

Elizabeth A Duke: Federal Reserve's initiatives to support minority-owned institutions

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the US Federal Reserve System, at the Minority Depository Institutions National Conference 2009, Chicago, Illinois, 9 July 2009.

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I am pleased to be with you today. These annual conferences are very important, offering essential opportunities for the banking agencies to meet with minority bankers to discuss emerging industry developments, to learn from your accomplishments and challenges, and to share our views on sound practices. They also highlight the importance that we place on promoting and ensuring the growth of minority-owned depositories.

I spent 30 years of my career as a banker, primarily as a community banker. I was, in fact, involved in two start-up banks. So for those of you who have had that experience – I have shared your pain, as well as the sense of accomplishment that comes from building an organization from scratch. I first became a community bank CEO in August 1991 when my boss and mentor died suddenly. As many of you remember, that was also a time of financial crisis. I spent my days as you may now be spending yours, struggling to maintain adequate capital and liquidity in the face of declining profitability and growing loan losses. I agonized over new-loan and loan-workout decisions affecting the small businesses that had been my customers for more than a decade. It wasn't easy to return the bank to a solid footing, and the process took years, but we made it through, as you will. The bank and its customers not only survived, they thrived.

Our survival was due in no small part to a strong working relationship, one based on mutual trust and respect, with our primary federal supervisor, the Federal Reserve. In fact, Gene Johnson, a Vice President at the Federal Reserve Bank of Richmond who is in the audience today, was a young examiner back when I was a young banker. Indeed, he was often the examiner-in-charge during those difficult years. We didn't always agree, but we always had the same objective – a safe and sound institution. Seventeen years later, in August 2008, my career in banking took a new direction when I joined the Board of Governors of the Federal Reserve System. And in this crisis I continue to believe in the importance of the working relationship between bankers and bank supervisors. You can count on me to be an advocate for the programs established by the Federal Reserve to support minority institutions.

The Federal Reserve, of course, is mainly known for its efforts in formulating the country's monetary policy. But as this group well knows, the Fed also plays an important part in the supervision of financial institutions. It has the primary rule-writing authority for many consumer protection regulations that govern a wide range of financial activities. It provides liquidity to the financial system. And, as has been seen in the current crisis, in times of financial stress the Federal Reserve joins with other government agencies to support financial stability. As community bankers, you understand how intertwined the strength of your institution is with the performance of your community's economy. The financial crisis has shown how true that is whether the economies and institutions are local, national, or even global.

I consider it my role to bring a banking perspective to the deliberations and decisions of the Board, with a hands-on understanding of the impact of public policy on banking and the impact of banking on the economy. In order to keep up with the latest issues and concerns in the banking community, I work hard to stay in close touch with bankers representing a wide range of banking markets, charters, and geographic locations. While I understand the community banking part of your business, I likely do not have a full appreciation of all the

challenges you face as minority bankers. So I am eager to hear your thoughts today and to continue the conversation in the months and years ahead.

I thought I would begin today with some of the topics that I hear about most from bankers. Then I will talk a bit about some of the efforts that have been taken to repair the financial system, with particular emphasis on the ways in which these actions might impact your banks and the broader economy. I plan to conclude by briefly discussing the current condition of minority banks and highlighting the importance of your lending activities to our economy. And then I would like to hear from you.

Community banker concerns

Overwhelmingly, the biggest concern I am hearing about these days is the public perception of banks and bankers. Clearly, the public is angry. They are angry at banks and, just as much, at bank regulators. They are angry about bailouts. They are angry about bad loans. They are angry about big salaries. They are angry because banks are not lending. And they are angry about high rates and fees.

Community bankers are angry, too. They are angry because they did not ask for or receive any bailouts. They did not make the subprime loans. They did not get the big bonuses. And they are still making every good loan they can find. But regardless of their innocence, they are paying the price for public anger at banks and are being vilified and stigmatized.

Much of the stigma has fallen especially on banks that received capital investments through the Treasury Department's Capital Purchase Program, a program established under the Troubled Asset Relief Program, or TARP, to make preferred stock investments in viable banks.

I can certainly understand your frustration with the time it took to get the details of the program finalized. Frankly, I think that everyone underestimated the complexity of offering the program to 8,000 institutions operating under many different charters and having different legal and capital structures. And I understand your discomfort with receiving capital from the government, an unusual source of equity in our banking market. I can also understand your feeling of frustration when the capital that was supposed to be a mark of strength and good health morphed into a perceived government bailout, a bailout from problems that most of you never had to begin with. And I absolutely understand your concern about losing key employees due to restrictions covering compensation policies.

And now, when some institutions are just applying for or receiving capital investments, others are applying to repay, or are actually repaying, their investments. As you make your own capital decision – whether that decision is to take the capital in the first place or to repay it – I would ask that you set aside any emotions about the process and evaluate your ability to access capital and liquidity to continue lending in your community.

Much of the financial weakness that led to establishment of the Capital Purchase Program still exists. Economic conditions are stabilizing or, where they are still deteriorating, appear to be doing so more slowly. But economic activity is still at a low level. Real estate prices are still declining. Confidence in the financial system has still not returned to pre-crisis levels. And you still may be faced with unusual opportunities for growth or unexpected challenges that may require more capital. Once you repay the TARP investment, it likely will not be available again. So, please, before you make your decision, take one more unemotional run through your projections, your assumptions, and your "what-ifs," and make sure you are comfortable with your decision. And if you have already received TARP capital, consider holding it in reserve for a little longer, at least until conditions are more favorable.

Another area of concern to some community bankers has been examination practices. While many report business as usual, others have raised concerns about overly strict asset classifications, particularly in regions experiencing substantial drops in real estate values. I

would imagine that this is a particular concern for minority banks, many of which serve economically disadvantaged neighborhoods that are being particularly hard hit in this crisis. Indeed, as the banking agencies pointed out in their November 2008 Interagency Policy Statement on Meeting the Needs of Creditworthy Borrowers, bankers and examiners need to respond realistically to recent deterioration in asset quality, but avoid overcorrecting to ensure that lending continues to flow to creditworthy borrowers.

Looking forward into the next cycle of examinations, I expect many of the priorities of Federal Reserve examiners to remain the same. But there may be some slight changes in focus. For example, examiners have for several years been paying significant attention to commercial real estate concentrations, encouraging banks to improve their management-reporting, stress-testing, and other credit-administration practices as their concentrations have increased in magnitude. Now, as examiners are seeing more and more loans secured by real estate projects that are not performing as expected, they are looking for bankers to have realistic views and to have considered the effect a change in a project's performance has on the value of its collateral. In some cases, an examiner may encourage a banker to obtain an updated valuation or appraisal of a project's supporting collateral.

In view of the strains on bank deposits in the wake of last year's bank failures and the difficulty that many banks are having in raising capital, examiners will also be redoubling their efforts at assessing liquidity and capital planning. Some liquidity and capital plans that banks had been relying on proved inadequate last year; others clearly were not sufficiently developed to address the range of contingencies that banks can face in a volatile market environment.

Compensation management systems also are under heightened scrutiny from regulators. Banks that have received TARP capital can expect to see some efforts by examiners to confirm compliance with the requirements of the Treasury Department's investment agreements. However, compensation plans for other banks will not escape attention. Banks should expect to see a growing focus on the incentives embedded in compensation plans, with examiners discouraging incentive structures that foster excessive risk-taking.

Finally, while I have talked about issues with the loans already on your books, it is especially important in this environment to be sure that you have the capacity to make – and are making – all possible loans to creditworthy borrowers. Making new loans and working out existing loans is hard work. It is even harder in stressed situations. But your deep understanding of the customers and communities you serve makes your work vitally important to this recovery.

Efforts to repair the financial system

While I will admit that many of the government initiatives aimed at easing the financial crisis have been focused on the largest institutions, I would still argue that many of these programs have recognized the importance of institutions of all sizes to a degree that I have never seen before. For example, when money market funds began experiencing runs after the Lehman bankruptcy, the Treasury immediately came out with a money market fund guarantee. After hearing from banks, especially community banks, about the risk the guarantee posed of draining uninsured deposits from the banking system, the Treasury modified the guarantee to cover only balances in place as of the date the guarantee was first announced.

Similarly, the capital available under the TARP Capital Purchase Program was made available to all institutions, regardless of size. In fact, about two-thirds of all recipients of TARP capital are community banks, demonstrating the degree to which these programs were made available to community banks.

The FDIC also initiated a number of changes to support the financial infrastructure, and community banks in particular. Deposit insurance was increased to \$250,000, something that had long been sought by community bankers. And the guarantee was recently extended to

the end of 2013. In addition, unlimited insurance was made available for demand deposits, and was modified to include IOLTA and low-interest NOW accounts. These changes have been of huge assistance to community banks and their small business customers. Moreover, the FDIC made its debt-guarantee program available to banks of all sizes. The debt-guarantee and demand-deposit-guarantee programs required joint action by the FDIC, Federal Reserve, and Treasury to invoke the systemic risk exception in the Federal Deposit Insurance Act.

In the past, systemic risk had been thought of as involving a single large institution. In the recent cases, we invoked the systemic risk exception with respect to the system as a whole, thereby allowing assistance to flow to institutions of all sizes.

For its part, the Federal Reserve has also taken steps to assist smaller institutions. For example, all banks can borrow funds under the Federal Reserve Term Auction Facility, which operates much the same as the discount window, but offers longer terms. And Regulation D was recently modified to allow community banks to earn interest on excess reserves held in bankers' banks on a pass-through basis.

So I hope that from these examples you see that the interests of community banks have been considered in many aspects of the government's effort to return financial stability.

Federal Reserve initiatives to promote the strength of minority depository institutions

Recently, the markets have shown signs of modest improvement, suggesting that government support of the financial system is having a positive effect. But the effects of the current recession continue to be seen in the financial performance of banks of all sizes and types. Indeed, some banks have not yet made their way across the "bridge to stabilization" that serves as a theme for this conference.

Like their competitors, minority depository institutions have weakened in the current environment. For example, for the full year 2008, 43 percent of the 217 minority depository institutions reported a loss, resulting in an aggregate return on assets of negative 0.16 percent. As with other banks, much of this deterioration stemmed from higher loan loss provisions, expanded noninterest expenses, and tighter net interest margins. Loan delinquencies also rose for these institutions, producing an average ratio of noncurrent loans to total loans of more than 3 percent. However, despite these pressures, minority depository institutions generally maintained sound capital positions at the end of the first quarter, with a 10.5 percent average tier 1 leverage ratio, tier 1 risk-based capital of 14.2 percent, and total risk-based capital ratio of 15.4 percent. The average reserve for loan losses reached 1.7 percent of total loans. Additional peer group statistics are available on the Federal Reserve's Partnership for Progress website at www.fedpartnership.gov.

Partnership for Progress is a Federal Reserve initiative launched last year in recognition of the importance of healthy minority depository institutions to the overall strength of communities in this country. The program seeks to promote the soundness and success of your institutions by increasing the level of technical assistance and support that we provide to minority depository institutions and de novo banks. Since the program was started, management of several state member banks and bank holding companies have contacted the Reserve Banks directly to provide helpful feedback and suggestions.

As part of the Partnership for Progress program, we have assigned dedicated contacts in each Federal Reserve District to work with minority-owned and de novo institutions. Mike Collins, the Executive Vice President in charge of Supervision at the Federal Reserve Bank of Philadelphia, who spoke with you yesterday, chairs the program on behalf of the Federal Reserve System. He works closely with a national coordinator on the Board's staff to ensure that the program is successful and provides effective and useful responses to your questions and concerns.

In December, we held the first annual meeting for the District contacts and invited several bankers to help us learn more about the challenges faced by your institutions. Drawing on the insights shared by the bankers at the meeting, we have refined our outreach efforts so that they better match the needs of your institutions. A key effort that we have completed since that meeting is the development of Federal Reserve training materials designed to help examiners understand the unique challenges faced by minority depository institutions. The training materials were recently shared with supervisory staff at a senior examiners' forum in Dallas and will soon be used in other training for examiners.

On the Community Reinvestment Act (CRA) front, the banking regulatory agencies approved Q&As in January that allow non-minority-owned banks and non-women-owned banks to receive positive CRA consideration for capital investments, loan participations, and other ventures made in cooperation with minority-owned banks, women-owned banks, or low-income credit unions. While these activities must help meet the credit needs of the local communities in which the minority-owned banks, women-owned banks, or low-income credit unions are chartered, the Q&As clarify that the activities do not also have to benefit the non-minority bank's assessment area. The Q&As apply to all types and sizes of banks, regardless of the performance test under which they are being evaluated. On June 24, the agencies announced proposed rulemaking for CRA that would codify the guidance provided in the January interagency Q&As.

In concluding, I would like to commend you for the important work that you do to support your communities. As a former banker and now as a regulator, I recognize the importance of fostering the soundness of minority-owned institutions to ensure that they can continue to provide access to credit, especially in our current economic environment.

I wish you success and would be happy to take questions at this time.