

For release on delivery
8:30 a.m. EST
February 5, 2013

The Future of Community Banking

Remarks by

Elizabeth A. Duke

Member

Board of Governors of the Federal Reserve System

at the

Southeastern Bank Management and Directors Conference

University of Georgia, Terry College of Business

Duluth, Georgia

February 5, 2013

I would like to thank the Terry College of Business at the University of Georgia for the opportunity to discuss the future of community banking at this annual conference for bank officers and directors. Community banks play an important role in our nation's financial system, and I believe that the future of community banking is bright. But that is not to say that it will be easy. Success, as always, will require energetic and engaged managers and board members who are sensitive to the financial needs of their communities, vigilant to economic conditions, and adaptive to changing regulatory requirements.

I hear from a lot of community bankers who are concerned that the community banking model might not survive. Many paint a picture so bleak that they see only personal retirement or sale of the bank as viable strategies. I completely understand how tiring it is to fight a financial crisis and survive a deep recession followed by a weak recovery only to confront what seems to be a tsunami of new regulations.

I felt all of those same emotions in 1991. I was a community banker then. We had survived the savings and loan crisis with some bruises, but we were still standing. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) had been followed by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991. I had more new regulations stacked on my desk than I had employees in the bank. My bank had just reached the \$100 million mark in total assets through the purchase of two branches from a failing thrift. Even more daunting for me personally, was the sudden death of my bank's chief executive officer (CEO), leaving me as the new CEO. Frankly, I didn't know how I was going to tackle all that lay in front of us. But those dark days in 1991 were followed by 15 years of exceptionally strong performance for all banks, including my own. And those experiences--the good and the bad--give me confidence in predicting a bright future for community banking today.

Just as the seeds of a crisis are often sown in earlier boom times, strength can be forged during the tough times that follow a crisis. As we did in the early 1990s, bankers and regulators today have learned from the lessons of the crisis and are determined not to repeat the mistakes of the past.

Credit metrics are now improving in most banks as problem loans have been addressed and resolved and new credit underwriting has been quite restrictive for a number of years. Deposit growth has outpaced loan demand and reliance on wholesale funding has been reduced. Capital positions are stronger. The interest margin pressure banks face today is partly due to low interest rates and partly due to weak loan demand, both of which are consequences of a sluggish economy. As the economic recovery gains momentum, however, both of these conditions should reverse and give bankers the opportunity to deploy the liquidity and capital they have amassed to the benefit of their shareholders and their local economies.

Community Bankers Are Being Heard

Even as they anticipate economic recovery, however, community bankers worry that the burden of new regulations may inhibit their ability to lend in their communities or prohibitively increase the costs of such lending. We certainly understand this concern. Federal Reserve research over the years has confirmed that the burden of regulations falls disproportionately on smaller banks.

Supervisors at the Federal Reserve Bank of Minneapolis have recently tried to quantify this effect. To do so, they used survey data to estimate the relative number of new employees that banks of different sizes might need to hire in response to the same regulatory requirement. Using Call Report data from 2011, they estimated in their preliminary analysis that hiring one additional employee would reduce the return on assets by 23 basis points for the median bank in

the group of smallest banks, those with total assets of \$50 million or less. To put this estimate in perspective, such a decline could cause about 13 percent of the banks of that size to go from profitable to unprofitable. As a comparison, given the same increase in regulation, they assume banks between \$500 million and \$1 billion would hire three employees and experience a decline of about 4 basis points in return on assets for the median bank. While this is still a significant effect, very few banks in this group would go from being profitable to unprofitable as a result of the regulatory burden.

Regulatory overreaction to a crisis is always a risk. But this time, I think community bankers have been more successful than they realize in making the case against “one-size-fits-all” regulation. I can’t remember a time when I have seen more regulatory proposals drafted that differentiate between banks based on size or complexity. I urge you to continue to identify the regulatory requirements that are the most onerous to your business model, and continue to suggest alternatives to achieve those regulatory objectives in a less intrusive way.

In fact, most of the regulations required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) are directed primarily at larger, systemically important banks, and many of the Act’s provisions specifically exempt community banks. For example, banks with less than \$10 billion in total assets were exempted from a number of the debit interchange restrictions, and early studies indicate that those exemptions are working. In addition, formal stress testing was required only for banks with total assets of \$10 billion or more. In implementing these requirements for the larger banks, the bank regulatory agencies specifically indicated that capital stress testing would not be required for community banks.¹

This does not mean that community banks are exempted from prudent risk management, but

¹ See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2012), “Agencies Clarify Supervisory Expectations for Stress Testing by Community Banks,” press release, May 14, <http://www.federalreserve.gov/newsevents/press/bcreg/20120514b.htm>.

rather than smaller banks should think about the negative shocks that could affect their business in the future and tailor their risk-management procedures to the risks and complexities of their individual business models.

The Consumer Financial Protection Bureau (CFPB) recently released final rules defining “qualified mortgages” that include safe harbors for mortgages that meet specific loan term and pricing criteria, including certain balloon loans made by community banks in rural or underserved areas.² At the same time, they issued a new proposal that contains additional community bank exceptions, as well as a question about the treatment of loans to refinance balloon payments on mortgages that community banks may already have on their books.³ Noting that smaller institutions have already demonstrated that they generally do a good job of servicing the loans they originate and that the investments necessary to meet the requirements would be unduly onerous for institutions that service a small number of loans, the CFPB also exempted most community banks from many of the provisions of new servicing requirements.⁴ I think such exceptions are especially important because, as I discussed in a recent speech and will touch upon later in my remarks, Federal Reserve research has shown that (1) community banks are important lenders in the mortgage market, (2) those mortgage loans represent a significant portion of community bank lending, and (3) community banks are quite responsible in their practices.⁵

² See Consumer Financial Protection Bureau (2013), “Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z),” final rule, *Federal Register*, vol. 78 (January 30), pp. 6408-6620.

³ See CFPB (2013), “Ability to Repay Standards Under the Truth in Lending Act (Regulation Z),” notice of proposed rulemaking, *Federal Register*, vol. 78 (January 30), pp. 6622-6672.

⁴ See CFPB (2013), “Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X),” final rule; and CFPB (2013), “Mortgage Servicing Rules under the Truth in Lending Act (Regulation Z),” final rule (accessed January 31, 2013), <http://www.consumerfinance.gov/regulations/2013-real-estate-settlement-procedures-act-regulation-x-and-truth-in-lending-act-regulation-z-mortgage-servicing-final-rules/>.

⁵ See Elizabeth A. Duke (2012), “Community Banks and Mortgage Lending,” speech delivered at the Community Bankers Symposium, Chicago, IL, November 9, <http://www.federalreserve.gov/newsevents/speech/duke20121109a.htm>.

At the Federal Reserve, we have formalized our process for considering the unique characteristics of community banks as we craft regulatory and supervisory policies. A few years ago, we created a subcommittee of the Board, which I chair, that makes recommendations about matters related to community bank supervision and regulation. This subcommittee reviews all regulatory proposals and supervisory guidance with an eye toward the possible effects on community banks. Remembering the days when I had to find time to read all those new regulations stacked up on my desk, I have insisted that all new proposals and rules start with a clear statement of their applicability to community banks so that bankers can spend their time on the rules and guidance that apply to them.

This approach was put into practice in a different way last year, when the banking agencies issued proposals for capital regulations that incorporated requirements of the Dodd-Frank Act and the Basel agreement.⁶ To help community banks identify the provisions that affected them and submit their comments more easily, the proposal included a short summary of the provisions that were most likely to affect community banks. We received more than 2,000 comments, many from community banks, and we are reviewing them. It's too early in the process to know how we and the other agencies are going to address the issues raised, or when final rules may be released. But what I can promise is that before we issue final capital rules, we will do everything possible to address the concerns that have been expressed by community bankers and still achieve the goal of having strong levels of high-quality capital--built up over a reasonable and realistic transitional period--in banks of all sizes, including community banks.

⁶ See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2012), "Agencies Seek Comment on Regulatory Capital Rules and Finalize Market Risk Rule," press release, June 12, <http://www.federalreserve.gov/newsevents/press/bcreg/20120612a.htm>.

Community Bank Research

To help us better understand community bank issues, our subcommittee established an informal working group of economists from both the research and supervision functions in the Federal Reserve System. The group is focused on understanding the factors that influence the viability and performance of community banks including, importantly, the effect of regulatory changes and their associated costs and benefits. Members of this working group are exploring a number of interesting topics that I hope will help us to better understand the issues that affect community banks and, where appropriate, have a practical impact on how we supervise these banks.

Determinants of Community Bank Profitability

For example, a recent study undertaken by two Federal Reserve Board economists explores the determinants of community bank profitability from 1992 through 2010.⁷ The findings indicate that a number of bank characteristics are strongly correlated with performance, including relative bank size, portfolio composition, and management quality. Within the group of banks with less than \$1 billion in total consolidated assets included in this study, larger bank size is associated with significantly higher profitability. Community banks with higher portfolio shares of real estate loans earn significantly lower profits, while those with higher portfolio shares of construction loans earn higher profits through most of the study period. But, perhaps not surprisingly, the latter relationship does not hold for 2008 through 2010, when greater reliance on construction lending is associated with lower profitability. Managerial quality, as measured by the management component of the banks' regulatory ratings, is strongly related to

⁷ Dean F. Amel and Robin A. Prager (2010), "Performance of Community Banks in Good Times and Bad Times," unpublished paper, Board of Governors of the Federal Reserve System, Division of Research and Statistics, May. The study defines community banks as those with total organizational banking assets less than \$1 billion in constant 2005 dollars and at least 70 percent of deposits derived from a single metropolitan area or rural county.

bank profitability. Moreover, the strength of the relationship increases during and immediately after the financial crisis, confirming that management quality is particularly important during times of economic stress.

Factors outside the control of bank management, however, are also importantly related to profitability, particularly over the past several years. For instance, it is not surprising that community banks operating in markets experiencing high unemployment rates have been less profitable since the financial crisis. Perhaps less obvious is that in urban markets, community bank profitability tends to decrease as the size of the market increases. One might suspect that this relationship derives from a more competitive landscape in larger urban areas; however, no relationship between market concentration and profits is evident in urban markets. In contrast, in rural areas, higher market concentration is associated with higher community bank profitability throughout most of the study period. In addition, the study finds that community banks operating in rural markets consistently earn higher average rates of return than do community banks operating in urban markets.

In a separate analysis of deposit market competition that may form the basis for a new research paper, one researcher has documented the competitive strength of community banks, especially in rural markets. Although the nationwide share of total deposits held by banks with assets less than \$10 billion has declined over the past decade, in rural markets, their deposit market share has increased slightly. Moreover, banks with assets less than \$10 billion retained their share of rural market deposits throughout the recent recession and recovery. At a more micro level, banks with assets less than \$10 billion gained market share in more than two-thirds of rural banking markets and in nearly half of urban markets between 2003 and 2012.

Expansion of deposit insurance during the crisis likely helped all banks retain deposits and may have changed competition somewhat. Deposit insurance has now been permanently increased from \$100,000 to \$250,000 per depositor, but the unlimited deposit insurance for noninterest-bearing transaction accounts was allowed to expire at the end of 2012. We are watching deposit movement carefully, but so far have seen little evidence of deposits moving out of the banking system or, as some had feared, moving from smaller banks to larger banks perceived as “too big to fail.” My own expectation is that, given all of the enhanced regulatory requirements that apply to larger banks, those larger banks will focus their efforts on large urban markets and that community banks will be even more competitive and more vital to the economic well-being of rural, suburban, and small urban markets.

Characteristics of Thriving Community Banks

Researchers at the Federal Reserve Bank of St. Louis took a different approach to measuring community bank success.⁸ Studying banks with total assets less than \$10 billion, the researchers attempted to identify the differences between banks that they classified as “thriving” and those that they classified as “surviving.” Banks were identified as “thriving” if they maintained the highest supervisory rating, a composite CAMELS “1,” continuously from 2006 through the end of 2011.⁹ Approximately 700 banks met this condition. The roughly 4,500 banks in the study that did not qualify as thriving and did not fail or merge out of existence during the period were classified as “surviving.”

⁸ See R. Alton Gilbert, Andrew P. Meyer, and James W. Fuchs (2013), “The Future of Community Banks: Lessons from the Banks that Thrived during the Recent Financial Crisis,” unpublished paper, Federal Reserve Bank of St. Louis, January.

⁹ CAMELS is the supervisory rating system for banks and other depository institutions, used by federal and state banking agencies to communicate to financial institutions their assessment of the institution and to identify institutions that raise concern or require special attention. CAMELS is an acronym for the six components of the rating system that examiners evaluate and take into account when assigning an overall composite rating: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. See Board of Governors of the Federal Reserve System (1996), Supervision and Regulation Letter 96-38, “Uniform Financial Institutions Rating System,” December 27, <http://www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm>.

After categorizing the banks, the first phase of analysis looked at the location and size of the thriving banks. Thriving banks were found in 40 of the 50 states but were concentrated in states with larger economic contributions from agriculture and energy, which held up relatively well during the downturn. The fewest thriving banks were found on the West Coast and in the Southeast, where real estate values fell the most. This pattern is consistent with previous Federal Reserve studies, which found that bank performance is heavily affected by the local economy, but I think it is important to note that even in states with high unemployment rates or sharp declines in property values, some community banks were able to thrive.

The St. Louis study did not find the thriving banks to be concentrated in any particular size range. Many had total assets less than \$50 million as of December 2011, but others had total assets between \$1 billion and \$10 billion. And thriving banks did more than just rate well with supervisors--the thriving banks outperformed the surviving banks on a wide range of performance indicators, including return on assets, return on equity, loan losses, provision expense, efficiency ratio, asset growth, net interest margin, and net noninterest margin.

Looking at balance sheet structure, when the researchers compared the characteristics of thriving banks with surviving banks, they found that the thriving banks had lower levels of loans-to-total-assets and were more reliant on core deposits. Thriving banks also had lower concentrations in commercial real estate (CRE) lending and much lower concentrations in construction and land development loans. Instead, thriving banks were slightly more concentrated in one- to four-family mortgage loans held in portfolio, as well as consumer loans. Despite these overall balance sheet findings, the researchers also noted the wide diversity of business models that they found among the thriving banks.

Recognizing that a large part of good performance comes from factors that are more difficult to measure statistically, the researchers examined a sample of comments in examination reports and found that thriving banks benefited from a strong and localized customer service focus with high visibility in the community, conservative underwriting, and products that were profitable and met customer needs. They supplemented their review of examination reports by interviewing management at some of the thriving banks. The bankers they interviewed attributed their success to strong ties to the community, relationship banking, conservative underwriting, and a focus on products and markets they understood. These results were strikingly similar to the results of interviews in separate studies at the Federal Reserve Bank of Kansas City¹⁰ and the Federal Reserve Bank of Richmond.¹¹

These studies confirm what experience has already taught me: Community banks that have deep ties to the community, engaged managers and directors, conservative underwriting, and strong risk management can not only survive, but thrive, even in adverse conditions.

Using Research to Shape Supervisory Guidance on Lending

While much of our regulatory work recently has involved implementing the requirements of the Dodd-Frank Act, we are also continuing to review the lessons we learned during the crisis and the results of our recent research. In most cases, this work is more likely to result in supervisory guidance than regulation. Supervisory guidance is commonly viewed as a means to restrict activity but, in fact, during the crisis much of the guidance we issued actually directed

¹⁰ See Forest Myers and Kenneth Spong (2003), "Community Bank Performance in Slower Growing Markets: Finding Sound Strategies for Success," Federal Reserve Bank of Kansas City, *Financial Industry Perspectives*, <http://www.kansascityfed.org/publicat/fip/prs03-2.pdf>.

¹¹ See Ray Brastow, Bob Carpenter, Susan Maxey, and Mike Riddle (2012), "Weathering the Storm: A Case Study of Healthy Fifth District State Member Banks Over the Recent Downturn," Federal Reserve Bank of Richmond, *S&R Perspectives*, Summer, http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2012/summer/article3.cfm. See also *Community Banking Connections* (2012), Federal Reserve System, Fourth Quarter, <http://www.communitybankingconnections.org/articles/2012/Q4/Weathering-the-Storm.cfm>.

bankers and bank examiners to take a balanced approach. For example, we issued guidance urging banks to continue to make loans to all qualified borrowers and, in particular, to continue lending to creditworthy small businesses.¹² We also issued detailed guidance about commercial real estate workouts to encourage prudent modifications of real estate loans.¹³

Lending is the primary source of income for most community banks and also the greatest source of risk. As you develop your business plans, some of the most important decisions you will make relate to lending. In the planning process, banks should define the portion of the lending portfolio they plan to allocate to different loan categories, the investments they are willing to make to develop expertise and to manage credit and compliance risk, and the levels of credit and interest rate risk they are willing to assume. So I thought it might be helpful to review some recent developments in loan types that are at the core of community bank lending.

Residential Mortgage Lending

Residential mortgage lending was at the heart of the financial crisis and has been the target of extensive new regulation and supervisory attention, including the rules issued by the CFPB that I discussed earlier. I think community banks are in an especially difficult position with respect to residential mortgage lending. On the one hand, community banks do not appear to have engaged in many of the more problematic practices that led to the crisis. And their rate of seriously delinquent residential mortgage loans is significantly lower than the overall rate of

¹² See 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,” press release, November 12, <http://www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm>; and Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Conference of State Bank Supervisors (2010), “Regulators Issue Statement on Lending to Creditworthy Small Businesses” press release, February 5, <http://www.federalreserve.gov/newsevents/press/bcreg/20100205a.htm>.

¹³ See Board of Governors of the Federal Reserve System (2009), Supervision and Regulation letter 09-7, “Prudent Commercial Real Estate Loan Workouts,” October 30, <http://www.federalreserve.gov/boarddocs/srletters/2009/SR0907.htm>.

serious delinquencies on such loans made to prime borrowers, indicating that community banks largely have managed their existing portfolios responsibly. On the other hand, residential mortgage loans made by community banks do frequently share some characteristics, such as higher rates and balloon payments, with the subprime lending that proved to be so disastrous. At the same time, mortgage lending, which averages about one-fourth of community bank loan portfolios, is an important product line for community banks. Further, Federal Reserve research indicates that the residential mortgage loans made by community banks make up a small but vital part of credit availability in the housing market.

The challenge for regulators is to design mortgage regulations to address practices that have proved harmful to consumers or financial stability without inhibiting lending to creditworthy borrowers. The challenge for community bankers is to review the full body of new regulations covering mortgage lending and to develop the expertise and control systems necessary to comply with these regulations while remaining active in this important market.

I think it is unfortunate when I hear some bankers say that they will stop offering mortgages if they can't make them the same way that they always have. While I certainly understand their frustration, I still believe that community bankers can respond within the new environment by creating products that are profitable and meet the needs of their customers, while still managing their interest rate and funding risks.

Even with some regulatory exceptions, compliance with new mortgage regulations likely will require changes to processing systems and extensive staff training. But it is also possible that the systems and expertise necessary to make qualified mortgages for the bank's books could also be used to originate loans for sale. For many community banks, this could represent a new revenue opportunity and a new alternative to offer the bank's customers.

Commercial Real Estate Lending

For community banks, it was CRE lending--in particular, lending for construction and land development--that caused the most problems during the crisis. As you may know, in 2006 the federal banking agencies issued supervisory guidance that set forth screening criteria based on certain types of CRE concentrations and rapid growth of CRE portfolios.¹⁴ These guidelines contained specific numerical thresholds for the ratios of construction and total CRE lending to an institution's total capital, as well as for identifying rapid growth of such lending.¹⁵ These criteria were never intended to result in hard caps, but were instead meant to trigger conversations between a bank and its supervisors about the bank's ability to manage the risks arising from these concentrations.

After our experience in the financial crisis, especially considering the severe problems in commercial real estate markets, we were interested in understanding how community banks were affected by the guidance and whether the screening criteria set forth in the guidance were effective indicators of risk. In that regard, Federal Reserve staff has worked with our counterparts at the Office of the Comptroller of the Currency to analyze how banks' holdings of CRE loans have evolved since the guidance was issued.¹⁶

¹⁴ See Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (2006), "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," final guidance, *Federal Register*, vol. 71 (December 12), pp 74580-88. See also Board of Governors of the Federal Reserve System (2007), Supervision and Regulation Letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate," January 4, <http://www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm>.

¹⁵ Specifically, the guidance indicated that examiners would give heightened supervisory scrutiny to banks where (1) total construction and land development loans represented 100 percent or more of the institution's total capital, or (2) total CRE loans represented 300 percent or more of the institution's total capital and the institution's CRE loan portfolio had increased by 50 percent or more during the prior 36 months. This second criteria is calculated excluding holdings of owner-occupied CRE loans.

¹⁶ Keith Friend, Harry Glenos, and Joseph B. Nichols (2013), "An Analysis of the Impact of the Commercial Real Estate Concentration Guidance," unpublished paper, Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, and Office of the Comptroller of the Currency, January; and William Bassett and W. Blake Marsh (2012), "Cause or Effect: Supervisory Guidance and the Collapse of Commercial Real Estate," unpublished paper, Board of Governors of the Federal Reserve System Division of Monetary Affairs, October.

We have learned a few interesting things based on the findings of this research. For example, the number of institutions that exceed at least one of the two screening criteria has declined substantially from 2006 to the present. While much of this decline seems to have resulted from the contraction of construction portfolios in the wake of the crisis, banks that exceeded the criteria when the guidance was issued appear to have experienced a bigger decline in total CRE loans than can be explained by the adverse economic environment alone. This finding could indicate that the thresholds are indeed being interpreted as hard caps. Moreover, it was apparent that banks that exceeded the criterion for construction and land development were far more likely to have failed over the period from 2007 to 2011 than were those banks that exceeded the criterion for overall CRE exposures and portfolio growth. We now recognize the importance of the rapid growth criterion, which may have received less attention than the criteria for construction and overall CRE lending concentrations. We intend to use the findings of this research to help clarify our communication and training for examiners and bankers around CRE lending concentrations.

Small Business Lending

There is probably no loan category in which community bankers' local knowledge and deep ties to the community are more important than small business lending. The Federal Reserve System has a project under way to try to improve our understanding of small business credit markets, which would of course include community banks. One challenge we have faced is that it is difficult to measure lending to small businesses precisely. For one thing, small business owners frequently tap their personal home equity, credit cards, or loans secured by commercial real estate that they own to finance their business operations,¹⁷ which means such

¹⁷ In the Federal Reserve's 2010 Survey of Consumer Finances, 18 percent of households reported personally guaranteeing or collateralizing loans to their family businesses, and 15 percent of households reported lending

borrowing is not reported as small business lending. But there is also no definition of small business borrowers for the reporting of small business lending as a loan category.

However, small loans to businesses--commercial and industrial loans and CRE loans with original principal amounts of less than \$1 million--are reported separately and can be used as a proxy for small business lending. Using this measure, we can estimate the importance of small business lending to community banks and the importance of community banks to small businesses. As of September 2012, banks with \$10 billion or less in assets accounted for more than 98 percent of all commercial banking institutions, but they held less than 20 percent of banking industry assets. However, they held more than half of outstanding small loans to businesses. For such institutions, these small loans to businesses represent nearly 20 percent of their total domestic lending and slightly more than 40 percent of their total commercial lending. Small business lending is likely even more important to smaller banks than these statistics show because these loans are identified by the size of the loan rather than the size of the borrower. I believe it is probable that many of the larger business loans made by these smaller banks were also made to small business borrowers.

At the other end of the spectrum, banking organizations with more than \$50 billion in assets accounted for less than one percent of institutions, but held 75 percent of the assets. Holding almost 40 percent of outstanding small loans to businesses, these large banks are important small business lenders, but small loans to businesses were not a significant segment of large bank loan portfolios. They represented less than five percent of these banks' total domestic lending.

money to their family businesses. See Jesse Bricker, Arthur B. Kennickell, Kevin B. Moore, and John Sabelhaus (2012), "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 98, no. 2 (June), <http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf>. See also the Federal Reserve public website for the Survey of Consumer Finances at <http://www.federalreserve.gov/econresdata/scf/scfindex.htm>.

These statistics demonstrate the importance of community banks to small business and the corresponding importance of small business lending to the community banking business model. In developing policies for small business lending, I think it is critically important for bank boards of directors to insist on appropriate risk management that retains the flexibility to use the bankers' knowledge of their customers' business to their best advantage. And it is equally critical that supervisors develop tools to measure the overall effectiveness of risk management in small business lending without being overly prescriptive for individual loans.

Conclusion

I would like to end where I began. I think the future for community banking is bright. I recognize that the regulatory changes underway are not without cost to community banks. But I also know that we at the Federal Reserve are doing our best to avoid adding to regulatory burden wherever possible as we respond to the worst excesses of the financial crisis and make the U.S. financial system more resilient. Research is helpful in this effort but it is also important to maintain an ongoing dialogue with community bankers and to actively solicit comment on regulatory proposals. So I urge you to continue to communicate about the challenges that regulations pose for community banks.

More importantly, I know that the natural advantages found in community banks--deep community ties, daily interaction between senior managers of banks and their customers, and the dexterity to customize financial solutions--have not been diminished in any way. Yes, the regulatory environment is challenging and the economy remains weak in many areas. But all our research shows that with creative, engaged bankers and strong risk-management processes, community banks can continue to not only survive but to thrive.

Thank you very much for your attention, and I would be interested in hearing your thoughts.