The Federal Reserve Board

Remarks by Governor Susan S. Bies

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Current Challenges of Community Banks

Good morning. I am delighted to be here to discuss a variety of issues that I believe are relevant today to directors and senior managers of banks. During my brief term on the Board, I have heard other governors say that they came to Washington expecting to spend most of their time discussing the economy and monetary policy with many of the Board's 225 PhD. economists and then making policy decisions and judgments. Although those activities are, in fact, an important part of the job, my colleagues have typically found that they spend significantly more time on bank supervisory and regulatory matters. I suspect that will be my experience as well, and--as a former banker--I look forward to dealing with these issues from the other side of the table. As I do so, I'm sure I will benefit greatly from opportunities like this one to meet with industry participants.

In my comments today, I will address three topics: the financial performance of U.S. banks, in particular, of community banks; the improvements that banks large and small are making in measuring and managing risk; and finally, the responsibilities of directors and senior managers in corporate governance. In my view, these topics are integrally linked and, in light of current questions of confidence in America's corporations, quite timely.

Financial Condition of U.S. Banks
Last year was exceptional in many respects, with the United States slipping into what appears to have been a mild recession, and with the terrorist attacks in September. In response, the Federal Reserve reduced interest rates at every meeting of the Federal Open Market Committee in 2001 and an additional three times between meetings, for a total of eleven rate cuts totaling 475 basis points. Also, by year-end, serious concerns had arisen about the integrity of corporate management and financial reporting. Credit quality deterioration was concentrated in larger corporations, with several filing for bankruptcy. Argentina's economic difficulties reminded us, yet again, that exposures to emerging economies could present substantial risk.

Given these events, the U.S. banking system has remained strong possibly in large part, because the recession in this country seems to have been relatively mild and short-lived. More directly, the strength seems also to reflect improvements in risk management at many banks and a greater awareness throughout the industry that institutions should promptly address problems as they emerge. This time, both the banking industry and the regulatory agencies appear to have done just that--acted promptly--and without going too far and unnecessarily constraining credit.

Much of the weakness among banks recently has been concentrated in large regional and money center banks, rather than in smaller institutions. Bank earnings, capital levels, and asset quality all remain strong by historical standards. Indeed, as the industry's problem assets began to climb in recent years, banks were generally better prepared to deal with potential threats than they were in the past. The industry entered the latest slowdown in solid financial condition, giving both the banking system and the regulatory agencies much more freedom to respond than they had a decade ago when losses were large and broadly based and bank capital positions were weak.

To be sure, there were signs that risks in recent years were building, to the point that both the Federal Reserve and the Office of the Comptroller of the Currency issued warnings about lending standards as early as 1998, a time when many of today's weak credits were booked. Financial problems in Asia later that year further sensitized large banks, in particular, to potential risks and led many to strengthen their lending standards and practices. That proverbial "stitch in time" may have helped greatly in preventing problems from becoming larger.

Nevertheless, for each of the past two years, the annual interagency reviews of shared national credits have shown clear deterioration in bank asset quality. Both times, the reviews of credits exceeding $20 million that are shared by three or more banking organizations indicated not only that problem assets were rising quickly but also that the lead underwriters were sometimes slow to recognize the deterioration in their internal credit ratings. Both of these findings were particularly apparent to us in 2000, but promptness in recognition of deteriorating credit ratings improved notably in 2001, when the supervisory reviews produced far fewer surprises to banks.

When the economy slows, one expects the volume of problem credit to rise. The key, of course, is to anticipate such slowdowns and to maintain sound credit standards at all times. As a former banker, I know that is easier said than done, given the uncertainties of credit and economic analysis and the level of competition. That's where sound risk- management processes and procedures, diversification, corporate governance, and strong capital ratios play important roles.

For the most part, community banks have so far been spared from the weakness in commercial and industrial loan portfolios that has affected many larger institutions. Though all banks were affected by the soft economy last year, those with less than $1 billion in assets saw little increase in their nonperforming C&I loans, compared with a rise of 37 percent for the industry overall. As a result, community banks generally avoided pressures to increase loss provisions and still maintained reserve coverage ratios that were stronger than those of larger banks. In short, smaller banks here in Ohio and across the country have weathered recent periods quite well and are advantageously situated to do their part in supporting economic growth.

If not C&I lending, what areas may present heightened risks to community banks today? First, for most of the past decade, community banks--particularly those in the asset range of $100 million to $1 billion--have actively expanded their commercial real estate lending. Since the early 1990s, larger community banks have grown commercial real estate portfolios from 13 percent to 22 percent of aggregate assets.

To date, these credits have generally performed well, and my comments are not intended to suggest a material concern. These credits, however, account for most of the group's increase in nonperforming assets last year. Given the checkered history of commercial real estate lending and its increased relevance to many community banks, this portfolio must be monitored and managed carefully. We have often seen the cyclical nature of commercial real estate and its links to the general level of economic activity. The loss of anchor firms such as K-Mart, for example, may reduce the market value of certain shopping centers and the consumer traffic and the financial strength of nearby businesses as well.

The second area of potential risk relates to interest rates. For the industry overall, the Federal Reserve's rate cuts last year may have proved to be a mixed blessing. Lower interest rates undoubtedly eased payment pressures on many borrowers and prevented further deterioration in the quality of bank loan portfolios. Liability-sensitive banks saw their funding costs fall faster than loan and investment yields, widening their net interest margin. Lower interest rates also spurred a record volume of mortgage refinancings and sizable gains in bank securities portfolios. However, the lower rates will begin to narrow net interest margins for some institutions. Rates paid on deposits are close to their effective floors, and yields on loan portfolios are lower because of refinancings and the falling prime rate.

Many banks responded to the low rates by sharply reducing their investments in Treasuries and shifting funds into mortgage-backed securities, as they searched for higher yields. Given the historically low interest rates at which recent mortgages have been originated or refinanced, one might expect that these loans would be much slower to prepay than previous ones. As a result, the effective maturity, or duration, of bank securities portfolios--and of many loan portfolios, as well--has been extended.

Clearly, I am not about to forecast interest rates, something I've already learned that central bankers never do. Nevertheless, the interest-rate environment could present banks with a greater challenge this year. In this situation, the simple concept of "reversion to the mean" suggests a greater awareness of the risk of rising rates and their effect on long-term assets. Even stable rates could present increased risks, if savings and money market deposit accounts deposits flow out of banks as quickly as they came in last year. We should all ask ourselves how long depositors would be content earning the currently low rates as equity markets improve or interest rates rise once again. At some point, even loyal customers--those on fixed incomes, in particular--may blink and take steps to improve their returns.

Turning to the longer-term outlook, what are the prospects for community banks? The picture is mixed. Clearly community banks have performed and continue to perform well, and they will retain an important role in our banking system. They have historically had higher profitability, as measured by the return on average assets, than large regional and money center banks and, on an individual-institution basis, have enjoyed relatively strong asset and deposit growth.

A study recently published in the Federal Reserve Bulletin examined growth rates during the past fifteen years for large and small banks. Adjusting the data for mergers and acquisitions, the authors found that small and medium-sized banks--defined as those below the 100 largest--grew faster than the larger banks in virtually every year between 1985 and 2000. Moreover, the smallest banks, those below the 1,000 largest in terms of assets, grew the fastest of all in both deposits and total assets.

The banks did this the old-fashioned way, by earning more on assets than larger institutions. Although small banks paid higher average deposit rates than the large banks paid, their net interest margins were still much higher, and by a growing differential in recent years. Measured by return on assets, small banks have done as well as or better than large banks in all but a handful of years over the past decade and a half.

Among small banks, those located in urban areas have done best, presumably because economic activity has been expanding the fastest in cities. Asset and deposit growth at small agricultural banks, by contrast, lagged behind that at other small banks, although not at large banks. The comparatively poor performance of agricultural banks seems to reflect the level of credit demand in the agricultural sector itself, as growth of farm business debt has lagged behind that of total nonfinancial debt. Another factor has been a pickup in market share by the Farm Credit System. Even so, when measured by return on assets, small agricultural banks have performed on a par with other small banks.

The surprisingly strong and persistent growth in the number of branch offices also suggests that the personal touch, which plays to the strength of community banks, remains an important element of banking in the age of the Internet. During the past fifteen years, the number of branch offices has steadily increased, rising more than 50 percent, from about 43,000 to more than 65,000 branches. The creation of de novo banks also remains strong, rising in recent years to about 200, annually, from roughly 100 new banks each year during 1993-95. Regardless of how long these trends continue, the creation of so many new banks and banking offices suggests that the market still views the opportunities and business franchise of small commercial banks to be quite sound.

On the other hand, trends in market share for community banks seem to present a less optimistic picture. Adjusting the data to account for inflation and real industry growth, the community bank share of industry assets has steadily declined, falling from 25 percent a decade ago to about 16 percent now. By other measures of industry structure, the number of banks, top-tier holding companies, and independent banks all declined sharply during the past ten to fifteen years.

If small banks are doing so well, what explains their steady decline in market share and number? Apparently, the industry's massive consolidation has simply allowed many owners of small banks--as well as not-so-small banks--to liquidate their investments at nice profits. For now, the future of community banks remains bright. These banks are performing well, and those that remain independent are likely to thrive in the years ahead. A crucial question, though, is how large the community-banking group will be a decade from now and how much additional industry consolidation lies ahead. Although the banks that survive may do well, the number of community banks may continue to decline significantly.

Managing Risks

For the moment, another dynamic that may be working for community banks is their relatively simple--and more readily transparent--operations. Certainly complex, off-balance-sheet transactions and the accounting standards associated with them have appropriately attracted much attention in recent months. This increased complexity has become a particular challenge for bank supervisors as well. In the current, post-Enron environment, financial institutions, their accountants, and regulators must understand each other's role and the need for adequate transparency in reporting to investors and customers. You may recall that in the wake of the thrift industry problems of the 1980s legislation required the banking agencies to apply generally accepted accounting principles in their regulatory reports, rather than special accounting rules established by depository institution regulators. At the time, the Congress saw the requirement as helpful in strengthening regulatory standards and reporting requirements. As new types of transactions have developed, and organizations of all types have become more complex, concerns have been raised about the robustness of accounting standards. For various reasons, accounting and disclosure practices have tended to obfuscate more than clarify and to conceal rather than disclose. That situation must change.

One of the challenges facing management and auditors is to fairly disclose the information that is most important to investors and customers in assessing the health of any organization they deal with. This necessarily includes sufficient information to understand the key risk exposures that the organization must manage successfully. Of course, before any risk can be disclosed it must first be identified and characterized in some fashion. Increasingly, this characterization and the entire risk- management process have become more quantitative, reflecting not only the enhanced ability and lower costs of collecting and processing data but also improved techniques for measuring and managing risk. Larger banking organizations quantify a borrower's probability of default, the bank's loss given default and its likely exposure at the time of default--practices upon which we are trying to construct new international capital standards.

At community banks, the greater use of credit-scoring has, it seems, improved risk management as well. Such tools should perform even better after the effects of the most recent economic slowdown are incorporated. Consumer credit models were developed after the 1990-91 recession, and so their reliability in predicting credit quality in the current slowdown is yet to be determined. Further, we are already observing increases in delinquencies in subprime lending. Since many of these borrowers did not have significant access to credit in previous recessions, their ultimate default rate will also help to validate the strength of the new statistical models.

Community banks have greatly improved their management of interest rate risk in recent years. Information developed from models that are used to identify sensitivity to market changes in the mix of loans and deposits are now part of asset/liability committee meetings at community banks. As a result, managers can better anticipate changes in net interest income and respond appropriately to their unique competitive conditions.

Community bankers are also developing new revenue streams that will help to manage risk by diversifying sources of earnings. In addition, the fee income streams help to increase the cross-sell ratio with key customers. This in turn should improve customer loyalty, another factor that should help manage risk by stabilizing revenue. Providing the personal touch has served community banks well, but conducting sound market research and pricing to reflect competition, customer value, and risk are becoming more important for success.

Corporate Governance

As bankers and bank directors, you have specific responsibilities to manage and control your risks well. Not only are the activities of banks central to credit intermediation, in this country banks fund those activities in part with federally insured deposits. These deposits are the lowest cost source of funds for bankers because of the government's guarantee. Bankers also have obligations to investors and customers to clearly disclose the condition of their organizations and effectively oversee the system of internal controls.

Bank directors are not expected to understand every nuance of banking or to oversee each transaction. They can look to management for that. They do, however, have the responsibility to set the tone regarding their institutions' risk-taking and to implement sufficient controls so that they can reasonably expect that their directives will be met. They also have the responsibility to hire individuals who they believe have integrity and can exercise a high level of judgment and competence.

All the banking agencies have issued guidance describing the proper roles of bank officers and directors that address such matters as policies, procedures, information systems, and controls. For example, interagency policy holds boards of directors responsible for ensuring that their organizations have an effective audit process and internal controls that are adequate for the nature and scope of the business. The reporting lines of the internal audit function should be such that the information directors receive is impartial and not unduly influenced by management. Internal audit is a key element of management's responsibility to validate the strength of their internal controls. If internal audit is outsourced, the best practice is to not use the same firm for the external audit engagement.

Indeed, the recent failure of Oakwood Deposit Bank Company, an Ohio institution, appears to underscore the importance of the audit function and sound internal controls in guarding a bank against harm.

Audit committee members should have regular time in meetings to talk with the outside auditors without managers present. Best practices for audit committee processes have been laid out many times, including in the 1980s by the Treadway Commission and in 2000 by the Blue Ribbon Committee. Beyond that, boards of directors and managers should periodically test where they stand on ethical business practices. For example, ask whether we squeaked by on technicalities and on the margin, adhering perhaps to the letter but not the spirit of the "law"? Are we compensating others and ourselves based on the value of our contributions to the organization, or are we taking advantage of opportunities and abusing our positions?

My intent today is to remind everyone of the importance of maintaining sound ethical practices to help protect the reputation of your bank. As recent events have demonstrated, if we fail to do so, the market will enforce the discipline. And that discipline can be harsh and sometimes indiscriminate. Investors and customers tend to vote quickly with their feet, once confidence is lost.

Conclusion

In closing, I commend you and the industry, generally, for the success of the 1990s and for dealing effectively with a challenging year in 2001. The industry has demonstrated that it is fundamentally sound and well positioned.

Bankers should support the development of risk-management processes for those types of risk that are most relevant for their particular institution.

Though the quality of bank accounting and control systems is strong, bankers should heed lessons to be learned from Enron. Strengthen corporate governance where needed to prevent such abusive practices from occurring at your institutions.

As bankers and bank regulators, we are responsible for conducting our affairs with competence and integrity. Let's take the opportunity times like this present and make our banking system even stronger.

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