

Community Bank Regulation: Intent vs. Reality

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

It is a pleasure to be invited to participate in today's conference. The Kansas City Fed's seven-state district is home to some 900 banks with less than \$1 billion of assets, which is 17 percent of the nation's small banks. With combined assets of about \$150 billion, these banks represent just 1 percent of total industry assets. However, size comparisons understate their important contribution to the regional and national economy.

Community banks in our region help finance farmers who contribute to 12 percent of the nation's agricultural output as well as oil and gas businesses that account for 16 percent of domestic energy output. These banks also are particularly critical for homeowners and business operators in rural areas because of their willingness to meet the demand for tailored, nonstandard mortgages and for small business loans.

There are more than 5,000 such banks in the United States. As the national economy strengthens, community banks are prepared to resume their important role in their communities and the broader economy. However, they argue that the regulatory environment has thrown sand in the gears of efficiently and competitively meeting the credit needs of their communities.

Four years ago, the regulatory reform known as the Dodd-Frank Act (DFA) was passed. With its aim squarely focused on addressing the supervision and regulation of the largest financial institutions, the law and its architects acknowledged that small banks were neither the cause of the crisis nor the target of reforms. And to that end, the DFA expressly exempted small banks from its reach. So, why since then have community banks increasingly become concerned and vocal about regulatory burden as a threat to their ability to serve the credit needs of their communities and, ultimately, to their viability?

This growing chorus of concern and frustration about regulatory burden has gotten the attention of policymakers and regulators. Federal banking regulators all agree that calibrating

supervision for community banks is appropriate and important, and they express genuine sympathy for the need to apply the right balance to the supervision and regulation of small banks.

Yet, in spite of legislators' and regulators' best intentions, customers and communities that rely on smaller banks for access to credit are feeling the weight of regulatory burden, and bankers are pleading for relief. Industry advocates have identified a number of specific remedies, and efforts are underway to consider how they might be implemented. For its part, the Federal Reserve has likewise expressed its commitment to a deeper understanding of these issues, including its partnership with the Conference of State Bank Supervisors in this forum today. I commend such efforts and look forward to the research insights and other learning from this program.

In my remarks today, I will offer my own views on the regulatory burden dilemma facing small banks, their regulators and legislators, and why it is proving to be so difficult to address in a meaningful way. I will also offer my perspective on a way forward to ensure that regulation retains its objectives for public interest and the safety of the banking system. Before going further, I need to note that my comments today are my views only and not those of the Federal Reserve System or its Board of Governors, which is charged with bank regulation responsibilities.

The aim of regulation

The aim of bank regulation in the United States is both to protect the public and foster an efficient competitive banking system. Similar to the backdrop for the DFA, much of the U.S. regulatory system developed in response to financial crises and other events.

Generally speaking, bank regulation is designed to protect depositors, ensure monetary and financial stability, provide for an efficient and competitive financial system and protect consumers. It is not intended to keep banks from failing or to hinder banks from taking risks in meeting the needs of their customers and efficiently allocating credit.¹

Striking an appropriate balance between regulation, banking and policy has always been a struggle. In that regard, today's environment is no different. Tension has long existed between allowing banks sufficient flexibility to adapt to a rapidly changing environment while maintaining a regulatory framework that ensures financial stability and adequate consumer protection.

Getting that balance right is critical. History offers any number of examples of well-intended regulation resulting in unintended outcomes. For example, the 1999 Gramm-Leach-Bliley Act that allowed banking organizations to expand into nonbank financial activities aimed to allow banks to diversify and reduce risk. Instead, as we learned from the financial crisis, substantial increases in risk-taking, leverage and business-model complexity increased financial fragility.

Likewise, the Basel capital requirements allowed the largest banks to use internal models to calculate their own risk weights for risk-based capital requirements, in part, "to build upon and further encourage investments banks are already making in their internal risk management systems."² While the intent was to improve risk management and better align capital ratios with portfolio risk, the result was regulatory arbitrage and leverage ratios that proved inadequate relative to the risks that many of the largest banks took leading into the crisis.

¹ For an in-depth review of the purposes of bank regulation as well as what bank regulation is not intended to do, see Kenneth Spong, *Banking Regulation: Its Purposes, Implementation, and Effects*, Federal Reserve Bank of Kansas City, 2000.

² See William J. McDonough, "Implementing the New Basel Accord," remarks to the Global Association of Risk Professionals, Feb. 11, 2003.

Getting the right balance for banking regulation is not easy. Legislators and regulators face the growing challenge of regulating an industry that over the past three decades has become highly concentrated and engaged in activities that range from traditional lending to complex finance. While commercial banks of all sizes benefit from public safety nets, the operating models, activities, and risk profiles they employ vary widely. Indeed, community banks are not smaller versions of the country's largest banks. If our regulatory apparatus is going to effectively meet its aims, policymakers must understand how these commercial banking business models operate and why a locally-owned community bank is not the same as a branch of a systemically important financial institution in meeting the credit needs of the local community.

Understanding relationship banking

The community bank business model is often described as relationship banking. Community bankers typically have long-term, direct relationships with their customers that provide the detailed knowledge about their character, reputation and history. This is necessary to make informed, qualitative assessments about credit quality. These relationships allow community banks to tailor loans and other services to their customers.

Many community banks also are closely held institutions with the top management and board members having significant ownership positions. These ownership incentives shape the bank's culture and help to ensure that its key policymakers are focused on achieving good performance, avoiding excessive risk-taking, and supporting the health of their communities. Studies by staff at our Reserve Bank on ownership and management structure find that the

better-performing and safer community banks are those where the major decision makers have much to lose if they do not make the right decisions.³

I often hear that such a business model is becoming less economical in a world that is fast paced and increasingly transactions-based. However, research from our Reserve Bank presented here at last year's conference shows there is real value in relationship lending and in the soft personal information on customers that community bankers typically have.⁴ This business model is one in which the incentives of banks are aligned with outcomes that benefit their customers and the economy. When incentives are aligned in this way, the need for an "ability to repay" rule, for example, seems unnecessary.

Another defining feature of community banking is its business model transparency. Traditional bank lending is inherently opaque because it is based on the inside, non-public information that bankers gain from their relationships with borrowers, but the business model need not be opaque. In contrast to the largest banks, community bank shareholders, creditors, customers and regulators find it relatively easy to monitor and verify risks. Management oversight and market discipline are much more effective with such a transparent business model. Employees know what is expected; regulators are better able to thoroughly examine the bank, identify risks and recommend appropriate corrective actions as needed.

Finally, to understand the community bank business model is to understand that failure is an option when risks are poorly managed. This feature offers a powerful incentive to manage risk. To be sure, community banks don't always get it right, and history points to their failures,

³ Robert DeYoung, Kenneth Spong, Richard J. Sullivan, "Who's Minding the Store? Motivating and Monitoring Hired Managers at Small, Closely held Commercial Banks," *Journal of Banking and Finance*, July 2001, pp. 1209-1243; and Richard J. Sullivan and Kenneth R. Spong, "Manager Wealth Concentration, Ownership Structure, and Risk in Commercial Banks," *Journal of Financial Intermediation*, April 2007, pp. 229-248.

⁴ See "Small Business Lending and Social Capital: Are Rural Relationships Different?" Robert DeYoung, Dennis Glennon, Peter Nigro, Kenneth Spong, presented at Community Banking in the 21st Century: A Community Banking Research and Policy Conference, October 2-3, 2013.

especially during past periods of financial stress. Fortunately, an efficient resolution process is available to minimize the cost to their communities and customers, maintain essential banking services and retain public confidence.

The reality of the current regulatory environment

The business model of community banks no longer dominates the commercial banking industry. Regulation has expanded to address the size, concentration and complexity of the largest banks. Unfortunately, it also has impinged on thousands of community and regional banks.

The issue is whether we can effectively achieve desired outcomes for all commercial banks under the current regulatory framework, or whether we will try to further bifurcate the system with separate rules for the largest banks and community banks. We face a decision about the path forward. Based on my own experience, I would offer three observations about the nature of today's regulatory environment that weigh most heavily on community banks in the interest of framing potential remedies.

My first observation is that the rules are increasingly prescriptive and complex. In a global market for finance and commerce, regulators have responded to a larger, more concentrated and complex banking industry with more complicated rules. However, the value of this complexity is questionable. In the case of capital rules—a key component of regulation and bank safety—recent empirical and theoretical research shows that simpler capital rules are better. For example, researchers at the Bank of England and Organisation for Economic Cooperation and Development have shown that simple leverage ratios are better than risk-based ratios in

predicting default.⁵ Researchers at the Bank of England also have shown that theoretically complicated rules can lead to worse results when granular measures of asset risk do not account for correlations among a bank's asset portfolio or when models attempt to estimate risk parameters for risks that are unknowable.⁶

Long before Basel III was adopted, community banks were considered well capitalized and their risks well understood. They remain so today. For example, banks with less than \$1 billion of assets had a Tier 1 leverage ratio of 9.5 percent in 1996, and today it is 10.5 percent. Even so, community banks must adopt the more complicated capital rules with finer degrees of risk weights and capital buffers. The risk-weighted asset schedule of the call report has 57 rows and 89 pages of instructions yet no additional capital was required for the majority of community banks.

In addition to the higher compliance costs associated with these capital rules, community banks continue to hold higher levels of capital than the largest banks. Unless and until the largest banks achieve commensurate levels of capital (inclusive of their off-balance-sheet assets), they retain a capital-ratio advantage over community and regional banks that is far more powerful than the funding cost subsidy confirmed in a recent Government Accountability Office study.

My second observation is that regulation and supervisory frameworks have evolved with far less reliance on examiner experience and supervisory judgment and more emphasis on data-driven, econometric models and measurement to produce a more systematic, objective and

⁵ See Andrew Haldane, "Constraining Discretion in Bank Regulation," Federal Reserve Bank of Atlanta Conference on "Maintaining Financial Stability: Holding a Tiger by the Tail(s)," April 9, 2013; and Adrian Blundell-Wignall, Paul Atkinson, and Caroline Roulet, "Bank Business Models and the Basel System: Complexity and Interconnectedness," *OECD Journal: Financial Market Trends*, Vol. 2014 – Issue 2.

⁶ See Andrew Haldane in note 5 and David Aikman, Mirta Galesic, Gerd Gigerenzer, Sujit Kapadia, Konstantinos Katsikopoulos, Amit Kothiyal, Emma Murphy, and Tobias Neumann, "Taking Uncertainty Seriously: Simplicity Versus Complexity in Financial Regulation," Financial Stability Paper No. 28, Bank of England, May 2014.

standardized approach to supervision. For the enhanced supervision of the country's largest banks, this approach has been considered highly successful, for example, in making assessments about capital adequacy under stress test scenarios. However, for community bank supervision, the substitution of rigid rules for examiner judgment has altered the supervisory process without adding value and has instead created higher costs of compliance.

Appraisal requirements have been cited as an example in this regard. Over the last two decades, the required use of appraisals has expanded in response to the 1990s savings and loans crisis and the 2008 financial crisis. For real estate in larger metropolitan areas, market values can be readily determined. For real estate in smaller communities, especially rural communities, there may in fact be no "objective" market price. Despite this difference, appraisal regulation is rigid and restricts the kind of judgment-based lending that facilitates lending to small businesses and individuals in rural and other small community markets.

My third observation is related to the nature of consumer compliance regulation, and here I worry the pendulum has swung too far. To be sure, regulation has an important role to play in consumer protection and fair access to credit. Those protections should not be diluted, especially for banks that rely on model-based consumer lending. However, for banks that depend on relationship lending with customized terms and conditions, the regulations and the focus on identifying specific undesirable products seems to run counter to the requisite subjectivity that underlies the strengths of community bank lending. Mortgage lending, UDAAP (Unfair, Deceptive, or Abusive Acts or Practices), CRA (Community Reinvestment Act) and fair lending must not only protect consumers from bad actors, but allow consumers to be served where subjectivity is required. Unfortunately, I frequently hear community bankers expressing concern that compliance reviews have taken a more prosecutorial tone. As one banker noted, these

reviews have forced bank customers to prove they aren't crooks and bankers to prove to regulators that they aren't deceptive and unfair.

Moving forward

In making these observations, I share the desire on the part of both bankers and regulators to find meaningful solutions. Community banks have become entangled in a web of reforms intended to address the risks in the largest banks. These reforms respond to a business model employed by a few large, globally active banks, but have created spillovers for community banks. Although it is enticing to contemplate the construction of separate rules and frameworks that reflect these different business models and risks, commercial banks of all sizes remain beneficiaries of a public safety net. For that reason, I believe community banks have a vested interest in seeing that regulatory reforms move ahead to ensure that the largest banks are well capitalized, well supervised, well managed and subject to failure. Achieving that end will serve the public well. While that work is underway, regulators must also allow examiner judgment and common sense to play a greater role in their supervisory regimes for community banks.

I'm often told that the world has become more complicated, that we have too many banks in the U.S. and that we cannot go back to less-complex and more-straightforward regulation and rules and greater supervisory judgment. I'm not convinced. One of the best responses to that assertion was from Sir Mervyn King, the former governor of the Bank of England. Although his reference was made in the context of finding a solution to the issue of too big to fail, the same might be said for addressing the regulatory environment more generally. He said, "There are those who claim that such proposals are impractical. It is hard to see why. ... What does seem impractical, however, are the current arrangements."