Why Community Banks Matter

Remarks by

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

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Community banks have an important connection with the Federal Reserve. Across the 12 Federal Reserve Banks, some 68 bankers serve as directors on either Reserve Bank or Branch boards and nearly all of them are community bankers. These individuals bring important perspectives to our work. I appreciate their contributions as well as the core function that community banks serve in thousands of communities across the United States.

I hope you'll indulge me as I briefly preface my remarks this morning with some personal history. Yesterday marked a milestone for me: 35 years of service with the Federal Reserve. When I came to work for the Kansas City Fed as a bank examiner in 1982, I was also a first-time homeowner. I was delighted to have a job that would help me pay my bills, especially my mortgage. At that time, I thought I'd made a steal to have assumed an existing mortgage at the low rate of 12 percent.

Working at the Fed, I soon came to appreciate that it was a particularly challenging year for the banking industry. Our region was hard hit by the trifecta of downturns in commercial real estate, energy and agriculture. That year, the failure of a small bank in Oklahoma triggered the failure and eventual government bailout of one of the largest banks in the U.S. Meanwhile, hundreds of banks failed in the Tenth District. This was the environment in which I was trained to be a bank supervisor.

This also was the year that a former New York Fed president, Gerald Corrigan, wrote an essay titled "Are Banks Special?"[1] It proved to be a foundational piece that has been occasionally revisited by others in the 35 years since. Today, I would like to return to the theme of Mr. Corrigan's essay by looking at the role of banks while asking a slightly different question, "Do traditional banks still matter to the U.S. economy?" A spoiler alert: My answer is a

[1] E. Gerald Corrigan served as president of the Federal Reserve Bank of Minneapolis from 1980 to 1984 and president of the Federal Reserve Bank of New York from 1985 to 1993.

definitive “yes.” I’ll use the remainder of my time today outlining why this is so, and why I believe this key component of the U.S. economy may be at risk.

Before going further, I should note that my comments today are my views only and not those of the Federal Reserve System or its Board of Governors.

The Banking Landscape in 1982

In an interview some years later, Mr. Corrigan recalled the reason he wrote the 1982 essay. Simply put, the competitive position of traditional banks was rapidly eroding, and policymakers were contemplating the implications.

In the early 1980s, the combination of high interest rates and deposit rate ceilings made it difficult for banks to compete with alternatives that were not subject to the same restrictions, including savings and loan NOW accounts and money market mutual funds. By the time interest rate ceilings were eliminated on most deposits, money market funds were well established.

In credit markets, the seeds of greater capital market competition for bank loans were also planted in the early 1980s. The development of government and agency mortgage-backed securities were followed by private label mortgage and other asset-backed securities. Another major innovation was funding new credits with high-yield bonds, which previously had been used only to refinance companies whose debt had been downgraded below investment grade.

Given the dramatic nature of these changes, questions arose about whether the role of banks had been diminished. Would these new nonbank entrants supplant their role? Did it matter?

With reflection on these questions, Mr. Corrigan concluded that banks were different and unique in three ways:

- Only banks offered transaction deposits payable on demand at par and readily transferable;
- Banks served as the primary and ultimate source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial;
- Banks served as the transmission mechanism for monetary policy which, combined with operating the payments mechanism, facilitates efficient markets and orderly end of day settlement – a particularly important role in periods of financial stress.

At that time, these special characteristics of banks had three important implications for the structure of our financial system and its regulation:

- No other type of financial company had its funding protected by the public safety net of federal deposit insurance and the Federal Reserve discount window.
- Banks were regulated and supervised because of this safety net and their key role in the economy. At that time, the separation of commercial banking from investment banking and commerce was an important part of the prudential regulatory structure.
- Only banks had direct access to the Federal Reserve's payments rails.

From 1982 to 1999, the financial system continued to evolve, aided by regulatory interpretation and court decisions. And the banking industry began to experience rapid consolidation. Much of the consolidation reflected mergers of smaller banks as intrastate and interstate restrictions were relaxed. However, the most significant effect for the banking system was an increase in the market share of the largest banks, driven by their efforts to create nationwide operations and enhance global competitiveness. During this period, the market share of the ten largest banking companies increased from 28 percent to 51 percent of total banking assets.

The scale of these firms made it profitable to operate securities dealing and underwriting subsidiaries under the Glass-Steagall Act's Section 20 authority. This was the first major crack in the wall between commercial and investment banking. In 1999, Glass-Steagall gave way to the Gramm-Leach-Bliley Act (GLBA), which invited bank holding companies to adopt investment banking activities with important safety net advantages.

With the addition of these nonbanking activities, the 10 largest banking organizations saw their market share rise further to 55 percent in 2007. Meanwhile, the composition of their assets changed dramatically. The average portfolio share of nonbanking assets rose from only 13 percent in 1997 to 25 percent in 2007.

This summer marks the tenth anniversary of the financial crisis. That event brought to light what had previously only been conceptually understood: the largest banking organizations were highly interconnected and indeed too big to fail (TBTF). The safety net designed to cover only commercial banking activities was stretched well beyond the insured depository subsidiaries to their parent companies and nonbanking subsidiaries. However, only commercial banks truly retained the unique characteristics that Mr. Corrigan argued made them special.

As a practical matter, the largest banks were the only firms that could acquire other large and troubled investment banks, commercial banks, and savings associations. The remaining large independent investment banks became bank holding companies. As a result, the 10 largest banking organizations now account for 67 percent of industry assets, while the average nonbanking-asset share of their portfolios has climbed to 29 percent.

As I look through the lens of the past 35 years, the financial system landscape has certainly changed. There are three features that I find particularly striking over this period.

- Banking system assets as a share of financial system assets have fallen from 37 to 19 percent.
- The number of banks has significantly declined from more than 18,000 to around 5,000, largely reflected in fewer community banks with less than $100 million of assets.
- Community banks' market share fell from 45 percent in 1982 to just 13 percent today.

What has emerged within the banking system are two very different kinds of commercial banking firms: a small number of very large banking organizations with significant nonbanking activities and sufficient scale to pose systemic risk to the economy, and thousands of traditional banks generally referred to as community banks.

Do Traditional Banks Matter to the U.S. Economy in 2017?

Despite such monumental shifts in the financial system landscape, one could reach the same conclusion today as Mr. Corrigan did in 1982. Namely, that the banking system retains a unique role in our economy. Banks are still the only type of financial firm that can provide liquidity whenever needed, ensure payments are readily transferable, and aid the implementation of monetary policy.

Yet, the differences between the largest banks and community banks are significant and those differences pose important challenges for setting effective regulatory policy. This leads me to ask a slightly different question than Mr. Corrigan asked: Are traditional banks, or community banks, still important to the U.S. economy in 2017?

I answered this question affirmatively at the beginning of my remarks. Indeed, traditional banks are essential to thousands of communities across the country. In contrast to the largest banks, community banks still rely primarily on relationship lending, with a focus on funding local loans with core deposits. Their heterogeneous customer base and credit decisions include not only quantitative but qualitative aspects including judgments about the repayment ability of their Main Street customers. These bankers serve on the boards of local schools, hospitals and other civic organizations, providing a key source of leadership in the community. They serve their communities and are part of their communities.

But do they matter to the U.S. economy as a whole? Can online banking and scale satisfy the credit needs on Main Streets and in rural areas? I am reminded that although we often refer to "the U.S. economy" in aggregate, as though it were a single monolithic entity, there are in fact thousands of micro-economies that taken together make up the $19 trillion U.S. economy. In these micro-economies, community banks are a critical source of financing for small businesses, including startups. While community banks account for just 13 percent of industry assets, they are responsible for some 40 percent of bank lending to small businesses. In turn, small businesses with less than 500 employees account for about 50 percent of U.S. private employment.[2] Moreover, recent research shows that small startups with 20 to 499 employees play a large role in net job creation that continues for up to five years after their formation.[3]

This evidence indicates community banks are still extremely important to our economy, although, their competitive position is under stress. Market forces of technology and innovation are everywhere and community banks will need to be responsive to customer demand for new services and methods of banking. But these are not the forces that particularly concern me. The risk I see stems from a misaligned regulatory environment that poses a threat in my view to the

[2] "United States Small Business Profile, 2016," U.S. Small Business Administration, Office of Advocacy.
[3] See Robert Jay Dilger, "Small Business Administration and Job Creation," Congressional Research Service, February 8, 2017.

diversity of the U.S. banking system and healthy competition that has long served the country well.

Policy Implications

Today, the nation stands at a crossroads of policy choices. As policymakers consider regulatory reform, the special role of banks in our economy and particularly the role of community banks, must factor into their decisions.

We witnessed the tremendous cost of a financial crisis. The regulatory response that followed was well intended and even justified in its aims to end TBTF and protect consumers. However, while the aim was specific to the largest banks, the regulatory net has ensnared thousands of community banks. Regulators have applied supervisory approaches and protections that often fail to take into account the incentives and risk profile associated with relationship lending models of community banks.

For example, international capital standards, which formed the basis to reduce leverage in the biggest banks, layer on unnecessary reporting requirements and complexity for banks that already held high levels of capital. Appraisal standards aimed to ensure independent valuations support new loans create challenges for thousands of smaller banks that are portfolio lenders. These small institutions, often located in more rural markets, struggle to find knowledgeable appraisers with sufficient comparable property sales to comply with the rules, and in some cases, conclude that qualified borrowers' credit needs can't be met.

Finally, rules aimed at protecting consumers and other customers from unfair and deceptive practices are important. However, long-term relationship lending also aligns the incentives that protect community bank customers. Unfortunately, the compliance burden for community banks introduces costly processes along with fear and confusion as they struggle to apply narrow legal interpretations and opaque statistical models to the fair credit needs of their borrowers.

Ultimately, communities suffer when access to credit is unnecessarily limited, and so does the larger economy. Rules that aim to address the business models and incentives of the largest banks may unintentionally put the diversity of the banking system at risk, and the lack of new bank charters over the past decade suggests the barriers to entry may be high.

Conclusion

The regulatory remedy for today's banking system will not be easily prescribed. But it will need to recognize that the institutions we collectively refer to as "commercial banks" have drifted apart over the past 35 years. At one end of the spectrum are banks that engage in global financing with systemic implications for failure and impact to the broader economy. At the other end are banks that engage in traditional lending and deposit-taking, whose impact on small business and small communities translates to real economic outcomes.

Today, the federal safety net supports both models and it is sagging, stretched by ever-larger and more complex firms with significant nonbanking activities. Banking regulation must do its best to offset the very real exposures for taxpayers and the risk to economic and financial stability. Nurturing incentives that reward success and punish failure are key. Aligning regulation that effectively addresses risk at both ends of this spectrum will require that regulators either close the gap between their differences or embrace the two models and attempt to apply very different supervisory frameworks and approaches.

Market forces will continue to reshape the industry as they have for the past 35 years and longer. And community bankers are no strangers to those market forces or a challenging operating environment. But the banking industry has evolved in very different ways and rules that inhibit market forces without offsetting gain warrant scrutiny.

As a highly concentrated banking system takes hold in the U.S., the issue of today's banking landscape poses a slightly different but important question about the ability of regulation to differentiate its aim. It will matter to thousands of communities served by you in the years ahead, and by extension to the U.S. economy.