STATEMENT OF

THE FEDERAL DEPOSIT INSURANCE CORPORATION
by

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EXAMINING THE STATE OF SMALL DEPOSITORY INSTITUTIONS

before the

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
US SENATE

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Chairman Johnson, Ranking Member Crapo and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the state of small depository institutions. As the primary federal regulator for the majority of community banks, the FDIC has a particular interest in understanding the challenges and opportunities they face.

My testimony will highlight some findings from our community bank research efforts and discuss some key performance statistics for community banks. I will describe the FDIC's oversight of community banks and how it differs from our supervision of large banks and will touch on some of our outreach and technical assistance efforts related to community banks. Additionally, I will discuss how the FDIC has taken the characteristics and needs of community banks into consideration in the drafting of regulations. Finally, as you requested in your letter of invitation, I will discuss some important factors for consideration when analyzing regulatory relief proposals.

Community Bank Research Agenda

FDIC Community Banking Study

Since late 2011, the FDIC has been engaged in a data-driven effort to identify and explore issues and questions about community banks – the institutions that provide traditional, relationship-based banking services in their local communities. Our research is based on a definition of community banks that goes beyond asset size alone to account for each institution's lending and deposit gathering activities, as well as the limited geographic scope of operations that is characteristic of community banks.

Our initial findings were presented in a comprehensive Community Banking Study (Study) published in December 2012.[1] The study covered topics such as structural change, geography, financial performance, lending strategies and capital formation, and highlighted the critical importance of community banks to our economy and our banking system.

While community banks account for about 14 percent of the banking assets in the United States, they now account for around 45 percent of all the small loans to businesses and farms made by all banks in the United States. In addition, the Study found that over 600 of the more than 3,100 U.S. counties – including small towns, rural communities and urban neighborhoods – would have no physical banking presence if not for the community banks operating there.

The Study highlighted some of the challenges facing community banks in the present environment. Beyond the high credit losses that were experienced as a result of the recession, community banks have also experienced a squeeze on net interest income during the protracted period of historically low interest rates that has followed. Also, while the available data do not permit a breakdown of regulatory versus non-regulatory expenses, a number of community bankers

[1] *FDIC Community Banking Study*, 2012. https://www.fdic.gov/regulations/resources/cbi/study.html

interviewed as part of the Study stated that the cumulative effect of regulation over time has led to increases in expenses related to complying with the supervisory and regulatory process.

Nonetheless, the Study also showed that the core business model of community banks – defined around well-structured relationship lending, funded by stable core deposits, and focused on the local geographic community that the bank knows well – actually performed comparatively well during the recent banking crisis. Amid the 500 some banks that have failed since 2007, the highest rates of failure were observed among non-community banks and among community banks that departed from the traditional model and tried to grow faster with risky assets often funded by volatile brokered deposits.

Our community bank research agenda remains active. Since the beginning of the year, FDIC analysts have published new papers dealing with consolidation among community banks, the effects of long-term rural depopulation on community banks, and on the efforts of Minority Depository Institutions to provide essential banking services in the communities they serve. [2]

[2] See: Backup, Benjamin R. and Richard A. Brown, "Community Banks Remain Resilient Amid Industry Consolidation," *FDIC Quarterly*, Volume 8, Number 2, 2014. pp. 33-43;
Anderlik, John M and Richard D. Cofer Jr., "Long-Term Trends in Rural Depopulation and Their Implications for Community Banks," *FDIC Quarterly*, Volume 8, Number 2, 2014, pp. 44-59.
Breitenstein, Eric C., Karyen Chu, Kathy R. Kalser, and Eric W. Robbins, "Minority Depository Institutions: Structure, Performance, and Social Impact," *FDIC Quarterly*, Volume 8, Number 3, 2014.
https://www.fdic.gov/bank/analytical/quarterly/

Community Bank Performance and the New Community Bank Quarterly Banking Profile

Another important development in our research effort has been the introduction this year of a new section in the FDIC *Quarterly Banking Profile*, or QBP, that focuses specifically on community banks.[3] Although some 93 percent of FDIC-insured institutions met our community bank definition in the first quarter, their relatively small size (encompassing only 14 percent of industry assets) tends to obscure community banking trends amid industry aggregate statistics. This new quarterly report on the structure, activities and performance of community banks should provide a useful barometer by which smaller institutions can compare their own results. This regular quarterly report is an important and ongoing aspect in the FDIC's active program of research and analysis on community banking.

Our most recent QBP shows that community bank loan balances grew by 7.6 percent in the year ending in June, outpacing a 4.9 percent rate of growth for the industry as a whole. All major loan categories increased for community banks. One-to-four family mortgages increased by 4.6 percent over the year. Small loans to businesses—loans to commercial borrowers up to $1 million, and farm loans up to $500,000—totaled $297.9 billion as of June 30, an increase of 3.1 percent from a year ago. Almost three-quarters of the year-over-year increase in small loans to businesses was driven by improvement in commercial and industrial loans and nonfarm nonresidential real estate loans.

[3] *FDIC Quarterly Banking Profile*, http://www2.fdic.gov/qbp

Net interest income—which accounts for almost 80 percent of net operating revenue at community banks—was $16.8 billion during the first quarter, up 6.3 percent from a year ago. The average net interest margin at community banks of 3.61 percent was 4 basis points higher than a year ago and 46 basis points above the industry average. However, noninterest income was down 9.5 percent from second quarter 2013, at $4.5 billion in the second quarter 2014, as revenue from the sale of mortgages and other loans declined by 29.1 percent from a year ago. Relative to total assets at community banks, noninterest expense declined to 2.91 percent (annualized) from 2.98 percent a year ago, as assets grew at a faster pace than noninterest expense.

As of second quarter 2014, our analysis shows that community banks reported net income of $4.9 billion, an increase of 3.5 percent from the same quarter a year ago, compared to an earnings increase of 5.3 percent for the industry as a whole. More than half (57.5 percent) of all community banks reported higher earnings than a year ago and the percentage reporting a quarterly loss fell to 7.0 percent from 8.4 percent.

<u>Supervisory Approach for Community Banks</u>

Since the 1990s, the FDIC has tailored its supervisory approach to the size, complexity, and risk profile of each institution. To improve our risk-focused process, in 2013, the FDIC restructured our pre-examination process to better tailor examination activities to the unique risk profile of the individual institution and help community bankers understand examination expectations. As part of this process, we developed and implemented an electronic pre-examination planning tool to ensure consistency nationwide and to ensure that only those items that are necessary for the examination process are requested from each institution.

Examination Cycle

With respect to on-site examinations, the Federal Deposit Insurance Act requires regular safety and soundness examinations of state non-member banks at least once during each 12-month period. However, examination intervals can be extended to 18-months for institutions with total assets of less than $500 million, provided they are well-managed, well-capitalized, and otherwise operating in a safe and sound condition. Most community banks we supervise have total assets under $500 million and meet the other criteria and, therefore, are subject to extended safety and soundness examination intervals. In contrast, the very largest institutions we supervise are subject to continuous safety and soundness supervision during the year rather than a point in time examination.

FDIC policy guides consumer compliance examination schedules, which also vary based on the institution's size, prior examination rating and risk profile. Community Reinvestment Act (CRA) examination schedules conform to the requirements of the Gramm Leach Bliley Act, which established the CRA exam cycle for most small institutions. The FDIC also uses different CRA examination procedures based upon the asset size of institutions. Those meeting the small and intermediate small asset-size threshold are not subject to the reporting requirements applicable to large banks and savings associations.

The FDIC utilizes offsite monitoring programs to supplement and guide the onsite examination process. Offsite monitoring programs can provide an early indication that an institution's risk profile may be changing. Offsite monitoring tools using key data from bank's quarterly Reports of Condition and Income, or Call Reports, have been developed to identify institutions that are experiencing rapid loan growth or reporting unusual levels or trends in problem loans, investment activities, funding strategies, earnings structure or capital levels that merit further review. In addition to identifying outliers, offsite monitoring using Call Report information helps us to determine whether it is appropriate to implement the extended examination timeframes.

The Call Report itself is tiered to size and complexity of the filing institution, in that more than one-third of the data items are linked to asset size or activity levels. Based on this tiering alone, community banks never, or rarely, need to fill out a number of pages in the Call Report, not counting the data items and pages that are not applicable to a particular bank based on its business model. For example, a typical $75 million community bank showed reportable amounts in only 14 percent of the data items in the Call Report and provided data on 40 pages. Even a relatively large community bank, at

$1.3 billion, showed reportable amounts in only 21 percent of data items and provided data on 47 pages.

Rulemaking

The FDIC also considers size, complexity, and risk profile of institutions during the rulemaking and supervisory guidance development processes, and where possible, we scale our regulations and policies according to these factors. The FDIC has a longstanding policy of implementing its regulations in the least burdensome manner possible. In 1998, the FDIC issued its *Statement of Policy on the Development and Review of FDIC Regulations and Policies*.[4] This policy statement, which was updated and reaffirmed, as recently as 2013, recognizes the FDIC's commitment to minimizing regulatory burdens on the public and the banking industry.

A number of recent FDIC rulemakings implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that were designed to benefit community institutions. For example, the assessment base for deposit insurance was changed from domestic deposits to average total assets minus average tangible equity, which shifted more of the deposit insurance assessment burden from smaller to larger institutions. As a result, aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately one-third in the second quarter of 2011, primarily due to the

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[4] http://www.fdic.gov/regulations/laws/rules/5000-400.html

assessment base change. Under the Dodd-Frank Act, the deposit insurance coverage limit was permanently increased to $250,000, which particularly benefits small businesses and other depositors of community institutions. The Dodd-Frank Act also increased the minimum reserve ratio for the Deposit Insurance Fund (or DIF) from 1.15 percent to 1.35 percent, with the increase in the minimum target to be funded entirely by larger banks.

In addition to issuing rules to implement the provisions of the Dodd-Frank Act that benefit community banks, the FDIC also has taken into account the unique characteristics of community banks in its rulemaking to implement other important reforms to the financial system. For example, in adopting the implementing regulations for the Volcker Rule, the agencies recognized that, while the requirements of the implementing statute apply to all banking entities regardless of size, the activities covered are generally conducted by larger, more complex banks. Accordingly, the agencies designed the Volcker Rule to reduce the burden placed on banks that do not engage in proprietary trading activities or have only limited exposure to fund investments.

Under the Volcker Rule, a bank is exempt from all of the compliance program requirements, and all of the associated costs, if it limits its covered activities to those that are excluded from the definition of proprietary trading. This exemption applies to the vast majority of community banks. For community banks that are less than $10 billion in assets but do engage in activities covered by the Volcker Rule, compliance program requirements can be met by simply including references to the relevant portions of the rule within the banks' existing policies and procedures. This should significantly reduce the compliance burden on smaller banks that may engage in a limited amount of covered activities.

The FDIC and other bank regulators also adopted regulatory capital rules for community banks. The FDIC recognizes that a number of the more complex requirements of our capital rules are not necessary or suitable for community banks. As such, many aspects of the revised capital rules do not apply to community banks. For example, the new capital rules introduce a number of provisions aimed only at the large, internationally active banks. These provisions include the supplementary leverage ratio, the countercyclical capital buffer, and capital requirements for credit valuation adjustments and operational risk, to name a few. In addition, the revised capital rules contain large sections that do not apply to community banks. Most notably, the advanced approaches framework only applies to internationally active banks and the market risk rule only applies to banks with material trading operations.

To assist bankers in understanding and complying with the revised capital rules, the FDIC conducted outreach and technical assistance designed specifically for community banks. In addition to the publication of a community bank guide and an informational video on the revised capital rules, FDIC staff conducted face-to-face informational sessions with bankers in each of the FDIC's six supervisory regions to discuss the revised capital rules most applicable to community banks.

Subchapter S

The Basel III capital rules introduce a capital conservation buffer for all banks (separate from the supplementary leverage ratio buffer applicable to the largest and most systemically important bank holding companies (BHCs) and their insured banks). If a bank's risk-based capital ratios fall below specified thresholds, dividends and discretionary bonus payments become subject to limits. The buffer is meant to conserve capital in banks whose capital ratios are close to the minimums and encourage banks to remain well-capitalized.

In July, the FDIC issued guidance clarifying how it will evaluate requests by S corporation banks to make dividend payments that would otherwise be prohibited under the capital conservation buffer. Federal income taxes of S corporation banks are paid by their investors. If an S corporation bank has income but is limited or prohibited from paying dividends, its shareholders may have to pay taxes on their pass-through share of the S-corporation's income from their own resources. Relatively few S corporation banks are likely to be affected by this issue, and in any case not for several years; the buffer is phased-in starting in 2016 and is not fully in place until 2019.

As described in the guidance, when an S corporation bank does face this tax issue, the Basel III capital rules allow it (like any other bank) to request an exception from the dividend restriction that the buffer would otherwise impose. The primary regulator can approve such a request if consistent with safety and soundness. Absent significant safety and soundness concerns about the requesting bank, the FDIC expects to approve on a timely basis exception requests by well-rated S corporations to pay dividends of up to 40 percent of net income to shareholders to cover taxes on their pass-through share of the bank's earnings.

Community Banking Initiative and Technical Assistance

In 2009, the FDIC established its *Advisory Committee on Community Banking* to provide advice and guidance on a broad range of policy issues impacting small community banks and the local communities they serve. In February 2012, the FDIC sponsored a national conference to examine the unique role of community banks in our nation's economy. Later in 2012, roundtable discussions were conducted in each of the FDIC's regions that focused on the financial and operational challenges and opportunities facing community banks, and the regulatory interaction process.

In discussions with community bankers in these venues and through our routine outreach efforts, it became clear that community banks were concerned about keeping up with changing regulations and policy issues and were interested in assistance from us to stay informed. As a result, in 2013, 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.

We also 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 spring 2013, we issued six videos designed to provide new bank directors with information to prepare them for their fiduciary role in overseeing the bank. This was followed by the release of a virtual version of the FDIC's Directors' College Program that regional offices deliver throughout the year. We have also issued a series of videos, primarily targeted to bank officers and employees, dealing with more in-depth coverage of important supervisory topics with a focus on bank management's responsibilities.[5] We have hosted banker call-ins on topics such as proposed new accounting rules, new mortgage rules, and Call Report changes. The FDIC is also currently offering a series of Deposit Insurance Coverage seminars for banking officers and employees.[6] These free seminars, which are offered nationwide, particularly benefit smaller institutions, which have limited training resources.

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[5] *Technical Assistance Video Program*: https://www.fdic.gov/regulations/resources/director/video.html.

[6] *Deposit Insurance Coverage: Free Nationwide Seminars for Bank Officers and Employees* (FIL-17-2014), dated April 18, 2014.

These resources can be found on the *Directors' Resource Center*, available through the FDIC's website.[7] Additionally, in June 2014, the FDIC mailed an Information Packet[8] to the chief executive officers (CEOs) of FDIC-supervised community banks containing resources and products developed as part of the FDIC's Community Banking Initiative, as well as documents describing our examination processes. In addition to an introductory letter to CEOs, the packet contains brochures highlighting the content of key resources and programs; a copy of the Cyber Challenge, a technical assistance product designed to assist with the assessment of operational readiness capabilities; and other information of interest to community bankers.

EGRPRA Review

The FDIC and other regulators are actively seeking input from the industry and the public on ways to reduce regulatory burden. The *Economic Growth and Regulatory Paperwork Reduction Act of 1996*[9] (EGRPRA) requires the Federal Financial Institutions Examination Council (FFIEC)[10] and the FDIC, the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC) to review their regulations at least once every ten years to identify any regulations that are outdated, unnecessary, or unduly burdensome. EGRPRA also requires the

[7] See https://www.fdic.gov/regulations/resources/director/.

[8] See http://www.fdic.gov/regulations/resources/cbi/infopackage.html

[9] Public Law 104-208 (1996), codified at 12 U.S.C. § 3311

[10] The FFIEC is comprised of the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Consumer Financial Protection Bureau (CFPB) and the State Liaison Committee (SLC), which is comprised of representatives from the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS).

agencies to eliminate unnecessary regulations to the extent such action is appropriate. The second decennial EGRPRA review is in process with a required report due to Congress in 2016. On June 4, 2014, the Federal banking agencies jointly published in the *Federal Register* the first of a series of requests for public comment on their regulations.[11] The comment period for this request closed on September 2, 2014. The agencies are currently reviewing the comments received. The agencies also plan to hold regional outreach meetings to get direct input as part of the EGRPRA review process before the end of 2015.

The FDIC has developed a comprehensive plan for conducting its EGRPRA review that includes coordination with the other Federal banking agencies.[12] As the primary federal regulator for the majority of community banks, the FDIC is keenly aware of the impact that its regulatory requirements can have on smaller institutions, which operate with less staff and other resources than their larger counterparts. Therefore, as part of its EGRPRA review, the FDIC is paying particular attention to the impact its regulations may have on smaller institutions.

Consideration of Regulatory Relief Proposals

As indicated above, the FDIC strives to tailor rules, policies, and supervisory practices to the size, complexity and risk profile of the institutions we supervise, and we welcome suggestions regarding where we can do more. When we review such

[11] http://www.gpo.gov/fdsys/pkg/FR-2014-06-04/pdf/2014-12741.pdf .
[12] http://www.fdic.gov/EGRPRA/

suggestions, our focus is their effect on the fundamental goals of maintaining the safety-and-soundness of the banking industry and protecting consumers.

Strong risk management practices and a strong capital base are fundamental to the long-term health of community banks and their ability to serve their local communities. Most community banks know how to manage the risks in their loan portfolios and have strong capital positions. And of course, community banks have a strong interest in retaining customers by treating them fairly. Serving the credit needs of their local communities, while managing the attendant credit risks, truly is the core expertise of many community banks and what they do best. Reports by the General Accounting Office (GAO) and the FDIC's Office of Inspector General (IG),[13] and our own Community Banking Study have shown that banks – even those with concentrated asset portfolios - with sound risk management practices and strong capital have been able to weather crises and remain strong.

Institutions that did not survive, according to these reports, were those with weaker or more aggressive risk management approaches, including imprudent loan underwriting and rapid growth often financed by wholesale funds or brokered deposits. One of our IG reports also found that banks that heeded supervisory directives regarding risk management practices were more likely to survive.

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[13] *Causes and Consequences of Recent Bank Failures* (January 2013), GAO-13-71 and *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (January 2013), EVAL-13-002

We believe the evidence strongly supports the idea that the best way to preserve the long term health and vibrancy of community banks, and their ability to serve their local communities, is to ensure their core strength is preserved: strong capital, strong risk management and fair and appropriate dealings with their customers. We also believe our own supervision plays an important role in obtaining corrective action to address problems where this is needed, and that this also promotes the long term health of community banks.

This being said, we remain alert to the importance of achieving the fundamental objectives of safety-and-soundness and consumer protection in ways that do not involve needless complexity or expense. As noted elsewhere in this testimony, we have a number of forums for hearing and considering suggestions in this regard, and we stand ready to provide our views and technical assistance to this Committee.

Conclusion

The FDIC's research and community bank operating results both show that the community banking model is doing well. The FDIC tailors its oversight of banks according to size, complexity and risk, and has provided a number of tools to assist community bankers understand regulatory requirements and expectations. Going forward, we continue to look for ways to improve our supervisory processes, and stand ready to provide technical assistance regarding proposals that seek to achieve the fundamental goals of safety-and-soundness and consumer protection in ways that are appropriately tailored for community banks.