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Community Banking and Community Bank Supervision in the Twenty-First Century

Remarks

by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

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Good morning. I am pleased to join you today to discuss matters of mutual interest to the Federal Reserve and community banks; to learn more about your business; and, I hope, to meet many of you in person.

Community banks have long played a critical role in the U.S. economy, and this is no less true in the twenty-first century. Today, I will begin by making some observations, based in part on research done at the Federal Reserve and elsewhere, about the health of community banks and their evolving role in our economy. Community banks are generally doing quite well, and I expect that good performance to continue. But community banks also face a changing business environment that presents a number of important long-run challenges. In the second portion of my remarks, I will speak a bit about how the Federal Reserve, as the supervisor of many community banks, is also adjusting to a changing environment, and I will review some of the key financial risks facing community banks.

Developments in Community Banking

By a wide variety of indicators, the overall performance of community banks in recent years has been quite strong. Average return on equity (ROE), for example, following a decline associated with the 2001 recession, remains solid and indeed has shown a slight upward trend. Return on assets for community banks as a whole demonstrates a similar pattern and has stayed well above traditional benchmarks of strong performance. Net interest margins remain higher than those of the largest banks, and this gap has even widened since 2003. Various measures of loan quality for community banks have been robust, and bank failures have been rare. Equally important, both our on-site examinations and our off-site surveillance system, which uses statistical models to attempt to flag emerging weaknesses at community banks, detect signs of potential problems at very few banks. Consistent with this view, community bank capital ratios remain impressively high, and community banks' ability to attract deposits continues to be a source of strength.

One strong indicator of the continued health of community banks is the rate at which new banks continue to be created. For example, if we define a community bank as any bank or thrift organization with total real (2002) assets of a billion dollars or less, slightly more than 700 community banks were formed from the beginning of 2000 through 2005, an average of about 120 per year. Clearly, many people remain willing to invest in the future of community banking. The Board has long taken the view that community banks will remain a vigorous and innovative sector of the economy. I think that forecast remains a good one today.

All of this is good news. But I am sure that many in this audience would agree that community banks also face serious challenges. Expansion of the geographic scope of banking activities, rapid technological change in the production of financial services, the increasing importance of nonbank providers, and evolving patterns of economic growth are among the factors that are changing the banking marketplace. And, while many of these changes have improved the efficiency of our financial system and lowered costs for consumers, it is only realistic to acknowledge that they also present new and sometimes daunting tests for community banks.

Indeed, we have seen major shifts in the structure of the U.S. banking industry in recent decades. Under the same definition of community banks that I used a moment ago, the share of banking industry assets held in community banks has fallen from about

20 percent in 1994 to a little more than 12 percent in 2005. In addition, the number of community banks has dropped from more than 10,000 in 1994 to about 7,200 in 2005. Other definitions of community banks and other structural measures, such as the share of total deposits, also show declines in recent years.

Most of this consolidation is a result of mergers. A recent study by a member of the Federal Reserve Board staff shows that between 1994 and 2003 there were more than 3,500 bank and thrift mergers (Pilloff, 2004). In about 92 percent of these mergers, the target institution had one billion dollars or less in total assets. Although bank merger activity has generally declined since the late 1990s, at least 200 deals were completed in each year from 2000 through 2005.

The Evolution of Relationship Finance

These developments notwithstanding, research by our staff and other economists supports the view that community banks continue to play an important role in the provision of financial services, particularly to small businesses, but also to a wide range of retail customers nationwide. Indeed, conventional wisdom in the research community is that "the central principle of community banking is 'relationship finance'" (DeYoung et al., 2004, p. 81). By relationship finance I mean financial services whose value-added depends importantly on the ongoing personal interactions of bankers with their customers, interactions that improve the flow of information and allow for more customized services. Relationship finance strengthens the economy by allowing credit and other financial services to be provided more efficiently.

But recent research also confirms what many community bankers tell us--that traditional notions of relationship finance are changing, along with the nature of community bank-customer relationships.

The conventional research paradigm included the idea that small businesses and households tend to be informationally "opaque"; that is, information about these potential borrowers can be costly to obtain and hard to quantify. According to this view, the efficient supply of credit to such parties required close interactions to elicit "soft," or qualitative, information, such as the personal characteristics of the borrower or relevant aspects of local markets and opportunities. This paradigm holds that large banks have a comparative advantage lending to those relatively transparent customers from which they can obtain "hard," or quantitative, information, such as standardized accounting data, and community banks have a comparative advantage lending to relatively opaque small businesses and households.

However, this division of labor between large and small institutions has begun to blur. Today, practitioners and researchers understand that low-cost information processing, improved credit-scoring, and more sophisticated management techniques are rapidly reducing the effective opacity of many small businesses and households. Credit card lending provides an example of this phenomenon. Technological and financial innovation, including credit scoring, securitization, and economies of scale in data processing, have combined to make credit card lending a hard-information, transactions-driven business, quite different from traditional unsecured personal lending, which relies heavily on personal knowledge and relationships.

Some recent data from the Board's forthcoming Survey of Small Business Finances sheds some light on how the marketplace, and the role of community banks, is changing. The Board conducts this survey every five years. Our most recent data, which are still preliminary and will be released later this year, are for year-end 2003; they are the result of interviews with more than 4,200 small businesses that represent an estimated 6.3 million small businesses in the United States. The surveys show that small businesses are heavy users of financial services. For example, the proportion of these businesses using some type of financial service at a bank or thrift rose from 92 percent in 1998 to 96 percent in 2003. Increases occurred across a broad range of financial services and were especially strong in the area of "financial management services," which includes activities such as check clearing, cash management, letters of credit, and credit card processing.

According to the surveys, community banks remain an important provider of these services, albeit in an increasingly competitive marketplace. Among small businesses that reported using a bank or thrift in 2003, about 37 percent used a community bank, down from about 42 percent in 1998. Over the same period, the share of small businesses using a financial service supplied by a nondepository institution rose from 40 percent to 54 percent.

Although these surveys show that community banks face increasing competition, including from nondepository providers, they also highlight the importance of one of the traditional strengths of community banks: local presence. For example, in 2003 the median distance between a small business's headquarters and its bank or thrift was three miles, about the same as in 1998. Indeed, part of the success of nondepository institutions may have been due to the fact that the median distance between a small-business customer and its nondepository service provider fell from 83 miles in 1998 to 37 miles in 2003, with most of the change resulting from greater proximity of customers to nondepository loan providers. Being close and convenient is important.

Data collected as part of the banking agencies' Community Reinvestment Act (CRA) activities also demonstrate the importance of proximity. As you know, the CRA focuses on banks' lending and services provided within their local communities. From CRA and other data, we can estimate the share of loans to small businesses made by depository institutions located physically within the local market area. These data show that between 1996 (the year we began collecting such data) and 2004, the competition from out-of-market lenders has increased, a result that will not surprise you. However, in value terms, the share of small-business loans made by out-of-market firms did not exceed 18 percent in any year. Small-business owners look overwhelmingly to local lenders for credit.

We see that, for community banks, the overall picture is complex. In financial terms, community banks remain quite strong, and there is considerable entry into the business. New technologies and management methods have eroded some of the traditional informational benefits of relationship finance, however, and community banks have lost market share to larger banks and to nondepository institutions. But the data also show that many customers want to be served locally; they value proximity and convenience. In my view, the strong relationships and personalized services provided by community banks remain an important reason for their continuing success.

Supervisory Perspectives

Like community banks, bank supervisors must also adapt to a changing financial and economic environment. I would like to discuss some of the ways in which the Federal Reserve's supervision of community banks has evolved in recent years and also briefly review some of the key financial risks that we see in our examinations.

In the 1990s, bank supervisors began to take a more proactive, risk-focused approach. Under this approach, examiners focus their on-site reviews on those activities that appear to pose the greatest risks to each individual banking organization, with particular attention to the bank's procedures for evaluating, monitoring, and managing those risks. The objective is to address weaknesses in management and internal controls before, rather than after, financial performance suffers.

In adapting to change, the Federal Reserve and the other banking agencies have also consistently kept in view the competitive pressures that community banks face, pressures that make the costs of regulation an important concern. Whenever possible, we have streamlined procedures and worked to eliminate unnecessary burden. For example, based on industry feedback and supervisory experience, the Federal Reserve recently modified its Small Bank Holding Company Policy Statement to raise the asset size used to define eligible companies from $150 million to $500 million. These revisions address changes in the industry and in the economy since the initial issuance of the policy statement in 1980. While the bank holding companies (BHCs) affected hold only 6 percent of total BHC assets, this change increases the exempt group to roughly 85 percent of all BHCs, thereby providing some burden relief to many smaller companies. These companies will be exempt from consolidated risk-based capital guidelines and will be allowed to file abbreviated semiannual reports in place of consolidated quarterly financial statements. Under the policy statement, the exemption would not be extended to holding companies with significant nonbank or off-balance-sheet activities or that have material amounts of public debt or equity securities outstanding. Of course, we and the other banking agencies will vigorously enforce prudential capital standards for all deposit-taking institutions, including those owned by the exempt BHCs.

Supervisors have sought to adjust regulatory procedures to account for the needs of community banking organizations in other ways. As you are no doubt aware, in tandem with the review of capital standards for the largest banks, known as Basel II, the federal banking agencies are taking a comprehensive look at additional possible changes to existing regulatory capital guidelines for banks that would not adopt the proposed Basel II revisions. These possible changes to Basel I would seek to increase the risk sensitivity of the framework and to help mitigate any competitive inequities that could result from the implementation of Basel II.

The recent update to the CRA regulations provides another example in which regulators have taken into account the special features of community banks. Last year, the Federal Reserve and other federal agencies issued final CRA rules that reduced compliance burden by creating a new category of intermediate small banks with assets between $250 million and $1 billion. Banks in this new category now face reduced requirements for data collection and reporting, and they have become eligible for a two-pronged set of CRA tests--a streamlined lending test and a community development test--rather than the three-part CRA criteria that larger banks must meet. These changes are intended to reduce the costs borne by smaller banks and to increase flexibility while still achieving the community development objectives of CRA.

To target examination resources and to limit the burden of on-site reviews, the Federal Reserve also has increasingly relied on automated off-site monitoring tools. For example, since the late 1990s, the Federal Reserve has supervised many small bank holding companies using an off-site review program. We support this program with a targeted monitoring system that seeks to identify parent company and nonbank issues that may adversely affect affiliated insured depository institutions. This program enables us to limit on-site reviews to those bank holding companies with characteristics that could pose risks to insured depositories. We also use statistical models to monitor the condition of state member banks and quickly address any issues that emerge between regularly scheduled on-site examinations. This year, we substantially updated these models to improve their performance. Thanks in large part to such efforts, examiners today conduct more of their supervisory activities offsite, helping to reduce the burden that is associated with on-site examinations at institutions like yours.

Beyond these changes, the Federal Reserve is participating in an ongoing interagency review of banking regulations pursuant to the Economic Growth and Regulatory Paperwork Reduction Act, known as EGRPRA. This review seeks to identify opportunities to streamline regulatory procedures and requirements when such changes would be consistent with maintaining bank safety and soundness. The Board has also supported various legislative changes that would ease regulatory burden. These include a recently proposed change that would permit supervisors to extend the time between on-site examinations to eighteen months for well-managed and well-capitalized banks with up to $500 million in assets. This change would double the current size threshold and has the potential to allow roughly 1,200 more community institutions to qualify for the extended examination cycle.

In my remaining time, I would like to discuss some of the key financial and risk-management challenges that we have identified through our supervisory activities.

Banking has always been a business of taking and managing risks, but evolving market and economic conditions affect the types of opportunities available. In recent years, community banks have become more focused on commercial real estate lending, leading to a significant shift in the balance sheet and risk profiles of growing numbers of banks.

In most local markets, commercial real estate loans have performed well. Our examiners tell us that lending standards are generally sound and are not comparable to the standards that contributed to broad problems in the banking industry two decades ago. In particular, real estate appraisal practices have improved. However, more recently, there have been signs of some easing of underwriting standards. The rapid growth in commercial real estate exposures relative to capital and assets raises the possibility that risk-management practices in community banks may not have kept pace with growing concentrations and may be due for upgrades in oversight, policies, information systems, and stress testing.

In response to these developments, the federal banking agencies have recently proposed guidance that would focus examiners' attention on those loans that are particularly vulnerable to adverse market conditions--that is, loans dependent primarily on the sale, lease, or refinancing of commercial property as the source of repayment.

I emphasize that, in proposing this guidance, supervisors are not aiming to discourage banks from making sound loans in commercial real estate or in any other loan category. Rather, we are affirming the need for each bank to recognize the risks arising from concentration and to have in place appropriate risk-management practices and capital levels.

Adjusting to changes in the level of short-term interest rates can also pose challenges to community banks. Thus far, the relative stability of community bank net interest margins suggests that they have done a good job of managing their interest rate risk exposure throughout the recent increase in market rates. Importantly, most community banks have effectively controlled the maturity distributions of their assets and made significant improvements over the past decade to their management and measurement of interest rate risk. Certainly, the procedures employed by community banks today are significantly more effective than those typically used as recently as a decade ago. However, we continue to see a small number of institutions with concentrations in longer-term assets. In these cases, our examiners encourage banks to gauge the risks of new yield-enhancing strategies over the intermediate and longer terms.

The unique funding structure of community banks supports their strong recent performance. For the most part, community banks continue to fund themselves primarily with relatively low cost and stable "core" deposits. However, a limited segment of community banks is increasing its reliance on wholesale sources of funding. Greater reliance on these sources places a premium on appropriate measurement and management of liquidity risk. Most community banks manage their liquidity risk positions well, but supervisory reviews suggest that some institutions have room for improvement. With the banking system enjoying a period of relatively high liquidity, now is a good time for all companies to assess the adequacy of their processes for managing liquidity risk.

I emphasize that, on the whole, we do not have broad supervisory concerns with community banks. But it is only prudent to reiterate the importance of sound risk management to the continued success of community banks.

Conclusion

In closing, I want to return to where I began. In my judgment, well-managed and innovative community banks will continue to play a critical role in the U.S. economy. Community banks provide vital services for their customers and are key contributors to sustained economic growth, both locally and nationally. Indeed, the performance of community banks over the past decade has been very impressive. But neither bankers nor their supervisors should become complacent. Doubtless the future will continue to require both of us to evaluate and respond to changes that are often complex and difficult to understand, much less to predict. It has been my pleasure to be here today, and I look forward to working with you in the coming years to ensure the continued vitality of the U.S. banking and financial system.

Thank you.

References

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