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Community Bank Examination and Supervision amid Economic Recovery

Remarks by

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Thank you for the opportunity to speak with you this afternoon. It is always a pleasure to be back in Baltimore and to see so many old friends. I was here during the most intense days of the financial crisis, and I will never forget how bankers worked around the clock to ensure that the credit needs of Maryland residents and businesses could continue to be met--a dedicated effort that benefited communities across the state. That episode is behind us now, but community banks continue to face numerous challenges, including challenges from an enhanced regulatory regime that has evolved in the wake of the crisis. This regime includes the potential effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). From my many conversations with you, I have a sense of the challenges that you face regarding the changing regulatory landscape. Against that backdrop, I appreciate the opportunity to speak at the First Friday Economic Outlook, at the start of a promising new year, and share my thoughts with you on two vitally important topics: how the Federal Reserve's monetary policy aims to increase the availability of credit to foster economic growth, and how we are tailoring our examination and supervision of community banks to ensure that we are not inadvertently constraining lending.

I believe that examination and supervision of community banks is a timely and important topic. Why do I say that? Because, as I will discuss shortly, lending by community banks plays an important role in the ongoing economic recovery, especially by providing credit to small businesses. And it is absolutely critical that examination and supervision do not produce outcomes that are barriers to small business expansion.

Unlike most other businesses, banks are subject to a system of examination and supervision, developed over the past century, that has particular and deliberate characteristics: regular on-site visits by specially trained examiners; exit meetings between examiners and bank senior management to explain examination findings; written examination reports with narratives and metrics describing the findings of the examiners; and, if necessary, follow-up on action items that the bank must pursue to remedy specific problems. The ultimate focus of examination and supervision is the safety and soundness of the bank, as well as compliance with laws and an assessment of the bank's ability to withstand risks and shocks.

Community bankers are very much accustomed to opening their doors to examiners for their on-site visits. I'm not sure if James Anthony made it here today from his bank in Chestertown, but I want to share with you two memorable conversations I had with James when I was the Maryland Commissioner of Financial Regulation. In one conversation, James told me how he left the glamour and fast pace of being a management consultant in New York City to return to the relative peace and serenity and awesome natural beauty of the Eastern Shore to run Chesapeake Bank and Trust where, he said, he could awaken each morning to the sights and sounds of the swallows and geese on the bay. In the second memorable conversation, James told me that my examiners in their dark suits were not only taking up all the spaces in the bank parking lot and occupying all the booths in the diner, but they were also, in his words, "scaring the bejesus" out of the same swallows and geese alighting on the bay, not to mention some residents of Chestertown who were convinced by the arrival of the many dark suits that the bank was on the verge of collapse. So from that point on, we implemented more

“town-friendly” approaches to examining our banks, including less-formal dress guidelines and more gentle parking practices for our examiners. I share this anecdote with you because it illustrates a mindset and approach that I bring with me to Washington every day of maintaining a focus on how what we do at the Board affects local communities.

Lingering a moment longer on the culture of bank examination and supervision, it may come as a surprise to some of the nonbankers in the room that community bankers typically welcome effective and appropriate examination and supervision. They value supervision because they know that good examiners will help them to be proactive and identify problems early, and because a strong and durable banking system is in everyone’s best interest. When I was appointed by Governor O’Malley as commissioner at the onset of the financial crisis, one of my first observations was that I was going to have a very hard time retaining and attracting good examiner talent, which was critical to helping manage the crisis. To get the resources needed to ensure that we maintained a strong, experienced examination staff, I faced two major hurdles: I had to deal with the state budget folks, and I had to make the case for higher assessments from the banks. Needless to say, I was rather dreading the conversation when I picked up the phone to call Kathleen Murphy, the president and chief executive officer of the Maryland Bankers Association. But I was pleasantly surprised to hear her say that not only did Maryland bankers want examiners who were well trained and held a level of expertise--so much so that they would pay for it--but that she would be willing to testify as such to the state legislature’s finance committee. That attitude underscores how the examination and

supervision functions are embraced and factored into the business of being an excellent community bank.

My perspective on the examination and supervision function has only deepened during my term as a Governor at the Federal Reserve Board. Indeed, being a Governor in the post-financial-crisis era has made me much more sensitive to the importance of making sure we conduct examination and supervision in a way that helps ensure we think through potential consequences, such as unnecessarily hindering lending to creditworthy borrowers. Access to credit, after all, is a critical factor supporting recovery in our economy.

Monetary Policy and Credit Availability

To gain some perspective on this issue, let's set aside for a moment the beautiful Eastern Shore and the examiners in their new business-casual attire, taking the bus to the banks, and approach examination and supervision from the perspective of monetary macroeconomics and the Federal Reserve's decisionmaking over the past several years.

As most of you know, the economy began slowing in late 2007 and early 2008 and turned sharply downward in the autumn of 2008 when the financial crisis intensified, resulting in the worst recession in many decades. By the end of 2009, the unemployment rate reached a horrifying 10 percent, corresponding to more than 15 million Americans being out of work, with all of the attendant social consequences--including lost income and wealth, mortgage foreclosures, family strains, health problems, and so on.

Officially, the recovery from the recession began in the third quarter of 2009, but the pace of recovery has been modest. Moreover, we know that the recession was deeper and the recovery weaker than had previously been thought. The resulting financial

strains on many businesses and households have been severe. This consequence is starkly evident in the recent pattern of loan delinquency rates. Delinquency rates have been slow to return to their pre-recession levels, with some of these measures, such as those associated with certain categories of real estate loans, staying still quite elevated today. Against this backdrop, the Federal Reserve's data show that after contracting for several quarters, lending by smaller domestic banks generally resumed expanding around the middle of last year. Although measures of community banks' profitability have risen from their recession lows, pressures on the banks' profitability and credit quality remain as a result of the lingering weak macroeconomic fundamentals, especially the stubbornly high amount of unemployment.

In that regard, although the pace of employment growth has picked up in recent months and the unemployment rate has fallen some, the labor market remains quite weak. At the end of 2011, more than 13 million Americans were out of work. An additional 8 million workers were classified as "part time for economic reasons" because their hours had been cut back or they were unable to find a full-time job. In addition, about 2-1/2 million Americans were classified as "marginally attached" to the labor force because even though they wanted to get a job, they had not searched for one in the past four weeks. And almost half of that group--nearly 1 million individuals--had given up searching for employment altogether because they did not believe any jobs were available to them. The unemployed, the underemployed, the marginally attached, and the discouraged can speak powerfully to the slow pace of the recovery.

The economic data in this regard correspond to what I have seen firsthand since being at the Federal Reserve. I have traveled to once-robust cities in the Midwest and in

other parts of the country. I have walked through foreclosed homes and have seen blighted neighborhoods. I have visited unemployment insurance offices and job training centers, and I have met lots of people who have been out of work for more than a year or two--out of work for so long that some of them are embarrassed to show their resumes to potential employers.

These circumstances have called for forceful policy measures.

In normal times, the Federal Reserve adjusts the stance of monetary policy largely through changes in the Federal Open Market Committee's (FOMC) target for the federal funds rate. The Federal Reserve then adjusts the supply of reserves in the banking system through open market operations to keep the federal funds rate close to the FOMC's target rate. The current and anticipated level of the target federal funds rate then influences the level of many other interest rates in the economy. For example, a reduction in the FOMC's target rate tends to reduce borrowing rates for households and businesses, including auto loan rates, mortgage rates, and rates on business loans.

With cheaper borrowing rates, consumers tend to increase their purchases of houses, cars, and various other goods and services. In response, businesses ramp up their production to meet the increased level of sales. Moreover, with lower costs of financing for new equipment and structures, businesses may be inclined to increase their own spending on investment projects that they might previously have seen as only marginally profitable.

The Federal Reserve's monetary policy has been accommodative since the onset of the financial crisis. In particular, the federal funds rate target, which stood at

5-1/4 percent in mid-2007, was subsequently reduced to a range of 0 to 1/4 percent by the end of 2008, and that target range has been maintained since then.

Given the magnitude of the financial crisis and its aftermath, the Federal Reserve clearly needed to provide additional monetary accommodation beyond simply keeping short-term interest rates close to zero. Consequently, like a number of other major central banks around the world, the FOMC has been deploying unconventional policy tools to promote the economic recovery.

In particular, we have provided conditional forward guidance about the likely future path of the federal funds rate, and we have engaged in balance sheet operations that involve changes in the size and composition of our securities holdings. Broadly speaking, these policy tools affect the economy through channels that are similar to those of conventional monetary policy. Specifically, forward guidance and balance sheet operations have been employed to put downward pressure on interest rates; lower interest rates, in turn, reduce the costs of borrowing for households and businesses and also boost household wealth, thereby providing economic stimulus.

In my judgment, our deployment of unconventional policy tools has been completely appropriate to help promote the Federal Reserve's statutory mandate of maximum employment and price stability. Ideally, monetary policy decisions would be informed by precise quantitative information about the effects of each tool. We do our best in this regard, and I can certainly attest that the FOMC reviews an enormous amount of information and analysis in reaching its decisions. That said, even in normal times, uncertainty is intrinsic to real-world monetary policymaking. Uncertainty about the effects of policy is particularly relevant under current circumstances where the scope for

conventional monetary policy is constrained by the zero lower bound on the federal funds rate, leaving unconventional tools as the only means of providing further monetary accommodation.

However, certain factors could be constraining the channels through which monetary policy accommodation affects the economy. In particular, many small businesses appear to be facing unusual obstacles in obtaining credit. If times were more typical, we would expect a smooth transmission in which lower interest rates would fuel credit expansion that would be used to finance expanding payrolls, capital investment, inventories, and other short-term operating expenses. Nonetheless, the latest Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, which was taken in October, indicated that although domestic banks continued to ease standards on their commercial and industrial loans, the net fraction reporting easing on such loans to smaller firms (those with annual sales of less than \$50 million) remained low.¹ Moreover, in recent quarters the fraction easing standards for smaller firms generally has been below that for loans to large and middle-sized firms. In its November survey, the National Federation of Independent Business continued to indicate a sizable proportion of small businesses reporting that credit has become more difficult to obtain.² These businesses not only expect credit to become tighter in coming months but--like other businesses--remain concerned about the broader economic outlook.

Supervision and Examination of Large and Community Banks

¹ The Senior Loan Officer Opinion Survey on Bank Lending Practices is available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

² See National Federation of Independent Business (2011), *NFIB Small Business Economic Trends* (Nashville: NFIB, December), www.nfib.com/Portals/0/PDF/sbet/sbet201112.pdf.

While the ability of businesses to access credit is a function of many factors, it is my view that the examination and supervision of the lender should not hinder the ability of creditworthy businesses to access credit. To be clear, I do not think this is occurring in any significant way, but it is an issue that we at the Federal Reserve focus on continually.

Of course, banks are far more likely to be able to lend when they are in sound financial condition. In that regard, I am encouraged that community banks are faring better in the current environment. There is still considerable uncertainty about the health of residential and commercial real estate markets in many parts of the country, and many community banks' balance sheets remain weighed down with nonperforming real estate loans. At the same time, the competitive landscape is being shaped by increasing consolidation in the industry. Having said that, despite the tough road that many community banks still must navigate, there are promising signs that conditions seem to be stabilizing. While profitability remains below long-run historical norms, returns on equity and assets have reached their highest post-crisis levels.³ Earnings have steadily improved in recent quarters despite compressed net interest margins. Although nonperforming asset ratios remain high, they have continued to decline for community banks broadly speaking, and small community banks (those with total assets of less than \$1 billion) in recent quarters have registered their first overall decreases in this ratio since the crisis began.

Nonetheless, we must continue to think about how we can improve the examination and supervision of community banks. One issue that we constantly must evaluate is the appropriate balance in the allocation of responsibilities between banks and

³ Observations about recent financial developments generally are based on Call Report data filed by banks as of September 30, 2011.

examiners.⁴ In addition, we must always think about whether the allocation of responsibilities should be different depending on whether the supervision is of a community bank rather than a large bank, especially one whose failure could significantly disrupt the broader financial system.⁵ Specifically, there are key differences between these two sets of institutions, and these differences have implications for our supervisory framework.

The way the banking industry has evolved over at least the past decade indicates a trend toward greater concentration. Ninety-nine percent of banks in the United States are community banks, with most of these holding less than \$1 billion in total assets. The remaining 1 percent of banks together hold more than 80 percent of the assets in the banking system, with much of this concentrated at a handful of the very largest banks. The four largest commercial banks, each of which has more than \$1 trillion in consolidated assets, collectively hold just under half of all U.S. banking assets.⁶

The largest commercial banks are characterized not only by their size, but also by their scope of operations and complexity. Their legal and business line structures, balance sheets, and product offerings often are extraordinarily complex. For example,

⁴ See Sarah Bloom Raskin (2011), “Community Bankers and Supervisors: Seeking Balance,” speech delivered at the Federal Reserve Bank of New York Community Bankers Conference, New York, N.Y., April 7, www.federalreserve.gov/newsevents/speech/raskin20110407a.htm.

⁵ For the purposes of these remarks and for the Federal Reserve’s supervisory programs, the largest banking organizations are generally considered to be those banks and bank holding companies with total consolidated assets of \$50 billion or greater. Oversight of approximately a dozen of the largest and most complex organizations is conducted by the Federal Reserve’s Large Institution Supervision Coordinating Committee; see Ben S. Bernanke (2011), “Implementing a Macroprudential Approach to Supervision and Regulation,” speech delivered at the Federal Reserve Bank of Chicago’s 47th Annual Conference on Bank Structure and Competition, Chicago, Ill., May 5, www.federalreserve.gov/newsevents/speech/bernanke20110505a.htm.

⁶ Of course, there are still banking organizations that are at neither end of the spectrum, which our supervisory program reflects. Regional banking organizations, for example, which are generally considered to be those banks and bank holding companies with total consolidated assets between \$10 billion and \$50 billion, share characteristics of both larger and smaller institutions, and we have a tailored supervisory program for those organizations. For the purposes of today’s discussion, however, I would like to focus my remarks on the institutions at opposite ends of the spectrum.

they have extensive trading and capital markets activities, and make significant use of over-the-counter derivative instruments and other complex financial products. They are relatively diversified, but also tend to be more highly leveraged than smaller institutions, and often rely on more volatile wholesale funding. These organizations often are tightly interconnected, raising the prospect that the failure of one institution could rapidly destabilize the wider financial system, giving rise to the “too-big-to-fail” problem.⁷

The characteristics of the largest commercial banks stand in contrast with those of community banks. To be clear, community banks are not immune from taking on excessive risk. But there are reasons why risks at community banks are likely to be less dangerous to the financial system. First, community banks generally are less complex and more easily understood. Second, community banks tend to be more traditional in approach. What is often referred to as “financial engineering” is less likely to become the norm in community banks because such engineering, by definition, may pose hidden risks that could reflect poorly on community bankers’ judgment and negatively affect their image in the community if these risks are realized. Third, community banks are less interconnected, so when a community bank fails, the effects are less widespread.

All of these characteristics have implications for how large and complex banks should be supervised, as compared with community banks. Notably, our supervision of large banks reflects the scope and complexity of their activities as well as their interactions with other firms and possible effects on financial markets, and incorporates

⁷ When the Basel Committee on Banking Supervision recently issued rules for global banks that are systemically important, the methodology for determining system importance was based on five criteria: size, interconnectedness, lack of available substitutes, global/cross-jurisdictional activity, and complexity. See Basel Committee on Banking Supervision (2011), *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement* (Basel, Switzerland: Bank for International Settlements, November), www.bis.org/publ/bcbs207.htm.

systemic risk considerations that could arise from the failure of these banks. This circumstance requires regulators to make capital, liquidity, and risk-management standards more stringent for large banks than for community banks. These standards not only are being established internationally, but also are required for the largest institutions under the Dodd-Frank Act. A critical part of this supervisory process is rigorous capital planning and stress testing to ensure that the largest institutions are capable of absorbing unforeseen shocks. The Federal Reserve, for example, requires the largest top-tier bank holding companies to submit annual capital plans and conduct rigorous stress tests as part of the Comprehensive Capital Analysis and Review exercise.⁸ In recognition of their systemic importance, the largest firms also are required to plan for their own orderly resolution in the event that they should fail.

Because of their complexity and risk characteristics, these firms require intensive and continuous on-site supervision; the Federal Reserve has dozens of full-time examiners on site at the largest banks to monitor their risk-management systems, strategies, and operations on an ongoing basis. In the years since the crisis began, our supervision of these firms has become arguably much more intensive, which I believe is perfectly appropriate given the effect that problems at the largest firms had on the financial system and the broader economy.

You may be asking, What does this have to do with community banks? Not very much--which is precisely my point. The community banking model is very different from that of the largest banks. Community banks are local by their very nature. They have deep roots in their communities. Their value proposition is that they are able and

⁸ See Board of Governors of the Federal Reserve System (2011), "Federal Reserve Board Issues Final Rule on Annual Capital Plans, Launches 2012 Review," press release, November 22, www.federalreserve.gov/newsevents/press/bcreg/20111122a.htm.

willing to take the time and effort to know and work with their customers in a way that may not be possible for a larger, more distant institution. This trait is particularly important when it comes to small business lending, where a local community bank may understand things about a prospective customer that cannot be captured in a more quantitative credit-scoring model that might be used by a larger institution. Risks at community banks tend to arise from their lending activities, whether in the form of credit or interest rate risk, and a lack of diversification can exacerbate these risks. Unlike large, complex banks, community banks typically do not rely on their investment portfolios or diversified business lines to offset low profits.

All of these characteristics call for a very different model of examination and supervision than what is required for the largest banks. Just as community banks have a deep understanding of their local communities, it is important that examiners also understand local market conditions to be able to put the bank's management and credit decisions in the proper context. For example, when I was commissioner here, there was an old joke among state examiners that you never dared set foot in a bank on the Eastern Shore if you didn't know the latest monthly count of blue crabs.

Strong lines of communication between examiners and community banks are vitally important. Examiners are only on site periodically at most community banks, so it is essential that when they are on site, they communicate clearly with management about supervisory concerns in order to help bankers make improvements as appropriate.⁹

Examiners need to listen carefully to management to understand their perspective where

⁹ Full-scope, on-site examinations of state member banks typically are required at least once during each 12-month period, although this may vary depending on, among other things, the size and condition of the bank. See Board of Governors of the Federal Reserve System (2000), *Commercial Bank Examination Manual*, section 1000.1 (Washington: Board of Governors, May), www.federalreserve.gov/boarddocs/supmanual/cbem/0005cbem.pdf.

views may differ. I also believe it is critically important for federal examiners to work closely with their state colleagues, especially since we have joint supervisory responsibility for state-chartered banks that are members of the Federal Reserve System. When these working relationships are strong, the banks we jointly oversee receive supervisory messages that are consistent.

The need for effective communication and feedback goes beyond the examination period. Examiners and other supervisory staff are often key sources of information on regulatory developments between examinations. We encourage our examiners to be responsive to questions from bankers and help banks understand new regulatory requirements, and they take this responsibility seriously.

One of the analogies that I began to use years ago--and that I've shared with many of you--is that the risk-management system of a healthy bank can be pictured as a series of concentric circles. The inner circles consist of the systems and functions that keep the bank healthy and allow it to meet the credit needs of its community while remaining financially sound and compliant with its legal and regulatory obligations. Moving outward, additional circles include processes and checks such as internal audit, executive management committees, risk-management and internal controls, and appropriate governance by the board of directors. The outermost circle is effective supervision. The critical element of this model is that problem identification is first and foremost the responsibility of the bank, while banking supervisors kick the tires of the bank's risk-management and internal control systems. The examiners are, in this sense, a last line of defense and do not substitute for a bank's own processes for risk identification and mitigation. They are not a guarantee of the bank's ultimate success or failure.

While I think this model of concentric circles generally holds true for banks of all sizes, the complexity of the largest institutions requires far more complex inner circles. Arguably, the financial crisis revealed that at many of the largest firms, the sophistication of these banks' governance, controls, and risk management did not keep pace with the rapid growth of risk. Moreover, because the potential cost of a breakdown at the largest firms includes losses that are external to the financial institution, it is essential that a strong outer circle of effective supervision be in place as an extra buffer to insulate other firms and taxpayers from systemic risk. I would suggest that the outer circle that is necessary at a systemically important bank should be far more layered than what is needed at a small community bank.

Community Bank Supervision at the Federal Reserve

One way we at the Federal Reserve are working to ensure that our supervisory program is properly tailored to the wide array of institutions we supervise is to review policies that are under development with an eye toward considering the effect that these policies might have on smaller institutions. In this regard, along with my colleague Governor Betsy Duke, I serve on a subcommittee of the Board that oversees the supervision of community and small regional banking organizations. Among other things, we consider not only whether specific policies are appropriate for community banks, but also whether these policies could have the effect of reducing the availability of credit to sound borrowers. We are actively involved in providing greater clarity and specificity regarding the applicability of supervisory policies to community banks. One of the things that I try to do whenever I review policies is to draw on my experience of working with community banks in Maryland and think about the effects these policies are

likely to have on community banks and the areas they serve. Ideally, our supervisory policies result in stronger community banks that are able to lend and promote sustainable economic growth in their communities.

Let me conclude my remarks by again thanking you for the opportunity to share my thoughts today. I certainly don't claim to have all the answers when it comes to supervising community banks, but I hope my remarks will at least continue our conversation about how best to structure a regulatory and supervisory framework for the banking system that effectively supports the real economy and encourages sound and sustained lending to creditworthy borrowers. In order to sustain the economic recovery, we need strong, well-run community banks that operate in a framework of smart and effective supervision. I commend you for the work that you are doing every day in your communities, and I look forward to continuing the dialogue.