

2019 Community Banking in the 21st Century Research and Policy Conference

Federal Reserve Bank of St. Louis
St. Louis, MO

October 2, 2019

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The views expressed today are my own and not necessarily those of the Federal Reserve System
or the Federal Open Market Committee (FOMC).

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Good morning and thank you. It's great to be here, and to share space on an agenda with so many experts and voices of authority on community banking issues, including some of my Federal Reserve colleagues. The one problem is that when you speak on day two of a conference like this, you run the risk that your colleagues already made the most important points, and you'll just sound repetitive.

And while we hopefully won't sound exactly the same, I'm sure we're all touching on at least some of the same themes. Because if there's one thing that I've found unanimous agreement on, it's the importance of community banks.

Since I'm mentioning the views of my Fed colleagues, now is probably a good time to interject the standard Fed disclaimer that the views I express today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System. Which is something else you've probably already heard ...

As I said, if there is one overarching message to both this conference and our work within the Federal Reserve, it is the critical importance of community banks. The Philadelphia Fed is largely a community bank supervisor, so we have a front-row seat to the effects of community banking throughout our District, and the way it's embedded in the DNA of our local economies.

We were particularly proud to note that the winning team in the CSBS's case study contest was won by a Pennsylvania school — congratulations again to Juniata College — and, in fact, almost one-third of the teams hailed from Pennsylvania.

The Philadelphia Fed has the smallest geographic District in the System, which I actually see as a strategic advantage. Within those borders, we have areas that reflect the makeup of the country as a whole: urban, rural, suburban, postindustrial. So we get insight on a diverse set of economic profiles. Our size also makes it easier to spend time out in the District, talking to business and community leaders to get a better take on what they're seeing day to day. Something I've seen again and again is that the places that are doing well are the places where there's a strong community banking presence. In fact, I'd say that, particularly for smaller cities and towns, community banks are essential to their economic success.

But community banks don't just have local or regional impact; the insight we get from our contacts gives context to a remarkably complex national economy. And that factors into my own views on monetary policy when we're considering what steps to take for the country as a whole.

I often note that the U.S. economy — the biggest, and arguably most complex, in the world — is fundamentally just a collection of myriad microeconomies. It's communities and localities, neighborhoods and families, and businesses of all sizes. As both businesses and as the touchstones of those individual economies, community banks play a key role in their success.

For that reason, it's important that regulators recognize — and help mitigate — the challenges you face. Because there are several issues on the horizon, including technological change, demographic pressures, and regulatory burden.

Again, I know I'm repeating the messages you've already heard from my colleagues and contemporaries. But given the importance of community banks to the economy and the financial system, they're worth repeating.

Technological Change

I'm being followed on the agenda by a panel on technology's impact on banking, and that's been a central discussion across industries for some time. Cybersecurity, of course, has been a concern for banks of all sizes, but the pressure on smaller institutions can intensify when they can't attain the same economies of scale as the larger ones.

Then there are advances in fintech and changes to businesses of all sorts with the continued march of overall technological disruption.

We at the Philadelphia Fed have a particular focus on technological advancement — how machine learning and AI affect the workforce and business decisions; how it's impacting choices people make about education and training; and how, frankly, it is changing the entire economic landscape. And community banks are certainly not immune.

But I think there are two important things to remember for this sector in particular.

First, that change isn't new; it's been a constant feature of the industry for decades. It just looks different now. Second, I think those advancements in general amplify the unique importance of community banks, and, in fact, create opportunities.

Taking those in turn, technological change itself is not new — many of you have been in the industry for a long time and have seen that firsthand. Fintech absolutely presents a fundamental change in the way we bank — but so did securitization, credit scoring, and prepaid cards. So did ATMs. It's true that they all look pretty quaint when you compare them to today's technology — just like a Walkman looks virtually antique compared to a streaming app on your phone. But both the Walkman and the ATM were revolutionary at the time.

Banking has seen constant change and churn for the past half century. The difference is that today's technology makes the delivery system more advanced than ever before, and it turbocharges the pace of change. Peer-to-peer lending, for instance, has been going on since humanity first established a barter system; it's just being delivered via a different platform. In my day, it took the form of Frankie borrowing \$20 from Jimmy at the local bar. I suppose one big difference is that Jimmy knew where Frankie lived, so default rates were significantly lower in the low-tech version.

Overall, however, with fintech, it's the platform that's new, rather than the product or service.

That, of course, presents a business opportunity. It's likely that partnerships between community banks and fintechs are going to increase, because the fundamentals of the banking system aren't going to change. Whatever mode or method technology provides to deliver those

services, they still need a trusted broker of money. And while bigger institutions may be better positioned to take on the risk of a fintech partnership, the fundamental advantage of community banks is the high level of trust their customers have in them. While community banks will obviously have to do their due diligence in forming partnerships, I'd argue that their deep base of trust is a valuable, competitive asset from the fintech perspective.

The second technology-based issue is the advances in AI and machine learning, which actually makes the case that the skills and expertise particular to community banking are more important now than ever before. Technology is only as smart as the data we input, and, particularly in the case of functions like algorithmic lending, the advantage of community banking is even more clear cut.

Community banks know their customers. There's a local understanding that can't be programmed into a one-size-fits-all approach to lending. You heard yesterday from the Bank of Bird-in-Hand's CEO Lori Maley. They're actually an example I often use, because it's a perfect case study in local understanding. On paper, the communities they serve wouldn't look creditworthy to most banks. But Bird-in-Hand knows that when something happens, the community comes together to fix it. When a barn burns down, the community comes together to build a new one. If someone's in danger of missing a scheduled payment, the community pools their resources to make it. That knowledge and understanding of who your customers are is an advantage that just can't be replicated by an algorithm.

My daughter and son-in-law encountered the same thing when they tried to buy insurance for their first house. Philadelphia, like most places, has some linguistic quirks, like the extra "r" in the word water — or "werder." We also have row houses, while most of the East Coast has townhouses or brownstones. In conversation, it's not a big deal. In real estate dealings, it's a very different story. My daughter's first broker didn't have row houses listed in the database, and they couldn't just reclassify the property because the roof didn't fit the narrow description of the alternatives. After a lot of time spent in a "Who's on First"-type back and forth, they walked down the street to a local agent who got the insurance approved that day.

That's just one example of how a molehill can turn into a mountain for customers. And the flexibility community banks have to meet local needs creates a loyal base.

So it's not just that technology highlights the competitive advantage of community banks' local knowledge; I honestly think it creates an opportunity as that specialist insight becomes more and more clear in comparison.

Demographic and Other Changes in Community Banking

So community banks have expert local knowledge, they know their customers, and they reflect the needs of the communities they serve. But the demographics of communities across the country are changing, as is the community banking landscape. Since 2009, the number of community banks has declined by about one-third. Nationwide, bank failures have accounted for about a fifth of the reduction, while the rest are due to M&As. In the Philadelphia Fed's District, the reduction in community banks has been slightly higher than the national average over that period — 38 percent for the Third District versus 34 percent nationwide. But the *size* of banks in the Philadelphia Fed's District has increased significantly more than the national average, with Third District banks' median assets increasing by 89 percent, versus the national rate of 57 percent. Those data point to rates of M&A activity that appear to have strengthened the resulting institutions and community banking overall. Over the same decade, we've seen a concurrent change in the asset mix with a significant rise in multifamily loans — 91 percent overall — though they still represent just 4 percent of total assets. And while securities have declined slightly, they remain the largest portion of the asset mix at 17 percent.

So while there are fewer community banks in the District, they've grown larger and more complex.

Demographic changes, such as aging and increasingly less-mobile populations, have already affected community banking as a whole, and that will likely continue, meaning they may have to rethink their business models. That might mean more personal lending and greater small business lending. It could mean more commercial real estate lending or more projects with greater potential risk, but also greater possibilities for reward. From the regulatory and

supervisory perspective, it will be important to watch for those changes and work to take them into account.

Regulatory Burden

We do a lot of work on economic mobility in our District, and community banks have been central to our impact. Given how much is tied up in their success, I think it's incumbent on us as regulators to be supportive of community banks' continued viability.

We are well aware of the regulatory burdens that community banks have faced. I think that humanity has a propensity to overcorrect in response to crisis, so the pendulum sometimes swings a bit too far in the other direction. In the aftermath of the financial crisis, it made sense to put every mechanism in place to prevent a reoccurrence of the worst economic disaster since the Great Depression. But there's a virtually universal agreement that community banks wound up on the wrong end of that pendulum swing. We've made progress in correcting that, including easing up on timelines and reporting requirements, but there's still more to do.

For me, a crucial element is how we work with banks. It's important that we're able to fix errors by working together, rather than at odds; to distinguish mistakes from bad faith. It's also critical that we continue to provide research and support. At the Philadelphia Fed, we've been looking at succession planning in particular, and our LINC program helps build relationships between community banks and community development organizations.

Because community banks play such a vital role in the vibrancy of local communities, it's important that their business strategies take that impact into account, particularly for groups on the margins. And from the regulatory side, it's important to make space for efforts that might involve more risk, but also have the potential for greater reward.

We have a bank in our District, ESSA Bank & Trust, that partnered with an existing program to ease ex-offenders' transition back into the community. They've set aside \$250,000 to make loans of up to \$15,000 per person for housing, transportation, or education and training. The participants have to take financial literacy courses and provide a plan for the loan: One needed

a car to get to work, one trained to become a commercial truck driver, one started a small business.

So far, things are going well. But I would argue that even if they did lose money, there's more to consider. ESSA is investing in their community, in an important way that's often overlooked and generally underfunded. It has the potential for a significant return on investment for the community, and that creates a new customer base for the bank. I think there's room for flexibility and a little more risk appetite to encourage innovation.

Conclusion

To sum up: Community banks are important. They play vital roles in communities across the country, and they make the difference between a local economy that merely survives and one that thrives. They offer insight to policymakers and a chance at success to their customers.

There are challenges, as there are in any industry. We've moved the needle on some, while others still have a ways to go. It's important that we work together as we address them, because the outcomes will have effects that resonate beyond a single sector. Because ultimately, community banking matters to all of us.