Systemic Risk & Community Banking

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Introduction

Good afternoon. I am pleased to have the opportunity to return to South Dakota. The Division of Banking has done well under Roger Novotny's leadership. I have been especially impressed by the work you have done together to promote banking education through this University.

For those of you who aren't familiar with CSBS, we are the nationwide organization representing state banking regulators in Washington. I was asked to share our observations on what is occurring in Washington and the impact it is having on the banking industry. As you would imagine, anyone having anything to do with financial regulation is working on implementing the Dodd-Frank Act. The Act is principally targeted at the largest firms. This is not to say community banks concerns about the law are not legitimate, but community banks were clearly not the focus of this legislation.

As Roger Novotny discussed this morning, the viability of the community banking business model is being questioned by the industry, regulators, and policymakers. This question has certainly garnered the attention of state bank commissioners. While the state system of bank regulation is diverse, the bulk of the institutions are community banks. These questions about viability are being driven by a troubled economy, which has led to hundreds of bank failures, and an uncertain regulatory environment. As a country, this is a concern which deserves our attention. I suspect community banking is not an obvious topic of national importance. However, its demise can pose enormous risk to access to credit, economic development and our financial system.

Too Big To Fail

This may seem odd, but to fully address the future of community banking, we need to start with the largest, most systemically significant firms. "Too big to fail" (TBTF) institutions have demonstrated the ability to bring the economy to its knees. Once mistakenly believed that their risk management was so sophisticated they could operate with lower capital and liquidity, the reality of carrying out operations in this manner soon came to light. In 2008, when these firms began to experience problems, we discovered how little we actually knew about these firms and how limited the government's power was to resolve them. Government officials felt they had few options except to prop them up with the public's money. We can debate whether the government should have done this, but our greatest concern should be why we let these firms create a business model and get to a size which allowed them to hold the economy hostage.

We arrived at this place through a stunning consolidation of the industry's assets into the largest institutions. In the last 25 years, we have lost 12,362 banks. While a significant portion of consolidation may be market driven, we do not believe all of the drivers and long-term impact of consolidation are fully understood. As the industry consolidates, the system is increasingly dominated by the largest institutions. In the last 10 years, the top 5 banks have increased their market share from 24 percent to 42 percent of total assets. You will be hard pressed to find anyone who thinks this trend will reverse.

Regulatory reform sought to fix the problem of TBTF. The Financial Stability Oversight Council (FSOC) was established in order to provide comprehensive monitoring to ensure financial stability in the U.S.; mainly by identifying and responding to imminent risks that threaten financial stability and promoting market discipline.

In my view, the most significant measure to address TBTF is expanded resolution authority for the FDIC. Traditionally, the FDIC has only had authority over the bank. This limitation proved problematic when faced with problems at large, complex firms where significant activities occurred outside the bank, but were interrelated within the broader organization and, even more dangerously, other firms. To get at this problem, systemically important firms are required to submit a "funeral plan," essentially telling the Federal Reserve and FDIC what it will take to unwind the firm's operations. There is broad speculation that these plans will cause a major restructuring for this part of the industry.

With resolution authority, the FDIC now has the authority to seek orderly resolution of financial companies whose failure poses a systemic risk. It is important to think about resolution authority in terms of a deterrent, not just a function. Resolution isn't just about a firm failure, but rather taking steps to ensure a firm becomes safer before it has to be resolved. This section of Dodd-Frank aims to improve financial stability, mitigate risk, end TBTF, and safeguard taxpayers by ending bailouts. If properly executed, never again should a firm be bailed out only to live another day.

While it may not seem like it on the surface, getting this right matters to community banks. There must be equity in how firms are regulated and treated when they are under stress. Without the appropriate prudential standards and regulatory regime, large, systemic firms have no incentive to effectively manage risk, exposing the nation's economy to excessive risk with downstream affects on all institutions. Given what we have been through over the last three years, this isn't just theory.

Community Banks & the Financial Crisis

There is a recognition that community banks performed much better in the financial crisis. Small, community banks kept the economy going when the credit crunch ensued, and other banks were not lending. More in tune with their local marketplace, community banks fared well by continuing to lend to the folks they knew. Last year, total loans issued by community banks increased by 2 percent, while large bank loans decreased by 6 percent. Community banks have proven to be a great source of strength and stability for communities across the nation. As consumers fled from highly volatile, precarious markets, community banks provided a secure and stable environment for nervous depositors.

To be fair, the Great Recession did expose risk management weaknesses in community banks. If there are any banking students in the room, the lesson here is the trigger may not be your fault, but you are still responsible for the effect. Bank performance deteriorated rapidly. By December 2008, nearly 25 percent of the industry was reporting net operating losses. Considerable stress was placed on community banks, especially those with concentrated balance sheets. Institutions falling below "well-capitalized" standards were barred from the brokered deposit market and consequently had to confront rigorous regulatory scrutiny and the challenges associated with a lack of liquidity. Acquisition, development, and construction lending was responsible for most of the failures of 2008 and 2009, while commercial real estate (CRE) was to blame for many 2010 failures. Within the regulatory environment, there has been a loss of confidence in bank management's ability to adequately manage risk and provide effective corporate governance. This will take time to heal.

Since 2008, 356 banks with $654 billion in assets have failed. Losses to the Deposit Insurance Fund have skyrocketed to $78 billion. There is a misconception that these failures have allowed large banks to only get larger, but eight banks with more than $100 billion in assets, acquired only 24 of the 356 failures. The community banking system is healing itself. Using the industry's money, failed banks are sold to other banks providing a public-private solution. This part of the system is working as designed. It did not work for the entire industry which is why the provisions in Dodd Frank are so important.

With the bulk of community banks surviving the worst of the recession, many are now questioning if they want to remain in this business. This is the systemic risk we are facing: a regulatory environment and structure that discourages community banks. Increased regulatory burden has been reverberated disproportionately through many community banks that lack the economies of scale of larger institutions. Our goal should be a structure and policy platform which encourages monetary and human capital to flow into the community banking space.

Why Community Banks Matter

The fact is community banks do business in ways far different than larger institutions. In community banking, both the borrower and the lender maintain a stake in the long-term outcome of the transaction. Community banks place a greater emphasis on long-term customer relationships, incorporating soft information that is not easily quantifiable or readily available. As opposed to transactional banking, relationship lending also typically involves more than simply transferring funds from lenders to borrowers. Community banks often add value by integrating accounting, business planning, and tax planning. Relationship lending is typically preferable for small business, agricultural lending, and retail customers. Until consumers have a complete lack of regard for this type of service, community banks remain valuable. I started my career in 1988 as a bank examiner in Iowa. I saw first-hand the difference an active and effective community bank can make. I think about a small town outside of Cedar Rapids, Iowa. The bank was in trouble due to years of mismanagement and, shall we say, questionable activity. Once the bank was sold to a group of local investors, the bank and the community improved dramatically. Over the course of just a few years, Main Street improved and came alive, and houses began to be built.

Challenges Facing Community Banks

Community banks continue to face a multitude of challenges. Criticism of the regulators – Congress, inspectors general, and state officials – has elicited a strong response to make changes. However, we must keep in mind that an overly restrictive regulatory response will constrain access to credit and be harmful to community banks and the markets they serve. The challenge for regulators is to ensure that the regulatory response is not overly aggressive on the banks that do not warrant additional scrutiny.

Another significant challenge facing community banks is the state of affairs of CRE and construction lending. After banks carved out their niche, construction and commercial real estate markets are dead.

When the economy entered the recession, these sectors were significantly weakened, posing enormous losses and raising doubt about the viability of these sectors in the foreseeable future. Many bankers contemplate what asset class can replace this source of revenue. As those opportunities are sought, banks will need to ensure they have the appropriate talent to understand, evaluate and manage the new risks.

Scrutiny over consumer finance continues as well. The mortgage business has changed significantly due to the SAFE Act and additional provisions in Dodd-Frank. We have a new player in this space with the creation of the Consumer Financial Protection Bureau. There is a benefit to this entity in that consumer regulations will be written with a single voice. The CFPB is also required by law to reconcile the rules under TILA and RESPA. With one under the purview of the Fed and the other HUD, these rules have long been a source of frustration for the industry. The industry does have concerns about the CFPB's broad authority and the approach it will take in rule-writing. Time will tell, but it will also require our engagement in the process.

The other piece of mortgage reform is the role of the GSEs. Uncertainty over mortgage finance reform and the role for community banks in origination is a reality we are facing. Community banks have a stake in the economic success of the rural communities they serve in a way that government sponsored enterprise could never have. And while the Administration and Congress decide precisely how privatized the market should be, it weighs heavily on our community banks' minds. As one of our commissioners pointedly stated, "roof tops matter." How homes are financed, construction, improvements, and family finances are all significant drivers of economic activity.

A Call to Action

We face many difficult challenges in the near future. And as such, it is critical that the industry, regulators and public officials work together to provide a viable framework for our economic benefit. There is a clear need to discuss and study these issues in both a broad and state specific context. To facilitate this discussion, CSBS has developed a community banking roundtable framework to serve as a forum designed to encourage economic development and job creation. The roundtable presents an opportunity to discuss the economic outlook of a state; the current business and banking environments; the regulatory, economic, and funding issues facing business; and regulatory and structural banking challenges. A community banking roundtable brings all stakeholders together – some of which may not even realize they are stakeholders – to identify opportunities and develop solutions to problems.

We also must establish a regulatory structure that supports and encourages innovation; one that allows specialized institutions to meet the needs of the market and attract capital. Supervision decisions need to be made at the local level where examiners understand the economy. Housing finance must accommodate all institutions: All lenders, regardless of size or volume, should be able to take part in the healthy competition of a normal mortgage market. Further consolidation could create a dangerous dynamic; resulting in only a few choices for consumers and irreparable harm to community banks. Accounting rules need to center on safety and soundness and the long-term, illiquid nature of banking. Capital standards ought to more appropriately align with the risks banks take on, and management of capital must also look forward.

Also imperative is the improvement of risk management, including tools such as stress testing. Risk management must involve a more comprehensive and forward looking approach. This is necessary not only to protect the stability of the financial system, but to protect the viability of the community banking model. While the financial crisis stemmed from large institutions and illustrious Wall Street firms, the recession revealed sizeable flaws at the community banking level as well. These weaknesses resulted from complacency generated by a period of long-term economic prosperity and ever increasing asset values. At the end of the day, community banks will need to be able to more accurately predict their solvency and liquidity through the economic cycle. Stress testing should be a key component in the new approach to risk management, assisting in the identification and quantification vulnerabilities.

There is now a greater appreciation for a traditional banker, one who understands how to assume and manage risk and measure performance. This is why the work of Northern State University is so important. South Dakota has recognized the importance of a traditional banker. I often say the era of the "cell phone banker" is over. This stems from the experience of a friend of mine: a former bank examiner turned commercial lender. During the boom times of the early 2000's his high level of skill was deemed replaceable by a person who sold cell phones in the mall. We need bankers in the traditional sense, which utilizes many consumers' preference of working directly with the same individual whom they do not have to frequently remind of their financial and business situations. Ultimately, this provides an exclusive niche for community banking institutions: one which the majority of large institutions could never provide. You obviously get this.

If community banks continue to exit the market, the banking industry will face increasing concentration. Consequently, this will increase the implicit guaranty of the federal government by cementing TBTF. Community banks provide a crucial source of competition in many markets across the nation, which would be lost. In turn, several less populated areas of the country – where community banks are a cornerstone – could lose substantial access to affordable credit. This will lead to the death of smaller communities or additional government regulation mandating credit availability in these areas. The viability of the community banking model has significant systemic consequences, which if left unaddressed will cause irreparable harm not only to local economies, but also critical underpinnings of our national economy.

Community banks have demonstrated an ability to adapt and continue to offer customized, high-touch lending commonplace for small businesses, farming operations, and higher-risk consumers. This provides us the confidence we need to address the real challenges facing the industry. It remains in our national economic interest.