SPEECH

Opening Remarks at the Community Bankers’ Conference

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Introduction

Good morning. I'm Kevin Stiroh, the head of the Supervision Group here at the Federal Reserve Bank of New York. I would like to welcome all of you to today's Community Bankers' Conference, which I am sure will be a productive and informative day.

We have representatives from over 50 community and regional banks from across New York, northern New Jersey, southern Connecticut, and the Commonwealth of Puerto Rico in attendance. In addition, my colleagues from the New York Fed and the Board of Governors will offer some supervisory perspective. I'm also pleased to welcome fellow supervisors from the states of New York, New Jersey, and Connecticut, plus federal colleagues from the FDIC, the Consumer Financial Protection Bureau, and our neighboring Reserve Banks in Cleveland and Philadelphia. This may be a record in terms of attendance at this annual event.

By way of introduction, I took over my current role as head of the Supervision Group at the New York Fed in October of 2015, after spending time in our Research, Markets and Integrated Policy Analysis Groups. I also held other positions in Supervision earlier in my tenure with the Bank.

I'm an economist by training and I spent part of my career studying the performance and function of financial institutions in the U.S. There is a long and distinguished academic literature that documents the unique role of community banks and the critical impact they can have on our economy. As an economist, I'll look to the data and that literature to make three points and then draw supervisory implications.

My comments today are my own and do not necessarily represent those of the Federal Reserve Bank of New York or the Federal Reserve System.

The Role of Community Banks

First, community banks are different from large banks, and not just in terms of their size. Community banks engage in a different form of banking that is more "high touch" and more reliant on "soft information" such as lenders' subjective judgment and knowledge of local markets, and relationships with borrowers. There is considerable academic research that documents this difference in lending strategy. As specific examples, smaller banks tend to make loans over shorter distances and interact with borrowers in more personal ways than larger banks with more in-person contact rather than phone calls or email. Both findings are consistent with the idea that smaller banks leverage softer information in important ways that creates a competitive niche.

Looking at balance sheet composition also reveals important differences. At the end of 2015, for example, banks with less than $10 billion in assets held over 40 percent of loans to small businesses (defined as loans below $1 million in size), but only 19 percent of total banking system assets. By contrast, regional banks with between $10 billion and $50 billion in assets held about 10 percent of both loans to small business and banking system assets. On the liability side, there is a greater focus on core deposits that are sourced from local savers.

Taken together, these differences paint a picture of local-facing banks that rely on local-sourced funds to support local lending to small businesses.

Second, this focus on small business lending supports local economic growth. Small businesses are vital to the health of local economies, employing about half of the U.S. labor force and creating nearly two-thirds of net new private sector jobs in the U.S. each year, according to the U.S. Small Business Administration. The academic literature makes this link: more small banks lead to more small business lending and a higher survival probability for those businesses. This link is also seen internationally as countries with larger community banking sectors tend to grow faster.

Third, community banks are less likely to create systemic risk for the broader national economy or financial markets than large banks. Community banks don't have the scale, the complex business models or the balance sheet composition to create the types of fire-sale externalities or interconnectedness features that are typically associated with systemic risk or contagion among financial institutions.

I should note that there is some tension here. Community banks are essential for economic growth at the local level, yet are not considered "systemically" important for the financial system or economy as a whole. This apparent contradiction can be resolved by focusing on the appropriate unit of analysis—a community bank can be crucially important for local consumers and businesses, but less so on a national level or the financial system as a whole.

Implications for Supervision

The implication of these observations is that community banks require prudential regulation and supervision, but in a form that is different from larger institutions. This is not a new or novel insight, but one that is receiving greater attention among policymakers. "Tailoring" of expectations is now an important part of the supervisory vocabulary. Both Federal Reserve Chair Yellen and Governor Tarullo have spoken recently about the need to tailor the scope of supervision to the activities and risks of specific banks. This can include things like limiting exam length, increasing off-site supervisory activities, or enhancing our analytical tools and processes.

All of this is designed to ensure that we achieve our safety and soundness, consumer protection, and economic growth objectives in the most efficient manner in terms of the burden placed on firms, our own supervisory resources, and the impact on critical financial intermediation.

As one example of the need to focus on prudential concerns, commercial real estate (CRE) continues to be an area of focus from the supervisory perspective as evidenced in a recent interagency statement, SR 15-17, that reminded banks of existing guidance on prudent risk management for CRE. As articulated in earlier guidance, financial institutions should maintain underwriting discipline and exercise prudent risk management practices in their CRE lending activity. There is evidence, for example, that higher concentrations of CRE are positively correlated with the probability of failure for community banks. Chris Calabia, who is responsible for the supervision of community, regional, and small foreign banking organizations and consumer compliance in the Second District, will talk more about our current focus on commercial real estate and what we're seeing in terms of performance and changing concentrations later in the program.

I hope you will find this conference informative and I look forward to meeting many of you later in the day and hearing more about your views on these important topics.

Thank you for your attention.