Can Community Banks Still Compete?

Esther L. George
President and CEO
Federal Reserve Bank of Kansas City

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Introduction

Community banks are an important part of the Federal Reserve Bank of Kansas City's regional economy, and we have significant supervisory responsibilities for those banks and their holding companies. Certainly, we recognize the challenges facing community banks today. In fact, some have questioned whether community banks will be able to effectively compete going forward. Others remain optimistic and continue to see opportunities for the community bank model, as discussed this morning.

Without question, the recent financial crisis and slow economic recovery are now focusing much attention on the banking industry and its regulatory framework. In particular, the Dodd-Frank Act and the proposed Basel III capital rules are bringing major changes to the regulatory structure. These include the new Financial Stability Oversight Council and Consumer Financial Protection Bureau, enhanced supervision and orderly liquidation authority for systemically important organizations, a new regulatory regime for the capital markets and financial infrastructure, and higher and more complex capital requirements.

Understandably, we often hear from community bankers that they do not expect this changing environment to work well for them. These bankers anticipate being hit with significant regulatory costs for a crisis that originated in other parts of the financial system. I have similar concerns about the current direction of regulatory policy and how it may negatively affect the ability of community banks to be competitive and serve the credit needs of their communities. Today I will discuss my concerns and the importance of ensuring a more equitable landscape for community banks.

Previous Challenges for Community Banks

I should begin by acknowledging that community bankers are no strangers to a challenging operating environment. Over the past few decades, community banks have encountered many challenges and developments that were often thought to favor larger institutions and threaten the future of community banks. Some of you here today experienced those challenges.

When I started at the Federal Reserve in 1982, bank expansion laws were viewed as a serious threat. In many parts of our District, we still had a unit banking structure in which banks could only operate out of a single office or perhaps with a few additional limited-service facilities. Several District states also did not allow multibank holding companies, and interstate banking was nonexistent outside of a few special exceptions.

When efforts were begun to relax these expansion restrictions, a common assertion was that larger, expansion-minded institutions would invade community bank markets and steal their business. We often heard that "Multibank holding companies would be the death of the community bank." As it happened, the liberalization of bank expansion laws still left many community banks in operation, albeit with some reduction in their numbers and overall share of industry assets. Many well-managed community banks have been able to capitalize on this new expansion framework by making acquisitions of their own and spreading their skills over a larger base of operations. In fact, about 60 percent of bank mergers since 1985 have involved one community banking organization acquiring another one.

Similarly, when deposit interest rate ceilings were removed in the 1980s, community bankers were concerned that larger banks would be able and willing to pay more for deposits than community banks—an outcome many claimed would pull deposits out of community banks and destroy their net interest margins. Technological change was also thought to favor large banks because they had the resources to be on the cutting edge of such developments as ATM networks, online banking, automation of banking operations, new financial instruments and risk-management models. Finally, community banks have seen certain lending and product markets shift to larger institutions, captive finance companies, credit unions and the capital markets. Among these shifts have been credit card lending, auto loans, equipment lending and the dominant role community banks once had as the principal repository for their customers' savings.

In all of these cases, community banks have established an innovative track record, whether it is an increased ability to manage funding needs by paying competitive deposit rates, develop their own expertise in technology and find vendors to provide other services, or discover new services to provide to customers. To be sure, the community bank business model has proven resilient and able to withstand significant challenges when boards of directors and their management teams demand strong performance and are willing to be flexible and ready to capitalize on new opportunities.

What Characteristics Allow Community Banks to Survive and Prosper?

Understanding how community banks successfully overcame these challenges is important, especially as we consider the direction of today's financial reforms. I'd like to highlight a couple of studies we've done to analyze this.

First, community banks generally operate with the right incentives and an effective corporate governance structure. Many community banks are closely held institutions with the top management and board members having significant ownership positions. These ownership incentives help to ensure that key policymakers are committed to achieving good performance, have enough at stake to avoid excessive risk-taking, and also have a vested interest in the health of their communities. This is well understood by community bankers, and it stands in sharp contrast to some of the governance problems apparent at larger banks, especially during the crisis. Few outside of the community banking sector, though, fully understand the significance and implications of this governance structure.

The staff of the Federal Reserve Bank of Kansas City has conducted several studies on the ownership and management structure of community banks.[1] We found that the better performing and safer community banks are those where the major policymakers have much to lose if they do not make the right decisions. This conclusion is significant when we consider how community banks should be supervised compared to larger banking organizations.

Another commonly noted strength of community banks is that they have close relationships with and detailed knowledge of their customers. As a general practice, community banks do not make "cookie-cutter" loans and do not offer the same standardized products as larger banks, but instead tailor their services to the needs of their customers.

While many now claim that the value of customer relationships is declining with credit scoring and credit risk models, a recent study at our Bank found that there is real value in relationship lending and in the soft personal information on customers that community bankers typically have.

This study looked at a large sample of Small Business Administration loans made by community banks to new businesses and to other businesses with blemished credit records.

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[1] Robert DeYoung, Kenneth Spong, Richard J. Sullivan, "Who's minding the store? Motivating and monitoring hired managers at small, closely held commercial banks," *Journal of Banking and Finance*, July 2001, pp. 1209-1243; and Richard J. Sullivan and Kenneth R. Spong, "Manager wealth concentration, ownership structure, and risk in commercial banks," *Journal of Financial Intermediation*, April 2007, pp. 229-248.

Given the inherent risk in such loans, one might expect that having a good personal knowledge of these customers would be useful. Not surprisingly, the study found that default rates on these loans were indeed lower when the lending was to businesses located in the same market as the bank. Defaults were higher when the borrowers were in a different market where the bank would not be expected to have the same type of close personal relationships with these borrowers.

Furthermore, the lowest default rates were in smaller communities where local bankers typically have lifelong knowledge of their customers and the closest personal relationships. This research suggests that community banks fulfill a very important function in establishing close relationships and directing credit to customers whose needs might otherwise go unserved. This evidence suggests that policymakers must understand the business model dynamics and incentives for banks of all sizes and must carefully consider the implications of new regulation, its cost and benefit, and its unintended consequences.

A More Equitable and Rational Path for Community Banks

Going forward, community bankers will be challenged once again to find ways to be successful in a difficult environment, ranging from an economy that is growing slowly amid an interest rate environment that is not especially conducive to good banking, to a complex and burdensome regulatory regime. I will focus my remarks on the latter.

The challenges of regulatory compliance have long ranked among community bankers' top concerns. And you and I both know that the industry and regulators view risk differently. For example, in 2006, the banking regulators issued interagency guidance regarding commercial real estate concentrations. Prior to issuing this guidance, we received thousands of letters from the industry and members of Congress questioning the guidance and causing regulators to back away. As it turned out, some bankers would have been well served to heed this warning. So, we believe supervision and regulation can and should play an important role. That said, having been involved in community bank supervision for 30 years, today's regulatory issues, in my view, have different implications.

As you are well aware, much of the new regulation is a reaction to the shortcomings and problems at large banks and within capital markets that contributed to this crisis. Their business model and related activities and practices, combined with lax supervision, have been well documented. The result is a new regulatory environment that is substantially at odds with how community banks actually operate.

For example, residential mortgage lending is likely to become much more complicated despite the focus on simplifying disclosures. This complexity includes new provisions defining qualified mortgage loans, requirements regarding a borrower's ability to repay the loan, risk-retention standards, and an array of risk weights under Basel III based on standard mortgage lending terms. In addition, the Consumer Financial Protection Bureau will be rewriting many of the key regulations related to mortgage lending.

This approach of specifying how residential mortgage loans should be structured and underwritten will undoubtedly leave community bankers with far less flexibility and authority to tailor such lending to the characteristics of their communities and customers. Because of this, it is not uncommon to hear community bankers say that they may be forced to cut back substantially on their home lending activities or even eliminate them entirely. Such unintended consequences are costly and impede mortgage lending at a time when housing markets are weak.

New capital rules, known as Basel III, contain a variety of features that could have a significant effect on community banks if they are adopted as originally proposed. I know this because I read all 1,000 pages of the draft rule. Some of these include higher and more complex risk weights for selected types of loans and securities, inclusion of unrealized gains and losses on certain debt securities in regulatory capital calculations, the treatment of trust preferred securities and additional capital deductions of mortgage servicing assets.

To be clear, I absolutely support efforts to increase the level of capital in our largest banks and improve the quality of this capital, but I find many of these rules to be costly for community banks and of little public benefit for this part of the industry. Risk weights based on standardized lending terms, for instance, completely ignore the data I referenced earlier—that lending relationships and personal information are of substantial value to community banks in controlling credit risks. Nor do the higher, more complex risk weights, as well as the restrictive provisions of Dodd-Frank, accurately reflect the low loss rates that community banks typically experienced on their residential mortgage lending and small business lending during the crisis. In addition, Basel III will almost certainly lead to greater fluctuations in regulatory capital levels at community banks even though the underlying assets and risks may not have changed much.

Furthermore, we should not forget that the proposed Basel III rules are designed to be a three-pillar approach, linking capital requirements with supervision and market discipline. Unfortunately, I think the complexity embedded in the proposed capital requirements fails to acknowledge that supervisory and market assessments of a bank's capital are critical factors in judging capital adequacy. In my experience, the supervision of community banks clearly provides a more refined measure of risk than can be achieved with one-dimensional, static risk weights. And, based on the performance of risk weights in the recent crisis, I support efforts to strengthen our supervisory regime for large banking institutions to balance the assessment of risk beyond quantitative measures of capital.

We should also acknowledge that market discipline plays an important role in community banks. As our studies have shown, the ownership and management structure of community banks provides important incentives, as does a strong corporate governance framework. In the end, community bankers know they are not "too big to fail" and must manage their operations and risk exposures accordingly.

Overall, the strength of the community banking model should tell us that a regulatory format aimed at the largest banking organizations and the recent crisis is not likely to be a good fit for community banks. Some have advocated for a different regulatory framework for community banks to recognize the difference in business models of large and small banks. At best, though, this strikes me as only a partial fix. Until we address the incentive problems and "too big to fail" status of our largest financial institutions, the entire financial sector—indeed the entire economy—will be vulnerable to future crises. For that reason, I would argue that we must also take steps to ensure that the largest institutions operate under a framework that encourages safe and sound banking and allows for failure of mismanaged risk.

Conclusion

In closing, history has shown that well-managed and innovative community banks are well positioned to handle the challenges of the future and to take advantage of new opportunities. The new regulatory challenges, though, may be a different type of battle. I have been involved in discussions to encourage regulators to take steps to ensure that community banks are not put at a disadvantage by laws and rules meant to fix problems that do not exist in community banks. This Reserve Bank is fully committed to this objective, and I encourage all of you to share your thoughts with us and with other regulatory agencies at every opportunity.