The Federal Reserve Board

Remarks by Vice Chairman Roger W. Ferguson, Jr.

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Community Banks: Opportunities and Challenges in the "Post Modernization Era"

It's a pleasure to be here today to discuss with you the opportunities for community banks in our evolving financial system and the challenges they face in this highly competitive environment. Clearly, our banking system has helped support the economic prosperity we are seeing today. Businesses and families have benefited from technological and other innovations as our banking system has made credit available to those that could make the best use of those funds. Despite rapid consolidation among banking institutions, thousands of smaller institutions continue to serve communities throughout the United States. This diversity in our banking system has helped ensure that credit continues to flow not only to the largest and most prominent borrowers, but also to small businesses and consumers with specialized circumstances and needs. Significantly, community banks have played an important role in filling the gaps created by some of the larger, nationwide institutions in which decisions to extend credit to smaller borrowers tend to be less customized and less responsive to local situations and needs.

Community Banks' Input to Policy
Community banks have also provided valuable insights to the Federal Reserve regarding their local economies, customer behavior, and emerging issues. These localized observations have become even more important as consolidation has moved the centralized management of larger organizations farther and farther from their customers and markets, making it more difficult for them to fully understand micro conditions and trends.

This is why the Federal Reserve has continued to rely, in part, on community banks to fill in the gaps in our understanding of economic conditions. On an ongoing basis, we receive impressions from community bankers through their membership on Reserve Bank boards and through their participation on the Federal Advisory and the Consumer Advisory Councils.

The Federal Reserve also has the advantage of supervising a broad array of institutions that provide us, from a hands-on perspective, insights into local lending conditions and emerging issues. More than 90 percent of the Federal Reserve's roughly 1,000 state member banks can be characterized as community banks, which provides us a close-up view regarding economic conditions at local levels. Some of these observations are made on an ad hoc basis through our contacts with supervisory staff, and others are made through our formal quarterly examiner surveys on credit standards and other issues.

You may also be surprised to learn that smaller community banks are becoming increasingly

important sources of localized information on credit conditions. With the advent of interstate branching and the consolidation undertaken in the past decade, the physical location of an institution's headquarters has become a less reliable indicator of where its credit exposures lie. For this reason, regulatory Call Reports submitted by larger organizations are less useful indicators than they once were of conditions in a particular metropolitan area, or even a state. In contrast, information reported by smaller community banks is likely to be more revealing in terms of local economic conditions, as the loans extended by these organizations are more likely to be made to individuals and businesses in nearby communities. Though not comprehensive, community bank regulatory Call Reports provide a needed window on local trends.

Through all these avenues--advisory councils, regulatory reports, examiner surveys, and supervision--information flows to the Board of Governors. That information in turn is used directly and indirectly in our deliberations regarding economic policy as well as supervisory and regulatory initiatives. Without that flow of information and hands-on contact with community banks, the Federal Reserve would be more susceptible to being out of touch with local concerns and conditions and would be less informed and less productive. This would clearly hinder the central bank from reaching its goals of achieving maximum sustainable long-term growth for the economy by maintaining low and stable inflation and promoting a safe, sound, competitive, and accessible banking system.

Community Bank Challenges

Community banks also provide an important service to customers. Their ability to tailor banking products and services to the needs of the individuals and small businesses they so ably serve is well understood. However, while community banks obviously add value in several ways, they do face challenges today--and they will have to fit into an evolving financial system in the post-Gramm-Leach-Bliley world. First, community banks are feeling the same intense competitive pressures that larger banks are feeling. Bank holding companies in every asset tier below $1 billion in assets have seen their return on assets fall from 1998 to 1999. For example, the group of bank holding companies with assets between $500 million and $1 billion has seen its ROA erode from 1.18 percent to 1.07 percent. Similarly, the group with assets between $300 million and $500 million has experienced a decline in ROA from 1.14 percent to 1.07 percent. One outgrowth of this competition and erosion of return is the tendency for loan officers to grant loans on the basis that the current exceptionally strong financial conditions are the most likely, and perhaps nearly guaranteed, scenario going forward. Financial intermediaries with strong credit cultures know that in analyzing risk, they must test assumptions and evaluate how borrowers might perform under more stressful conditions.

Pricing competition has also been fierce, which has hurt margins. To make up for some of this margin erosion, some banks, both large and small, have been going after loans to potentially riskier credits. Of course, these loans should carry higher yields to compensate for having more risk. However, to the extent bank managements are not evaluating their income on a risk-adjusted basis, they are deluding themselves and their boards into thinking that profits are improving, when in fact, greater embedded losses may be growing beneath the surface of ostensibly sound loan portfolios. These losses, of course, emerge in force under more stressful conditions. Furthermore, when the additional credit risk is concentrated in a particular market or loan class, it increases the risk of failure.

The late 1980s and early 1990s are a vivid illustration of the perils of weakening

underwriting standards and credit concentrations. I should note that despite these lessons, many community banks have been expanding commercial real estate and construction lending as never before. In particular, for banks with less than $1 billion in assets, commercial and construction loans accounted for 12 percent of assets in 1990. Today, this concentration stands at nearly 17 percent of assets. There is also anecdotal evidence that some banks are offering long-term permanent financing, which had been avoided historically. Commercial real estate markets appear to be healthy now, but they are cyclical in nature and therefore must be approached with caution. Fortunately, better risk management and higher capital levels mitigate concern somewhat, and the industry is to be commended for developing those tools. As a supervisory response, we are stepping up oversight of those individual institutions that have higher concentrations of commercial and construction loans, especially in markets in which growth has been particularly strong and those in which vacancy rates appear to be rising. The good news is that, by and large, commercial real estate markets, while clearly strong, do not appear to be suffering from overbuilding and the unreasonable plans of developers that were seen in the past.

We all recognize that by definition community banks hold concentrations of credit risk within the areas they serve, which only heightens the need to diversify loan types as much as possible, to establish covenants and other safeguards that might mitigate losses, and to hold strong levels of capital. Again, the positive story is that community banks, by and large, appear to have a solid capital base, which has remained strong during the course of this expansion.

At the same time that credit risk may be rising largely unseen within bank loan portfolios, interest rate risk also appears to be on the uptick. That risk is arising from both the asset and the liability sides of community bank balance sheets. The eroding level of core deposits has made many banks more dependent on large time deposits and wholesale funds, which are more responsive to interest shocks, than on customer deposits, for which rate changes can be managed to the bank's advantage. Further, asset maturities have been steadily lengthening over the past decade. Previously, conventional wisdom among community bankers was that taking on assets having longer maturities, such as fixed-rate mortgage loans and pass-throughs, was undesirable and entailed too much interest rate risk. Today, there appears to be a marked change in attitude regarding interest rate risk. For example, the portion of assets maturing in more than five years among banks having less than $1 billion in assets was just 12 percent in 1990. As of year-end 1999, that proportion had risen substantially, to more than 20 percent of assets. Shrinking interest margins for many institutions as rates have risen, as well as the results of our surveillance screens, further confirm the rising levels of interest rate risk. Consequently, we are scrutinizing more carefully the management of interest rate risk and have found that most banks appear to be fully aware of and responsive to the need to understand and manage the risk they are taking.

In addition to the credit risk and market risk arising from competitive pressures, what of the pressures that might arise from the Gramm-Leach-Bliley-Act? Although the act is a long overdue and welcome reform of existing laws, as you know, much innovation has already been undertaken by banks themselves. While banks will now be able to create fully diversified financial holding companies with insurance, brokerage, and banking operations, many banks have already chosen a simpler route. By partnering with various insurance firms and brokerage and mutual fund firms, banks of all sizes have been able to offer their customers a broad array of products. However, now with the Gramm-Leach-Bliley-Act, those wishing to attempt to manage the attendant start-up costs or undertake the risk of

acquisitions can do so. Nevertheless, partnering arrangements will always be an attractive, and not necessarily less profitable, option, particularly for smaller organizations.

Why then are more than three-quarters of the more than 240 FHC filings we have received from banks having less than $1 billion in assets? Some anecdotal evidence suggests that community banks wish to have their options open as opportunities present themselves in the future. There also seems to be an appetite for minor tinkering with activities on the margin, rather than a stampede into new business lines through large-scale acquisitions. That seems a prudent route to take given the risks involved in undertaking any new activity.

Despite community banks' proven ability to compete against larger firms and to lure away the customers of larger institutions as those firms consolidate, some pundits would suggest that community banks are a dying breed. In fact, it occurs to me that with the avalanche of financial products and service choices now available to consumers, community banks are well positioned to fill a void that technology or specialized marketing techniques are unable to fill. Clearly, some of the more sophisticated customers of larger banks will gravitate toward slick technology and the ability to independently select and purchase various products, perhaps over the Internet with no human contact. However, there is always going to be a customer segment that prefers human contact or that requires a more specialized response to meet individual circumstances. As our world becomes more complex, the need for more handholding and educating customers can be expected to increase. As customers learn from their banker during this process, their loyalty and the importance of their loyalty may grow. At the same time, a more educated consumer who can take charge of his or her financial future can only improve the community at large and enhance the likelihood that the fruits of our economic prosperity will reach a wider spectrum of people.

Supervising Community Banks

Given the opportunities, as well as pressures and risks, how can supervisors work to increase the probability that community banks remain sound, continue to fulfill their economic function, and support their communities? The Federal Reserve System has been working on several fronts to make sure that we are more effective and less burdensome in the supervisory process.

For example, today the Federal Reserve has assigned examiners to act as "central points of contact" for most state member banks. These examiners are expected to maintain ongoing knowledge of the bank and its business and to cultivate key management contacts. This arrangement permits more tailored planning of our on-site review and provides a better avenue for you to ask questions or convey concerns.

We are also responding to your desire to have single, rather than multiple, on-site examinations. Previously, we have performed specialized information technology and trust exams at times other than when the broad safety and soundness exams were conducted; we are now working to integrate these into one comprehensive review that should be less burdensome. An integrated review should also improve our analysis of an institution's overall condition and quality of management. We are also considering ways of performing our compliance examinations in a less-burdensome fashion now that the CRA exam frequency has been extended for eligible banks.

To ensure that the Federal Reserve's limited supervisory resources are focused on the right institutions, we also have for some time maintained an extensive off-site surveillance system

to identify banks that are weak or that have the potential to deteriorate significantly. These institutions are identified by looking at a combination of financial and examination rankings and are subject to closer monitoring in between on-site examinations. If off-site data suggest that significant deterioration has occurred, an on-site visit may take place, or the timing of a regularly scheduled safety and soundness examination may be moved up. Alternatively, if investigation suggests that the cause for triggering a surveillance screen is relatively benign or is being properly addressed, we may make no change to our supervisory strategy for the bank. This approach allows us to better tailor our supervisory responses to individual institutions experiencing significant change or evidencing deterioration and promotes more directed and effective on-site examinations.

A growing area of potential burden is the presence of multiple and overlapping regulators for a single bank or holding company, including state banking departments, the FDIC, OCC, OTS, and the Federal Reserve. For financial holding companies, these issues are compounded by the added presence of federal securities and state insurance regulators. Fortunately, I think we in the regulatory community have made some progress on community holding companies with multiple charters or with branches in more than one state. The implementation of the State/Federal Protocol in 1996 was a key initiative in making supervision across state lines more "seamless." For smaller organizations, generally those having less than $500 million in total assets, we are working with the states on alternate-examination programs, and where we do work jointly, we are attempting to work as one coordinated team. At the federal level for multiple charter organizations, we are working on joint supervision plans and reviews with the FDIC, OCC, and OTS, so that information requested and the amount of time spent within the organization is as streamlined as is practicable.

As you may be aware, on a more fundamental level the Federal Reserve's overall approach to supervision is essentially split into two programs, one for community and regional organizations and one for larger, more complex organizations. The large complex companies are receiving a more continuous level of oversight given the rapidly shifting risk profiles that can result from their operations, while well-capitalized and well-managed regional and community organizations receive a greater degree of off-site monitoring and less frequent on-site visitations. Of course, these two programs are flexible and really reflect a continuum, with the supervision of some of our medium-sized institutions blending the two programs.

Given the differences between the two groups, we are also considering a bifurcated approach to capital. The current efforts under way by the Basel Committee on Banking Supervision that would make the Basel Accord more sensitive to the underlying risk of bank portfolios is directed at the operations and risk profiles of internationally active banks. As such, it entails a level of complexity that may not be necessary or practical for domestic institutions with more basic risk profiles. That incompatibility with domestic community banks has prompted discussions about implementing a second, more basic or streamlined capital adequacy standard. While these discussions are still very preliminary, such efforts would seem to be fully compatible with our initiatives to more carefully calibrate our regulatory and supervisory approach to the individual risk profiles of the institutions we supervise.

Having better and more timely information about the nature and volume of risk that banking organizations are undertaking is key to ensuring that our supervisory program, approaches,

and regulations are indeed well suited for particular institutions. As one effort toward that end, the banking agencies will soon be publishing proposals to revise the regulatory Call Report. First, we will propose the elimination of many items that are either outmoded or serve little purpose in today's environment. Second, we will propose new Call Report items that better reflect the activities that are growing in prominence in banking organizations. For example, we will propose collecting more comprehensive securitization balances and related exposures as well as more detail on noninterest income, including servicing, securitization, venture capital, and insurance revenues. Institutions that are not engaged in sophisticated securitization activities need report nothing, while those engaged in the activity should have such information available both for their own risk-management purposes as well as for regulators. It is through these types of disclosures that we will be better able to ask you the right questions during the examinations. Part of that will involve knowing in advance the activities your bank is undertaking so that examiners with the right skill set are on-site. More relevant regulatory reporting will facilitate those efforts.

You may also be aware of the Federal Reserve's promotion of improved disclosure as a complement to our supervisory approach and capital adequacy standards. With the significant complexity in financial markets today and the added organizational complexity available through financial reform legislation, the marketplace will be further challenged to collect and interpret meaningful information on financial institutions. It is our belief that more complete and analytically useful disclosures can help the marketplace to interpret risk profiles and price debt and equity more appropriately. As a consequence, banks that are undertaking imprudent risk are more likely to be chastened by adverse market reactions to their strategies. Toward this end, the Federal Reserve has established a private-sector working group to develop options for improving the public disclosure of financial information by large, complex banking and securities organizations. The group's report will be released to the public upon completion and describe industry best practices and develop options for improving disclosure.

Conclusion

In conclusion, community banks not only provide the obvious benefit of delivering a wide range of financial services to customers at the local level, but they also serve as one of the many valuable conduits of information for the central bank. These are times of both opportunity and challenge for all banks, regardless of the size of the institution. I have highlighted the risks that often emerge during a very long expansion but have also noted that we, as regulators, have reminded you of these risks and that you, as bank managers, appear to be mindful of these challenges and, in general, ready to meet them successfully.

With rapid changes taking place in the economy, community banks will need to continue to adapt to both the opportunities and the new ways that risks appear and customize their products and services for a customer base that is also attempting to adapt to change. I am confident that as we experience astonishing changes in the economy in the decades to come, community banks will continue to thrive and benefit both businesses and consumers, and by doing so, serve the nation.