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Tailored Supervision of Community Banks

Remarks

by

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Chair

Board of Governors of the Federal Reserve System

at the

Independent Community Bankers of America
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Thank you for inviting me to ICBA's policy summit. I am pleased to have this opportunity to share my views on some of the key issues facing community banks and how I see the community banking model fitting into the financial system in the years ahead. In particular, I will discuss steps the Federal Reserve has taken to address the "too-big-to-fail" problem and how these steps affect community banks; I will describe how the Fed strives to improve our understanding of the unique role that community banks play in the economy; and then I'll show how we are using this knowledge to better tailor our supervisory expectations and approaches to community banks.

As you may know, before I rejoined the Federal Reserve Board as Vice Chair in 2010, I had the privilege of serving for six years as president and chief executive of the Federal Reserve Bank of San Francisco. The 12th district is the largest of the Fed's districts, covering nine western states, and it is home to a significant number of community banks, the majority of which are supervised by the San Francisco Fed directly or indirectly through bank holding companies. Community bankers helped me, when I served as president, to take the pulse of the local economy and also to understand how regulatory and policy decisions in Washington affect financial institutions of different sizes and types, sometimes in very different ways. During the financial crisis, I saw firsthand the challenges that community banks faced in a crisis they did little to cause, and I have felt strongly ever since that the Fed must do what it can to ensure that the actions taken following the crisis do not place undue burdens on your institutions.

I believe a healthy financial system relies on institutions of different sizes performing a variety of functions and serving different needs. In some communities, your banks are actually situated on Main Street, but all community banks serve Main Street by providing credit to small business owners, homebuyers, households, and farmers.

Because of their important role, I am pleased that the condition of many community banks has been improving. Although there is still considerable revenue pressure from low margins, earnings for most community banks have rebounded since the financial crisis. Asset quality and capital ratios continue to improve, and the number of problem banks continues to decline. Notably, after several years of reduced lending following the recession, we are starting to see slow but steady loan growth at community banks. While this expansion in lending must be prudent, on balance I consider this growth an encouraging sign of an improving economy.

Addressing Too Big to Fail

Let me begin by discussing an issue that I know has been on the minds of many community bankers: how policymakers are addressing the problem of banks that are perceived to be too big to fail.[1] Community banks share the interest we all have in reducing the systemic risk posed by firms that are large, complex, and interconnected, and also in reducing any potential competitive advantages that such firms may enjoy as a result of too-big-to-fail.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) addresses the too-big-to-fail issue through steps intended to limit both the likelihood that systemically important firms would fail and the potential damage from any that do. The Federal Reserve and the other financial regulatory agencies have issued a number of regulations to implement the requirements set forth in the legislation and to enhance the supervision of the largest financial firms.

[1] This topic has been addressed in greater detail in previous speeches by Federal Reserve governors, including Daniel K. Tarullo (2013), "Evaluating Progress in Regulatory Reforms to Promote Financial Stability," speech delivered at the Peterson Institute for International Economics, Washington, May 3; Jerome H. Powell (2013), "Ending 'Too Big to Fail,'" speech delivered at the Institute of International Bankers 2013 Washington Conference, Washington, March 4; and Janet L. Yellen (2013), "Regulatory Landscapes: A U.S. Perspective," speech delivered at the International Monetary Conference, Shanghai, June 3. These speeches are available at www.federalreserve.gov/newsevents/speech/2013speech.htm.

But even before Dodd-Frank became law, the Federal Reserve began to strengthen its oversight of the largest, most complex banking firms and require these firms to materially improve their capital adequacy. For example, in 2009, we conducted the first stress tests of the largest 19 U.S. bank holding companies. That test has subsequently evolved into our annual Comprehensive Capital Analysis and Review, known as CCAR, which requires all bank holding companies with total assets of $50 billion or more to submit annual capital plans for review by the Federal Reserve. CCAR helps ensure that the largest banking organizations will have enough capital to continue operating through times of economic and financial stress.[2] To be clear, as the federal banking agencies have stated previously, these stress testing and capital planning requirements do not, and should not, apply to community banks.[3]

In addition to strengthening requirements for stress testing and capital planning, the agencies have also strengthened capital requirements for the largest firms by approving more robust risk-based and leverage capital requirements. Because the financial crisis demonstrated the importance of having adequate levels of high-quality capital at banks of all sizes, many elements of the revised capital framework apply to all banking organizations. In designing the revised capital rules, however, the agencies considered financial stability risks and adjusted the

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[2] The results of the 2014 CCAR exercise are available on the Federal Reserve's website. Board of Governors of the Federal Reserve System (2014), "Federal Reserve Releases Results of Comprehensive Capital Analysis and Review (CCAR)," press release, March 26, www.federalreserve.gov/newsevents/press/bcreg/20140326a.htm.

Pursuant to the Dodd-Frank Act, the Federal Reserve and the other federal banking agencies require banking organizations with total consolidated assets between $10 billion and $50 billion to conduct annual company-run stress tests. The agencies recently published guidance to clarify supervisory expectations for these firms. See Board of Governors of the Federal Reserve System (Board of Governors), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) (2014), "Agencies Issue Final Dodd-Frank Act Stress Test Guidance for Medium-Sized Firms," press release, March 5, www.federalreserve.gov/newsevents/press/bcreg/20140305a.htm.

[3] Board of Governors (2012), "Agencies Clarify Supervisory Expectations for Stress Testing by Community Banks," press release, May 14, www.federalreserve.gov/newsevents/press/bcreg/20120514b.htm.

final rules to make the requirements substantially more rigorous for the largest, most systemically important banking organizations than for community banks.[4]

While we have taken a number of steps to address too-big-to-fail concerns, our work is not finished. Because the failure of a systemic institution could impose significant costs on the financial system and the economy, the Board recently finalized a requirement for the eight large, globally systemic banks to meet a significantly higher leverage requirement than other banking organizations. And we are working to implement risk-based capital surcharges for these systemically important firms. We also need to ensure that the new rules are embedded in our supervision of the largest firms; and, we must continue to watch for emerging sources of systemic risk and take steps as appropriate to address these risks.

One such risk that the Federal Reserve has been monitoring closely is the reliance of some firms on potentially volatile short-term wholesale funding.[5] We are carefully considering the systemic vulnerabilities that may be posed by overreliance on short-term wholesale funding and are weighing potential policy responses. While it would be premature to indicate whether or how we might address these vulnerabilities, I can say that few, if any, community banks are reliant on levels of short-term wholesale funding that could raise concerns about systemic risk, and regulators would carefully consider the ramifications of any action, including the effect on community banks.

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[4] To help non-complex community banking organizations better understand the new capital rule, the agencies published a guide that summarizes changes to the capital rules for exposures commonly held by such organizations. See Board of Governors, FDIC, and OCC (2013), *New Capital Rule: Community Bank Guide* (Washington: Board of Governors, FDIC, and OCC, July), www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf.

[5] See, for example, Daniel K. Tarullo (2013), “Shadow Banking and Systemic Risk Regulation,” speech delivered at the Americans for Financial Reform and Economic Policy Institute Conference, Washington, November 22, www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm; and Daniel K. Tarullo (2013), “Macroprudential Regulation,” speech delivered at the Yale Law School Conference on Challenges in Global Financial Services, New Haven, CT, September 20, www.federalreserve.gov/newsevents/speech/tarullo20130920a.htm.

Improving Our Understanding of Community Banks

In carefully considering how our actions affect community banks, the Federal Reserve is committed to understanding your institutions and the challenges you face. We continue to try to improve that understanding in two important ways--research and outreach. The Fed is uniquely positioned to employ these two methods because of our traditional strength as a research institution and because of our structure, with Reserve Banks that have deep roots in communities in every region of the country.

In the past several years, research staff across the Federal Reserve System who were independently exploring issues related to community banking have developed an informal network to share findings and identify areas for further research. After some of the fruits of this effort were shared with the Board, we decided to join with the Conference of State Bank Supervisors (CSBS) to host a research and policy conference focused on community banks. This conference, "Community Banking in the 21st Century," was held in October 2013 at the Federal Reserve Bank of St. Louis.[6] It was one of very few research conferences to focus specifically on community banks and also brought together researchers, community bankers, policymakers, and bank supervisors to discuss the practical implications of the papers presented.

Among the topics that researchers addressed in their papers were the link between bank failures and local economic performance,[7] the role of management in the performance of

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[6] Conference materials, including research papers, are available on the conference website at www.stlouisfed.org/banking/community-banking-conference/. See also Jerome H. Powell (2013), "Community Banking: Connecting Research and Policy," speech delivered at the Federal Reserve/Conference of State Bank Supervisors Community Banking Research Conference, St. Louis, October 3, www.federalreserve.gov/newsevents/speech/powell20131003a.htm.

[7] John Kandrac (2013), "Bank Failure, Relationship Lending, and Local Economic Performance," paper presented at the Federal Reserve/Conference of State Bank Supervisors Community Banking Research Conference, St. Louis, October 2, www.stlouisfed.org/banking/community-banking-conference/PDF/Kandrac_BankFailure_CBRC2013.pdf.

community banks,[8] and the impact of Dodd-Frank on community banks.[9] I'm pleased to say that the conference was so successful that the Federal Reserve and CSBS are planning another in September.[10]

In addition to research, our understanding of community banks is enhanced by the Fed's outreach to community bankers. At the most basic level, supervisory staff at each Reserve Bank gain insights from their regular contact with community bankers. Additional knowledge comes by way of community outreach initiatives, which provide the added benefit of informing the Fed about local economic conditions. Here in Washington, in addition to participating in events like this one, the Board of Governors meets twice a year with the Community Depository Institutions Advisory Council (CDIAC).[11] The council, which includes representatives from small banks, credit unions, and savings associations from each Federal Reserve district, provides information about economic conditions around the country and those issues that are of greatest concern to community institutions.

In addition, we have been taking steps to improve our communication with community bankers. In that regard, we have been using various platforms to go beyond formal policy issuances and better explain our supervisory expectations for community banks. We have also

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[8] Dean F. Amel and Robin A. Prager (2013), "Performance of Community Banks in Good Times and Bad Times: Does Management Matter?" (preliminary draft), paper presented at the Federal Reserve/Conference of State Bank Supervisors Community Banking Research Conference, St. Louis, October 3, www.stlouisfed.org/banking/community-banking-conference/PDF/Amel-Prager_Community_Bank_Draft_9-18-13_with_Tables.pdf.

[9] Tanya D. Marsh and Joseph W. Norman (2013), "The Impact of Dodd-Frank on Community Banks," paper presented at the Federal Reserve/Conference of State Bank Supervisors Community Banking Research Conference, St. Louis, October 3, www.stlouisfed.org/banking/community-banking-conference/PDF/Marsh_Norman_Reforming_Regulation.pdf.

[10] See www.stlouisfed.org/banking/community-banking-conference-2014/.

[11] For more information on the CDIAC, see www.federalreserve.gov/aboutthefed/cdiac.htm.

developed and continue to enhance our industry training efforts. In particular, we have developed two programs--Ask the Fed and Outlook Live--that have become quite popular with community bankers who are interested in learning more about topics that are of importance to both banks and supervisors. Ask the Fed is a program for officials of state member banks, bank and thrift holding companies, and state bank commissioners. Outlook Live, which is a companion program to the Federal Reserve's quarterly *Consumer Compliance Outlook* publication, is a webinar series on consumer compliance issues that is led by Federal Reserve staff.[12]

We are also now using periodic newsletters and other communication tools to highlight information that community bankers may be interested in knowing and to provide information on how examiners will assess compliance with Federal Reserve policies. In addition to *Consumer Compliance Outlook*, in 2012 the Federal Reserve System established a *Community Banking Connections* website and quarterly newsletter to focus on safety-and-soundness issues that are of practical interest to community bankers and bank board members.[13] The Federal Reserve also launched a series of special-purpose publications called *FedLinks*.[14] These publications highlight key elements of specific supervisory topics and discuss how examiners will typically address the topic. The common goal for all of these outreach efforts is building and sustaining an ongoing dialogue with community bankers.

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[12] *Consumer Compliance Outlook* is available at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/, and Outlook Live is available at www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/.

[13] Community Banking Connections is available at www.communitybankingconnections.org/.

[14] *FedLinks* is available at www.communitybankingconnections.org/fedlinks.cfm.

Tailored Community Bank Supervision

One theme that has come through loud and clear in this outreach is concern about regulatory burden. The financial crisis has prompted significant changes to regulation, so the Federal Reserve understands this concern and strives to minimize regulatory burden for all institutions, including community banks. At the same time, we are taking a fresh look at how we supervise community banks and possible ways that supervision can be smarter, more nimble, and more effective. In that regard, and consistent with my earlier points about too big to fail, we know that a one-size-fits-all approach to supervision is often not appropriate. In recent years, we have taken a number of actions to tailor supervisory expectations to the size and complexity of the banking organizations we supervise.

The first step is taking a disciplined approach to judging which supervisory policies should apply to community banking organizations. This involves not only weighing the costs and benefits of proposed rules and their implementation, but in some cases also asking whether it makes sense for a specific policy to apply to community banks.

In other cases, it may not make sense to exclude community banking organizations entirely from the scope of a supervisory policy, but we may be able to scale expectations to the size and complexity of the supervisory portfolio, to minimize the burden where possible and appropriate. The final capital rules for community banks that I mentioned earlier illustrate this kind of tailoring.

Let me turn now to upcoming changes in the accounting standard for credit losses on loans and securities. We have heard the concern that overly complex accounting rules in this area would increase costs with little benefit for the users of community bank financial statements. We are working with the Financial Accounting Standards Board (FASB) to help ensure that the new standard, which is an important component of financial reform efforts, can be implemented in a reasonable and practical way for community banks. We have stressed to FASB that its proposal should not require community banks to utilize complex modeling processes. We expect that a final standard will permit loss-estimation techniques that build upon current credit-risk management techniques used by community banks.[15] We will work with community banks to help implement the new standard when it is final. In addition, our supervisory guidance will emphasize that regulatory expectations for implementation of the standard will differ based on bank size and complexity.

In addition to tailoring our rules, we are also taking steps to tailor and improve our examination processes to be more efficient and effective. For example, we are currently in the process of developing and adopting common technology tools across the Federal Reserve System that should allow our examiners to more effectively focus their time and enhance the consistency of our examination processes nationwide.

Furthermore, we are exploring ways that our community bank examiners may be able to complete more examination work off site. For example, for banks that have electronic loan files, examiners may be able to read these files off site rather than on the bank premises. We are also seeking ways to utilize the financial information that we collect from banks to tailor the examination procedures that are used on site, with less work being required at institutions with

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[15] Financial Accounting Standards Board (2012), "Financial Instruments—Credit Losses (Subtopic 825-15)," Exposure Draft: Proposed Accounting Standards Update (Norwalk, CT: December 20), www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825477164&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1381874&blobheadervalue1=filename%3DProposed_ASU%25E2%2580%2594Financial_Instruments%25E2%2580%2594Credit_Losses_%2528_Subtopic_825-15%2529.pdf&blobcol=urldata&blobtable=MungoBlobs.

lower risk profiles. These efforts should reduce the disruption that an on-site examination can cause to a bank's day-to-day operations.

We recently adopted a new consumer compliance examination framework for community banks.[16] Under this new program, our consumer compliance examiners base examination intensity more explicitly on the individual community bank's risk profile, weighed against the effectiveness of the bank's compliance controls. We expect that examiners will spend less time on low-risk compliance issues at community banks, increasing the efficiency of our supervision and reducing regulatory burden on many community banks.

Much of the work to tailor our supervisory requirements and programs is being overseen by the community bank subcommittee of the Board's Committee on Bank Supervision. This subcommittee oversees the supervision of community and regional banks and reviews proposed supervisory policies to help ensure that they are appropriate for, and tailored to, community banks. This subcommittee was formed several years ago under the direction of now former governors Betsy Duke and Sarah Bloom Raskin, and I want to assure you that the subcommittee will continue to play an important role in helping ensure that our supervisory policies make sense for community banks. I should also add that we are working closely with our colleagues at the state level to help ensure that our supervisory approaches and methodologies are as consistent as possible.

Conclusion

[16] Board of Governors, Division of Consumer and Community Affairs (2013), "Community Bank Risk-Focused Consumer Compliance Supervision Program," Consumer Affairs Letter CA 13-19 (November 18), www.federalreserve.gov/bankinforeg/caletters/caltr1319.htm; and "Consumer Compliance and Community Reinvestment Act (CRA) Examination Frequency Policy," Consumer Affairs Letter CA 13-20 (November 18), www.federalreserve.gov/bankinforeg/caletters/caltr1320.htm.

In closing, let me repeat my strong belief that community banks will continue to play an important role in our financial system in the years ahead, serving the credit needs of the communities they are a part of and know so well. The Federal Reserve will continue to promote a stronger and more resilient financial system, while carefully considering the effects of our actions on community banks and tailoring supervision appropriately.

Thank you.