

For release on delivery  
Noon EDT (9:00 a.m. MST)  
March 20, 2009

The Financial Crisis and Community Banking

Remarks by

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at the

Independent Community Bankers of America's National Convention and Techworld

Phoenix, Arizona

March 20, 2009

When I addressed this convention three years ago, with all of five weeks under my belt as Chairman of the Federal Reserve Board, I opened my remarks with three observations: that community banks played a critical role in the U.S. economy, that community banks were generally doing well, and that community banks faced a changing business environment that posed important challenges. I am struck that all three observations, at least to some degree, still hold true today. Community banks continue to play a critical role in our economy and, in many cases, have an opportunity to step in and make sound profitable loans, where some competitors have pulled back. Relatively speaking at least, community banks are doing better as a group than other segments of our financial system, but at the same time they are far from immune to current conditions. And, surely, it is still true that the business environment poses important challenges to community banks.

In fact, I think it is safe to say that few of us in the convention hall three years ago envisioned the financial and economic environment we now confront. Envisioning the conditions we will face three years from now is equally difficult, but it is my hope and expectation that those conditions will be significantly brighter. This morning, I'd like to spend some time reviewing the Federal Reserve's response to the financial crisis of the past 18 months, as well as the current challenges--and opportunities--facing community banks. In addition, I'll discuss two important steps that policymakers can and should take to improve the financial regulatory system that likely are of particular interest to you. The first step is the need to address the very real problem caused by institutions that are too big--or too interconnected--to fail in a disorderly manner. The second involves ways of making the system less procyclical, so that the financial system is less susceptible to exuberant booms and disastrous busts. In discussing the road back to financial stability and economic prosperity, I want to leave you with the idea that,

yes, this is indeed a time of challenge for community bankers, as it is for all Americans, but it also is a time of opportunity.

### **Federal Reserve Actions to Address the Financial Crisis**

The depth and complexity of the strains that have gripped financial markets and institutions since the summer of 2007 have led the Federal Reserve to take innovative and extraordinary actions aimed at restoring stability to markets and supporting the flow of credit to businesses and households.

Most directly, the Federal Open Market Committee (FOMC) has eased monetary policy aggressively. From the second half of 2007 to the spring of 2008, the Committee reduced its target for the federal funds rate from 5-1/4 percent to 2 percent. And, as the financial turbulence intensified last fall and the economic outlook deteriorated, the Committee responded by cutting the target for the federal funds rate to near zero by the end of last year.

As a result, a number of interest rates, especially shorter-term rates, have declined significantly, offsetting, at least to some degree, the effects of the financial turmoil on the cost of credit. However, as community bankers are no doubt aware, that offset has been incomplete. Widening credit spreads, more-restrictive lending standards, and credit market dysfunction are working against the monetary easing and leading to tighter financial conditions overall. To address these problems, the Federal Reserve has employed a range of additional tools.

These tools can be divided into three sets. The first set is closely tied to the central bank's traditional role of provider of short-term liquidity to sound financial institutions. Over the course of the crisis, the Fed has sought to ensure that financial institutions--including banks of all sizes

as well as primary dealers--have had adequate access to short-term credit.<sup>1</sup> We substantially reduced the spread of the primary credit rate over the target federal funds rate and increased the maximum maturity of primary credit loans to 90 days; we have also been conducting regular auctions of discount window credit for terms of up to 84 days. In fulfilling this traditional lending function, we have helped ease conditions in interbank funding markets, thus increasing the willingness of banks to extend loans and thereby easing credit conditions for the households and businesses that depend on banks.

Despite our provision of liquidity to banks and broker-dealers, a number of critical nonbank financial markets--such as the commercial paper market and the market for asset-backed securities--deteriorated significantly. Under normal circumstances, these markets are important sources of credit for American businesses and their customers. Thus, we developed a second set of policy tools to provide liquidity directly to borrowers and investors in key credit markets. Notably, we have introduced facilities to purchase highly rated commercial paper at a term of three months and to provide backup liquidity for money market mutual funds.

In addition, the Federal Reserve and the Treasury have jointly established a facility--the Term Asset-Backed Securities Loan Facility, or TALF--that lends against AAA-rated asset-backed securities collateralized by recently originated student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. This program just got under way; the first subscription for funding under the program was completed yesterday, with the funds to be disbursed next week. Over time, we expect to expand this facility to include loans against other types of newly issued AAA-rated asset-backed securities, such as commercial mortgage-backed securities and private-label residential mortgage-backed securities. If this program works

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<sup>1</sup> Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York. The New York Fed's Open Market Desk engages in trades on behalf of the Federal Reserve System to implement monetary policy.

as planned, it should make new consumer, business, and mortgage loans more available, at lower cost.

The Federal Reserve's third set of tools for supporting the credit markets involves the purchase of longer-term securities for the Fed's portfolio. As we announced this week, we are purchasing up to \$300 billion in Treasury debt, \$200 billion of the debt of government-sponsored enterprises (GSEs), and up to \$1.25 trillion of mortgage-backed securities guaranteed by the GSEs and federal agencies this year. These purchases are intended to improve conditions in private credit markets. In particular, they are helping to reduce the interest rates that the GSEs require on the mortgages that they purchase or securitize, thereby lowering the rate at which lenders, including community banks, can fund new mortgages.

The Federal Reserve continuously assesses the effectiveness of its credit-related tools. So far, we have generally been encouraged by the market responses, including the decline in mortgage interest rates I mentioned. In addition, our commercial paper facility has helped American businesses finance their payrolls and other operational obligations by significantly lowering rates on the paper and opening access to financing at terms longer than a few days. Our actions to stabilize the money market mutual fund industry, together with other government programs, have also shown some success--the sharp withdrawals from funds in September on balance have given way to modest inflows.

These credit-easing programs, along with actions taken by the Treasury and other government entities, are crucial determinants of the timing and strength of the economic recovery. However, although low interest rates and ongoing fiscal stimulus will help, we cannot have a vigorous economic recovery unless we succeed in restoring a reasonable degree of financial stability.

## **Conditions and Outlook for Community Banks**

As you well know, community banks have been adversely affected by the turmoil in the financial system. As a group, community banks--which I define to include commercial banks with assets of \$1 billion or less--have seen their financial performance and condition deteriorate substantially since the middle of 2007. Nevertheless, as I will discuss, the longer-term outlook for community banks is positive in light of their unique competitive advantages.

Looking first at current conditions, higher loan loss provisions and significant realized losses on investment securities--related in many cases to impairment of Fannie Mae and Freddie Mac equity holdings--substantially eroded the profitability of community banks in 2008. Community banks reported net income of just \$4.6 billion, less than one-half of the level of 2007. In the fourth quarter, almost one in every three community banks reported a loss, and overall they reported a small net loss of about \$150 million. Community banks entered the crisis with strong capital, and, despite weakening earnings, the vast majority--well over 95 percent--remained well capitalized at year-end 2008 under Prompt Corrective Action standards. Nevertheless, the ratio of nonperforming assets to total assets rose to its highest level since 1992 as residential mortgage and construction loans continued to deteriorate. And given the near-term economic outlook, loan quality at many community banks may decline further.

I know that bankers--including community bankers--have expressed concern over some of the "mixed messages" they perceive are coming from the federal banking agencies in the current environment--particularly admonitions to continue lending at the same time that institutions are being urged to maintain adequate capital and prudent lending standards. We are sensitive to this issue, which is why last November the agencies jointly issued the "Interagency

Statement on Meeting the Needs of Creditworthy Borrowers.”<sup>2</sup> In that statement, we noted that continuing to lend in this environment is not inconsistent with maintaining good risk management and high underwriting standards. For example, we emphasized that, while rectifying past shortcomings in underwriting standards and other aspects of risk management, banks can and should continue to provide loans to creditworthy customers. We have directed our examiners to be mindful of the procyclical effects of excessive credit tightening and to encourage banks to make economically viable loans, provided such lending is based on realistic asset valuations and a balanced assessment of borrowers’ repayment capacities. Across the Federal Reserve System, we have implemented training and outreach to underscore that direction.

In recent years, I and others from the Federal Reserve have underscored the importance of community banks to the U.S. financial system and economy. I continue to believe that firmly. Community banks serve businesses and consumers throughout the country, in both rural and urban areas. They are a leading provider of credit to small businesses, a key source of job creation in this country.

In the decades leading up to the current crisis, the nature of lending had changed dramatically, with greater industry consolidation, increased economies of scale and scope, and a larger portion of credit being supplied by nonbanks. While such changes challenged community bankers, your institutions have remained vitally important. Indeed, during the current crisis, some data show recent increases in loan and deposit balances at community banks, while such balances are generally flat or even decreasing at the largest banks.

The various efforts that the Federal Reserve has taken to provide backup liquidity to financial firms and to improve the functioning of financial markets have, I believe, helped all

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<sup>2</sup> Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), “Interagency Statement on Meeting the Needs of Creditworthy Borrowers,” joint press release, [www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm).

segments of the financial system, including the community banking sector, and the economy more generally. Helping community banks also helps the local communities that they serve. One important way that community banks may assist their communities is by working with at-risk homeowners to avoid preventable foreclosures. Foreclosures can result in clusters of vacant properties, which in turn can foster crime, stretch municipal resources at a time of weakening revenue, and lead to lower house prices throughout the neighborhood. These are some of the reasons why the Federal Reserve, along with the other U.S. banking agencies, has encouraged banks to participate in the Making Home Affordable loan modification program established by the Treasury.

While continuing challenges remain, opportunities also exist for community banks. In some instances, community banks are able to step in at crucial moments when local businesses or consumers have been unable to find credit elsewhere. Indeed, as some banks have chosen to cut back on lending to conserve capital and liquidity, community banks in strong financial condition may find that they can gain creditworthy customers even in today's economic environment. Such community banks also may find opportunities to reclaim customers and business from nonbank lenders who have drawn back as the securitization markets have encountered difficulties. Community banks are able to respond promptly in such cases because of their in-depth knowledge of their markets, their locally focused management teams and boards, and their commitment to tailoring unique credit products for individual borrowers and businesses.

### **Addressing the "Too Big to Fail" Problem**

Many of you likely are frustrated, and rightfully so, by the impact that the financial crisis and economic downturn has had on your banks, as well as on the reputation of bankers more generally. You may well have built your reputations and institutions through responsible lending

and community-focused operations, but nonetheless, you now find yourselves facing higher deposit insurance assessments and increasing public skepticism about the behavior of bankers--outcomes that you perceive were largely caused by the actions of larger financial institutions. Many of you managed your businesses prudently and shunned more exotic instruments and activities. And many of your customers--households and businesses--avoided excesses and are able to meet their financial commitments on a timely basis.

No doubt this frustration has been heightened by the problems caused by financial firms that are too big or too interconnected to fail. Indeed, the too-big-to-fail issue has emerged as an enormous problem, both for policymakers and for financial institutions generally. Creditors of a firm perceived as too big to fail have less incentive to monitor and restrict the firm's risk-taking through adjustments to the price at which they lend money to the firm. If left unaddressed, this weakening of market discipline creates an unlevel playing field for smaller institutions, which may not be able to raise funds as cheaply, even if their individual risk profiles are better, or at least no worse, than those of their larger competitors. The erosion in market discipline distorts market behavior and can give firms an incentive to grow--either internally or through acquisitions--in order to be perceived as too big to fail.

Government rescues to prevent the failure of major financial institutions also have required large amounts of public resources. These actions have involved extremely unpleasant and difficult choices, but given the interconnected nature of our financial system and the potentially devastating effects on confidence, financial markets, and the broader economy that would likely arise from the disorderly failure of a major financial firm in the current environment, I do not think we have had a realistic alternative to preventing such failures. That said, these episodes have shown clearly that the problem of too-big-to-fail is extremely serious.

To address this issue, which should be a top priority for financial reform, policymakers will need to act on several fronts.

First, supervisors--as we are already doing--must vigorously address the weaknesses at major financial institutions with regard to capital adequacy, liquidity management, and risk management. Firms whose failure would pose a systemic risk must receive especially close supervisory oversight and be held to the highest prudential standards. Aside from its direct benefits for the safety and soundness of these large institutions, such an approach also would help offset financial firms' incentive to grow until they are perceived to be too big to fail.

Second, supervisors must pay close attention to compensation practices that can create mismatches between the rewards and risks borne by institutions or their managers. As the Federal Reserve and other banking agencies have noted, poorly designed compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization. Management compensation policies should be aligned with the long-term prudential interests of the institution, be tied to the risks being borne by the organization, provide appropriate incentives for safe and sound behavior, and avoid short-term payments for transactions with long-term horizons.<sup>3</sup>

Third, as the recent financial crisis has highlighted, risks to the financial system may arise not only in the banking sector, but also from financial firms that traditionally have been outside the regulatory and supervisory framework applied to banking organizations. Under federal law, all banking organizations--regardless of size--are subject to consolidated supervision for safety and soundness purposes. At a minimum, policymakers must ensure that a similar statutory framework is put in place for all systemically important financial firms organized as holding companies. The agencies responsible for implementing this framework also must vigorously

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<sup>3</sup> See "Interagency Statement," note 2.

exercise their authority to help ensure the safety and soundness of nonbank firms whose failure could threaten the stability of the financial system. Broad-based application of the principle of consolidated supervision would also serve to eliminate gaps in oversight that would otherwise allow risk-taking to migrate from more-regulated to less-regulated sectors.

Fourth, continued strong and concerted efforts are needed to improve the financial infrastructure--or “plumbing”--that supports the trading, payments, clearing, and settlement activities that are so critical to the functioning of the financial system. I have described elsewhere the various steps that the Federal Reserve is taking in coordination with other supervisors and market participants to improve the resiliency of over-the-counter derivative markets and the market for triparty repurchase agreements.<sup>4</sup> Improvements in these areas should reduce the likelihood that the failure of any individual institution would have substantial spillover effects on other financial institutions or the broader markets, and thereby make it less likely that the government would need to intervene.

Finally, an important element of addressing the too-big-to-fail problem is the development of an improved resolution regime in the United States that permits the orderly resolution of a systemically important nonbank financial firm. We have such a regime for insured depository institutions, but it is clear we need something similar for systemically important nonbank financial entities. Improved resolution procedures for these firms would help reduce the too-big-to-fail problem by giving the government the option of safely winding down a systemically important firm rather than keeping it operating.

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<sup>4</sup> Ben S. Bernanke (2009), “Financial Reform to Address Systemic Risk,” speech delivered at the Council of Foreign Relations, Washington, D.C., March 10, [www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm](http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm).

## **Reducing Procyclicality in the Financial System**

In the current environment, financial institutions of all sizes are trying to meet the needs of creditworthy borrowers while at the same time maintaining sufficient capital and other resources to weather the ongoing crisis. Capital rules, accounting policies, and other regulatory standards should not make this job even more difficult by encouraging excessively procyclical behavior by financial institutions--that is, behavior that causes financial institutions to tighten credit in downturns and ease credit in booms more than is justified by changes in the creditworthiness of borrowers.

No one questions the underlying objectives of capital rules and accounting standards, which are to ensure the safety and soundness of financial institutions and to accurately and transparently disclose an institution's financial condition, respectively. However, some aspects of existing capital rules and accounting standards may unduly magnify the ups and downs in the financial system and the economy. For example, the capital rules require banks to maintain capital ratios that meet or exceed fixed minimum standards. Because banks typically find raising capital to be difficult in economic downturns or periods of financial stress, their best means of boosting regulatory capital ratios during difficult periods may be to reduce new lending, perhaps more so than is justified by the credit environment. Moreover, as many institutions and auditors will attest, determining the appropriate valuation of illiquid or idiosyncratic assets can be very challenging, especially in highly strained market conditions. The economic downturn also has renewed the debate concerning the appropriate levels of loan loss reserves over the cycle.

Institutions themselves often try to offset the potential for procyclicality in capital levels by maintaining strong capital buffers to absorb swings in regulatory capital requirements. This type of action is in line with supervisory expectations that call for banking organizations to be

able to assess their overall capital needs and hold capital commensurate with their individual risk profiles--beyond complying with minimum regulatory capital requirements. Most community bankers understand this point. Your institutions generally hold capital in excess of minimum regulatory requirements--sometimes well in excess.

Nonetheless, the issues surrounding procyclicality are not easy, and their consideration will require a careful balancing of important public policy interests. Policymakers should review existing capital rules and accounting standards to determine whether these rules and standards could be modified to reduce their potential to have unduly procyclical effects without weakening their ability to achieve their fundamental objectives. I'm pleased to note that the Basel Committee and the Financial Stability Forum already have work under way to address excessive procyclicality in capital regulations, and that the Financial Accounting Standards Board is issuing new guidance that relates to market-to-market accounting in inactive markets and other-than-temporary impairments.

## **Conclusion**

I want to conclude by encouraging you as community bankers to operate prudently in the current environment, but not to let fear drive your decisions. You should all continue to exercise good risk management--including strong underwriting for individual exposures and proper management of credit concentrations in your portfolios. You should also be certain that any deterioration in asset quality and borrowers' conditions are accurately identified, measured, and managed. And you should take steps to maintain a strong financial condition with sufficient capital and liquidity levels as preparation for any future economic and financial uncertainty. By doing so, you can ensure that your institutions can continue to provide a steady and consistent source of credit to businesses and borrowers for years to come. If community banks are prudent

but opportunistic in extending credit to strong borrowers, they will help the economy recover while benefiting from that recovery themselves.