

The Current and Future State of Community Banking*

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I want to thank Marshall and other ICBM officers and members for inviting me to your annual conference. I appreciate the opportunity to share my views on community banking with all of you, but just as importantly, I look forward to your questions and our discussion following my talk. Today I will talk mainly about the state of community banking, especially here in Minnesota. Before I begin, just a reminder that the following views are my own and not necessarily those of my Federal Reserve colleagues.

Pairing community banking and economic performance is natural and important. What happens in Main Street credit markets has a significant influence on the broader economy. Community banks are an essential credit provider for Main Street. Community banks have the skills and knowledge to evaluate borrowers who, because of their size, activity or location, are relatively costly for an outside firm to evaluate. As a result, community banks facilitate beneficial economic activity that would not otherwise take place. The individuals and businesses receiving credit from your banks are key components in both local and national economies; they produce valuable output and provide numerous jobs. As I

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will describe later, these are central concerns of the Federal Reserve as we seek to promote maximum employment and price stability.

I will make my four main points on the state of community banking.

- Community bank recovery from the financial crisis has been strong with regard to asset quality, but earnings and loan growth have lagged.
- Lagging earnings and loans have raised questions about the cost of new, post-crisis supervision and regulation.
- Low earnings and higher regulatory costs have also raised concerns about community bank consolidation and its potential acceleration.

- In response to these concerns and as a matter of prudent public policy, I strongly support “tailoring” supervision and regulation to reflect the risks and roles of community banks.

I will now describe these issues in more detail.

Community bank conditions

Community banks in Minnesota and the nation experienced a very sharp increase in problem loans during the financial crisis. Fortunately, that trend has now reversed.

Consider a standard measure of problem loans: the ratio of noncurrent and delinquent loans to bank capital and the allowance for loan loss. In the first quarter of 2009, that ratio rose for all loans to 24 percent for the median Minnesota bank, double the 25-year median level of 12 percent. For commercial real estate loans, the problem loan ratio rose to about 9 percent, nine times higher than the 20-year median of 1 percent.

The problem loan story has changed completely. The ratio for total loans is at 9.5 percent for the

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median Minnesota bank, right around the 25-year low. And the ratio for problem commercial real estate loans for the median Minnesota bank is at 2 percent and rapidly returning to precrisis levels. These same general patterns hold for the nation’s banks.

The low earnings and negative loan growth for the median Minnesota bank have also improved, but not yet to precrisis levels. Return on average assets, a standard measure of profitability, has been holding very steady for the past several years at just below 1 percent. This is clearly better than the trough of 0.5 percent during the crisis. But the 20-year median is 1.15 percent. Currently, the return on average assets of the median Minnesota bank is at 0.94 percent, which is at the 19th percentile for the past 20 years.

Year-over-year net loan growth for the Minnesota

median bank is at 4.6 percent. Again, this is much better than the -4.7 percent crisis trough; indeed, negative growth persisted through the end of 2012. But the 25-year median is nearly 6 percent for Minnesota banks, while 4.6 percent is at the 39th percentile. The nation’s banks show similar general patterns.

So, yes, there has been recovery in important ways for community banks in the state. But other important measures continue to lag historical norms more than five years after crisis depths. This weaker-than-hoped-for performance is one factor raising concerns for community banks about the additional supervision and regulation burden that faces them post-crisis. I’d like to turn to those concerns now.

Post-financial crisis supervision and regulation of community banks

Low earnings levels have many potential sources. Let me mention three. First, on the revenue side, weak loan growth naturally leads to more competition for available loans and drives down returns. Second, if banks can’t make more loans, they typically replace loans going off their books with securities. But securities usually earn less than loans, lowering bank returns. Finally, interest rates are at very low levels, and that compresses bank margins.

Higher costs can also reduce bank earnings, and it is clear that the costs of complying with bank regulation and supervision are increasing. Since the financial crisis, and the 2010 Dodd-Frank Act, supervision of community banks and the entire banking sector has become more intense. This is not a transitory change reflecting weak asset quality. Instead, supervisors have recalibrated risk management expectations broadly for community banks. I see higher expectations continuing to spread across bank operations. Meeting these expectations will increase bank costs.

To what extent has additional supervision and regulation raised costs, reduced earnings and shrunk profits? This is difficult to answer with precision, but analysis at the Minneapolis Fed indicates that reductions to profitability could be material, particularly for the smallest community banks. Our estimates suggest, for example, that the median reduction in return on assets for banks with less than \$50 million

in assets would be 14 basis points if they need to increase staff by half a person, and 45 basis points if by two employees.¹

Reduced returns on assets can encourage capital to flow from the banking industry. Indeed, bankers routinely raise concerns with me about the potential for more regulation to drive consolidation in the industry, a topic to which I now turn.

Community bank consolidation

The number of community banks in Minnesota has been falling for some time. There were 341 banks chartered in Minnesota as of the first quarter of 2014, down from a peak of 760 in 1980. As noted, many are concerned that the rate of decline will rise as increased supervision and regulation depresses earnings. Many bankers also tell me about intangible costs, arguing that some new compliance requirements distract from serving customers. These soft costs could also drive bankers to exit the industry.

My concern is with the public policy aspect of this matter. It is possible that the evolution of information technology may have increased the returns to scale in banking. As a society, we should expect and indeed welcome consolidation as a response to this natural economic force. But there is a policy concern if negative benefit/cost regulation or supervision drives out banks that would otherwise effectively serve customers.

To help determine if new regulations and supervision introduced since the financial crisis have led to more rapid consolidation, the Minneapolis Fed is estimating future consolidation of banks in the United States and Ninth District states based on historical trends. If consolidation exceeds projected rates, that might suggest that new supervision and regulation has changed the dynamics of banking. So far, however, the rate of recent consolidation of Minnesota community banks has been consistent with historical patterns. We continue to monitor consolidation rates relative to forecasts in order to be able to detect changes that are not readily attributable to technological forces. Our website contains quarterly updates of these forecasts.

But both bankers and policymakers are concerned about the long-term health of community banking, not just next year's numbers. How many community banks will exist in 10 years? Of course, I cannot answer this question with certainty, but I can offer a few perspectives. If historical patterns con-

tinue, the number will fall considerably. There will be just 263 banks in Minnesota in 2024, a 23 percent decline from 341 currently, assuming that consolidation over the next 10 years continues the trend seen over the past 30. Or we could assume a slower rate of consolidation, like the 14 percent decline from 1995 to 2005. That would put the number at 293 community banks 10 years from now.

This is an admittedly crude modeling approach. We have also constructed a more elaborate statistical model of the potential long-run decline in the number of banks in Minnesota. Our statistical model is based on the historical movement of banks into, and out of, different asset groupings. Some banks get larger and move from one size bucket to another, while other banks exit the industry altogether. This transitional model—which we use to forecast the number of banks in Minnesota one year out on our website—suggests that the number of banks in the state will fall to 282 in 10 years.

I've discussed three different estimates. They all predict that the number of banks in Minnesota will fall sharply over the next 10 years—from the current 341 to a number in the high 200s. By way of comparison, the median decline in the number of banks for all states across all 10-year periods since 1985 is 25 percent, a bit higher than some of the estimates we provided.

To be clear, these forecasts are only estimates. They should be interpreted accordingly. The actual number of banks may turn out to be smaller—or, indeed, it might turn out to be larger.

Tailoring community bank supervision

I've already noted that it is a matter of considerable public policy concern if regulations, not market forces, are important causes of bank consolidation. Federal Reserve policymakers have recently discussed how better tailoring of supervision and regulation to community banks can be helpful in reducing the extent of this problem.² The Federal Reserve does some tailoring already, but I think we should do more. I'll mention two examples of the kind of tailoring that I have in mind. I'll then turn to two additional steps we might consider.

On safety and soundness, the Federal Reserve and other agencies received excellent comments from community banks on the Basel III proposal. These comments led to changes to the proposed rule

that reduce unnecessary burdens on smaller banks.³ Smaller banks can opt out from having their capital levels vary due to changes in particularly volatile aspects of income. The final rule also allows smaller institutions to continue to count certain types of stock or securities as capital, when larger banks cannot. I think the rule-making process worked well in this instance. Issuing a preliminary rule and receiving comments from bankers allowed the final regulation to better address the actual risks posed by community banks.

On the consumer side, the Federal Reserve has moved to a more risk-focused exam process, from the less flexible previous approach. The new framework allows our examiners to better tailor their exams to the consumer risks that a particular bank may actually pose. Many banks that the Minneapolis Fed supervises do not engage in activities that pose a high risk to consumer protection. And many also have a strong, documented record of compliance and relatively little change in operations. Under the new framework, examiners can more readily eliminate certain areas of review.

The benefits of the new consumer program go beyond a more focused scope. The new framework encourages more of our supervisory work to occur off-site, thereby reducing the on-site burden we put on community banks. At the same time, where there are potentially risky activities, the new framework allows for a deeper dive.

In sum, I think the new consumer exam framework epitomizes the tailoring we need. It's based on an analytical approach aimed at improving supervision, and it also captures institution-specific details where appropriate.

Where can we engage in additional tailoring? Governor Daniel Tarullo has noted potential benefits in reviewing statutes that apply new regulations to all banks. Community banks may not create the risks that a specific regulation addresses. In that vein, he noted the so-called Volcker rule and Dodd-Frank incentive compensation requirements. I strongly agree with Governor Tarullo's point that Congress and supervisors should exempt all community banks from certain regulations. Exempting is the best way to guard against regulatory trickle-down.

A second fruitful approach to additional tailoring concerns supervision, not regulation. I worry that our current supervisory methods establish expectations that are too detailed across too many areas of bank

operations and too wide a swath of banks. Alternatively, supervisors could concentrate on a smaller number of activities that we believe are correlated with bad outcomes. To be specific, supervisors could choose to focus on rapid loan growth, high lending concentrations, specific high-risk types of lending and wholesale funding strategies and skip some of the more detailed reviews. This shift in focus might generate higher returns to society, in terms of improved safety and soundness per dollar spent, than detailed work programs. To be clear: I'm suggesting a tailored approach, and so supervisors could retain the more comprehensive, proscriptive approach for larger, systemically important banks.

I offer these ideas not as final prescriptions, but in the spirit of open inquiry. My main point is that we need to further investigate ways to tailor the supervision and regulation of community banks.

Conclusion

I began this talk describing the important link between what you do as community lenders and what we strive to achieve at the FOMC—namely, to put the economy's resources to work. The FOMC's low-interest rate policy in recent years has certainly provided some challenges for banks, but the Committee's ultimate goal is one that we share with you—a stronger, growing economy that benefits all. On that, I'm sure we can all agree.

Thank you once again for the invitation to join you here today. I look forward to your questions. ■

Endnotes

¹ These examples reflect a baseline scenario with a fixed set of key assumptions detailed on our website at minneapolisfed.org/banking/communitybank/. The impact of new regulatory costs in our model includes the hiring of additional staff, which results in higher total compensation and lower profitability. We then analyze the changes in the distribution of community bank profitability.

² Chair Janet Yellen (federalreserve.gov/newsevents/speech/yellen20140501a.htm), Governor Daniel Tarullo (federalreserve.gov/newsevents/speech/tarullo20140508a.htm) and President Dennis Lockhart (frbatlanta.org/news/speeches/140527_speech_lockhart.cfm) have all spoken to this issue in recent months.

³ See the Summer 2013 *Central Banker* at stlouisfed.org/publications/cb/articles/?id=2415.