Jerome H Powell: Regulation and supervision of community banks

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, at the Annual Community Bankers Conference, sponsored by the Federal Reserve Bank of New York, New York City, 14 May 2015.

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The views I express here today are my own, and not necessarily those of any other person in the Federal Reserve System.

Good morning. I am delighted to join you here today to discuss the state of community banking and issues of importance to community banks like yours. New York may be home to Wall Street, but, just like the rest of the country, most of the banks in the Second District are community banks. There are more than 170 banking organizations here with less than $10 billion in assets, serving millions of customers.

Community banks play an essential role in our financial system, supporting the economic health and vitality of the communities you serve. Unlike many of your larger competitors, community banks offer customers face-to-face interaction with a local banker who has the authority to make the final decision on a loan – a banker with a long-term investment in the community who will not be moving to another branch in a new town within a few years. Community bankers benefit from local knowledge and relationships that often lead to more successful and efficient lending decisions. These advantages have enabled many community banks in the Second District and around the country to maintain or increase their local market shares while competing with larger regional and money center banks, and I expect that they will continue to do so.

Nonetheless, community banks face significant challenges today. The number of community banks has declined significantly over the past decade. The Federal Deposit Insurance Corporation's "Problem List" of at-risk banks has declined from 888 at the peak of the financial crisis to 291 at the end of 2014, but that is still well above typical pre-crisis levels of fewer than 100. There are several factors driving consolidation and elevating the number of problem banks, beyond the lasting effects of the recession. For starters, community banks have been challenged in some of your traditional product lines by competition from larger financial institutions that can achieve lower costs through economies of scale. At the same time, historically thin net interest margins have constrained profitability, and, although not aimed at community banks, new post-crisis regulations meant to strengthen the financial system are coming into place that require additional management attention.

The Federal Reserve recognizes the importance of a healthy community banking sector for our nation's prosperity, and we are committed to understanding the challenges faced by community banks and to carefully considering the effects of new regulations on these institutions. Our mandate is to protect the safety and soundness of the nation's financial system, and we aim to do so in a manner that promotes a level playing field for all institutions while taking into account the risks those institutions could pose to our financial system. As you know, the Federal Reserve tiers its regulations to be commensurate with the risks presented by different institutions. The risks presented by an institution with $300 million in assets are very different from those presented by an institution with $300 billion in assets. Although the credit that a community bank extends to households and businesses within its local area may be difficult to replace, the failure of a community bank would not cause a widespread contraction in credit or have any other systemic consequences. For that reason, community banks are not subject to the same regulations that are applied to the most systemically important banking organizations.

The Federal Reserve's 2013 capital guidelines are a good example of how we have taken into account the effect of our regulations on community banks. The recession made it clear that strong capital positions are essential for banks of all sizes, including community banks.

After issuing our proposed guidelines, we received considerable input from community bankers helping us to identify which portions of our original proposal were, and were not, appropriate for community banks. Based on this input, we made some significant adjustments to the proposal to alter, for example, the risk-weighting of mortgage loans and the regulatory capital treatment of certain unrealized gains and losses and trust preferred securities for community banking organizations. Regulators also developed a community bank guide, which outlined the relevant provisions for smaller, noncomplex institutions and compared the new requirements to the previous standards.[1]

In addition, the Federal Reserve Board recently issued a final rule raising the limit on the maximum size of banks covered by our Small Bank Holding Company Statement.[2] This policy statement, originally issued in 1980, fosters local ownership of small community banks. While the Board generally discourages the use of debt by bank holding companies to finance acquisitions, it recognizes that the limited access small institutions have to equity funding means that such firms often must rely on acquisition debt to accomplish a transfer of ownership. The policy statement allows small, noncomplex bank holding companies to temporarily operate with higher levels of debt than would otherwise be permitted. It also exempts them from the Board's risk-based and leverage capital guidelines and eliminates some regulatory reporting requirements. Of course, regulatory capital requirements will continue to apply to the depository institution subsidiaries of these companies.

The policy statement originally applied only to qualifying holding companies with no more than $150 million in total consolidated assets. In 2006, the maximum asset size was raised to $500 million. Significant changes in the structure of the banking industry since 2006 led Board members to believe that a further increase in the limit to $1 billion in assets should be considered. However, because of limitations imposed by the Collins Amendment to the Dodd-Frank Act, the Board could not raise the limit without further statutory action. We are very pleased that the Congress passed legislation in December 2014 that enabled the Board to raise the limit. The policy statement now covers nearly 90 percent of bank holding companies.

The Volcker rule and incentive compensation are two additional areas where I believe relief for smaller institutions would be helpful. The risks identified by the Dodd-Frank Act in these areas apply almost exclusively to larger financial institutions. Community banks rarely engage in any of the activities prohibited by the Volcker rule, and community banks generally do not face the adverse incentives of compensation agreements that may encourage executives and loan officers to maximize lending volume at the expense of safety and soundness. I believe community banks should not face significant burdens from complying with these requirements, so I support raising the asset threshold for both the Volcker rule and incentive compensation rules, perhaps to $10billion. In the event where the actions of a community bank might raise concerns in either of these areas, that could be addressed through our normal examination process.

The Board has undertaken substantial efforts to tailor its supervisory practices to the size of the bank examined. We supervise banks in four tiers, with requirements that are lowest for smaller, local institutions and increase with the size, complexity, and geographic reach of

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[1] The document New Capital Rule: Community Bank Guide (PDF)**,** issued July 2013 by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency; and the table "Final Rule on Enhanced Regulatory Capital Standards – Implications for Community Banking Organizations" is available at www.federalreserve.gov/newsevents/press/bcreg/commbankguide20130702.pdf.

[2] See Board of Governors of the Federal Reserve System (2015), "Federal Reserve Board Issues Final Rule to Expand Applicability of Small Bank Holding Company Policy Statement and Apply It to Certain Savings and Loan Holding Companies," press release, April 9,www.federalreserve.gov/newsevents/press/bcreg/20150409a.htm.

firms. This system helps community banks by eliminating requirements that are relevant only to large, geographically diversified banks. This tiered approach allows us to account for the differences in business models and risk levels among different types of banks. Our goal is not to develop one state-of-the-art approach to regulation and supervision, but instead multiple state-of-the-art approaches that are appropriate for each type of institution we oversee. Supervision of community banks is not a watered-down version of supervision of larger banks, but a significantly different process tailored to the business model of smaller banks.

For community banks, the primary purpose of prudential regulation is to ensure the safety and soundness of each individual institution, thereby protecting the deposit insurance fund. The crisis showed that such a focus on individual institutions was inadequate to account for and contain the systemic threats posed by risks at larger, more complex institutions, and much of the improvement in oversight has been directed at systemic risk. The Board is committed to making sure that new supervisory standards do not trickle down to community banks when they may only be appropriate for larger institutions, whether they be systemically important institutions overseen by the Large Institution Supervision Coordination Committee, other large banking organizations with more than $50 billion in assets, or regional banking organizations with between $10 billion and $50 billion in assets.[3]

For example, the Board has made it clear that capital stress tests and other aspects of the Comprehensive Capital Analysis and Review requirements do not apply to community banks, either explicitly or implicitly. In addition to Board members making this point in public speeches and in meetings with bankers, the Federal Reserve's examiner training emphasizes that these requirements, which were established under the Dodd-Frank Act, will apply only to large banking organizations.

The Fed also made changes in 2014 to better tailor our program of consumer compliance supervision of smaller institutions. Under the new approach, the intensity of bank examinations is based on our assessment of the risk profile of individual community banks, including how each identifies and manages consumer compliance risk. Risk assessment begins before examiners arrive at the bank, allowing examiners to focus on higher-risk concerns at the banks they supervise. We have also directed examiners to spend less time on those areas of consumer compliance where problems are uncommon, although we are ready to ramp up that scrutiny if we have concerns about practices at a particular institution.

Since making these changes 16 months ago, the average length of time for examinations has dropped, and the feedback we have heard from you is mostly positive. Bankers have told us that the examiners seem to have a better grasp of the key issues and that exams are, as we intended, more closely tailored to the business characteristics and risk profile of individual institutions. Examiners also tell us they sometimes see increased consumer compliance risk at community banks that are expanding beyond their traditional product offerings, often using outside vendors to introduce new products such as prepaid cards or credit card add-ons. These products are often complex, and community banks may not always be familiar with the risks the products pose. Banks may not have sufficient expertise to thoroughly check out a vendor and monitor its performance.

Beyond consumer compliance supervision, the Federal Reserve has expanded our ability to conduct more of the work of bank examinations off site. If banks have electronic loan records, it is possible for examiners to assess loan quality and underwriting practices remotely, spending much less time on site. This approach has the potential to improve examination efficiency and to reduce the examination-related disruption to banking

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[3] More on the Large Institution Supervision Coordination Committee is available on the Board's website at www.federalreserve.gov/bankinforeg/large-institution-supervision.htm.

operations. However, if banks prefer more face-to-face interaction with examiners – and there are banks that do – we will continue the traditional on-site review.

Our efforts to further tailor bank supervision at community banks continue. Staff members from the Federal Reserve, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation are working through a major review of regulations called for in the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). We are still in the midst of this effort, which is being conducted with a broad mandate to identify and revise where possible outdated, unnecessary, or unduly burdensome regulations, including those that apply to community banks. The agencies are carefully considering public comments. Although some burden-reducing measures may require congressional action, the agencies will act to implement regulatory relief when possible before the end of the EGRPRA review period. The results of our EGRPRA review will be included in the agencies' joint report to the Congress.

In addition, the Federal Reserve System has expanded our economic research into issues of consequence to community banks and has worked to encourage similar research efforts at academic institutions. Several years ago, a group of economists from across the System formed an informal working group to share ongoing research related to community banking. Encouraging results from this internal forum led, in 2013, to an inaugural research and policy conference titled "Community Banking in the 21st Century," sponsored jointly by the Federal Reserve System and the Conference of State Bank Supervisors. The conference provided a unique opportunity for researchers, community bankers, and bank supervisors to come together to hear some of the latest research on topics related to community banking and discuss the practical implications of this research. The 2013 conference was so successful that we decided to make it an annual event. The third annual conference will take place this coming fall at the Federal Reserve Bank of St. Louis, and Chair Yellen is scheduled to provide opening remarks.

I had the pleasure of participating in the first two conferences and found the presentations and conversations to be extremely enlightening. Many of the researchers who presented at these conferences said that the feedback they received from bankers and bank supervisors was valuable in helping them shape their future research endeavors. The conference organizing committee has launched a new website with the URL "www.communitybanking.org," which they hope will become a focal point for all who are interested in community banking research. The website provides links to the papers and presentations from the previous conferences, news about future conference plans, and other information that might be of interest to community banking researchers.

Although research is an important avenue for improving our understanding of the community bank business model and the effects of changing market and regulatory conditions on the viability of that model, understanding is further enhanced through direct interactions between regulators and community bankers. For this reason, the Federal Reserve System has taken a number of steps to expand its outreach to community banks.

As you probably know, in 2010 the Board created the Community Depository Institutions Advisory Council, which includes representatives from community banks, credit unions, and savings associations from each Federal Reserve District.[4] The Board of Governors meets twice each year to hear the council's valuable insights into the most pressing concerns of community bankers from across the country. There is also a council for each of the 12 Reserve Banks, which meets regularly with its Reserve Bank leadership.

[4] More on the Community Depository Institutions Advisory Council is available on the Board's website at www.federalreserve.gov/aboutthefed/cdiac.htm.

We have taken other steps to improve communications with community bankers so that we may better explain our supervisory expectations for community banks and hear your concerns as well. Our Reserve Banks have together developed a number of channels of communication with community banks over the years, and some of the most promising of those initiatives have been expanded nationwide. Two programs, Ask the Fed and Outlook Live, have become quite popular with community bankers who are interested in learning more about timely financial or regulatory topics of interest to both bankers and supervisors. Ask the Fed is a program for officials of state member banks, holding companies, and state bank commissioners. Outlook Live is a webinar series led by Federal Reserve staff that serves as a companion to our quarterly publication, *Consumer Compliance Outlook.*[5] Last year I participated in a webinar hosted by the Federal Reserve Bank of St. Louis and very much enjoyed hearing directly from community bankers.[6]

Another effort to improve communication with community bankers is our new Community Banking Connections website and quarterly newsletter. These sources of information focus on safety-and-soundness issues that are of practical interest to community bankers and bank board members. We have also launched a series of special-purpose publications called *Fed Links* that highlight key elements of specific supervisory topics and discuss how examiners typically address the topic.[7] The common goal of all of these outreach efforts is building and sustaining an ongoing dialogue with community bankers.

Despite the challenges that you face, I firmly believe that community banks are here to stay. Banks of different sizes serve different functions, and both large and small banks are needed to meet the funding needs of a healthy economy. The Federal Reserve does not use a one-size-fits-all approach to regulation and supervision and is committed to continually reevaluating and improving oversight to meet the complementary goals of bank soundness, financial stability, and economic growth. The risks and vulnerabilities of community banks differ substantially from those of larger banks, and an explicit tailoring of regulation and supervision for community banks is appropriate.

I look forward to our discussion.

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[5] Current and past issues of *Consumer Compliance Outlook* are available at https://consumercomplianceoutlook.org.

[6] See Jerome H. Powell (2014), "Opening Remarks," speech delivered at the Webinar on Community Banking, Washington, October 20, www.federalreserve.gov/newsevents/speech/powell20141020a.htm.

[7] More information is available for Community Banking Connections at https://communitybankingconnections.org and for *Fed Links* at https://www.communitybankingconnections.org/fedlinks.