CSBS CEO John W. Ryan, The Banking System We Need

Nov 1, 2013

INTRODUCTION

I'd like to start by thanking the Federal Reserve, the FDIC, and the OCC for organizing – and particularly to the Federal Reserve Bank of Chicago for hosting – this event and creating a forum for us to share information and discuss opportunities for improving the strength and well-being of the financial services industry.

It is through an open, meaningful dialogue between bankers and regulators that we can begin to understand where the industry is now, where it is headed, and where it should be going. This work is critically important as we create, implement, and review the policies, regulations, and supervisory practices that shape not just the financial services industry, but our economy as well.

After surviving the worst financial crisis since the Great Depression, we meet here today a little battered and a little wary as we work our way through a challenging economic environment and new regulatory expectations. But these concerns are balanced with the optimism about the resilient and innovative nature of the American economy and the fundamental value of the community banking model.

IMPORTANCE AND VALUE OF COMMUNITY BANKING

Community Banks as a Proxy for Health of Economy

Moments like this give us an opportunity to take stock of the long line of decisions that have led us to this point, and articulate a vision of the future. As Washington continues to develop and implement financial regulatory policy, it is critical that policymakers have a better understanding of the important role community banks have played and will continue to play, not only in the daily lives of their customers, but also in helping to maintain the health and stability of our national financial system.

I doubt that the health of the largest global U.S. banks will ever serve as a proxy for the health of our national and local economies. But I think the state of community banking should be considered an important indicator. The well-being of our community banks correlates directly to the health of the communities they serve and collectively reflects the health of the overall economy. So if we want a more sustainable banking system that promotes real economic growth, we may need to spend a little less time worrying about the ability of U.S. banks to compete with European banks, and a little more time focused on how to empower local banks to serve their customers.

Diversity of Institutions

As you know, the United States stands alone among nations in the number and diversity of our banking organizations – nearly 6,950 at last count.[1] These banks range in size and business model from the smallest community bank operating in one town to some of the world's largest financial firms operating across the globe.

Distinctly American System

This uniquely diverse banking system may sometimes be called an accident of history, but it is not. It is born from our founders' commitment to decentralized power and economic self-determination. It is the result of almost 200 years of carefully considered and thoroughly debated policy decisions.

Furthermore, our regulatory system has been designed and evolved to reflect core American values, such as checks and balances, dispersion of power, and a balance of national interests with local control.

Ours is a truly American system:

It is a system that allows federal and state governments to focus on their strengths.

It is a system that balances the stability of a strong national framework with the ability of states to solve problems and provide for the well-being of their citizens in ways that best serve local needs.

It is a system that provides access to financial services for almost every segment of population, and I would propose also offers the best way forward for the health of our banking system and our economy.

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With the possible exception of your hometown newspaper, most media outlets could lead one to believe that only the biggest of the big banks make up our financial industry. It is unfortunate that the balance sheets with the most commas on the bottom line are often the only ones deemed worthy of attention. But assets alone do not tell the whole story.

Contributions by Community Banks

Community banks have always been a vital part of our diverse American banking system. Even though community banks only hold about 14 percent of total banking assets in the country,[2] they play an essential role in our national economy. According to a report published by the FDIC in December 2012, community banks provide:

- 46 percent of loans to small businesses;
- 35 percent of commercial real estate loans; 66 percent of farm lending; and
- 16 percent of residential mortgage lending.[3]

While community banks are often focused on providing banking services and funding to small business owners and entrepreneurs, consolidation in the banking sector may be giving consumers and businesses fewer options. Between the years of 1984 and 2011, the number of banks in the U.S. declined from 17,901 to 7,357 – a 59 percent decrease in fewer than 30 years. During the same period, the share of U.S. banking assets held by community banks also declined, from 38 percent in 1984 to 14 percent in 2011.[4]

What happened to the system’s assets? Well, the 20 U.S. banks with assets in excess of $100 billion hold 62 percent of total system assets and 60 percent of total bank deposits, even though these 20 banks account for only 0.3 percent of the total number of banks.[5] Furthermore, the biggest banks continue to get bigger. The average large bank is now 64 times the size of the average community bank, compared to 12 times larger in 1985.[6] The growth of the largest banks was overwhelmingly achieved through acquisition, not organic growth.

I make this point because over the same period of time, Washington's conventional wisdom has seen this consolidation as a good thing. Or, at the very least, it is not considered a bad thing. Policymakers have seemed to agree that bigger is better: that large institutions, both geographically diverse and diversified in their product offerings, would be more stable and resilient. So, Washington policy has promoted or even enabled industry consolidation and the rapid growth of the largest financial firms. And while the recent financial crisis may have given pause to these assumptions, it has not fundamentally changed them.

Need for Data and Research

Before I say more about the potential risks of an increasingly consolidated industry, I think it is important to stress the need for a better understanding of how the various aspects of the U.S. financial system serve our national economic needs. After all, every part of this discussion benefits from a better understanding of what is going on in the world outside the Capital Beltway and the confines of Wall Street. The community bankers here today base their business decisions on data and analysis combined with a healthy dose of judgment. Policymakers and regulators should do the same.

To that end, state regulators, through CSBS, have stepped up their efforts to bring more information to the table – most recently, publishing a white paper that discusses the shifting composition of the Federal Reserve Board and its implications for bank regulatory policy.[7] As we have moved forward in our efforts to help recalibrate the public policy that governs our banking system, we have sought to improve data collection, use better research, and provide more information to organizations and agencies that need it.

Along with forums such as this one, regulators and bankers need to find more opportunities to leverage our collective expertise and the expertise of scholars across the country to provide a better sense of what is working and what isn't, and also to provide an early detection system for potential problems.

In that vein, I'd like to recognize the great research the FDIC has done under the leadership of Chairman Marty Gruenberg to better understand community banking. The December 2012 FDIC Community Banking Study was a tremendous first step to creating a foundation for the examination of the community banking sector.

Additionally, last month, CSBS and the Federal Reserve System hosted the first-ever community banking research conference. More than 150 bankers, regulators, and scholars came together to share recent research related to community banking with the goal of finding and creating better tools to assess our banking system's performance.

Some of the research that came out of that conference found that:

- Proximity matters. A new business' physical distance to its nearest bank affects the business' access to bank credit and, consequently, its chances of survival.[8] The closer a business is to a credit decision maker the better its chance of success. Relationship lending techniques matter. Loans originated by rural community banks and/or loans borrowed by rural businesses default substantially less often than loans made by urban banks and/or in urban areas. Also, loan default rates are substantially higher when borrowers are located outside the geographic market of their lenders.[9]
- It is economically significant when a community bank fails. Recent bank failures were followed by significantly lower income and compensation growth, higher poverty rates, and lower employment within the communities those banks served.[10]
- Capital doesn't have to be so complex. In an examination of 400 recent bank failures, a simple leverage ratio was as effective as complex risk based models, at predicting failure and conversely as a capital regulatory tool.[11]

More Study Needed

The research conference was an important first step, but it is clear that ongoing research in a variety of areas is necessary to better inform policy decisions. What are the true costs and benefits of supervision? Have bank acquisitions affected local economies? How does the relationship-banking model impact economic growth at the local level? If the community bank business model is endangered by regulatory forces, this would be critical information for policymakers to understand.

There is a fair amount of angst about the lack of de novo banks. I believe the short-term issues will work themselves out. But I think we should be focused on the longer-term impact and understand if structural changes have created unintended disincentives to new market participants. Our ability to charter new banks is a strength of our banking system. Organizers bring in new capital to the system to meet identified needs. This is an aspect of our banking system we need to understand and nurture.

For this and many other questions, we must gather the necessary data to better understand the realities of our banking system and the role community banks play in economic development, job creation, and market stabilization.

State regulators remain committed to a robust and honest understanding of our banking system, and are willing to challenge conventional wisdom or to have our own assumptions challenged. We want what is best for the citizens of our states and our communities.

TOO BIG WILL FAIL

While I recognize more research is necessary to fully understand the impact of industry consolidation and that it's not a simple narrative, I believe that the continuing trend of consolidation into a handful of mega banks is a risk to the health, strength, or stability of our financial system and our economy.

"We're Overbanked"

Some, however, believe that consolidation is a good thing. They argue that the United States is "overbanked." Here in Chicago – or in most major cities around the country – that may feel true.

Cook County, Illinois is the second most populous county in the United States. Nearly 41 percent of Illinois residents live in this county. In total, 142 financial institutions with nearly 1,600 offices or branches serve Cook County.[12]

But if you were to drive just about 115 miles southwest of here, you'd come across Putnam County, the smallest county in Illinois. Putnam has very low population density, with just 39 residents per square mile. Putnam's residents are served by only three banks with a grand total of three branch offices. Bureau County, Illinois and its 35,000 residents are served by 14 small banks with a total of 23 branches. And Gallatin County's 6,000 residents are served by only two small community banks.[13]

In fact, a growing number of smaller communities and rural areas are at risk of low access to vital banking services. The FDIC tells us that more than 600 American counties – that's almost one out of every five counties in the U.S. – have no physical banking offices, except those operated by community banks.[14]

Even in metropolitan areas where there seems to be a bank on every street corner, consumers are often left with banking stores or offices that do not always offer a full range of banking services. And many of those branches stick to rigid corporate standards and quotas that have little to do with the banking needs of the communities in which they do business. At the other end of that spectrum, community banks continue to apply their local knowledge and their personal stake in their community to their business practices.

European Model of Banking

Some see the bank failures of the past five years and assume it's because we have too many banks and too much competition. They look at the number and diversity of our banks and ask 'what's wrong with consolidation?' Most European countries only have a handful of large firms. Their concept of a competitive marketplace is, paradoxically, a narrow one: in looking at the global market, they ignore the marketplace of individual communities, small businesses, farmers, and entrepreneurs. In short, they ignore the very foundation of our economy's success.

But would a European system here in the United States be possible or preferable? I don't believe so. In a September 30 piece by Financial Times editorialist Wolfgang Münchau titled "Do not kid yourself that the Eurozone is recovering," he wrote that "the single largest constraint on the resumption of Eurozone growth is … the continued failure to clean up the banks."[15] Furthermore, Münchau observes that the banking sector will not be fixed because of the close relationship between the banks and their sovereign governments. Just like Japan, they are stuck in a "no-growth" cycle.

How does this happen? Here's my layman's understanding. The government has allowed or encouraged consolidation of their banking sectors, or nationalized them, and then again privatized the banks. Whether state-owned or privately held, these mega banks are able to hold less capital because they explicitly or implicitly have the government's backing.

The government permits this because higher leverage can fuel higher growth. Investors allow this because a government guarantee limits risk and higher leverage means higher returns.

The government eventually defends lower levels of capital, to enable their banks to make up for their inefficiencies and maintain growth domestically while competing internationally with more efficient banks that are subject to greater market discipline.

But our own experience, after a banking-led recession and financial crisis, shows how treacherous this model can be. Allowing for market discipline in these mega banking systems seems catastrophic. Hitting up the taxpayers to bear the losses seems politically untenable. And governments, in an attempt to protect the taxpayers, buckle down on their regulated entities with lower risk tolerances and more prescriptive regulations.

Thus the no-growth cycle is reborn.

I see some heads around the room nodding as you recognize some of the very milestones we've passed here in the U.S. I, too, recognize these symptoms in our own system, and I fear we could be heading down the same road as Europe or Japan if we're not careful.

The American Model

Our more entrepreneurial banking system, of which community banking is the clearest expression, has and can be different from the European model.

Our uniquely American system allows new entrants that can – and do – compete with larger competitors. Local regulators tend to a system that supports new entrants because we see the value of competition or greater availability of services in local markets. Failure is an integral part of the system, and is possible because losses can be absorbed by a diverse industry and investors instead of taxpayers. Local markets are better served by local decision makers who originate loans because they have a stake in the health of the economy, not because the government tells them to make those loans.

I recognize that our system hasn't always lived up to these ideals. We can all point to many examples of its failings. But some of its perceived failings are truly great attributes. The ability to allow for orderly failure, to allow for market discipline while protecting depositors has been our banking system's greatest and most underappreciated strength. Put simply, from where state regulators sit, we don't see another model that meets our economic needs as well as the dual-banking system.

Furthermore, without the unique dynamic of small diverse institutions, our system quickly starts to lose its distinction and value. Community banks represent far more than just 14 percent of assets. They represent what has made our system unique, our banking system dynamic, and our economy outperform all others.

Our System is Undervalued

If we wish to preserve this uniquely American system, we must value it. This system is by no means inevitable, despite its resilience throughout our history. We need only look to our European or Japanese counterparts to bear witness to a financial system's ultimate fragility.

And in all honesty, I do not believe we are valuing our system enough. Federal policy has been almost entirely focused on trying to limit the risks of large complex institutions and systemic interconnectedness, and understandably so.

I do not believe policymakers have spent enough time understanding the full impact of increased regulatory complexity on the system as a whole and how it imperils small institutions.

I do not believe that we as state and federal regulators have given enough attention to developing a supervisory model that is appropriate to the diverse business models, geographic locations, and scale of our community banks. If we gave half the time, brain power, and high-level attention to an appropriate regulatory model for community banks as we have to the Basel capital framework, I think we'd have better solutions.

I believe that as financial regulators we must provide more leadership in understanding what aspects of our financial services system best meet the needs of our country. It is not enough to wonder if a bank must have one billion dollars in assets to survive; we must understand why that may or may not be true.

And I'll go one step further. I believe we must rethink our system of supervision. I challenge us regulators to ensure that regulation is not the reason that a $35 million bank sells or self-liquidates. If we find we can't differentiate between business models, if we must accept centralized, complex and intrusive regulation as necessary for all to respond to the risks posed by the largest banks, then I believe we need to go back to the drawing board.

We need large financial institutions, but not so large and so complex that our efforts to regulate them come at the expense of our diverse industry and our American system.

A Vision for the Future of our Regulatory System

State regulators have a vision for the future of the industry and its supervision: a vision of a flourishing financial services industry that provides for safe savings, secure and efficient payments, and access to credit in every corner of the United States and across the globe in a manner that allows for borrowers

to achieve their vision of success.

Our experience has been that a diverse industry, complete with local banks making local and individualized credit decisions, is key to achieving this vision. In order to succeed, the country needs the relationship-based banking services that community banks provide and the state-federal regulatory structure that enables these banks to thrive.

Supervision for All, Not Just the Biggest

Unfortunately, the push is quietly on again in Washington to reform our regulatory structure to better reflect the business models of our largest banks. We fight a constant undercurrent of those who would like to see a single financial regulator and an industry of just a handful of banks, or a one-size-fits-all system of supervision. But what we really need is a financial structure and supervision that allows for a diverse and competitive industry.

Supervisory Structure is Not an Accident of History

Throughout our nation's history, particularly during times of crisis and economic stress, policymakers have sought to reform our financial regulatory system. Indeed, we have been asking many of the same difficult questions and having the same heated debates about the country's regulatory structure since Thomas Jefferson and Alexander Hamilton debated them.

At most every major juncture, policymakers have deliberately chosen options that favored diversity and discouraged the concentration of either financial assets or supervisory authority. The notion of a single federal regulator, for example, dates back 150 years, to the enactment of the National Banking Act. And yet, even then in the midst of a Civil War fought partly over the states' rights, Congress did not rescind the states' authority to charter or regulate financial institutions. Offered the opportunity to install a single federal regulator, Congress has declined to do so time and time again:

- They declined in 1914, when an original goal of the Federal Reserve Act was to create a single, unified federal bank regulator;[16]
- They declined in 1971, when President Nixon's Hunt Commission recommended reducing the number of federal banking agencies from five to two, including a federal Administrator of State Banks;[17]
- They declined in 1984, when President Reagan's Task Force on Regulation of Financial Services proposed ending the FDIC's regulatory and supervisory

authority;[18]

- They declined in 1991, when Treasury's original proposal for FIRREA called for dividing federal bank supervisory authority between the Fed and a new, consolidated Federal Banking Agency;[19]
- They declined in 2008, when Treasury Secretary Paulson envisioned a new regulatory triumvirate that would have vested all safety-and-soundness supervision in a single agency;[20] and
- They declined in 2010 when Senate Banking Committee Chairman Dodd proposed several variants of consolidation throughout the course of the Dodd-Frank debate.

Each and every time, Congress had the opportunity to consolidate our regulatory and supervisory system. And each and every time, Congress decided to maintain a state-federal structure of financial oversight. This is because if history teaches us anything, it is that any single system is subject to failure. Safety and stability require back-up.

Throughout our history, when we have experienced financial crises, these have not occurred because of our system's unique design, but more often than not, because we've strayed from time proven principles, and had a lack of political or regulatory will to stand by those principles. Consolidating and concentrating authority into a large federal agency would exacerbate these problems, not correct them.

The fundamental principle of checks and balances applies to our bank regulatory system, just as it applies to all other elements of our government. Our dual system of federal and state supervision is an example of the principle's success, creating more comprehensive and meaningful bank regulation even as we have improved cooperation and coordination among state and federal regulators.

CONCLUSION

Even as I see ongoing negative and threatening trends – such as the decline in the number of banks, the consolidation of assets in the biggest firms, and an array of overly complex statutes and regulations applied inappropriately to simple and small banks – I do see some positive developments.

I see more and more symposiums, forums, and conferences just like this one, that are dedicated to understanding the importance of the community banking system.

I see research being performed on the unique role of community banks, their performance, and the financial supervisory framework.

I hear in speeches and testimony from key policymakers about the necessity of preserving a diverse, dynamic, and durable dual-banking system.

And I see progress, as policymakers are putting words into action by tailoring their rules and regulations to accommodate for the varying business models among our nation's banks.

These developments are promising. But we are still at a watershed. We can be overcome by the negative ongoing trends and misconceptions about our financial system. Or we can strike out on a new path that recognizes the reasons for, and the value of, what has come before.

So I challenge those of you here today.

I challenge you to examine your role in our system. To examine what you can do to contribute to an industry or a system of supervision that is competitive, diverse, dynamic, and contributes to the health and strength of local, state, and national economies.

I look forward to working with you all as we move to strengthen and improve our uniquely diverse system.

Thank you again for the opportunity to share CSBS's views with you today. I would be happy to take any questions.

Footnotes

1. Source: Federal Deposit Insurance Corporation Statistics on Depository Institutions, as of June 30, 2013.
2. FDIC Community Banking Study, December 2012, http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.
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4. Ibid.
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6. FDIC Community Banking Study.
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8. Yan Y. Lee and Smith Williams (2013). Do Community Banks Play a Role in New Firms' Access to Credit? http://www.stlouisfed.org/banking/community-banking-

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Statements & Comments

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