The Evolving Financial Services Industry and the Outlook for U.S. Economic Growth

Opening Remarks
When I was preparing my comments for today, I was reminded that the Community Bankers Association of Ohio was founded in 1974 and at your first annual meeting, you welcomed about a dozen members to the table. Today this convention draws nearly 400 members from across the state. What a testament to the tremendous value your organization has brought to Ohio’s community bankers for nearly four decades.

I’m sure I don’t need to tell this audience about the critical role that community banks play not just in our local economies, but in America’s economy. As president of the Federal Reserve Bank of Cleveland, I rely on input from community bankers to better understand economic activity in my district. Your perspective matters. Community bankers serve on the board of directors of the Cleveland Federal Reserve Bank as well as on our branch boards in Cincinnati and Pittsburgh.

In fact, the entire Federal Reserve System values your voice. This past year, we formed Community Depository Institution Advisory Councils in each of our 12 Federal Reserve districts across the country. A national council comprised of the chairs of each regional advisory panel meets with the Board of Governors in Washington twice a year. These councils were formed to collect information and insights on the economy, lending conditions, regulatory matters, and other issues from the standpoint of community bankers. And believe me—I am listening. What I am consistently hearing from you are concerns about the many challenges facing your industry. In the aftermath of the financial crisis and the very deep recession, you find yourselves dealing with new regulations, fierce competition, and tepid demand for loans in a disappointingly weak economy.

Today, I am going to give you my perspective on some of these challenges. Specifically, in my comments this morning, I’m going to touch upon three related areas.

--First, I’ll share my outlook for the U.S. economy.
--Next, I’ll talk about small business access to credit.
--Finally, I’ll discuss the ongoing process of regulatory reform.
Please note that the views I’ll share with you today are my own and do not necessarily represent the opinions of my colleagues in the Federal Reserve System.

Economic Outlook
Let me begin, then, with a description of my outlook for the U.S. economy.

Usually, deep recessions produce strong and fast recoveries. Based on historic patterns, we should have experienced a roughly 10 percent rebound in real GDP growth during the first year of our expansion. Instead, our first four quarters of growth amounted to only a 3.3 percent gain. In fact, we are still not back to the overall level of economic activity that we attained before the recession that began at the end of 2007.

The unusual combination of forces that caused the recession is also making the exact course of the recovery difficult to forecast. You might recall that early last year, it appeared that the economy was finally showing the first "green shoots" of growth. Yet, over the summer, dark clouds appeared on the horizon in the form of a weakening recovery and falling inflation leading the Federal Open Market Committee to initiate a second round of large scale asset purchases. Early this year, once again, the economy appeared to be strengthening, and yet once again, in the summer, storm clouds appeared. In January, most FOMC members projected real GDP would expand by 3-1/2 to 4 percent this year. In June, the FOMC's projections fell to the range of 2-3/4 to 3 percent.

Then a lightning bolt struck on Friday, July 29, when the Commerce Department revised its estimates for economic growth going back to 2003, and at the same time, gave us our first look at economic growth in the second quarter of this year. The new statistics gave us two critically important pieces of information. First, we learned that the magnitude of the recession was worse than we had thought, and second, we learned that growth in the first half of this year was considerably slower than we had expected. In the period between the FOMC's June and August meetings, other incoming data had also been disappointing, leading the Committee to conclude at our meeting last week that labor market conditions had deteriorated in recent months, household spending had flattened out, and the housing sector remained depressed. As a result, last week the Committee indicated that it now expected a somewhat slower pace of recovery over the coming quarters and that the downside risks to the economic outlook had increased.

Key among the issues revealed in the latest GDP release is that consumption growth has been exceptionally soft throughout the recovery and was virtually unchanged in the second quarter. Consumer spending accounts for two-thirds of GDP, so it is a key driver of economic growth. This year, consumers are being extraordinarily cautious, and perhaps understandably so. Those who haven't lost their jobs have certainly seen friends and family lose theirs. And just about every American household has suffered losses of wealth during the past four years. Under these conditions, it's understandable that consumers are focused on rebuilding their lost wealth, not on spending.

Household incomes have been growing slowly during the past two years, and consumers are spending less of what income they are earning. They are saving more, and they are reluctant to take on new debt. Last month, consumer confidence fell to levels not seen since the depths of the recession in 2009. More households expect their incomes to fall over the next 12 months than to rise. The recent volatility we have seen in equity markets is both an expression of worry and yet another cause for worry about consumer spending. When I put all of these facts together, I do not expect much of an economic boost from consumer spending anytime soon.

Then there is the housing market, whose fortunes are closely tied to the welfare of most households. Although the housing sector accounts
For only about 5 percent of GDP, it is very sensitive to interest rates and normally grows rapidly in the early stages of an expansion. Not this time, though. The housing sector remains very depressed. Home prices are still under downward pressure, inventories of existing homes are still very high, and foreclosures continue to be a serious national problem.

Under these conditions, many people are reluctant to buy homes out of concern that prices may fall further, while others are reluctant to sell because they believe they won't receive the full value of their homes. Also, lenders have tightened their underwriting standards, so some who may want to buy a home are unable to do so because they can't secure a loan. Bottom line—there is actually less investment in housing taking place in our economy today than there was at the bottom of the recession. This situation is putting a severe strain on our recovery.

Business investment on equipment and software has been relatively strong and continues to expand. Many businesses have the capacity to spend more, but are simply hesitant to do so; they are still stockpiling record amounts of cash. Lately, business executives have been telling me that they are just unsure whether consumer demand will be strong enough to justify much in the way of new job creation.

Nine million jobs were lost in the recession, and we have added back only 2 million jobs in the past two years. Recent labor reports have not brought any relief, either. We're now contending with an extremely high unemployment rate of 9.1 percent, and nearly half of those currently unemployed have been without a job for six months or longer. Millions more are underemployed. What's more, the loss of income and income security is feeding back through the system and further impairing growth.

My latest forecast is for the economy to grow at a rate of about 2 percent this year, and about 3 percent in each of the next two years. Our economy has to grow at about a 2-1/2 percent clip just to absorb new labor force entrants and to keep the unemployment rate from rising. If we're going to dig ourselves out of the hole that we're in and begin to drive down the unemployment rate, we need even faster growth than that. I think it will take a quite a few years for the unemployment rate to fall to more typical levels, in the neighborhood of 5-1/2 percent.

Turning to inflation, there is no question that food and energy prices have risen rapidly this year, but I expect these pressures to abate over time. As always, monthly inflation statistics reflect some forces that are temporary and others that are more persistent. In my view, after allowing for all of the temporary factors that cause consumer prices to bounce up and down, and in light of the amount of slack in the economy, I see the inflation rate stepping down from its current level over the rest of this year and into next year as well. I project that overall inflation will average 2 percent or a bit less in 2012 and 2013. Financial market participants appear to agree: my projection is consistent with a measure of inflation expectations that we produce at the Federal Reserve Bank of Cleveland that is based partly on financial market data.

With my diminished outlook for economic growth, and my outlook for inflation to soon fall back to 2 percent, I was in favor of providing additional support to the recovery at last week's FOMC meeting. With the federal funds rate essentially at zero, the FOMC needed a way to put downward pressure on interest rates along the yield curve. That need led us to employ a nontraditional monetary policy tool; namely, clarifying our intention about the period of time we have in mind for keeping our federal funds rate target exceptionally low.
Our outlook could change, of course, but right now the Committee anticipates that it will be at least mid-2013 before we increase our federal funds rate target. Under the circumstances, I think it made sense to take the unprecedented step of including that conditional guidance in our press statement.

In the week leading up to our meeting, most market participants had already fixed on mid-2013 as the time when we would begin to raise our federal funds rate target. So, you might ask, how does being more specific about our monetary policy intentions make any difference? I expected that the announcement would push interest rates down along the yield curve, especially in the middle range of maturities, as a result of changing the expectations of those who thought a rate increase would come sooner, and by providing more certainty for everyone. The result of our action has been consistent with what I had anticipated.

I grant you that monetary policy alone cannot cure all of the economy’s ills. Nevertheless, I think it is vital that monetary policy does what it can to promote a stronger economic recovery in the context of price stability.

**Small Business Access to Credit and Bank Supervision**

Well, as the old saying goes, "Enough about me; let's talk about YOU!" I'm well aware of the fact that these tough times are providing you with plenty of challenges. Among them is the challenge of providing credit to small businesses. I am sure I don't have to sell the importance of a healthy small business sector to community bankers. In the early stages of an economic recovery, small businesses provide much-needed fuel to job creation.

I would like to take a moment to address some of the concerns I have heard about small business access to credit. I know that bankers are eager to make loans to creditworthy borrowers, and that small business owners report that weak customer demand is a bigger problem for them than access to credit. Nevertheless, some small business owners do think that bankers are being too stringent in their evaluation of requests for credit, and some bankers are blaming banking supervisors for discouraging them from lending. To be blunt, some bankers have been outspoken in their belief that supervisors are being overly harsh in evaluating small business loans.

This is an issue that greatly concerns me and my colleagues in the Federal Reserve System. The Federal Reserve Board, along with the other bank supervisory agencies, has issued examination guidance over the past years to stress the importance of taking a fair and balanced approach in assessing loans, one that considers the full range of information provided by bankers. Now, it’s one thing to provide this guidance; it’s another to know how it’s working in practice.

To learn more, the Federal Reserve Bank of Cleveland and other bank regulatory agencies worked with the Ohio Bankers League to survey Ohio bankers on the topic of small business lending. The survey results suggested that some bankers had concerns about the supervisory process, but the results were not specific enough. So we decided to drill down deeper. A few members of my non-supervisory staff spent a fair amount of time talking individually with about two dozen community bankers about supervisory practices, regardless of which agency was responsible for their supervision.

Based on their responses, the bankers who participated in the interviews can be divided into three distinct categories. The first
group—slightly more than a third of the bankers we spoke with—told us that their lending decisions were not influenced by their banking supervisors.

A second group of bankers explained that supervisory pressure was a factor in their small business lending decisions. However, they acknowledged that some underlying problems at their banks, such as growing loan losses and deterioration in their capital positions, may have been the cause of this increased scrutiny. These bankers generally conceded that their supervisors’ actions were appropriate.

We were most interested in the responses from the third group of bankers, nearly a quarter of those interviewed. These bankers described their banks’ financial condition and supervisory ratings as strong and yet they said that they were holding back lending because of the supervisory and regulatory environment. These bankers have become intensely cautious about risks even when they feel borrowers are creditworthy. The feedback from this group is what concerns me.

Based on what we learned, we have discussed the interview results with our supervision staff at the Cleveland Fed to remind them about the importance of frequent, clear, and open communication during the exam process. It’s a two-way street; we expect bankers to ask questions about findings they don’t understand, or disagree with, and we expect our examiners to provide factual support for their supervisory findings.

Our supervisors are well-trained and take their responsibilities seriously. They know that their actions have consequences. I do not want to have situations where bankers deny loans to creditworthy small businesses, especially in this slow-growth economy in which every good loan counts.

I can tell you that the bankers we spoke with were very appreciative of the opportunity to discuss these supervisory issues outside their examination cycle. They also took advantage of the opportunity to share some opinions about the ongoing process of regulatory reform. So let me now turn to that topic.

Impact of Regulations on the Financial Services Industry

The Dodd-Frank Wall Street Reform and Consumer Protection Act is just over a year old. As you know, the Federal Reserve and other financial regulators are in the process of developing and implementing hundreds of new rules. The reforms will affect nearly every aspect of the financial services industry, including how regulators operate. For example, the Federal Reserve recently assumed responsibility for savings and loan holding company supervision. While savings and loan holding companies are similar to bank holding companies, they are not identical, so we are working to deepen our knowledge about the savings and loan industry.

Let me point out that the bulk of Dodd-Frank is aimed primarily at the very large, complex banks and financial services providers, some of whom were less tightly regulated before the financial crisis—in other words, the shadow players. Nevertheless, I hear from community bankers that you are concerned that the expectations being set for the largest institutions will ultimately be imposed in a burdensome manner on smaller institutions, adversely affecting the community bank model. I understand your concerns and recognize that well-intentioned legislation can sometimes lead to unintended consequences.

In the past, you may have heard me talk about a regulatory and supervisory framework called “tiered parity.” In this framework,
financial firms would be placed into a particular category, or tier, based on their complexity and the level of risk they pose to the overall financial system. The regulatory and supervisory approach applied to each tier would be consistent within each tier—resulting in parity of treatment for firms with similar risk profiles. However, the regulatory and supervisory approach would differ between the tiers. They would become less restrictive from one tier to the next as the risk to the financial system decreases.

I am pleased that the provisions of the Dodd-Frank Act embody the spirit of this tiered parity framework—that is, the most restrictive regulatory requirements are imposed on the riskiest, systemically important firms. That means that the riskiest firms receive the highest degree of supervisory scrutiny. At the same time, the Act also clearly seeks to minimize the regulatory burden on banks with assets of less than $10 billion. So there is no "one size fits all" formula for regulations or supervision.

To be realistic, though, all players in the financial services industry will face a number of challenges as they adapt to the new regulatory environment. While Dodd-Frank is not fundamentally aimed at community banks, your institutions will also have to adjust to this new environment.

An important and relevant example involves enterprise risk management. The Dodd-Frank Act requires that large, complex financial organizations establish risk committees and risk management processes. But truthfully, financial firms of all sizes would benefit from an effective enterprise risk management program that is scaled to the nature and complexity of the risk found in that institution.

Let me provide a specific illustration. One component of enterprise risk management is managing concentrations of credit. I have no doubt that all of you know the importance of managing the risks posed by credit concentrations within your organizations. However, with the benefit of hindsight, it is clear that poorly managed concentrations in commercial real estate and construction lending made many small and mid-size institutions highly vulnerable to a real estate downturn. In fact, such concentrations have been at the heart of many of the bank failures we have seen across the country.

These failures punctuate the need for an effective risk management program to go beyond traditional audit, compliance functions, and loan review. These programs should look broadly and holistically at the many places where risks can build up in an institution, and to mitigate excessive exposures such as concentrations of credit. I realize that small banks have limited resources to engage in this sort of effort, but even a modest program that uses key personnel to develop internal checks and balances and to develop effective management reports can pay big dividends.

I could make similar observations about many other topics--such as stress testing, capital planning, and incentive compensation--that financial regulators are working to overhaul. The point is, as new regulations and supervisory practices are developed, it is important that the regulatory agencies remain sensitive to the burden that new regulations will place on all banks. The supervisory demands must be calibrated to the risks we see.

I assure you that the Federal Reserve Bank of Cleveland is committed to ensuring that our supervisory practices are appropriate to the size and risk profile of the institution. We will continue to strive to be fair, balanced, and consistent supervisors.
Conclusion

As community bankers, you are on the front lines of our nation's battle to emerge from the recession. You are out there in the neighborhoods and understand the challenges brought by layoffs and foreclosures, stressed government budgets, and nervous business owners. These are your customers, your depositors, and your friends.

But we all have to keep moving forward with a positive attitude. Remember that even in a slow-growth economy, people will continue to buy homes and cars and finance their children's educations. The question then becomes, who will help them fund these purchases? Business will always need a trusted financial partner to help them grow; who will be that partner? With your deep knowledge of your customers, your commitment to your community, and your back-to-basics approach to banking, you can position yourselves to be that partner.