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Community Banking: Aligning Ideals with Practice

Remarks by

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Introduction

Good morning. It is a pleasure to be here in Phoenix and an honor to be speaking to so many community bankers. I should also say, welcome to the Twelfth Federal Reserve District. We are delighted to have you!

I am really looking forward to a great discussion. To get us started, I will provide a few opening remarks, reflections from my vantage point as a Reserve Bank President.

As presidents, my colleagues and I occupy a unique place in the conversation about banking and community banks. We don't have a role in regulatory or supervisory policy, nor a direct role in the execution of these programs. These responsibilities reside with the Board of Governors.

But that doesn't mean we don't have insights. Reserve Banks house many of the teams that do direct supervision. And Reserve Bank presidents spend considerable time talking to bankers and their customers as part of our economic and community outreach. All of this gives us perspective on the challenges and opportunities for all banks, especially community banks.

Reflecting on these insights in preparation for this conference, a consistent theme emerges. And that is the growing gap between how we talk about community banks—often extolling their virtues and importance—and the environment we create for them through regulatory and supervisory frameworks.

Of course, we all want a safe and sound banking system. Something we have here in the United States. But we also want a banking system that supports innovation and growth, where banks, businesses, and households can thrive. To do both takes balance, ensuring that regulatory and supervisory practices match the risks to and the aspirations for our financial system.

That is the subject of my remarks today. Now before I go any further, it's a good time to remind you that the views I share today are my own and not necessarily those of anyone else in the Federal Reserve System.

A Growing Gap

The U.S. banking system is one of the most vibrant and diverse in the world. We have more than 4,500 FDIC-insured institutions of varying sizes, geographies, focuses, and footprints.[1] This creates a rich financial ecosystem that enables households and businesses to gain access to a broad array of financial services, including credit.

Community banks play a crucial role in this ecosystem, supporting almost every geography in America.[2] I see countless examples of how they are woven into the fabric of cities, towns, and neighborhoods across the Twelfth District and beyond. You can also see this in the data on community banks, which consistently show the important role you play in providing essential financial services, particularly to small businesses.[3,4] Most notably, perhaps, community banks are there in good and challenging times. The COVID response is a good example. Community banks stepped in to ensure that businesses new and old received funding from the Paycheck Protection Program.[5,6] I know firsthand how important this lifeline was for many businesses.

But acknowledging importance is not enough to guarantee the future of community banks. We also need a regulatory and supervisory framework that fits their size, complexity, and risk.

More and more we are hearing this is not the case. The 2024 Conference of State Bank Supervisors Survey of Community Banks[7] found that concerns over regulatory burden remained elevated, and were nearly as high as concerns over the cost of funds. Looking at the data, you can see why banks

[1] Federal Deposit Insurance Corporation (2024).
[2] There are over 4,000 community banking organizations in the U.S. with roughly $2.8 trillion in assets. Federal Deposit Insurance Corporation (2024).
[3] Barca and Hou (2024).
[4] Holod, Peek, and Torna (2024)
[5] The Federal Reserve in concert with the U.S. Treasury also administered the Paycheck Protection Program Liquidity Facility (PPPLF). The Paycheck Protection Program and PPPLF aided the liquidity positions of community banks and encouraged lending to small businesses during the COVID-19 pandemic. Lopez and Spiegel (2023).
[6] James, Lu, and Sun (2021).
[7] Conference of State Bank Supervisors (2024).

are feeling the pressure. A 2020 FDIC study showed that from 2008 to 2019, federal financial regulators issued 157 final rules and programs applying to community banks, an average of one every 28 days.[8]

All this adds up to an environment where community banking has become harder. Between increased competition, compressed margins, and the growing costs of complying with regulation, it has become more challenging to become or stay a community banker.

Balancing the Tradeoffs

So what do we do? I want to start with how I think about the tradeoffs in banking regulation. And here, I am going to look through the lens of my training as an economist.

The first thing to know is that the right answer is usually somewhere in the middle. The range of tradeoffs between a lot and a little regulatory oversight fall along a continuum. On one end, we can let banks do whatever they want, with no constraints on behavior or risk taking. In theory, that would spur innovation, encourage competition, and promote at least short-term growth. But it could also impose significant risks on customers, taxpayers, and the broader financial system. On the other end, we can try to regulate the risk out of the system. But that would bridle innovation, lending, and dynamism—things that have made the U.S. financial system one of the best in the world.

Public commentary often focuses on these binary choices at the extremes. But that's not where the answer lies. The goal of regulation is not to remove all risk, but rather to ensure that banks manage it well. The middle ground. To find the right place, you need a set of principles, and that is where I will focus the rest of my time. These principles are not about banks per se, but rather about regulation and risk.

The first principle is that the job of getting this right is never done. It's a continuous process of evaluating and changing when necessary. That doesn't mean we change things every second or every

[8] Federal Deposit Insurance Corporation (2020).

month, but rather that we recognize the world is a dynamic place, and we must adjust. This principle underlies the Economic Growth and Regulatory Paperwork Reduction Act.[9] But it really is an ongoing process. Regulation is only as effective as our commitment to evaluating it.

The second principle is that the cost-benefit ratio for any regulation must pencil out. Every rule has costs and benefits.[10] That much we know. The question for policy makers is, does the benefit make the cost worthwhile?

And here, it is important to look beyond the average. Cost of compliance, and the benefits of any rule, will likely vary by bank size, complexity, and risk profile. Taking that heterogeneity into account ensures that we get what we intend from regulatory policy and that we do so fairly, without unduly advantaging or disadvantaging any single institution or group of institutions. This is the essence of tailoring and an essential element of right-sizing rules.

And this brings me to the last principle. It is the sum of regulation that matters. To accurately measure the costs and benefits, we have to account for the cumulative impact. Rules and regulations are made individually, but their effects are felt as a whole. This is particularly salient for community banks.[11] Getting it right in terms of costs and benefits requires this holistic view of how regulations add up.

These principles are not a playbook. They are a framing device to help us think about where we should land along the regulatory continuum for banking.

Regulations are tools. They need to balance protection of the consumer and the financial system against costs to financial institutions, innovation, and economic growth. And they need to recognize that not all banks are the same. Carefully considered and appropriately tailored rules, that evolve as the economy does, can ensure that banks of all sizes take appropriate risks and continue to thrive.

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[9] The Economic Growth and Regulatory Paperwork Reduction Act (12 U.S.C. § 3311) requires agencies, with input from the public, to review their regulations at least once every 10 years to identify any outdated or otherwise unnecessary regulatory requirements applicable to their supervised institutions. Federal bank regulatory agencies will hold their next public outreach meeting on March 6, 2025.

[10] In talking about costs and benefits, I am abstracting from whether they accrued to the bank, the customer, or the public.

[11] Dahl, Meyer, and Neely (2016).

Summing Up

Regulatory policy is meant to set guardrails. It should not pick winners and losers. That is the job of the marketplace.

No community banker I have ever spoken with wants a special deal, they just want a fair one. The onus is on us—those in the room, Reserve Bank presidents, regulators, and the public—to be sure that we match our practices with our ideals. The future of community banking depends on it.

Thank you and I look forward to our discussion.

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