FEDERAL RESERVE BANK of CLEVELAND

home | news & media | careers | site map

Search

About Us | For the Public | Community Development | Our Region | Research | Banking | Learning Center

Tours | News & Media | Streaming Media | Speakers Bureau | Savings Bonds | Forefront Magazine

Home > For the Public > News and Media > Speeches > 2012 > Communication - A Key to Value-Added Supervision

SHARE

Communication - A Key to Value-Added Supervision

Additional Information

Sandra Pianalto

President and CEO,
Federal Reserve Bank of Cleveland

Kentucky Department of Financial Institutions: A Day with the Commissioner

Lexington, Kentucky

April 16, 2012

I know that my colleague Jim Bullard, president of the Federal Reserve Bank of St. Louis, joined you last year when you met in Louisville. Jim's Federal Reserve District includes the western part of Kentucky, while eastern Kentucky sits in my District. My District also includes Ohio, western Pennsylvania, and the northern panhandle of West Virginia. Activities such as these programs and my ongoing meetings with community bankers provide me the opportunity to learn what's on your mind, share information, answer questions, and sometimes, correct misperceptions. It's the type of two-way communication I'm going to talk about later in my remarks that is very important. Insights from local bankers on business conditions in your communities are also important inputs as I put together my outlook for the economy.

I know that I am singing to the choir, but community banks and thrifts are a critical component of our financial system and our American economy. You provide funding to families and individuals, small and midsized businesses, and you support community development throughout Kentucky. Your detailed knowledge of your customers and close connections with your communities allows you to respond with agility to lending requests. And you get to see the results of your investments every day, as they are usually close at hand.

In my remarks today, I would like to cover three topics: First, I will talk about current economic conditions and my outlook. Second, I will discuss the challenges you and the industry are facing. Finally, I will conclude with some thoughts on actions we can take together to develop the kind of value-added relationships that we at the Federal Reserve Bank want to sustain.

Let me begin with some comments about the economy. As we all know, the recession following the financial crisis was quite long and severe. We have been digging out of a deep hole ever since the recession officially ended in June 2009, but progress has been slow and uneven. Early in 2010, and again early last year, economic growth seemed poised to accelerate, only to disappoint. The economy grew at 3 percent in 2010, and 1.7 percent in 2011. Our economy needs to grow at a rate of 2 percent just to absorb new entrants in the labor force. To repair the damage from the last few years and speed the pace of employment growth, the economy needs to grow at a faster rate.

Recent labor market data provide an example of the uneven pattern of economic activity. Employment gains picked up in January and February, holding out hopes of a similarly good report for March. However, the Bureau of Labor Statistics recently reported meager employment gains for March. The unusually warm weather of the past few months might have pulled forward some hiring that would eventually have taken place in March and April. Monthly ups and downs like these make it hard to confirm the underlying pace of job creation. On the plus side, new claims for unemployment insurance have continued to trend down, reaching their lowest level since April 2008. In addition, employment increased at a faster rate in the first three months of this year than it did in the prior three months. So it seems as though the labor market is still improving, albeit at a modest pace.

Ordinarily, as employment and work hours expand, we see consumers willing to step up their spending. In this period of economic recovery, the pace of consumer spending has been held back by the amount of balance sheet damage that households have suffered. Households lost $16 trillion in net worth from 2007 to 2009 due to declines in real estate holdings and financial assets. The financial collapse left many consumers with a lot of debt, fewer assets, and in too many cases, lower incomes. Yet, many people have made notable progress in reducing their debt, as they have paid down balances, refinanced loans, and benefited from lower interest rates. Home mortgage debt outstanding continued to decline last year, as it has since 2007. In 2007, for the entire household sector, debt amounted to 30 percent more than income—a record high. Recent readings are in the range of only 15 percent greater than income—better, but still far above the percentages we saw before the decade of the 2000s. In the 1990s, debt carried by the household sector typically amounted to 15 percent less than its disposable income.

As they have reduced various types of debt, families and individuals free up more dollars for spending and saving. Nevertheless, consumers have lost a great deal of wealth since the onset of the financial crisis, and are acting cautiously in the marketplace. One area where spending has increased is automobile sales, which have been climbing since last summer and running at a brisk pace for the past few months. One factor behind this surge is the fact that the average age of the cars and light trucks on the road has reached a record high of nearly 11 years. People are finally making up for those purchases they put off since 2008, and loan rates are attractive.

As households put themselves in a better financial position, repair their personal balance sheets, and regain confidence, the banking industry stands to benefit. You are in business to lend, and you want to make loans to creditworthy borrowers. Total loans and loan commitments across the Fourth Federal Reserve District increased about 6 percent last year. By comparison, lending fell about 2 percent in 2010. Nationally, total bank lending increased 1.4 percent in 2011. The increases have been predominantly in the commercial and industrial loan sector.

Kentucky bankers have managed their finances well during the past few years. The return on average assets for Kentucky banks was 0.86 percent last year, outperforming the national average of 0.72 percent. This better performance was due to a slightly stronger net interest margin and lower levels of charge-offs compared with the national averages. Kentucky banks have also been able to maintain comparable levels of capital when compared with national averages, while paying out dividends at levels slightly above the national average. No Kentucky bank has failed in the past few years.[1]

Despite some evidence of progress in the labor markets, household finances, and banking conditions, the economy still faces a number of headwinds. Housing markets are still in distress throughout much of the country; state and local governments are still in the process of adjusting to budget pressures; and rising gasoline prices are likely to restrain household spending. Furthermore, strains in European financial markets continue to pose downside risks. For all of these reasons, businesses and households remain cautious about the future.

Let me comment briefly on my outlook for the economy and inflation, because my outlook is central to my views on monetary policy and ultimately to how I vote at the Federal Open Market Committee meetings. In fact, we'll be meeting again next week. Obviously there are a lot of forces shaping the economic landscape, and many factors to consider in constructing an economic forecast. I expect the economy to grow at a moderate rate of 2-1/2 percent this year, followed by a slight pickup to around 3 percent next year. At the pace of growth I am anticipating, it could take as long as four or five years for the unemployment rate to fall to the 6 percent rate that I judge to be consistent with maximum employment.

Inflation as measured by the Federal Reserve's chosen yardstick, the personal consumption expenditure (PCE) price index, has averaged 1.5 percent over the past three years. On a monthly basis, of course, inflation can be volatile because some prices can rise or fall quite a bit in any given month or quarter. Sharp movements in the prices of items such as gasoline and food products can either temporarily boost or depress the overall inflation rate. While sharp movements in particular components of the index can help or hurt consumers' budgets in the short term, these temporary movements can be misleading signals of where inflation is heading over an extended period of time.

At the Cleveland Fed, researchers have developed a measure of the underlying inflation rate, called the median CPI, which is a better predictor of inflation. This measure looks at the price change that's right in the middle of the long list of individual price changes. I also pay close attention to other factors that could affect my inflation outlook, such as labor costs. They too, are subdued. Finally, my staff's estimate of inflation expectations indicates that financial market participants expect inflation to remain below 2 percent for quite a while. Based on all the information I consider, my outlook is for inflation to remain close to 2 percent on average for the next few years. Still, if gasoline prices continue to climb, that could complicate the inflation picture.

The good news is that the economy is displaying forward momentum. The banking industry is healthier than it has been in several years. Much of the harm caused by the severe recession is being repaired. If our economy were a Kentucky thoroughbred, I'd say we have moved from a walk to a trot, but we're far from a gallop. The pace of growth is still frustratingly slow, and in a slow-growth economy, it is all the more difficult to generate the confidence that encourages people to expand their businesses, buy homes, and invest in activities that lead to more jobs, rising incomes, and reinvigorated communities.

This slow-growing economy is creating some challenges for everyone, including community bankers. The team at my bank responsible for bank supervision has identified four challenges facing community bankers today.

First, in the current low-growth, intensely competitive environment, community bankers are trying to enhance and diversify earnings. The drive to diversify into new products or business lines often requires new expertise and infrastructure changes. To be successful, as you all know, it is important to move systematically and carefully into new areas, and to maintain appropriate risk-management practices.

A second challenge is capital planning. Community banks want to attract capital to expand or improve financial ratios, or pay back

TARP investments, but often they are constrained by market conditions and limited investor demand in the sector.

A third challenge is managing interest-rate risk effectively. As you navigate through the extremely low interest-rate environment, it is important to be wary of chasing higher yields with longer-term loans and investments.

And finally, a fourth challenge is management succession at both the senior management and board of director levels. The aging workforce and the fact that management teams have been in place for some time at many banks is prompting more discussions around succession, recruitment, and internal development of new leaders. Today's more complex banking environment requires a broader set of management skills. Sometimes that background can be acquired through training, development, and internal succession planning. Sometimes, it requires recruiting a seasoned banker to a new community.

These are some of the challenges that my supervisory team has highlighted, but I know from my conversations with bankers that you would add to the list the challenges of regulatory burden and more specifically, the Dodd-Frank legislation. I want to emphasize that Dodd-Frank is aimed principally at large, complex banks. The majority of the provisions of the legislation do not affect community banks, that is, those with under $10 billion in assets. You should expect regulatory changes coming out of Dodd-Frank to affect the nation's most complex financial services organizations to a much greater degree than community banks. Importantly, Dodd-Frank also aims to improve regulatory oversight of many non-bank financial institutions that today are not subject to regulations that commercial banks face. It will help level the playing field, which I also know is a topic that is on your minds. That said, I understand that coping with the unintended consequences of new regulations can be a cause for worry for community bankers.

Let me turn to one more challenge that bankers periodically cite: the bank examination process. Specifically, some community bankers have told me that as new supervisory standards are developed for large and complex institutions, they have a tendency to "trickle down" to community banks.

Our approach to supervising banking organizations is that supervision should be commensurate with the size, complexity, and riskiness of banking organizations. One size does not fit all. This has been a long-held viewpoint of the Federal Reserve Bank of Cleveland, and one that is shared across the Federal Reserve System. We refer to it as "risk-based supervision."

Generally speaking, the risks posed by community banks are much less significant than risks posed by larger, more complex banking organizations. As such, community banks are subject to a much different supervision program than regional banking organizations, for example. These differences would include the frequency, depth and duration of exams; the number of examiners involved; and the extent of their requests for data and information.

Another aspect of the exam process that I hear about from bankers is that at times, examiners are not clear or consistent in the way they communicate. I'm not surprised that, periodically, disagreements will emerge during an exam. By that I mean that informed people can sometimes draw different conclusions from the same set of facts. It's okay to disagree, but it's not okay if you don't understand how the examiners arrived at their conclusions. We want to know of situations where you have concerns, or need more information or clarity. We appreciate your feedback, and act on it.

Let me share a couple of examples to illustrate this point. About a year ago, I became aware that some bankers felt that the supervisors were discouraging them from lending. To be blunt, some bankers were outspoken in their belief that supervisors were being overly harsh in evaluating small business loans. This concerned us at the Federal Reserve Bank of Cleveland, and to learn more, we worked with the Ohio Bankers League to survey bankers on the topic of small business lending. 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. Some of those we reached out to were Kentucky bankers.

Based on their responses, the bankers who participated in the interviews could 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 had become intensely cautious about lending even when they felt borrowers were creditworthy. The feedback from this group is what concerned me most.

With this more complete insight into the issue, we discussed the interview results with our supervision staff at the Federal Reserve Bank of Cleveland to remind them about the importance of frequent, clear, and open communication during the exam process. The message here goes both ways: We need bankers to ask questions about findings they don't understand, findings they disagree with, or rumors they are hearing from other bankers. And we expect our examiners to provide factual support for their supervisory findings.

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. This highlights the importance of ongoing and candid communications between bankers and supervisors to ensure that we prevent any miscommunications or unintended messages from hindering the operations of your banks.

Another very recent example of the importance of active two-way communication relates to feedback received by a community banker after an examination. A banker told us that as a result of his most recent exam, he believed that his institution would be expected to conduct stress testing, not unlike those of the nation’s largest financial institutions. This was not true, and we were able to quickly correct the misunderstanding, which was based on the general use of the term "stress test," which now holds a very specific meaning to bankers as a result of the recent tests conducted on the largest financial services institutions in our country. Fortunately, the banker did not hesitate to share his concerns with us, and we were able to get down to the bottom of the miscommunication.

So my appeal to you is that we actively practice more two-way communication, before, during, and after exams. Our supervisory staff is being encouraged to gather information and to listen. Please tell us your concerns, and keep the dialogue open - and please know that we are committed to do the same.

The Federal Reserve Bank of Cleveland has the long-held view that the supervisory process should add value to the banks we supervise, and this can be more effectively accomplished through ongoing and proactive communication. I am very proud to say that the Federal Reserve Bank of Cleveland, in the early 1990s, was the first among regulatory agencies to coin the phrase "value-added supervision" as the philosophy behind the practices we have adopted in supervising banking organizations. We want to be part of solutions, not create new problems. I recognize this is a culture shift from the "gotcha" approach to supervision that some may perceive from the past. But I want you to know this "value-added supervision" is the culture I believe is most effective in the long run, and sustaining and building on it requires your involvement, too.

Ultimately, some degree of judgment will always be a part of the examination process, particularly in those areas that are grey, as opposed to black-and-white. Examiners must be wise and consistent in their criticisms and direction, and bankers equally thoughtful and diligent in their decision-making. The point is that it is exactly in these intersections where judgment is needed most where we must communicate most effectively, because the costs of poor judgment, by either examiner or banker, can be harmful.

This again highlights the importance of open communication, both in the supervisory process, and as it relates to the development of rules and regulations that implement laws such as the Dodd-Frank Act. It is critical that we maintain the dialogue between our community banks and the Federal Reserve so that we can bring a balanced perspective to formulating regulations and developing supervisory approaches that are appropriate for community banking organizations. We have developed several ways to hear from community bankers across the Fourth District.

First, our Community Depository Institutions Advisory Council, or CDIAC, meets twice a year to discuss issues of relevance and concern to community banking organizations. I also hold small-group sessions around the District to give me a chance to talk candidly with community bankers in an informal setting that is more conducive to discussion. And, of course, we have community bankers on the Board of Directors of our Bank in Cleveland, as well as on the boards of our Cincinnati and Pittsburgh branch offices. The Federal Reserve Bank of St. Louis has similar programs.

Before I turn to your questions, let me close by saying that we want banks to make decisions that are in their long-term best interests. Our goals are aligned with yours. Community banks should meet the credit needs of your customers and communities, operate in a safe and sound manner, and be profitable. By achieving these shared objectives, I believe that bankers will also maximize shareholder value.

Some regulatory and supervisory burdens will always exist. The challenge is to strike the proper balance where regulations and supervision are commensurate with the complexity and riskiness of banking organizations. Although judgments will be made, our goal is to add value. I believe this approach to supervision requires more intentional and active communication from both sides.

We are navigating through what is likely the most challenging period for most of us in our lifetimes. There has been significant progress. We can't change the events that have transpired, but we can commit to listening, acting, and building a stronger banking system and supporting our country's recovery.

---

1. A Kentucky-based thrift subsidiary of an Indiana banking organization was closed by the Office of Thrift Supervision in 2009.