These are difficult times for many community banks, a reflection of the difficult times for the many workers and businesses across the nation who depend on the loans provided by your institutions. This morning I will address some of the problems that you currently face and offer a few thoughts about the future of community banking. Before doing so, however, I thought it would be useful to explain my perspective on the Federal Reserve’s monetary policy posture, which will obviously have great significance for the economic environment in which community banks will be operating. Specifically, I want to speak about what has become known as our “exit strategy” – that is, the means by which the Federal Reserve will bring to an end the extraordinary lending and monetary policies that it adopted in response to the financial crisis.

Planning and implementing an exit strategy

In thinking about an exit strategy, it is important to distinguish between two types of policies that the Federal Reserve adopted, beginning in 2007 and continuing thereafter, beyond its sharp reductions in the target for the federal funds rate. First, the Federal Reserve created a number of liquidity programs, which provided well-secured, mostly short-term credit to various parts of the financial system that were under increasingly severe strains. Among these were the Term Auction Facility (TAF), which auctioned short-term funds to banks; the Primary Dealer Credit Facility, which served as a backstop liquidity provider for securities firms; the Term Asset-Backed Securities Loan Facility (TALF), which was designed to help revive the market for asset-backed securities, and others.

Second, and separately, the Federal Open Market Committee (FOMC) undertook large-scale purchases of Treasury securities, agency mortgage-backed securities, and agency debt. This unconventional monetary policy action was taken because the FOMC, after having reduced short-term interest rates nearly to zero, determined that the severity of the economic downturn made additional stimulus necessary. In addition to improving conditions in mortgage markets, these asset purchases helped lower yields on long-term debt; they also substantially increased the level of reserve balances that depository institutions held with Federal Reserve Banks.

Thus, while reference is often made to a single exit strategy, there are in fact two separate objectives: One is to terminate the special liquidity facilities and otherwise normalize our activities as liquidity provider of last resort when the exceptional stresses have eased sufficiently. The other is to raise interest rates when warranted by economic conditions. Historically, the Fed has affected the level of short-term interest rates primarily by varying the supply of bank reserves. However, as I just mentioned, the Fed’s asset purchases have had the effect of putting an unusually high level of reserves into the banking system. Thus, in order to tighten monetary policy, the Fed cannot simply raise its target for the federal funds rate; it will have to take other steps to ensure that interest rates actually increase.

The first objective has now been substantially achieved. Diminished use of some of our special facilities followed the easing of liquidity stresses in the relevant markets, and led naturally to our closing those facilities. In other cases, we decided that liquidity conditions...
had improved enough that further support was not warranted and that markets should function on their own. Many of our liquidity facilities expired in February, and last month we ended the TAF and most of the TALF. All that now remains of the special liquidity facilities is the part of the TALF for loans backed by newly issued commercial mortgage-backed securities, which itself is scheduled to close on June 30. We have also restored pre-crisis practice with respect to the maximum maturity of discount window loans and have increased the rate on such loans to 50 basis points over the rate we pay on reserve balances, from the 25 basis point level that was put in place during the crisis. I would emphasize that the winding down of our emergency liquidity facilities and the normalization of the terms for discount window credit were undertaken because the recovery in financial markets suggested that they were no longer necessary. These changes were not expected to lead to tighter financial conditions for households and businesses and they did not signal any change in the outlook for the economy or for monetary policy.

As I have indicated, the second objective will likely require some innovative measures, insofar as, all else equal, the unusually high level of reserve balances would undercut efforts to raise the federal funds rate through conventional means. As Chairman Bernanke has detailed in his speeches and Congressional testimony, we have a number of tools that will allow us to accomplish this task at the appropriate time. The most important instrument is likely to be increasing the interest rate paid to banks on the reserves they hold with the Fed. Raising this rate should itself tend to raise the federal funds rate, because banks have little incentive to lend into the federal funds market at rates below what they can earn risk-free at the Fed. The efficacy of this instrument can be increased by draining reserves through the use of a number of instruments, including reverse repurchase agreements (reverse repos), term deposits for reserve balances, and, if necessary, sales of assets on our balance sheet. Thus, unlike a monetary policy action under more normal conditions, our eventual decision to raise interest rates will require a determination of the mix and sequencing of these policy tools, as well as the basic determination of when monetary tightening is appropriate.

In recent months, the Federal Reserve has been evaluating the likely effects of each of these tools. We have also successfully tested our capacity to carry out reverse repo transactions and are expanding the group of counterparties with which these transactions can be carried out. We have also been working on the development of a term deposit facility. These analytic and practical steps are obviously taking place in preparation for a change in monetary policy. But it is important to emphasize that the completion of preparatory steps need not be followed in short order by the initiation of tightening measures. The preparations for exit will allow us to move with confidence when the time is right. They do not push us toward the door. Indeed, the relatively modest pace of recovery, the continued high rate of unemployment, subdued inflation trends, and well-anchored inflation expectations together suggest that the need for highly accommodative monetary policies will not diminish soon. Of course, we should and will be attentive to new information suggesting otherwise.

As to the precise mix and sequencing of tools when the time to tighten does come, the FOMC should continue to analyze conditions and keep the public apprised of our thinking. But it seems to me neither necessary nor advisable to decide upon a single game plan that will be announced in advance and rigidly implemented after a decision is made to raise rates. Apart from the key element of raising interest rates on reserves, the optimal strategy will likely depend on the specific money market and lending conditions that prevail at the time. For instance, some circumstances might dictate the advisability of a quite rapid sequence of reserve draining and interest rate raising steps, whereas other conditions might argue for a more measured and incremental approach.

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Like many others – on and off the FOMC – I have certain predispositions in considering the question of an exit strategy. For example, I would be very cautious about any exit strategy that includes early asset sales. While we ultimately want to move our balance sheet back to a more traditional structure, the effects of such sales are very uncertain, particularly in a period before a sustainable recovery is well established. But, as with all monetary policy decisions, we should ultimately tailor the particulars of our response to the circumstances as we find them. If anything, the unprecedented nature of this exercise means that we should be unusually attuned to economic and financial conditions during, as well as before, our exit, and we should be prepared to make prudent adjustments as necessary.

Community banks today

Let me turn now more specifically to the state of community banking. Convention at the Federal Reserve defines a community banking organization as any institution with assets of $10 billion or less. Although this size-based definition correlates well with the other characteristics of community banks, such a quantitative measure doesn’t capture the full meaning of the term “community bank” or illuminate the business model behind the term.

Community banks are locally owned and focus their attention on the needs of the community and its businesses. Because they are grounded in their communities, these banks are able to provide services that are personalized, and tailored to meet local preferences and needs. Community banks transform local deposits into loans to the community where their depositors live and work. By doing this, they help to keep their local economies vital and growing.

Community banks thus epitomize the notion of relationship banking. They are better positioned than their national competitors to go beyond models and consider other factors when making credit decisions. They can often respond faster to lending requests than their national competitors because of their direct knowledge of their customers’ financing needs and debt servicing capacities.

To appreciate the importance of community banks, we need look no further than small business lending. Other than personal borrowing or credit card use by proprietors, community banks are often the only source of credit potentially available to smaller businesses. Indeed, it is precisely in this kind of lending that an exercise of judgment based on the characteristics of borrowers and local economic conditions is most likely to be significant in making decisions on creditworthiness.

Large numbers of community banks thrive in the United States operating under the model just described. But, as with all banks, the fortunes of these institutions have ebbed and flowed with economic conditions, and the number of community banks has consistently declined over the last few decades. During the current economic downturn, community banks have been particularly hard hit. During 2009, banks with assets of $10 billion or less recorded an aggregate net loss of more than $4 billion. This weak performance stemmed primarily from sustained deterioration in residential mortgages and commercial real estate loans. Loan loss provisions reached $33.0 billion, seven times the pre-crisis level of $4.5 billion recorded in 2006. Net interest margins also narrowed, squeezed by a substantial rise in nonaccruing assets, and the nonperforming assets ratio reached nearly five percent.

Almost one in every three community banks recorded a net loss last year. Moreover, only a little more than one quarter of these institutions reported a return on assets of one percent or more (a typical measure of sound earnings performance), down from 56 percent of institutions in the pre-crisis year 2006. And the FDIC problem list recently reached 702 banks and thrifts, its highest level since 1993.
The challenges for community banks

Given these circumstances, the immediate challenges for many community banks are clear. The first order of business for many will be to address concentrations and weaknesses in commercial real estate (CRE) lending activities. This will require not only rethinking credit administration practices and management information system (MIS) requirements, but also expanding loan workout expertise and disposing of acquired real estate with a minimum of additional loss. This last task could be complicated by the large volume of commercial properties expected to come onto the market as a result of failures of other banks that concentrated their lending in the commercial real estate sector. Loan writedowns and loan provisioning will also require management attention, and frequent updates of appraisals or evaluations may be required to support impairment analyses.

Coping with CRE problems will not be easy. I expect these problems to be with us for some time to come, with both direct and indirect consequences for many smaller banks. Recognizing the effect that difficult real estate conditions were having on banks’ loan quality and thereby their lending activities, last year the Federal Reserve and other banking agencies issued guidance addressing the restructuring and workout of commercial real estate loans. This policy statement set forth a framework for prudently working out commercial real estate loans and, importantly, included specific examples to guide examiners and bankers in evaluating these loans and their prospects for rehabilitation. Because many small business loans are supported by commercial real estate collateral, we hope that this guidance will not only help to alleviate undue pressures on commercial real estate markets, but also to improve the climate for small business lending.

Our guidance is not an invitation to lend and pretend. It is a commitment that Federal Reserve supervisors will not take a mechanical or reflexive approach to your management of CRE exposures that are, or soon could be, problems. If you believe that we are not implementing the terms of this guidance, please let us know and give us the details. Only with such detailed information can our senior supervisory officials at the Federal Reserve Board determine if our implementation is in fact promoting the policies set forth in last fall’s guidance.

As if the core CRE problems were not enough, community banks face other short-term challenges. While liquidity strains have eased following temporary increases in deposit insurance and the gradual stabilization of market conditions, banks will also have to bolster liquidity contingency funding planning. Some banks that relied to a significant degree on so-called noncore funding sources to grow rapidly in the run-up to the crisis may have to rework their business plans to secure more stable funding sources. Additionally, capital planning will need to be strengthened across all institutions as companies adjust to the change in market conditions and investor expectations for higher capital cushions.

Although these immediate financial challenges will, I am afraid, overwhelm quite a number of community banks this year, the vast majority will survive the present downturn. These survivors, however, will face a substantially different operating environment than they saw earlier this decade, and will need to adjust their operations to prosper over the long term.

The financial crisis was ignited far from the operations of community banks. However, we must overhaul our regulatory regime, so as better to contain systemic risk and the threats posed to the financial system by institutions perceived as too big to fail. Still, as the CRE situation graphically demonstrates, too many community banks have proven unable to manage their high concentrations of exposures. As a result, we expect bankers in the coming years to try to escape, and then avoid, high loan concentrations, regardless of loan type.

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Important as this goal is, it will not be easy to achieve for many banks. For example, one means to this end would be to operate a bank with much higher capital ratios and thereby lower concentrations. This strategy, however, would lower a bank’s returns and, while that may be manageable for a closely held bank, it would make any needed capital raises more difficult for a publicly traded community bank.

Alternatively, banks could further diversify their loan and investment portfolios, expanding into lower risk or new loan and investment segments. But this too presents difficulties. For one thing, lower risk assets have lower returns. Also, one of the reasons community banks have been so concentrated in commercial real estate loans is stiff competition for other types of loans, such as consumer installment loans, from larger banks and other nonbank competitors.

A second long-term challenge facing community banks is the secular compression in the net interest margin. Despite all of the emphasis on noninterest revenues in recent years, community banks have continued to rely heavily on spread income, indicating that many community banks have been unsuccessful in diversifying their revenue streams. The aggregate net interest margin for banks with assets of $10 billion or less has also tightened considerably as competition in the debt and lending markets has intensified, compressing by more than 70 basis points over the last 10 years to 3.63 percent. As a result, it becomes more difficult for community banks to cover their overhead, pressuring their earnings and their ability to support capital needs from internal sources.

It is possible that this declining trend in spread income could be reversed once the high level of non-accruing assets falls and if the premium charged for credit risk remains elevated once the current crisis has passed. Smaller banks may also find that they are able to win good, solid business away from their national competitors, if customers turn away from large banks as a consequence of the crisis. But community banks cannot count on this happening.

As a result, some banks may reach further out on the risk spectrum to relieve earnings pressures. We have seen these actions in the past, for example, when banks have engaged in ill-conceived investment securities leveraging programs or entered the subprime credit card market to expand their income. Others may be tempted to cut back on critical risk-management infrastructure, such as loan review, to pare expenses and enhance returns. Some may also simply pull back from market pricing if they think it is too thin and accept a lower return.

Regardless of the course of action you pursue, you will confront risk and reward trade-offs that will fundamentally affect the financial condition and performance, and ultimately safety and soundness, of your banks. I cannot emphasize enough the importance of being attentive to the implications of changes in your business activities for your risk levels. Far more often than you might expect, we encounter banks that have not adequately thought through the potential risks of a new business line or lending product and that later suffer adverse financial consequences.

Conclusion

In closing, let me say how encouraged I am that, despite your struggles in the current economic environment, most community banks remain sound and profitable. In a sense, the lessons from the financial crisis are paradoxical. On the one hand, the crisis has underscored the importance of a strong community banking system to the health of local economies around the country, particularly in keeping credit flowing to small businesses. On the other hand, the crisis and its aftermath will work changes, some painful, in all parts of our financial

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3 On average, during the five years ending December 31, 2004, community banks generated 32 percent of their revenue from noninterest-based sources. For the most recent five years ending December 31, 2009, the average contribution of noninterest income to total revenues was even lower, at 27 percent.
system, including those involving community banks. My concluding thought is that it is not too soon to begin considering your strategy in light of these changes.