well.

But we must do this in a way that also preserves what we know works and what we learned can work during the pandemic.

Before sharing my views on the underlying principles that need to guide our thinking on our future supervisory approaches, I'll first offer some thoughts on a few aspects of Federal Reserve supervision that I believe must be preserved even as we think expansively about the future:

1. **The first being the Federal Reserve's Supervisory structure.** Although the Fed's supervision and regulation of banks is the responsibility of the Board of Governors, the day-to-day supervision of banks is delegated to the Reserve Banks. This distributed system ensures we have most of our examination workforce living and working in the same communities served by our community banks. This structure, perhaps more importantly, gives our examiners deep insights into thousands of local economies across the U.S. and helps us understand the local industries that are vital to the long-term health and success of these communities. This local knowledge is what enables our examiners to tailor our supervision of institutions based not only on the complexity of the bank but based on the unique characteristics of the industries they support.
2. **The second is the Federal Reserve's direct outreach and engagement with banks and financial institutions.** Since the 2008 financial crisis, the Federal Reserve has built an extensive communications infrastructure—through national

programs, such as *Ask the Fed*®, and though hundreds of local Reserve Bank programs—to share important supervisory and regulatory information with banks. The goal was simple: provide a mechanism that enables us to quickly share information and perspectives with institutions outside of the exam process, provide timely and accurate responses to questions, and give the banks the tools they need to meet our supervisory expectations. I believe supervision works best when supervisors clearly communicate their expectations with banks—there shouldn't be any "surprises" about our expectations during an exam. In my calls with bankers, I'm reminded that one of the biggest sources of regulatory burden is regulatory and supervisory uncertainty. By clearly communicating our expectations, by engaging the industry directly to understand the impact of these expectations and, when appropriate, providing banks with tools and resources to meet those expectations, we reduce uncertainty for banks.

We continued to expand our communication approach this past July with the launch of the Federal Reserve's Scaled CECL Allowance for Losses Estimator or SCALE tool. SCALE gives community banks a tangible tool to help with their calculation of loan loss allowance under the Current Expected Credit Losses methodology. Our effort to identify simple and practical ways to implement CECL that would help reduce costs and complexity for smaller community banks was supported by the Financial Accounting Standards Board. The launch of SCALE represents a significant cultural shift in how we intend to supervise in the future: when there is significant uncertainty around a new regulation, supervisory expectation, or practice, we will look beyond our traditional communications tools to find innovative ways to reduce that uncertainty.

So, what will this new approach to supervision look like and what principles will guide us?

- First, we must maintain a firm commitment to preserving the stability, integrity, functionality, and diversity of our banking system.
- Second, we must maintain consumer protection as we innovate and ensure that banks can safely offer financial products and services that consumers demand and are uniquely tailored to their circumstances and goals.
- Third, as we adjust our supervisory approach, we must avoid adding new burdens on banks, particularly on those that maintain a more traditional business model. We must be consistent in how we view similar activities at similar institutions, but our approach must also allow for de novo banks and allow for greater innovation at our nation's banks. And we need to continue to provide examiners with the ability to tailor their expectations based on the risks posed by individual institutions. We must move even further beyond the "one size fits all" supervisory model that defined our approach in the past.
- Fourth, we must enhance transparency around our supervisory expectations for safety and soundness and consumer compliance matters and be timelier in our feedback to banks. We must fully leverage our distributed structure to delegate decision making to our Reserve Banks, without diminishing the Board's important policymaking and oversight role over the supervision of banks.

- And fifth, we must ensure that we are always able to adjust our supervisory expectations effectively and efficiently as conditions warrant to enable banks to be more flexible in serving their communities and in providing credit to the areas of our economy that most need it.

When I spoke at this conference in 2019, I discussed a number of very practical problems that we needed to solve. These included understanding how technology, competition, regulation, and other factors drive industry consolidation, quantifying the benefits community banks provide to their communities, and defining the full economic effects a community bank has on its community.[7]

As we move forward with modernizing our supervisory approach, these questions remain at the forefront of our thinking. But, based on our experiences of the past few years, we also have a number of new questions that we'll need to address if we are to be successful.

For example, what do banks see as the most transformative technological innovations that will drive changes to their business models? How do banking institutions prefer to interact with their supervisors, and what do they think makes for a successful relationship between the supervisor and the supervised?

The factors that are identified through this initiative as having the greatest potential influence on future bank business models will vary based on several factors, including size, complexity, geography, staff capacity, and business strategy, but, taken

[7] Michelle W. Bowman, "Advancing Our Understanding of Community Banking" (speech at the Community Banking Research and Policy Conference, St. Louis, MO, October 1, 2019), https://www.federalreserve.gov/newsevents/speech/bowman20191001a.htm.

together, they will give us important insights into how we, as bank supervisors, might need to evolve our supervisory practices as the bank business model evolves.

And as we consider our own evolution in the face of these changes, we will need to ask ourselves:

- What changes to the Federal Reserve System Supervision function's workforce, processes and technology are necessary to execute our supervisory activities given the factors affecting the industry?
- How should the Federal Reserve structure its supervisory activities across its portfolios of supervised firms?
- Where are we aligned across the Supervision function in conducting our work? Where might we be out of alignment?
- Should innovations in technology, such as artificial intelligence, be used to better accomplish supervision?

In the future, I look forward to sharing our progress on this initiative and providing specific examples of how our supervisory practices are evolving alongside those of the industry.

Times of crisis, such as the COVID-19 pandemic, provide us a unique opportunity to see how our banking system operates under stress—and to see both the strengths of our current system of supervision as well as opportunities for improvement.

The lessons we learned over the past 18 months, supported by research from this conference and from other sources, offer important lessons on how we can appropriately evolve our supervisory approaches.

What we learn over the next two days from the researchers, policymakers, and community bankers presenting during this year's conference proceedings will factor into our overall thinking as we embark on this journey to modernize our supervisory practices and develop new supervisory approaches that can meet the needs of today, and the challenges of tomorrow.