SPEECHES

The Banking System We Need: One Year Later

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INTRODUCTION

Thank you to the Federal Reserve, the FDIC, and the OCC for organizing and hosting this important symposium. It is a real honor to be asked to speak with you again this year, and I appreciate the invitation.

For those of you who may not be familiar with the Conference of State Bank Supervisors, CSBS is the professional association of financial regulators from all 50 states, the District of Columbia, and the territories. Our members are the state government officials who are responsible for chartering and regulating banks.

Last year I spoke at this conference about “The Banking System We Need.” I spoke about how financial regulatory policy created in Washington, D.C. must be developed with a better understanding of the important role community banks have played and will continue to play, not only in the daily lives of their customers, but also in helping to maintain the health and stability of our national financial system.

So what’s happened in the banking industry since I made that speech just over a year ago? Have policymakers and regulators made strides to ensure the diversity of our banking system so that banks of all sizes can thrive? Are American citizens and businesses getting the financial services they need to support their families and grow their businesses? Do we have the measures in place to maintain the safety and stability of our financial system? And just as importantly, do we know what we need to know?

The short answer is mixed.

MORE DIALOGUE AND RESEARCH

The good news is that over the last year there has been a growing acknowledgment and appreciation of the fundamental value of and challenges to community banking. Collectively we have seen an increase in meaningful discussions, research, analysis, and data collection regarding community banks. And federal legislation has progressed that is geared toward addressing the mismatch between some federal laws and

regulations and the community bank business model.

Something particularly important to me is the Federal Reserve-CSBS "Community Banking in the 21st Century" research conference. Just a few weeks ago we held the second annual community banking research conference, hosted by the Federal Reserve Bank of St. Louis. And let me just take a second here to comment on the Federal Reserve System, and particularly the presidents and senior staff of the Reserve Banks, for being such tremendous partners in this undertaking. Their commitment and engagement have been crucial in advancing the research and resources needed to better understand and address the challenges that face banks today.

The conference in St. Louis drew together academics, community bankers, and federal and state policymakers from across the country to discuss the latest research and trends in community banking. The conference is unique in how it brings together researchers from the fields of economics, law, and business with bankers and regulators to better understand the role of community banks in our financial system.

A highlight of the conference was the participation of community bankers on the panels of academic researchers. This helpful addition allowed bankers to provide real-world insight on the academic findings and conclusions.

The research and discussions centered around three main focal points: new banks and emerging technologies; the effect of government policy on bank lending and risk taking; and the effect of government policy on community bank viability.

The research presented at the conference confirmed what many of us already suspected. But more importantly, it provided the detail and quantified objective data needed to guide federal policy. Some of the research showed:

- That economic conditions alone do not explain why there have been almost no new bank charters since 2008.[1]
- That Commercial Real Estate guidance in 2006 may have had a positive macroprudential impact by "pulling away the punch bowl." But it also seems to have reduced commercial and industrial lending which may have hastened the economic recession. It may have redirected resources to housing finance at the height of the bubble.[2]
- That the due process needs of community banks are not being met by the appeals processes of the various federal banking agencies.[3]
- That rising compliance costs have the potential to limit financial services available to communities.[4]
- And that Washington's one-size-fits-all approach to regulation has a disproportionate impact on community banks and their relationship-based lending models.[5]

No doubt some of you are thinking, "I could have told you that." And others might be thinking "I did tell you that!" Indeed many in this room have been telling policymakers and regulators for years that compliance costs are rising and a lack of de novo activity is signaling that something is wrong in our banking system. You shouldn't have to prove that one size doesn't fit all. After all, Aristotle observed two thousand years ago that "It is the greatest inequality to try to make unequal things equal."

But D.C. is a data-driven town. So while your anecdotes are important, it is this research and data – combined with the on-the-ground reports you provide to Members of Congress and regulators – that will motivate a meaningful and appropriate response in Washington.

During last year's inaugural conference, the Federal Reserve System and CSBS issued a first-of- its-kind report that assessed the challenges and opportunities community banks face. This

year's report builds on that research and includes data gathered from a survey of more than 1,000 banks from across the country. The survey complements what we hear at town hall meetings conducted by state regulators. It clarifies, and in some cases, challenges the conventional wisdom of anecdotal evidence provided by community bankers every day. Taken together, we are able to put in perspective the challenges and opportunities community banks are facing today.

POSITIVE DEVELOPMENTS

Another positive development in the past year has been that more and more policymakers and pundits in D.C. are saying all the right things about community banks. Members of Congress, regulators, and industry observers are acknowledging the need for industry diversity and for banks of all sizes.

Increasingly, I hear a broader recognition of the important role community banks play in the financial life of our communities and our nation. From small business lending and local economic development, to maintaining access to credit for individuals and businesses alike.

I am particularly encouraged by Governor Daniel Tarullo's remarks earlier this year about the importance of varying prudential regulation for traditional banking organizations so that it

recognizes the "size, scope, and range of activities of the organizations."[6]

And while modest, the actions of Congress and federal regulators have also been more reflective of this need for right sizing regulation for community banks.

Recent efforts include:

- Excluding small banks from Basel III provisions designed for global institutions, such as the new global liquidity rules or more stringent leverage ratio requirements.
- House passage of revisions to the Dodd-Frank rural designation provision for qualified mortgages (QM).
- House and Senate bills to grant QM status to mortgages held in a bank's portfolio.

Through efforts like these, Congress and federal regulators have recognized that the risks and operations of community banks are different. However, regulators must also allow examiners to exercise judgment and be flexible when supervising financial institutions, especially community banks. A one-size-fits-all approach does not work for bankers looking to serve the unique needs of their clients and their communities, and it does not work for regulators trying to ensure a safe and diverse banking system. As Kansas City Federal Reserve President Esther George said last month at the Community Banking Research Conference, "For community bank supervision, the substitution of rigid rules for examiner judgment has altered the supervisory process without adding value and has instead created higher costs of compliance."[7]

While we certainly don't have all the answers, we believe policymakers could help better align regulation to the community bank business model by taking the following actions:

- Remove barriers to private capital investment for small bank holding companies.
- Provide community banks with regulatory clarity and transparency regarding fair lending requirements.
- Speed up the Federal Reserve application process for community banks by evaluating merger, acquisition, and new activities applications based on their business model, and not how application decisions might establish a precedent for large banks to exploit.
- Eliminate the brokered deposit designation for reciprocal deposits.[8]

These would be good first steps, but there needs to be a more holistic approach to right-sizing regulation.

RELATIONSHIP LENDING

Critical to the future of community banking is a federal regulatory and supervisory structure that works with and not against the relationship lending model.

Unlike the nation's largest banks, community banks customize their products and rely on the relationships they have with their customers and the first-hand knowledge they have of their communities. They rely on "soft" data, which requires judgment calls and local knowledge. Generally speaking, this model of banking has been a critical source of credit for small businesses, agricultural customers, and individuals.[9]

This is not an outdated business model. Small business loans have a lower rate of default when the lending community bank is closer to the business borrower.[10] This is why small rural banks can operate on a relatively small scale. They make higher quality loans based on the detailed knowledge they have of their customers.

As a result of relationship lending techniques, community banks tend to make loans the largest banks will not make. But one-size-fits-all regulations are making it harder for even community banks to make those loans. When compliance on a $50,000 mortgage costs a bank as much as for a $500,000 mortgage, banks are less inclined to serve all parts of their communities.

Similarly, something is wrong with a system that allows a credit decision on a $50,000 car in a single afternoon, but a $50,000 mortgage will take weeks and reams of paper. With such hurdles banks will understandably make business decisions that don't serve all parts of their communities.

ACCESS TO CREDIT

Earlier I mentioned the Town Hall meetings state regulators held with community banks over the spring and summer in preparation for the Community Banking Research Conference. Time and again, in states across the nation we heard similar concerns: community banks are being forced into standardizing the products they offer. The regulatory and supervisory environment is impeding or preventing a community banker's ability to tailor a product to suit the needs of its customers.

Whether policymakers believe this environment is real or not, we need to understand the impact of the public policy actions we are taking. From my perspective, we want and need community banks to engage in this type of lending. This is to the benefit of a diverse country and diverse economy. This is about communities controlling their own economic destiny. This is about jobs.

LACKING A SENSE OF URGENCY

I believe it is our responsibility as banking regulators to serve as guardians of the public interest and to have a vision for and ownership of the consequences of regulation. If we see that the laws that Congress passed and the rules we have implemented are not having the intended effect or are having unintended effects, there is an expectation that we speak up.

At a recent congressional hearing on community banking, a Senator asked state and federal regulators, "Is it you or is it us?" Meaning is it the laws or the implementation of the laws that has community banks questioning their future viability. I think we as regulators need to take that question seriously and provide not just an answer but solutions.

Additionally, from where we state regulators sit, there is a need for a greater sense of urgency. Why? We fear that if we don't act that we could lose critical banking and financial infrastructure, particularly for rural America. The loss of these institutions could be difficult, if not impossible, to reverse. We see that the impact of a reduction from 7,000 to 5,000 or 4,000 banks as very different from the consolidation of the past 20 years. It is the difference of going from "some to none" in many parts of the country. This loss of service could be as devastating to rural communities as was the "redlining" of urban minority communities. This possibility deserves our attention.

As one can observe from the FDIC's studies on the unbanked and underbanked, even with decades of policy responses from Washington, there is still a significant disparity between the banking services provided in urban minority communities and the country as a whole. If we lose services that community banks presently provide to rural America, I expect the unbanked and underbanked problem would be even more challenging.

More often than not, access to credit in rural communities is exclusively provided by community banks. There are more than 600 counties – or one out of every five U.S. counties – that have no physical banking offices except those operated by community banks.[11] To these parts of the country, citizens don't differentiate between community banks, regional banks, or the largest banks in the world. For these small or rural towns, the community banking system is the banking system, and they rely tremendously upon the products and services offered by community banks. And this does not include the many rural banks, such as the Village Bank located in St. Libory, Illinois, that are technically in metropolitan areas, but function like small community banks in rural areas. The Village Bank is an $80 million bank serving a village of 600 residents, but is not considered "rural," even though it's only half a mile from a county that is rural.

Community banks aren't just vital in rural areas. They are just as embedded in and committed to metropolitan areas as well, serving their urban communities and customers in ways that largest banks cannot. For example, Chicago is home to 10 minority-owned community banks. This may sound like a small number, but these institutions make a big impact. FDIC research shows that minority depository institutions promote economic growth by providing home loans and banking services to minority populations and low- or moderate-income customers that are underserved by large financial institutions.[12]

Of course, the biggest banks do have branches in some smaller towns or rural communities. But just because one of the four biggest banks in the country has a branch in a small town, that doesn't mean they provide the same essential services a community bank does.

Furthermore, there's no guarantee that those nationwide banks will stay in a community. It just takes a quick Google search to see how often in recent years large banks are selling off or closing multiple branches in small towns. In most cases the buyers of those branches are community banks. If the smaller, local banks weren't there to take over those branches, it is unlikely there would be any institution willing to fill the gap and continue to provide banking services.

That is why we need banks of all sizes and business models in communities around the country.

CONSOLIDATION OF THE INDUSTRY

Even though community banks only hold about 13 percent of total banking assets in the U.S.,[13] they play an essential role in our national economy providing the majority of farm lending, almost half of small business lending, and over 35 percent of commercial real estate loans.

Consolidation of the banking industry continues, and is leading to fewer options for consumers and businesses. Between the years of 1984 and 2014, the number of banks in the U.S. declined from 17,901 to 6,656 – a 62 percent decrease over 30 years. During the same period, the share of U.S. banking assets held by community banks also declined, from 37.7 percent in 1984 to

13.3 percent at present.

What happened to the system's assets? The four U.S. banks with assets in excess of $500 billion hold 41 percent of total system assets and 39 percent of total bank deposits, even

though these four banks account for only .06 percent of the total number of banks.[14] Furthermore, the biggest banks continue to get bigger. The average large bank is now 64 times the size of the average community bank, compared to 12 times larger in 1985.[15] The growth of the largest banks was overwhelmingly achieved through acquisition, not organic growth.

As I have noted before, Washington's conventional wisdom has seen this consolidation as a good thing. Or, at the very least, it is not considered a bad thing.

One fallacy is policymakers' assumption that bigger is better: that large institutions, both geographically diverse and diversified in their product offerings, would be more stable and resilient. So, Washington policy has enabled or even promoted industry consolidation and the rapid growth of the largest financial firms.

Many assume that consumers without a brick-and-mortar bank in their community can rely on Internet or mobile banking. Not only does this ignore issues related to Internet access, but it also forces the consumer to rely on a set of services that are likely to be even more standardized than those of a nationwide branch network.

NEED FOR NEW MARKET ENTRANTS

Another factor that could make industry consolidation detrimental is the lack of new market participants. De novo activity in recent years has been practically stagnant. From 2000 to 2008, more than 1,000 community bank de novos were chartered.[16] Since 2010, there have only been two new charters. Research from this year's Community Banking Research Conference suggest that the decline in de novo activity is most often attributable to the decline in interest rates and demographic variables, however, those factors alone don't explain the lack of any charters in recent years. It is possible that regulatory burden may in fact be a contributor.[17]

Regardless of the cause, we should focus on the long-term impact a lack of de novo activity and new market participants has upon our banking system. The ability to charter new banks and allow for new competition to the marketplace is a strength of our system. We must ensure that regulatory expectations and the application process are not so stringent as to prohibit the formation of new banks. This is an aspect of our system we must understand.

CONCLUSION

Last year I challenged state and federal regulators to ensure that a $34 million bank in rural America doesn't go out of business just because of the increased costs of regulation.

Unfortunately, this challenge hasn't been met. There still seems to be a willingness in Washington to believe that the disappearance of small banks is due to a force of nature rather than the forces of regulation. This year I want to renew that challenge and pose an additional one. The opportunity to form a de novo bank shouldn't be only

limited to communities in the largest metropolitan areas or in the fastest growing states. Nostalgia isn't the only reason small communities should be able to support a local bank and there is nothing quaint about a system that allows a community bank to just be a community bank.

Rebeca Romero Rainey is the third generation of her family to run Centinel Bank in Taos, New Mexico. At the Community Bank Research Conference this year she told the story of how her family's bank with less than $200 million in assets has been an important resources for the many small businesses that have helped Taos prosper and develop into the thriving ski resort, artists community, and tourist destination it has become.

This is the value of a diverse banking system and of community banks. It is the impact they have on their communities, states, and our nation as a whole.

Our challenge is to make sure that the future of bank chartering doesn't shut out banks like Centinel to the detriment of communities like Taos – before it was Taos. I fear that too many are content to just sit back and preside over their disappearance.

We face challenges to ensure the health and stability of the banking system.

But I strongly believe that it is possible to reduce the burden and complexity – or more precisely the burden of complexity – of our existing regulatory system for community banks in ways that actually improve their safety and soundness and better serves the interest of consumers. State regulators are under no illusions that this sort of recalibration is easy to achieve. However, it can be achieved with leadership and commitment. It is not without risk to attempt a meaningful reconsideration of regulation but it is a risk worth taking.

I am encouraged by the increase in public symposiums like this one to highlight the importance of community banks.

The future of community banking is not just about the future of community banks, but the ability of communities to define their future, the future of rural America, the future of small businesses across our country, and the future of individual choice.

We have inherited an important legacy: a diverse banking system. I believe that by all of us working together we can ensure its future.

Footnotes

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