Community Banks: Stability in Crisis and Catalysts for Recovery

Remarks by

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Thank you for the opportunity to join you today.

In my remarks, I am going to focus on the role that community banks have played in supporting the economy throughout the pandemic. I'll begin by talking for a few minutes about the Federal Reserve's response to the crisis and some of the immediate issues we saw in the banking sector early on. I will then turn to the importance of community banks throughout this period. I'll also offer some considerations on how the pandemic could shape banking going forward, with a particular emphasis on industry concentration.[1]

The Fed's Crisis Response

The Covid-19 pandemic, and the actions required to contain it, have had a profound impact on the U.S. economy and financial system. As the virus spread throughout the country, the economic outlook deteriorated sharply. In March, businesses began to slow production or close their doors and consumers reduced spending, both as they withdrew from economic activity and to buffer against an impending downturn. These actions, and the continued uncertainty around the virus's projected path, sparked a full-scale economic recession and financial panic.

The Federal Reserve's unprecedented actions to support the economy during the pandemic involved a combination of conventional and unconventional monetary tools and discount window lending. Borrowing from the Financial Crisis playbook, the Federal Reserve issued credit to a number of financial actors including primary dealers, commercial banks, money market funds, and special purpose vehicles holding asset-backed securities in order to facilitate the continued flow of credit into the real economy. In an unprecedented step, the Federal Reserve joined with the U.S. Treasury to issue credit to non-financial firms and local governments. These programs require the Federal Reserve to take on some amount of credit risk, and as such they are backed by an equity stake from the U.S. Treasury. In addition, the Federal Reserve purchased sizable amounts of Treasury and mortgage-backed securities to ensure that capital markets continued to remain liquid and open to investors.

[1] I thank Rajdeep Sengupta, Blake Marsh and Nick Baker of the Federal Reserve Bank of Kansas City for their assistance in preparing these remarks.

The Federal Reserve's actions rely on commercial banks as a conduit to channel funds into the real economy, and we have taken steps to ensure that banks can continue to lend. For example, the U.S. Treasury provided loans to businesses under the Payroll Protection Program (PPP) made through partner lending institutions. By taking extraordinary measures to reach out to customers and work with existing borrowers, small banks accounted for 40 percent of the program's total lending. This surge in lending, however, resulted in reduced balance sheet capacity for participating banks. In response, the Federal Reserve established the PPP liquidity facility, which accepts these loans as collateral in order to free up cash for additional lending.[2] Capital regulations for certain asset classes and loan types were also eased to facilitate Treasury market functioning and to blunt the balance sheet impact of business lending.

Other aspects of the crisis response have also importantly involved banks. The CARES Act authorized forbearance programs to ease payment pressures on a number of consumer loan products. Forbearance allows consumers to delay payment of their loans until employment conditions return to more-normal levels and helps banks conserve capital by avoiding delinquencies that become charge-offs down the road. In this aspect, the banking agencies are committed to working with banks to find acceptable ways to mitigate loan losses throughout the remainder of the pandemic. Preserving bank capital and keeping credit flowing throughout the economy is essential.

The Early Impact of the Pandemic on the Banking Sector

During the early days of the crisis, businesses turned to banks of all sizes in an effort to protect themselves against rising economic and financial stress. Precautionary draws on existing lines of credit increased sharply in March as firms tried to cover expected revenue declines. At the same time, deposits flowed into the banking system as a flight-to-quality ensued and both firms and investors showed a preference for holding cash over other financial assets.

The effects of the crisis varied among banks of different sizes and operating models. While balance sheets grew quickly across the banking universe, large banks experienced the majority of the loan draws and deposit inflows and, therefore, bore the brunt of the immediate

[2] Community banks have been important users of the PPPLF with 50 percent of current total take up, or $34 billion, as of August 31, 2020.

pandemic-related activity. Smaller banks quickly engaged with borrowers to assess their needs and offered payment deferral.

To date, few stresses have emerged across banks despite the severe economic contraction. The level of problem assets reported by banks in the second quarter remained at historic lows, and capital buffers, despite declining as balance sheets grew, stayed above regulatory minimums. The resilience of the banking system certainly reflects stronger capital and liquidity positions built up over the last decade. The response of fiscal and monetary policy to support households and businesses, along with actions taken by the banking agencies to offer aspects of supervisory and regulatory relief, has undoubtedly muted the impact to banking conditions so far.

The economic recovery, however, is far from complete. Strains on household and commercial balance sheets since March have created fragilities that could yet threaten bank profitability and loss-absorbing capacity for some time. Adequate capital is critically important for the safety and soundness of banks, as well as for the continued provisioning of credit that keeps our financial system and our economy functioning during periods of stress. There is widespread consensus among economists and policymakers that bank capital not only serves as a buffer against unexpected losses and insolvency, but also mitigates excessive risk-taking incentives. Higher capital levels reduce the probability of failure and crises, and better capitalized banks can hasten a post-crisis recovery.

The Pandemic and Community Banks

Community banks continue to be central to the health of local communities and collectively to the health of the nation's economy. This is particularly true for the access to credit required for small businesses, which have been hit hard by the pandemic. These businesses employed 60 million people or 47 percent of the private workforce in 2016.[3] As of August, both small business revenue and employment were down 19 percent since the beginning of the year.[4]

Community banks are particularly well-situated to understand the needs of small- to medium-sized businesses where local knowledge and lending relationships exist. These relationships prompted community bankers to reach out and offer assistance to their customers early in the pandemic. It is has also been evident in the launch of the Federal Reserve's Main

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[3] https://cdn.advocacy.sba.gov/wp-content/uploads/2019/04/23142719/2019-Small-Business-Profiles-US.pdf
[4] https://tracktherecovery.org/

Street Loan Facility. Among the more than 500 registered lenders, the overwhelming majority are community banks. And to date, nearly half of the loans purchased by the facility have been extended by community banks. Although there has been some criticism that this program has not been more widely utilized, it appears that the program is serving its intended purpose, and broader use of this funding may be a function of specific terms and operational needs.

In responding to the crisis, community and regional banks have taken prompt action to strengthen balance sheets in light of expected future credit losses. This is evident in the bolstering of loan loss reserves in the first two quarters of this year.[5] For many community banks, commercial real estate and agricultural lending are cornerstones of the business model; as such, concentration risk warrants ongoing attention as strained business revenues and commodity prices threaten the ability of some borrowers to repay their obligations.[6] Thus, community bankers must remain vigilant.

As you well know, the banking landscape has changed significantly over the past three decades. Industry-wide consolidation over this period has increasingly led to the concentration of banking assets in large banking organizations, with the highest concentration of assets within the eight U.S. banks known as the G-SIBs, or global systemically important banks. At the turn of the century, U.S. G-SIBs held one-third of total banking assets and generated around 40 percent of industry profits. As of year-end 2019, G-SIBs account for 60 percent of both the banking industry's assets and its profits. The financial crisis led to a wave of bank failures and mergers that contributed to the ongoing consolidation. Despite the resolution of many failed banks during the crisis (2007-10), unassisted mergers accounted for more of the increased concentration than the resolution of failed banks.[7] While it is always difficult to forecast economic trends, consolidation in the banking industry has continued since the mid-1980s and is likely to continue in the post-pandemic recovery.

[5] Second quarter 2020 data shows substantial provision expense across banks of all sizes.

[6] Risks also noted in the Federal Reserve's May 2020 Financial Stability Report: https://www.federalreserve.gov/publications/2020-may-financial-stability-report-purpose.htm

[7] David C. Wheelock, 2011. "Banking industry consolidation and market structure: impact of the financial crisis and recession," *Review*, Federal Reserve Bank of St. Louis, vol. 93(Nov), pages 419-438.

Recent changes to the operating environment in banking are likely to exacerbate this trend of consolidation. Most economists and policymakers believe that because of differences in size, interconnectedness, complexity, and cross-jurisdictional activity, larger banks should hold relatively more capital than their smaller counterparts. And yet, despite the lessons of the financial crisis and as mentioned previously, critical capital ratios at community banks have been persistently higher than that at the largest banks.[8] Community banks entered this extreme shock with leverage capital at a 20-year high and a collective leverage ratio 270 basis points above that of the GSIBs.[9] This capital advantage undoubtedly affects the competitive environment for community banks. Moreover, recent regulatory changes intended to provide significant capital relief to the largest banks not only raise concerns about financial stability but also could further widen the difference in capital ratios between small and large banks. Capital regulation is creating incentives for banks to grow significantly larger.

Community banks have also noted the challenges they face with persistently low interest rates as another important factor in this operating environment. While low-for-long interest rates negatively affect net interest margins for all banks, margin compression puts community banks at a disadvantage relative to large banks because it is their principal source of income. In contrast, large banks can rely on alternative sources of (noninterest) income such as trading revenues and intermediation fees to offset any decrease in interest margins. From the standpoint of community banks, the large bank model that relies on transactional lending and fee-based income while holding relatively less capital becomes increasingly attractive. In short, both regulation and monetary policy appear to be tilting the scales in favor of large banks.

Some argue that efforts to ease capital requirements are necessary to support the provision of credit to individuals and businesses. I do not find this argument compelling. The Federal Reserve's most recent Senior Loan Officer Lending Survey indicated that no large banks considered their current or expected capital position a "very important" reason in their determination of credit standards.[10] Additionally, large banks benefiting from this change have made significant distributions to shareholders since the pandemic began. These large banks

[8] The Federal Reserve Bank of Kansas City publishes a horizontal comparison of capital adequacy among banking organizations with different risk profiles: https://www.kansascityfed.org/research/bankingandpayments/bca.
[9] Ibid.
[10] July 2020 Senior Loan Officer Survey: https://www.federalreserve.gov/data/sloos/sloos-202007.htm.

distributed more than $50 billion of capital through shareholder dividends and share repurchases in the first six months of this year, representing the equivalent of nearly $1 trillion in balance sheet capacity.[11]

To be sure, regulatory relief during this pandemic likely has played a role in ensuring that banks are able to continue to serve as financial intermediaries. But once the crisis has passed, maintaining robust capital levels at the largest banks will be essential to the nation's economic and financial stability and to the long-term health of a diverse banking system.

There are of course other factors, beyond regulatory incentives, behind banking consolidation trends. Transformational changes in information technology and payments systems also have been important forces that have yielded significant efficiency gains from consolidation, especially in the early years after branching deregulation in the mid-1990s. This consolidation, of course, raises concerns. With policies favoring a banking model that relies on transactional lending and fee-based incomes, a traditional model of banking that relies on lending relationships and local knowledge faces pressure. Numerous studies, including research on the Financial Crisis, have shown that, despite the technology and efficiency gains, abandoning the traditional model has often yielded worse lending outcomes.[12]

Extending broad access to payment systems has long been an objective of the Federal Reserve. As scale and network effects begin to dominate the landscape for instant payment methods, community and regional banks have expressed a desire to provide access to their customers. To facilitate access to faster payments, the Federal Reserve will provide a new payment service called FedNow, providing public benefits related to the safety, efficiency, and accessibility of instant payments, specifically through its ability to reach more than 10,000 of the country's diverse depository institutions, including community banks and rural customers. The pandemic itself has highlighted the need for this capability to expedite payments as the government issued Economic Impact Payments to millions of Americans.

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[11] Distribution data contained in second quarter financial reports. $1 trillion is an estimate using a 15x multiple (5% minimum = 3% SLR minimum + 2% Leverage buffer to avoid distribution limitations).

[12] See, for example, Patrick Bolton & Xavier Freixas & Leonardo Gambacorta & Paolo Emilio Mistrulli, 2016. "Relationship and Transaction Lending in a Crisis," Review of Financial Studies, Society for Financial Studies, vol. 29(10), pages 2643-2676.

Conclusion

The fiscal and monetary policy response to the pandemic has been extraordinary, and the banking industry has played an essential role in supporting this response and providing credit to households and business. Community banks in particular have been indispensable in maintaining access to credit for small business and in doing so have served the needs of local communities as well as contributed to the nation's economic recovery. To be sure, the banking industry must navigate the path to economic recovery, and community banks face the particular challenges of industry concentration and consolidation. Finding ways to address these challenges will shape the diversity of the nation's banks and the crucial role they play as catalysts of the recovery.