Narayana Kocherlakota: The current and future state of community banking

Speech by Mr Narayana Kocherlakota, President of the Federal Reserve Bank of Minneapolis, to the Independent Community Bankers of Minnesota, Brainerd, Minnesota, 15 August 2014.

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I want to thank Marshall and other ICBM officers and members for inviting me to your annual conference. I appreciate the opportunity to share my views on community banking with all of you, but just as importantly, I look forward to your questions and our discussion following my talk. Today I will talk mainly about the state of community banking, especially here in Minnesota, and I will conclude with some thoughts on the country's economic performance. Before I begin, just a reminder that the following views are my own and not necessarily those of my Federal Reserve colleagues.

This pairing of community banking and economic performance is natural and important. What happens in Main Street credit markets has a significant influence on the broader economy. Community banks are an essential credit provider for Main Street. Community banks have the skills and knowledge to evaluate borrowers who, because of their size, activity or location, are relatively costly for an outside firm to evaluate. As a result, community banks facilitate beneficial economic activity that would not otherwise take place. The individuals and businesses receiving credit from your banks are key components in both local and national economies; they produce valuable output and provide numerous jobs. As I will describe later, these are central concerns of the Federal Reserve as we seek to promote maximum employment and price stability.

I will make my four main points on the state of community banking.

- Community bank recovery from the financial crisis has been strong with regard to asset quality, but earnings and loan growth have lagged.
- Lagging earnings and loans have raised questions about the cost of new, post-crisis supervision and regulation.
- Low earnings and higher regulatory costs have also raised concerns about community bank consolidation and its potential acceleration.
- In response to these concerns and as a matter of prudent public policy, I strongly support "tailoring" supervision and regulation to reflect the risks and roles of community banks.

I will now describe these issues in more detail.

Community bank conditions

Community banks in Minnesota and the nation experienced a very sharp increase in problem loans during the financial crisis. Fortunately, that trend has now reversed.

Consider a standard measure of problem loans: the ratio of noncurrent and delinquent loans to bank capital and the allowance for loan loss. In the first quarter of 2009, that ratio rose for all loans to 24 percent for the median Minnesota bank, double the 25-year median level of 12 percent. For commercial real estate loans, the problem loan ratio rose to about 9 percent, nine times higher than the 20-year median of 1 percent.

The problem loan story has changed completely. The ratio for total loans is at 9.5 percent for the median Minnesota bank, right around the 25-year low. And the ratio for problem commercial real estate loans for the median Minnesota bank is at 2 percent and rapidly returning to pre-crisis levels. These same general patterns hold for the nation's banks.

The low earnings and negative loan growth for the median Minnesota bank have also improved, but not yet to pre-crisis levels. Return on average assets, a standard measure of profitability, has been holding very steady for the past several years at just below 1 percent. This is clearly better than the trough of 0.5 percent during the crisis. But the 20-year median is 1.15 percent. Currently, the return on average assets of the median Minnesota bank is at 0.94 percent, which is at the 19th percentile for the past 20 years.

Year-over-year net loan growth for the Minnesota median bank is at 4.6 percent. Again, this is much better than the –4.7 percent crisis trough; indeed, negative growth persisted through the end of 2012. But the 25-year median is nearly 6 percent for Minnesota banks, while 4.6 percent is at the 39th percentile. The nation's banks show similar general patterns.

So, yes, there has been recovery in important ways for community banks in the state. But other important measures continue to lag historical norms more than five years after crisis depths. This weaker-than-hoped-for performance is one factor raising concerns for community banks about the additional supervision and regulation burden that faces them post-crisis. I'd like to turn to those concerns now.

Post-financial crisis supervision and regulation of community banks

Low earnings levels have many potential sources. Let me mention three. First, on the revenue side, weak loan growth naturally leads to more competition for available loans and drives down returns. Second, if banks can't make more loans, they typically replace loans going off their books with securities. But securities usually earn less than loans, lowering bank returns. Finally, interest rates are at very low levels, and that compresses bank margins.

Higher costs can also reduce bank earnings, and it is clear that the costs of complying with bank regulation and supervision are increasing. Since the financial crisis, and the 2010 Dodd-Frank Act, supervision of community banks and the entire banking sector has become more intense. This is not a transitory change reflecting weak asset quality. Instead, supervisors have recalibrated risk management expectations broadly for community banks. I see higher expectations continuing to spread across bank operations. Meeting these expectations will increase bank costs.

To what extent has additional supervision and regulation raised costs, reduced earnings and shrunk profits? This is difficult to answer with precision, but analysis at the Minneapolis Fed indicates that reductions to profitability could be material, particularly for the smallest community banks. Our estimates suggest, for example, that the median reduction in return on assets for banks with less than $50 million in assets would be 14 basis points if they need to increase staff by half a person, and 45 basis points if by two employees.[1]

Reduced returns on assets can encourage capital to flow from the banking industry. And, indeed, bankers routinely raise concerns with me about the potential for more regulation to drive consolidation in the industry, a topic to which I now turn.

[1] These examples reflect a baseline scenario with a fixed set of key assumptions detailed on our website. The impact of new regulatory costs in our model includes the hiring of additional staff, which results in higher total compensation and lower profitability. We then analyze the changes in the distribution of community bank profitability.

Community bank consolidation

The number of community banks in Minnesota has been falling for some time. There were 341 banks chartered in Minnesota as of the first quarter of 2014, down from a peak of 760 in 1980. As noted, many are concerned that the rate of decline will rise as increased supervision and regulation depresses earnings. Many bankers also tell me about intangible costs, arguing that some new compliance requirements distract from serving customers. These soft costs could also drive bankers to exit the industry.

My concern is with the public policy aspect of this matter. It is possible that the evolution of information technology may have increased the returns to scale in banking. As a society, we should expect and indeed welcome consolidation as a response to this natural economic force. But there *is* a policy concern if negative benefit/cost regulation or supervision drives out banks that would otherwise effectively serve customers.

To help determine if new regulations and supervision introduced since the financial crisis have led to more rapid consolidation, the Minneapolis Fed is estimating future consolidation of banks in the United States and Ninth District states based on historical trends. If consolidation exceeds projected rates, that might suggest that new supervision and regulation has changed the dynamics of banking. So far, however, the rate of recent consolidation of Minnesota community banks has been consistent with historical patterns. We continue to monitor consolidation rates relative to forecasts in order to be able to detect changes that are not readily attributable to technological forces. Our website contains quarterly updates of these forecasts.

But both bankers and policymakers are concerned about the long-term health of community banking, not just next year's numbers. How many community banks will exist in 10 years? Of course, I cannot answer this question with certainty, but I can offer a few perspectives. If historical patterns continue, the number will fall considerably. There will be just 263 banks in Minnesota in 2024, a 23 percent decline from 341 currently, assuming that consolidation over the next 10 years continues the trend seen over the past 30. Or we could assume a slower rate of consolidation, like the 14 percent decline from 1995 to 2005. That would put the number at 293 community banks 10 years from now.

This is an admittedly crude modeling approach. We have also constructed a more elaborate statistical model of the potential long-run decline in the number of banks in Minnesota. Our statistical model is based on the historical movement of banks into, and out of, different asset groupings. Some banks get larger and move from one size bucket to another, while other banks exit the industry altogether. This transitional model – which we use to forecast the number of banks in Minnesota one year out on our website – suggests that the number of banks in the state will fall to 282 in 10 years.

I've discussed three different estimates. They all predict that the number of banks in Minnesota will fall sharply over the next 10 years – from the current 341 to a number in the high 200s. By way of comparison, the median decline in the number of banks for all states across all 10-year periods since 1985 is 25 percent, a bit higher than some of the estimates we provided.

To be clear, these forecasts are only estimates. They should be interpreted accordingly. The actual number of banks may turn out to be smaller – or, indeed, it might turn out be larger.

Tailoring community bank supervision

I've already noted that it is a matter of considerable public policy concern if regulations, not market forces, are important causes of bank consolidation. Federal Reserve policymakers have recently discussed how better tailoring of supervision and regulation to community banks can be helpful in reducing the extent of this problem.[2] The Federal Reserve does some tailoring already, but I think we should do more. I'll mention two examples of the kind of tailoring that I have in mind. I'll then turn to two additional steps we might consider.

On safety and soundness, the Federal Reserve and other agencies received excellent comments from community banks on the Basel III proposal. These comments led to changes to the proposed rule that reduce unnecessary burdens on smaller banks.[3] Smaller banks can opt out from having their capital levels vary due to changes in particularly volatile aspects of income. The final rule also allows smaller institutions to continue to count certain types of stock or securities as capital, when larger banks cannot. I think the rule-making process worked well in this instance. Issuing a preliminary rule and receiving comments from bankers allowed the final regulation to better address the actual risks posed by community banks.

On the consumer side, the Federal Reserve has moved to a more risk-focused exam process, from the less flexible previous approach. The new framework allows our examiners to better tailor their exams to the consumer risks that a particular bank may actually pose. Many banks that the Minneapolis Fed supervises do not engage in activities that pose a high risk to consumer protection. And many also have a strong, documented record of compliance and relatively little change in operations. Under the new framework, examiners can more readily eliminate certain areas of review.

The benefits of the new consumer program go beyond a more focused scope. The new framework encourages more of our supervisory work to occur off-site, thereby reducing the on-site burden we put on community banks. At the same time, where there are potentially risky activities, the new framework allows for a deeper dive.

In sum, I think the new consumer exam framework epitomizes the tailoring we need. It's based on an analytical approach aimed at improving supervision, and it also captures institution-specific details where appropriate.

Where can we engage in additional tailoring? Governor Daniel Tarullo has noted potential benefits in reviewing statutes that apply new regulations to all banks. Community banks may not create the risks that a specific regulation addresses. In that vein, he noted the so-called Volcker rule and Dodd-Frank incentive compensation requirements. I strongly agree with Governor Tarullo's point that Congress and supervisors should exempt all community banks from certain regulations. Exempting is the best way to guard against regulatory trickle-down.

A second fruitful approach to additional tailoring concerns supervision, not regulation. I worry that our current supervisory methods establish expectations that are too detailed across too many areas of bank operations and too wide a swath of banks. Alternatively, supervisors could concentrate on a smaller number of activities that we believe are correlated with bad outcomes. To be specific, supervisors could choose to focus on rapid loan growth, high lending concentrations, specific high-risk types of lending and wholesale funding strategies and skip some of the more detailed reviews. This shift in focus might generate higher returns to society, in terms of improved safety and soundness per dollar spent, than detailed work programs. To be clear: I'm suggesting a tailored approach, and so supervisors could retain the more comprehensive, proscriptive approach for larger, systemically important banks.

I offer these ideas not as final prescriptions, but in the spirit of open inquiry. My main point is that we need to further investigate ways to tailor the supervision and regulation of community banks. For the remainder of my remarks, I will turn my attention to the country's economic performance.

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2 Chair Janet Yellen, Governor Daniel Tarullo and President Dennis Lockhart have all spoken to this issue in recent months.

3 See the Summer 2013 *Central Banker*.

Brief economic review

However, don't worry – I won't have as much to say about the state of the economy as I did about community banking. I'm a member of the Federal Open Market Committee – the FOMC – and, as a monetary policymaker, my discussion will be framed by the goals of monetary policy. Congress has charged the FOMC with making monetary policy so as to promote price stability and maximum employment. I'll discuss the state of the macroeconomy in terms of these goals.

Let me start with price stability. The FOMC has translated the price stability objective into an inflation rate goal of 2 percent per year. This inflation rate target refers to the personal consumption expenditures, or PCE, price index. This is a measure of inflation that is based on the rate of increase in the prices of all goods and services, including those related to food and energy. That rate currently stands at 1.6 percent, which is below the FOMC's target of 2 percent. In fact, the inflation rate has averaged 1.6 percent since the start of the recession six and a half years ago, and inflation is expected to remain low for some time. For example, the minutes from the June FOMC meeting reveal that the Federal Reserve Board staff outlook is for inflation to remain below 2 percent over the next few years.

In a similar vein, earlier this year, the Congressional Budget Office (CBO) predicted that inflation will not reach 2 percent until 2018 – more than 10 years after the beginning of the Great Recession. I agree with this forecast. This means that the FOMC is still a long way from meeting its targeted goal of price stability.

The second FOMC goal is to promote maximum employment. What, then, is the state of U.S. labor markets? The latest unemployment rate was 6.2 percent for July. This number is representative of the significant improvement in labor market conditions that we've seen since October 2009, when the unemployment rate was 10 percent. And I expect this number to fall further through the course of this year, to around 5.7 percent. However, this progress in the decline of the unemployment rate masks continued weakness in labor markets.

There are many ways to see this continued weakness. I'll mention two that I see as especially significant. First, the fraction of people aged 25 to 54 – our prime-aged potential workers – who actually have a job is still at a disturbingly low rate. Second, a historically high percentage of workers would like a full-time job, but can only find part-time work. Bottom line: I see labor markets as remaining some way from meeting the FOMC's goal of full employment.

So I've told you that inflation rates will remain low for a number of years and that labor markets are still weak. It is important, I think, to understand the connection between these two phenomena. As I have discussed in greater detail in recent speeches, a persistently below-target inflation rate is a signal that the U.S. economy is not taking advantage of all of its available resources. If demand were sufficiently high to generate 2 percent inflation, the underutilized resources would be put to work. And the most important of those resources is the American people. There are many people in this country who want to work more hours, and our society is deprived of their production.

As bankers, you know this all too well. You see this underutilization of resources in your own communities. I began this talk describing the important link between what you do as community lenders and what we strive to achieve at the FOMC – namely, to put the economy's resources to work. The FOMC's low-interest rate policy in recent years has certainly provided some challenges for banks, but the Committee's ultimate goal is one that we share with you – a stronger, growing economy that benefits all. On that, I'm sure we can all agree.

Thank you once again for the invitation to join you here today. I look forward to your questions.