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# Community Banking: Connecting Research and Policy


Remarks by

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Good afternoon. I am delighted to have the opportunity to participate in this inaugural conference on community banking research and policy. By way of introduction, I have spent most of my career in the private sector, including many years as an investor in small and medium-size companies. Although I have never worked in a community bank, I have been a customer, and I know from personal experience the special skills that these institutions bring to their customers. Community banks are a crucial part of our economy and the fabric of our society.

My colleagues on the Board of Governors and I understand the value of having a diverse financial system that includes a large and vibrant contingent of community banks. By fostering the economic health and vitality of local communities throughout the country, community banks play a central role in our national economy. One important aspect of that role is to serve as a primary source of credit for the small businesses that are responsible for creating a substantial proportion of all new jobs. A thriving community banking sector is essential to sustaining our ongoing economic recovery.

Community banks have faced significant challenges in recent years, as our nation has endured a major financial crisis and recession, followed by a painfully slow recovery. To make matters worse, community bankers, who played no part in causing the financial crisis, have been forced to fight to ensure that they are not swept up in a torrent of costly new regulations that were intended to address problems at those very large banks that did contribute to the crisis. The Federal Reserve will continue to be alert to the possible unintended consequences of regulatory policies, and we welcome input from community bankers as we develop and implement those policies.

We have established a number of channels of communication to facilitate such input. For starters, the Reserve Banks have long had programs in place to provide training and guidance to banks in their districts. Recently, some of these programs have been expanded nationwide. For example, our host, the Federal Reserve Bank of St. Louis, organizes national "Ask the Fed" calls to provide an opportunity for bankers all over the country to hear Federal Reserve staff discuss timely financial or regulatory topics and to ask questions on these topics. Similarly, for consumer compliance issues, the Federal Reserve Bank of San Francisco hosts a national webinar series called "Outlook Live," which complements the "Consumer Compliance Outlook," a quarterly publication sponsored by the Federal Reserve Bank of Philadelphia. In addition, the Federal Reserve recently launched "Community Banking Connections," a website that serves as a "one-stop shop" for information on issues that affect community banks, as well as providing links to tools and resources that can help them.

Another recently established communication channel is the Community Depository Institutions Advisory Council (CDIAC).[1] The council, which is made up of representatives of smaller banks, credit unions, and savings associations from each of the 12 Federal Reserve Districts, meets with the Board of Governors in Washington twice a year. These meetings allow the Board to gather firsthand information from community bankers about issues that concern them most and about economic conditions in their areas.

In addition, the Board of Governors has a community bank subcommittee of our Committee on Bank Supervision that oversees the supervision of community banks and reviews regulatory proposals to ensure they are appropriately tailored for community banks. The subcommittee also meets with Federal Reserve staff to hear about ongoing research in the

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

community banking area. As a new member of this subcommittee, I look forward to helping ensure that community bank concerns receive the attention they deserve in every Federal Reserve policy decision. I also look forward to having the opportunity to help shape the important community banking research that is being conducted by staff across the Federal Reserve System.

As Chairman Bernanke mentioned yesterday, this conference was conceived as a result of discussions that took place during a community bank subcommittee meeting. I don't know about you, but I think that, so far, the conference has been a great success. The quality and policy-relevance of papers presented here have been excellent. This work will, no doubt, spur continued research as well as policy discussions about ways in which we can better tailor regulations to meet our legal and prudential goals while reducing burdens on smaller financial institutions.

In my view, the research presented at this conference reaffirms the importance of community banks to our economy. In the rest of my talk, I'll try to summarize and tie together what I've learned from the research that has been presented,[2] suggest some areas where further research would be helpful, and discuss what I believe should be the focus for supervision and regulation of community banks going forward.

Yesterday afternoon's session on the role of community banks provided ample evidence of their continued viability and importance. The Lee and Williams paper provides evidence of the importance of small businesses to job creation in our economy and the important contribution that community bank lending makes to the survival of small businesses. Focusing on start-ups,

[2] Abstracts of papers presented at the conference are available on the Federal Reserve Bank of St. Louis website at www.stlouisfed.org/banking/community-banking-conference/abstracts.cfm.

Lee and Williams find that proximity to a community bank increases the likelihood that a new small business uses bank credit to finance its operations. Their findings support the importance of local knowledge and "soft information" that emerges from a bank's relationship with its customers in underwriting loans to particularly opaque small businesses.

DeYoung and his coauthors look at differences in loan default rates across community banks and find that banks in rural areas make loans that default less often than loans made by community banks in urban areas. They also find that loans made outside of a bank's local area default at higher rates than do local loans. Both results can be interpreted as showing the value of banking relationships, because loans default less often in situations in which soft information is likely to be more available to the lender.

If any doubt remains about the importance of community banks to local economies, the Kandrac paper looks at the extreme situation in which a community bank fails, and documents the subsequent harm to local economic growth resulting from that failure. Of particular relevance to regulators, Kandrac points out that the effect of a bank's failure on the local economy differs depending on the resolution method. In particular, he finds that resolutions that include loss-sharing agreements tend to have smaller negative effects on local economic growth than resolutions that do not include such agreements; Kandrac attributes these differences to the greater harm done to banking relationships when there is no loss-sharing agreement.

In another result, Kandrac finds that relationship lending appears to be stronger in local markets where banking competition is more intense. This is a contribution to a substantial economic literature that has discussed whether there is a conflict between the desire of antitrust authorities to maintain competitive markets and the desire to foster productive long-term relationships between small businesses and their lenders. Kandrac's finding of no conflict is reassuring for those of us charged with both encouraging economic growth and enforcing antitrust statutes.

The Kelly, Khayum, and Price paper notes that there has been more emphasis in recent years on the challenges facing community banks than on the opportunities available to them. Given the success that community banks have enjoyed in lending to small businesses, this paper explores the possibility that these institutions could expand their involvement in business equipment leasing, a potential growth area that community banks might want to investigate. The authors find that community banks that are actively involved in lease financing are more profitable and efficient than other community banks.

This morning's first session on community bank performance highlighted the heterogeneity of community banks. The Shen and Hartarska paper notes that while use of financial derivatives by community banks has increased rapidly in recent years, only about one in six community banks were active users of derivatives markets in 2012. Shen and Hartarska estimate that community banks could improve their profitability and reduce their risk of default through increased use of derivatives. They also point out that implementation of the Dodd-Frank Act--in particular the Volcker rule--could prevent the realization of these gains, although I should note that the Volcker rule includes an exception for hedging activities that is intended to allow banking organizations of all sizes to appropriately manage their risks. This is an important point to bear in mind. I believe we are doing so in drafting the regulation and that implementation of the Volcker Rule should not prevent community banks from using derivatives to manage their risks in a safe and sound manner.

Gilbert, Meyer, and Fuchs have completed two important studies on the experiences of community banks during the recent recession. Their first paper looked at banks that thrived throughout that period of economic distress while the second paper, presented this morning, looks at community banks that endured some level of financial distress during the downturn but then recovered. This research goes beyond statistical analysis to conduct interviews with a sample of bank presidents and CEOs to gain further insight into banks' unique experiences in recent years. They identify two paths to recovery from financial distress. The first is a return to conservative underwriting practices and sound policies and practices, work that can provide a "road map" for community bankers to follow when confronted with the next--one hopes, less extreme--financial downturn. The second path to recovery is a change of bank ownership or management.

Consolidation among community banks has been a constant theme in recent decades, and the Ferrier and Yeager study yields some interesting results on the profitability of community bank acquisitions and reorganizations. Their findings on bank acquisitions echo both the findings of DeYoung and his coauthors and the wisdom of many community bankers, namely that you increase your profits by sticking to what you know. Post-acquisition performance of community banks is better, the closer the target bank is to the acquirer. While more-distant acquisitions might lead to greater diversification benefits, these appear to be outweighed by the greater difficulties in managing the performance of two banks operating far apart from each other.

I should note that these findings could conflict to some extent with the antitrust responsibilities of financial regulators and the Department of Justice. While a merger with a crosstown rival might lead to the greatest efficiency gains, the Federal Reserve has a statutory responsibility to make sure that such consolidations leave a sufficient number of local firms to ensure a competitive banking environment.

Community bank profitability is affected by both external factors outside of bank control, such as local economic conditions, and factors within bank control, such as the composition and stability of the bank's loan portfolio. The paper by Amel and Prager examines the effects of these two sets of factors on bank profitability over the past 20 years. They find that local economic conditions and demographic changes certainly affect bank profitability, but also that the quality of bank management and the stability of bank portfolio composition consistently have a very substantial impact on a bank's level of profits. They find that any major change in a bank's portfolio composition tends to lower bank profits, indicating yet again that banks tend to be better off when they stick to the markets and products that they know.

The papers in this morning's second session on supervision and regulation of community banks are of great interest to me, given my current responsibilities on the community bank subcommittee at the Board. The papers in this session stress the need for flexibility in bank regulation and the need--subject to the constraints imposed by Congress--to tailor regulations to fit banking organizations that cover a huge range, from quite simple to extraordinarily complex.

The paper by Bassett, Lee, and Spiller provides reassuring evidence that CAMELS standards have been quite consistent over time, with no indication that CAMELS ratings were unduly stringent during the recovery from the recent recession. However, they do find that there was a slight tendency for exam ratings to become more stringent as we entered both the recession of the early 1990s and the one we just experienced. This finding should be brought to the attention of our examiners, because even a slight tightening of standards can have a significant effect on credit markets, especially if combined with other supervisory actions, and a tightening at the beginning of a recession could cause it to be deeper or longer than might otherwise be the case.

Marsh and Norman highlight the need to avoid requiring excessive standardization of bank loans. Such standardization could interfere with effective relationship lending, and as we've seen from the research I've already discussed, that relationship lending is a key aspect that makes community banks such valuable assets to small businesses and so important to a thriving economy. The Marsh and Norman paper stresses that, to the extent the laws allow, we should reduce compliance costs for community banks, such as by simplifying capital rules for smaller banks and relying on market incentives, when feasible. The Moore and Seamans results from their failure-prediction model contribute to this discussion by demonstrating that simple capital ratios do a good job of identifying those community banks with the greatest probability of failure, so that regulators need not unduly impede the actions of the great majority of community banks that are highly unlikely to fail. Meanwhile, the Rosenblum and Organ paper argues for an alternative approach to addressing "too big to fail" that the authors suggest would benefit community banks by creating a more level playing field.

Although both the traditional bank regulatory agencies and the Consumer Financial Protection Bureau (CFPB) are constrained, to some extent, by the language in the Dodd-Frank Act, all regulators should aim to ensure that we are not unduly rigid in our actions. Indeed, some steps have already been taken with that goal in mind. For example, the federal banking agencies carefully considered the thousands of comments received from community bankers regarding three notices of proposed rulemaking for revisions to the capital framework. In response to these comments, the agencies reduced and simplified many of the proposed changes to the risk-based capital rules that apply to community banks. And the CFPB has shown an openness to input from the industry and from other regulators in crafting its regulations.

In our role as a bank supervisor, the Federal Reserve has been refining our examination programs and recently launched an initiative to review our consumer compliance supervision program for community banks. While Federal Reserve consumer compliance examiners have traditionally applied a risk-driven approach to supervision, we recognized the need to provide more specific guidance to our examiners. Under the updated program, our consumer compliance examiners will base the examination intensity more explicitly on the individual bank's risk profile, including its consumer compliance culture and how effectively it identifies and manages consumer compliance risk. We plan to launch this new consumer compliance supervision program for community banks in 2014. We will begin training for our examiners and outreach to our member community banks later this year.

While this conference has presented much valuable research of direct relevance to community bankers, I'd like to recommend a few areas where further work could be of value. First, it would be interesting to explore the effects of risk-retention policies on community banks. To what extent do community banks currently retain a percentage of their loans, and how do small banks compare to money-center banks when it comes to utilizing the secondary markets for loans? Would risk-retention policies be a non-issue for community banks, or would some banks be seriously constrained by such policies? Even if such policies do not constrain community bank activities, would new reporting requirements related to such policies increase the reporting burden faced by small banks?

These questions point to a more general area in which more research could be useful, namely a detailed examination of the compliance costs for community banks that can highlight the most beneficial areas for regulatory relief. The Dodd-Frank Act has spawned a variety of new regulatory initiatives that add to the already-substantial regulatory burden faced by community banks. Which regulations--whether new or existing--impose the greatest regulatory burden compared to their benefits? Can regulatory agencies modify or provide exemptions to these regulations so as to make life a bit easier and more profitable for community banks, without adversely affecting bank safety and soundness or financial stability?

To give just one example, one area in which new regulations are being developed involves incentive compensation. This area seems to me to be of much more concern when we consider a money-center bank with thousands of shareholders, none of whom has a major stake, than when we consider a community bank in which management has a large or even majority ownership share. Before imposing more regulatory burden on smaller banks in this area, I would like to understand whether there is any evidence that incentive compensation has caused excessive risk taking in such institutions.

We are nearing the end of the rulemaking phase of Dodd-Frank and our changes on capital standards, at least those regulations that most directly affect community banks. While we have tried to tailor rules to the size and complexity of institutions, we may not have gotten the balance right in every instance. Thus we will continue to assess the overall effects of the new rules on the safety and soundness of community banks and to consider whether modifications to rules, or the ways in which we implement them, could achieve our safety and soundness aims with a lesser burden on this class of depository institutions. We, of course, would value any observations and suggestions you have along these lines.

My fellow governors and I encourage community bankers to use all the available communication channels to share with us their insights and concerns regarding new and existing regulations. And I promise that their voices will be heard in Washington when policy issues that may affect the ability of community banks to thrive are under consideration. While community banks certainly face challenges, I do not see their future as bleak. Community banks continue to do a good job of attracting core deposits, and those stable and relatively inexpensive deposits remain the most sought-after liability on bank balance sheets. However, many of the asset classes that traditionally comprised much of community bank portfolios have faced increasing competition in recent decades from firms that operate at the national level. As auto, mortgage, and credit card loans have become increasingly standardized, community banks have had to focus to a greater extent on small business and commercial real estate lending--products where community banks' advantages in forming relationships with local borrowers are still important. These are not cheap or easy loans to make, and the loss of some traditional product lines has threatened the stability of some community banks. It is incumbent on the Federal Reserve and other regulators to understand the challenges community banks face and to ensure that our regulatory policies do not exacerbate them.

I look forward to hearing from the community bankers who will be participating in the conference's final session. Thank you for your attention and for your participation in this inaugural community banking conference. I would be happy to take some questions from the audience.