President's message

The outlook for 2014

The U.S. economy has been recovering steadily the past few years despite facing obstacles ranging from fiscal policy issues to weak global growth. As we start a new year, the outlook for both the economy and community banks is brighter, but challenges remain.

Real gross domestic product (GDP), one of our broadest measures of economic activity, has shown steady growth over each of the last three quarters. Some of the improvement has been driven by temporary factors, such as inventory accumulation, but if we look past such transitory issues, the data suggest the growth outlook for 2014 may be among the strongest since the end of the recession.

One simple reason growth should improve is the initial impact of last year's fiscal policy stance has eased. The cumulative effect of the mandated spending cuts and higher taxes, by some estimates, was to lower overall real GDP growth by about 1.5 percentage points. Granted, there will likely be further adjustments to fiscal policy to ensure long-term stability, but with the effects from 2013 fading and the recent budget agreement reducing some policy uncertainty, the growth outlook is positive.

Beyond these fiscal issues, more importantly, is the fundamental strengthening in private demand. Better labor markets, stronger household balance sheets and income growth have fostered this improvement. Real disposable income growth and average hourly earnings in the private sector have been trending higher. Employment growth, too, has gained strength, as nearly every major sector has higher employment compared to a year ago.

Businesses also are well-positioned to begin increasing investment in new capital. Corporate profits are at record highs, balance sheets are healthy and many firms have the resources to make new capital expenditures and expand capacity. Many businesses, however, have remained cautious the past few years due to a number of uncertainties that include the strength of the global and U.S. recovery, the impact of regulations and new laws, and concerns over the direction of both fiscal and monetary policy. To the extent these uncertainties fade and global growth strengthens, as it could if Europe continues to recover, business investment is poised for growth.

Accordingly, absent an unexpected shock or a downturn in global growth this year, I expect U.S. growth for 2014 to be in the range of 2.5 percent to 3 percent, reflecting the combination of less fiscal drag, healthier household balance sheets and improving labor markets—one of the better years in some time.

Even as growth projections strengthen, inflation measures remain low. In fact, some have questioned whether inflation is too low given the Fed's inflation target of 2 percent or whether the United States could face the risk of deflation. I do not share those concerns because several special factors appear to be weighing on inflation measures, such as lower-than-usual healthcare costs, changes in how the price of

some financial services are calculated, and low import prices. Additionally, longer-term inflation expectations have remained stable near the 2 percent goal.

The outlook for community banks

As the U.S. economy continues its path to full recovery, a vibrant and diverse system of banks with sustainable, long-term prospects is critical to support the health of local and regional economies, and therefore, the national economy.

Overall, the health of community banks is good, although it has not fully recovered to pre-crisis levels. Net earnings have been relatively flat since 2012, but they are at a respectable level of about 1 percent of assets. Problem assets are trending down, and although they are still somewhat elevated, I expect the trend to continue. Capital ratios also continue to strengthen.

What concerns me, though, is that the quality of net earnings is not strong. Earnings have been largely supported by declining provisions and reserve releases, which we know cannot continue much longer. At the same time, we've seen that the net interest margin, which is the primary source of revenue for community banks, has lost much of its post-recession gain and is near a 40-year low due to the low interest rates and weak loan demand.

With this extreme pressure on net interest margins, bankers have expressed concern about lower underwriting standards, longer maturities at fixed rates and increased competition from larger banks that are likely to pull out of local markets when the economy improves further. Bank supervisors are monitoring these risks for vulnerabilities that will lead to asset quality problems when interest rates start to rise or if there is a downturn in the economy. Even so, an extended period of zero interest rates is not conducive to good banking and encourages a reach for yield.

The effects of this unfavorable interest rate environment are compounded by the regulatory framework. After two decades of deregulation and misplaced confidence in the ability of market discipline to moderate risk exposures, the pendulum has swung in favor of new, complex regulation. Congress responded to the financial panic and the resulting deep recession by passing the Dodd-Frank Act, aimed at reducing the systemic risks posed to our economy by firms that we commonly refer to as too big to fail (TBTF). It remains unclear whether the new regulatory regime will in fact end TBTF and thereby reduce the systemic risk posed by the largest banks and the subsidy they enjoy. My own view is that incentives have not changed in a way that would achieve the desired outcome of a safer, more competitive financial system.

What is clear is that while much effort has been directed to implementing the Dodd-Frank Act, the competitive and regulatory pressures on the community bank model have only worsened. Over the past 30 years, the distribution of banking assets across community, regional and large global banks has moved steadily toward more concentration. Industry concentration has accelerated over the past 15 years with the 10 largest banking firms increasing their share of industry assets from 44

percent in 1997 to 68 percent in 2013. Even more striking, their size has almost tripled as a share of GDP, rising from 24 percent to 68 percent. With this growing scale, the scope of their activities expanded as well. In 1997, these large banking organizations held nearly 90 percent of their assets in traditional banking activities. In 2013, traditional banking accounted for just 67 percent of assets. And the five largest banks designated as posing a systemic risk hold far less equity as a percent of total assets than community banks.

Community banks have lost market share to these large players with a share of industry assets half as large as 15 years ago, falling from 35 percent to 17 percent. Yet, they have generally retained a business model that we associate with traditional banking: making loans and taking deposits in their local communities. In fact, community banks make more than half of all small business loans and extend credit in thousands of locales across the country, including rural areas. Return on equity may be the bottom line in financial reports, but the foundation for the community bank is customer relationships and community economic health.

So as we look toward an improving outlook for 2014, the viability of community banking in the current regulatory and monetary policy environment is a relevant consideration given their important role in meeting local credit needs.

An effective regulatory system

To address the regulatory burden on community banks, a rising chorus is calling for a two-tiered regulatory system to better calibrate regulations according to the business model and size of banks. While I am sympathetic to the idea of this kind of differentiation and the desired relief it hopes to offer, I do not think it is the answer. As we have seen with certain provisions of the Dodd-Frank Act, calibrating regulations across broad groupings of banks is very difficult and the outcomes are not always as intended. And fundamentally, it does not address a more threatening issue to the viability of community banks and the perseverance of a diverse banking system. That issue is TBTF. We must pursue the essential reform needed to eliminate TBTF, which is the cause of the increasingly complex regulatory system confronting community banks and stands in the way of securing a financial system that serves—not threatens—the economic well-being of the country.

I realize that ending TBTF is not necessarily viewed as a community bank's biggest issue. In my own region, community bankers will readily acknowledge that TBTF is a serious problem, but their focus understandably is on the competitor across the street which is generally a government sponsored enterprise, a credit union or another community or regional bank. Others are reluctant to call for reform of these largest banks because they view all banks as part of the same industry and advocate such. Still others have become resigned to TBTF as a permanent fixture of the global financial system that cannot be changed, and therefore, hinge the community bank's survival prospects on tiered regulation as the most practical answer to the regulatory burden.

In many respects, policymakers have already moved toward a bifurcated regulatory

system by resorting to massive and complex rules for TBTF banks in hopes of smothering their systemic risk. These rules may temporarily handicap TBTF risks, but I do not believe these policies can solve the problem. Research suggests that regulatory complexity incentivizes the regulated to game the rules (Kane), while other research finds that simple rules are harder to manipulate and more durable (Haldane).[1]

Because community banks and TBTF banks are inextricably linked by public safety nets, I believe it is in the long-term interest of community banks and the health of our economy to rely on a single regulatory framework. Our existing regulatory framework rests on sound principles—a safe, stable and competitive banking system; equal access to services; consumer protection; and the prevention of illegal activities. To implement these principles, we need rules for banks of all sizes that are understandable, enforceable and equitable. We also need a supervisory process with appropriate flexibility so examiners can apply experienced judgment and thereby differentiate the supervisory regime based on the risk profile and business practices of individual institutions.

In addition, policymakers should consider alternatives that could foster both a safer system and a simpler regulatory framework. Such alternatives include strengthening the separation of banking and commerce or adopting a modern version of Glass-Steagall.[2]

Unfortunately, these ideas have been sidetracked as too blunt or overly simplistic. Such reforms would change incentives to take excessive risk and would simplify the largest banking organizations, providing a stronger foundation for management and boards of directors to govern compliance and risk management. For supervisors, it would improve their ability to enforce rules and facilitate orderly resolutions if a large bank fails. Until TBTF and its subsidized advantages are adequately addressed, economic security remains at risk, and community banks might well expect to lose market share while continuing to deal with the issue of how future regulatory changes can appropriately be applied to them.

In the near term, timely shifts in monetary policy and better calibration of regulatory requirements may offer potential relief to smaller banks. Ultimately, though, ending TBTF and its related advantages will serve to enhance the viability of community banks and restore public confidence. I am hopeful that policymakers will continue to vigorously pursue this important objective.

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The preceding was adapted from remarks delivered during a public address in Madison, Wis., earlier this year.

[1]Edward Kane, "Good Intentions and Unintended Evil: The Case Against Selective Credit Allocation," *Journal of Money, Credit, and Banking*, February 1977. Andrew Haldane, "The Dog and the Frisbee," Federal Reserve Bank of Kansas City's 36th annual Jackson Hole symposium, August 2012. Andrew Haldane, "Constraining Discretion in Bank Regulation," Federal Reserve Bank of Atlanta Conference on "Maintaining Financial Stability: Holding a Tiger by the Tail(s)," April 2013.

[2]For a proposal for a modern version of Glass-Steagall, see Thomas M. Hoenig and Charles S. Morris, "Restructuring the Banking System to Improve Safety and Soundness," Federal Reserve Bank of Kansas City, November 2013. Senators Elizabeth Warren and John McCain proposed the "21st Century Glass-Steagall Act of 2013" to reinstate certain provisions of Glass Steagall that were repealed by the 1999 Gramm-Leach-Bliley Act.