Statement of the
Federal Deposit Insurance Corporation
By
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from the
Financial Crisis Regarding Community Banks
before the
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And
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Chairman Johnson, Ranking Member Crapo, and members of the Committee, we appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the state of community banking and to describe the findings of the FDIC Community Banking Study (the Study), a comprehensive review based on 27 years of data on community banks.1

As the Committee is well aware, the recent financial crisis has proved challenging for all financial institutions. The FDIC's problem bank list peaked at 888 institutions in 2011. Since January 2008, 481 insured depository institutions have failed, with banks under $1 billion making up 419 of those failures. Fortunately, the pace of failures has declined significantly since 2010, a trend we expect to continue.

Given the challenges that community banks, in particular, have faced in recent years, the FDIC launched a "Community Banking Initiative" (Initiative) last year to refocus our efforts to communicate with community banks and to better understand their concerns. The knowledge gathered through this Initiative will help to ensure that our supervisory actions are grounded in the recognition of the important role that community banks play in our economy. A key product of the Initiative was our FDIC Community Banking Study, published last December, which is discussed in more detail below.

In my testimony, I describe some key lessons from the failures of certain community banks during the recent crisis identified by the FDIC Community Banking Study. Consistent with the studies performed under P.L. 112-88 by the FDIC Office of Inspector General (OIG) and Government Accountability Office (GAO), the Study found three primary factors that contributed to bank failures in the recent crisis, namely: 1) rapid growth; 2) excessive concentrations in commercial real estate lending (especially acquisition and development lending); and 3) funding through highly volatile deposits. By contrast, community banks that followed a traditional, conservative business plan of prudent growth, careful underwriting and stable deposit funding overwhelmingly were able to survive the recent crisis.

FDIC Community Banking Study

In December 2012, the FDIC released the FDIC Community Banking Study, a comprehensive review of the U.S. community banking sector covering 27 years of data. The Study set out to explore some of the important trends that have shaped the operating environment for community banks over this period, including: long-term industry consolidation; the geographic footprint of community banks; their comparative financial performance overall and by lending specialty group; efficiency and economies of scale; and access to capital. This research was based on a new definition of community bank that goes beyond the asset size of institutions to also account for the types of lending and deposit gathering activities and the limited geographic scope that are characteristic of community banks.

Specifically, where most previous studies have defined community banks strictly in terms of asset size (typically including banks with assets less than $1 billion), our study introduced a definition that takes into account a focus on lending, reliance on core deposit funding, and a limited geographic scope of operations. Applying these criteria for the baseline year of 2010 had the effect of excluding 92 banking organizations with assets less than $1 billion while including 330 banking organizations with assets greater than $1 billion. Importantly, the 330 community banks over $1 billion in size held $623 billion in total assets – approximately one-third of the community bank total. While these institutions would have been excluded under many size-based definitions, we found that they operated in a similar fashion to smaller community banks. It is important to note that the purpose of this definition is research and analysis; it is not intended to substitute for size-based thresholds that are currently embedded in statute, regulation, and supervisory practice

Our research confirms the crucial role that community banks play in the American financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions accounted for just 14 percent of the U.S. banking assets in our nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.2 The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns and urban neighborhoods would have little or no physical access to mainstream banking services.

Our Study took an in-depth look at the long-term trend of banking industry consolidation that has reduced the number of federally insured banks and thrifts from 17,901 in 1984 to 7,357 in 2011. All of this net consolidation can be accounted for by an even larger decline in the number of institutions with assets less than $100 million. But a closer look casts significant doubt on the notion that future consolidation will continue at this same pace, or that the community banking model is in any way obsolete.

More than 2,500 institutions have failed since 1984, with the vast majority failing in the crisis periods of the 1980s, early 1990s, and the period since 2007. To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future consolidation. In addition, about one third of the consolidation that has taken place since 1984 is the result of charter consolidation within bank holding companies, while just under half is the result of voluntary mergers. But both of these trends were greatly facilitated by the gradual relaxation of restrictions on intrastate branching at the state level in the 1980s and early 1990s, as well as the rising trend of interstate branching that followed enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The pace of voluntary consolidation has indeed slowed over the past 15 years as the effects of these one-time changes were realized. Finally, the Study questions whether the rapid pre-crisis growth of some of the nation's largest banks, which occurred largely as a result of mergers and acquisitions and growth in retail lending, can continue at the same pace going forward. Some of the pre-crisis cost savings realized by large banks have proven to be unsustainable in the post-crisis period, and a return to pre-crisis rates of growth in consumer and mortgage lending appears, for now anyway, to be a questionable assumption.

The Study finds that community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies during the Study period exhibited relatively strong and stable performance over time. The strongest performing lending groups across the entire Study period were community banks specializing in agricultural lending, diversified banks with no single specialty, and consumer lending specialists, although the latter group had shrunk to fewer than one percent of community banks by 2011. Agricultural specialists and diversified non-specialists also failed at rates well below other community banks during the Study period. Other types of institutions that pursued higher-growth strategies – frequently through commercial real estate or construction and development lending – encountered severe problems during real estate downturns and generally underperformed over the long run.

Moreover, the Study finds that economies of scale play a limited role in the viability of community banks. While average costs are found to be higher for very small community banks, most economies of scale are largely realized by the time an institution reaches $100 million to $300 million in size, depending on the lending specialty. These results comport well with the experience of banking industry consolidation during our Study period (1984 – 2011), in which the number of bank and thrift charters with assets less than $25 million declined by 96 percent, while the number of charters with assets between $100 million and $1 billion grew by 19 percent.

With regard to measuring the costs associated with regulatory compliance, the Study noted that the financial data collected by regulators does not identify regulatory costs as a distinct category of expenses. In light of the limitations of the data and the importance of this topic in our discussions with community bankers, as part of our Study the FDIC conducted interviews with a group of community banks to try to learn more about regulatory costs. As described in Appendix B of the Study, most interview participants stated that no single regulation or practice had a significant effect on their institution. Instead, most stated that the strain on their organization came from the cumulative effects of all the regulatory requirements that have built up over time. Many of the interview participants indicated that they have increased staff over the past ten years to support the enhanced responsibility associated with regulatory compliance. Still, none of the interview participants indicated that they actively track the various costs associated with regulatory compliance, because it is too time-consuming, too costly, and so interwoven into their operations that it would be difficult to break out these specific costs. These responses point to the challenges of achieving a greater degree of quantification in studying this important topic.

In summary, the Study finds that, despite the challenges of the current operating environment, the community banking sector remains a viable and vital component of the overall U.S. financial system. It identifies a number of issues for future research, including the role of commercial real estate lending at community banks, their use of new technologies, and how additional information might be obtained on regulatory compliance costs.

Examination and Rulemaking Review

In addition to the comprehensive study on community banks, the FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent , while maintaining safe and sound banking practices. This review was informed by a February 2012 FDIC conference on the challenges and opportunities facing community banks, a series of six roundtable discussions with community bankers around the nation, and by ongoing discussions with the FDIC’s Advisory Committee on Community Banking.

Based on concerns raised in these discussions, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has restructured the pre-exam process to better scope examinations, define expectations, and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision. Using web-based tools, the FDIC created a regulatory calendar that alerts stakeholders to critical information as well as comment and compliance deadlines relating to new or amended federal banking laws, regulations and supervisory guidance. The calendar includes notices of proposed, interim and final rulemakings, and provides information about banker teleconferences and other important events related to changes in laws, regulations, and supervisory guidance. The FDIC also is actively taking steps to provide bankers with additional insights on proposed or changing rules, regulations and guidance through regional meetings and outreach. Further, we clarify and communicate whether specific rules, regulations, and guidance apply to the operations of community banks through the use of statements of applicability in our Financial Institution Letters.

Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. In April, the FDIC issued six videos designed to provide new bank directors with information to prepare them for their fiduciary role in overseeing the bank. A second installment, to be released very soon, is a virtual version of the FDIC's Directors' College Program that regional offices deliver throughout the year. A third installment, expected to be released by year-end will provide more in-depth coverage of important supervisory topics and focus on management's responsibilities. The FDIC plans to continue its review of examination and rulemaking processes, and continues to explore new initiatives to provide technical assistance to community banks.

Conclusion

The recent financial crisis has proved challenging for financial institutions in general and for community banks in particular. Analyses of bank failures during the crisis by the FDIC, the FDIC OIG and the GAO point to some common risk factors for institutions that failed during the recent crisis, including rapid growth, concentrations in high-risk loans, and funding through volatile deposits. In contrast, community banks that followed traditional, conservative business models overwhelmingly survived the recent crisis. The FDIC's extensive study of community banking over a 27-year period shows that while these institutions face a number of challenges, they will remain a viable and vital component of the overall U.S. financial system in the years ahead.

1 FDIC Community Banking Study, December 2012, http://www.fdic.gov/regulations/resources/cbi/study.html .

2 The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with population between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

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