Community Banking by the Numbers

ART MURTON , Director, Division of Insurance and Research, FDIC

My name is Art Murton. I'm the director of the FDIC's Division of Insurance and Research. As Acting Chairman Gruenberg indicated earlier, the FDIC is undertaking a major study of community banking. We spent the last few months getting that study under way and we identified some questions that we seek to answer, including what is a community bank, what are the different business models that community banks pursue, what leads to success, what are the challenges they face raising capital, adapting to new technologies, keeping personnel. We are very privileged today to have a panel that will help us address some of those questions. First, we are going to hear from the FDIC's Chief Economist Rich Brown. He will present some of our preliminary work looking back at some of the trends over the past 25 years. After Rich, we will hear from Tim Koch, who is the banking and finance professor at the University of South Carolina. Tim was also one of the founding members of the FDIC's Advisory Committee on Community Banking. Next we will hear from Kevin Moore, who is the senior vice president of supervision and risk management at the Kansas City Federal Reserve Bank. Kevin has vast experience. He has been through both banking crises, and he is in the Kansas City region, where community banking is a very important aspect of the financial system. Finally, we will hear from Chris Whalen, who is the senior managing director of Tangent Capital Partners in New

York and a co-founder of the institutional risk analytics. We will look forward to hearing from Chris, who is a very astute observer of the financial industry. Before I turn it over to Rich, I just want to mention we are talking about 25 years of data that Rich will present, and that 25-year period stretches back to the mid-1980s, and that was a period that followed shortly after major deregulation of the banking and thrift industry. It was the onset of the first banking crisis and the S&L crisis. Then it takes you through what some call the "Golden Age of Banking," leading up to this most recent financial crisis, which we hope and expect is coming to an end. The reason we have that 25 years of data is that call reports have been around for a long time. The primary use is an examination tool. But in the mid-1980s, under the direct leadership of then Chairman Bill Seidman, the FDIC made a conscious decision to retain, organize, and publish the call report information to make it available to research analysts and the general public. We devoted a lot of resources to that over the years. I think you will see some of the benefits of that shortly. With that I will turn it over to Rich Brown.

RICH BROWN, Chief Economist, FDIC

Thank you, Art. Good morning, everyone. As Art said, we will look at 25 years of data and we will take you on a whirlwind tour of the quantitative history of banking in the United States over that period. I will say at the outset that this represents the collective work of a lot of people in the FDIC's Division of Insurance and Research. I'm happy to have a chance to present their work to you today. We will start out with a look at long-term consolidation in the industry. It went from over 18,000 individual charters in 1985 to just under 7,700 at the end of 2010. Now all of this net decline can be accounted for by a decline in the number of banks that started the period with assets of less than $100 million. That's the dark blue band there. At first glance, this is the end of little banks. But we have to recognize a couple of facts. First, $100 million is not what it used to be. Between 1985 and 2010, the consumer price index rose by 2.2 times in the size of the U.S. economy and the size of assets in the banking industry increased by about 3.4 times. We have to adjust our notion of size in looking over such a long period of time. When you look more deeply at some of the specific types of structural change that occurred during this period, you get some unexpected results. We will look at those next. Over this 25-year period, we saw 14,600 charters disappear, almost 4,300 came into existence for a net decline of about 10,400. Of the charters that disappeared, 11 percent of them failed, 31 percent of them merged with different banking companies, and 24 percent of them consolidated within the same banking organization. Now first let's look at the survival rate according to the 1985 size group. Somewhat surprisingly, it was the smallest size groups, the banks under $100 million, that was most likely to survive the entire period, followed by the largest size group. Now the smallest size group also has the lowest rate of failure of any of the other size groups, again followed by the largest banks. Now, institutions with 1985 assets between $1 billion and $10 billion had the highest failure rate, just over 20 percent. The rate of mergers between different banking organizations—that's the blue chart—was also lowest for the smallest size group by a small margin, while the rate of intracompany consolidation, the last chart, was comparable to every other size group except the very largest institutions. So I think the picture we get from these charts is very different from the picture we had on the last charts. How is it that the smallest group of institutions could survive more often and fail and merge less often than any other size group and still account for all of the net decline in the number of charters during that period? The answers, in a nutshell, are growth in new charters. Of all the institutions that started out with under $100 million in assets, some 20 percent of them—almost 2,900 institutions—survived the entire period and grew into one of the larger size groups. In fact, 12 of these charters ended up the period with assets of more than $10 billion. And while more than 4,000 new charters came into the industry, they were typically very small when they came in. They also prospered and grew and help to replenish those smaller cohorts of the midsize and larger institutions that you see on the first chart. So the picture is a little more complicated than what we saw in the look at consolidation at the outset. Now we wanted our community bank research project to be based on a common definition of a community bank that we could use for all periods of time and all of our individual researchers could appeal to when doing their work. We wanted to get away from size as the sole determinant of what is and what is not a community bank. Now it's true that the academic literature typically relies on size. Usually it is a size cutoff of $1 billion that is indexed backward over time. Why is this? First, size is a convenient cutoff because it's easy to implement; it's easy to understand. I think there is good reason to believe that size is highly correlated with the aspects that people generally associate with community banking. One of those attributes is a primary focus on lending and deposit gathering, and some reasonable combination of those activities. Another attribute is the relatively limited geographic scope of operations. Community bankers tell us that they have local ownership, they make decisions locally and it's based on their knowledge of the local market area. They also tell us there is a different way of doing business at community institutions. Some researchers, including Professor Koch on today's panel, have described these differences in terms of relationship lending instead of transactional lending. And we try to capture some of these attributes in our definition and make a definition that could be based on the quarterly financial data that we have and also can be applied objectively to every FDIC-insured institution over that time period. Now what I am going to describe to you is the research definition of a community bank. This is not a new designation for supervisory purposes. There are a number of size thresholds written into statute and regulation that serve their purpose very well. We are not looking to mess with that. We started making our designation at the level of the banking organization of fundamental decision-making unit. All of the charters under one holding company will be designated either as community bank or non-community bank. In a few minutes, we will go back to the charter level when doing some of the analysis after designating at the organizational level. First, we went straight in and excluded some institutions that simply did not fit the profile of community banks. You see those exclusions in the lower right panel on this chart. After that, we tried to be as inclusive as we could be given the institution’s balance sheet and geographic structure. Any institution with assets less than $1 billion at the end of 2010 was presumptively included as a community bank. That size cutoff was indexed backwards over time, so by 1995 it’s $250 million. We also included any bank over the size threshold if it met our tests for balance sheet structure and geographic scope. There are minimum levels for loans to assets and core deposits to assets and ceilings for the number of banks—number of total banking offices and the size of those banking offices and those limits are indexed backwards over time as well. Now these larger institutions must have offices in no more than three states and no more than two large metro areas, and those limits are not indexed. Now, let's look at how this worked out by year-end 2010. Applying our exclusions on the left-hand side of the diagram, we exclude 126 institutions right out of the box. Then on the right side of the diagram, we apply our conditions for balance sheet, geographic scope to all institutions over the $1 billion threshold and we eliminate 264 of them. Finally, we presumptively include all institutions under that size threshold. This leaves us with 6,526 community banking organizations. They represent about 94 percent of all U.S. bank and thrift organizations. The net effect of our efforts to get away from this simple billion-dollar threshold can be seen in the 92 small institutions excluded in the lower left and the 330 large institutions we added back in the middle right of the diagram. As a percent of the total number of banking organizations, these are not huge changes. But, we were able to add back more than half of the eligible organizations with assets over $1 billion, so I think that's pretty important. These institutions are performing community-banking functions that would have been left out of a simple size-based definition. This chart will show our designations going back to 1985. The small community banks under the size threshold are dark blue. The large community banks above the size threshold are shaded blue, and the non-community banks are in red. Again, this is at the level of the organization. Out of about 15,000 banking organizations in 1985, about 97 percent of them are community banks. Out of 6,900 banking organizations at the end of 2010, just over 94 percent are community banking organizations. Now viewed this way, industry consolidation has been somewhat less pronounced than we saw in the chart a few minutes ago. The nearly 5,000 intracompany consolidations that took place over this period happened under the surface when you look at it from the level of the banking organization. Also, under our community bank definition, the consolidation that did happen is more proportional between those we designated as community banks and those that are non-community banks. Both groups saw a substantial decline in their numbers over this period. Let's take one more look at these designations and then switch and look at their total assets. Here you will get a very different picture. While community bank assets grew by one-third over this period, the non-community banks saw their assets grow by four and a half times. The story of consolidation at the top is well known to all of you. The share of industry assets held by the top ten banking organizations grew from 19 percent in 1985 to 55 percent by the end of 2010, and that's what you see going on here. So now we will try and draw you a basic snapshot of U.S. community banks, including how big they are, where they operate, what types of business lines do they specialize in. We will revisit some of the structural issues based on these new designations and not purely based on size. As we do so, again the community banking designations are made at the organizational level, but we will switch and do the analysis at the charter level. It's more convenient and clear for a variety of reasons. First, it comes as no surprise that the average size of non-community institutions has zoomed far ahead of the average size of community banks since 1985. Back at that time, the average community banking charter had $93 million, compared with $1.1 billion for the average non-community banking charter. By the time we get to 2010, the size of the average community banking charter has risen to $227 million. The size of the non-community banking charter, on average, has ballooned to almost $18 billion. Now again, due to the consolidation at the top end of the industry. If you look at medians, the differences and the divergence is less pronounced. In 1985, the difference in medians was about three times; and in 2010, the difference in medians between non-community banks and community banks was about nine times. We also looked at where these institutions tend to operate. Now it's no surprise that most bank headquarters and most bank branch offices for community banks and non-community banks are located in metro areas. That's where the people are and that's where the offices are going to be. But community banks are three times more likely than other banks to be headquartered in a rural area for a micropolitan area with populations between 10,000 and 50,000 people than are non-community institutions. It's about the same split for banking offices as well. Now our analysts looked at total banking offices, community banks, and non-community banks at the state level. They calculated the total percent of these banking offices that belong to the community banks by state. What you see here, the seven light blue states have the highest percentage, more than 60 percent of their banking offices belong to community banks. Just behind are the dark green states of the lower Mississippi Valley and Appalachia, where community institutions make up between 50 percent and 60 percent of the total banking offices. There are 26 states with a community banking office between 25 percent and 50 percent of the total. The outliers on the low side are the seven states plus the District of Columbia, where community banking offices make up less than 25 percent of total banking offices. For a variety of reasons, these larger banks have captured a larger market share in some of these states at least in terms of the number of banking offices. Next, we move to balance sheet structure. It's no surprise that community institutions have higher percentages of loans to assets and core deposits to assets than non-community institutions. After all, we imposed these thresholds on the large institutions just a moment ago. Perhaps it's a little surprising that the non-community institutions still have an average loans-to-asset ratio greater than 50 percent. We do see that the disparity in core deposit funding is more pronounced—a bigger difference between the groups there. Non-community institutions tend to rely much more heavily on non-core deposit funding and on non-deposit borrowings than do community institutions. We also see a persistent difference in average core capital ratios for community banks in dark blue compared with other institutions. The ratios for both groups increased during the 1990s with the introduction of the Basel 1 capital rules and prompt corrective action. We also saw a narrowing of the difference in capital ratios in 2009 and 2010, as some of the largest institutions received capital infusions, first from the TARP program and then from capital raises and retained earnings. The community bank capital ratio also improved in 2010 after declining in 2008 and 2009. Now one of the most important sources of structural change is bank failure, and this chart shows the annual rate of failure by group as a percent of the number of institutions in each group at the beginning of the year. Both community banks and other banks saw spikes in the rate of failure in the late 1980s and early 1990s and again during the recent crisis. Between these episodes, as Art mentioned, was a period of more of a decade where failure was very rare. Between 1996 and 2005, there were fewer than 50 failures of FDIC-insured institutions.

A couple of things to point out here. First, because community institutions at the charter level will always make up about 90 percent of all banks, most of the failures will be community institutions. So over this period, over 80 percent of failed institutions were community institutions, but the average rate of failure for these two groups of institutions was virtually statistically identical. Right around seven-tenths of 1 percent per year on average. In the most recent crisis, we see the failure rates spiked first for non-community institutions and the rate fell sharply in 2010 and 2011. The failure rate for community banks started rising later in 2008 and peaked later in 2009, and it only started falling last year. Here we will revisit some of the other concepts of structural change that we introduced near the beginning of the talk. This time again we are not focused on size, but we are focused on the new community bank definition. Thirty-six percent of community bank charters that began the period in 1985 managed to survive all the way until 2010, although 2 percent of them no longer met the community bank definition at the end of that period. By contrast, only 6 percent of non-community institutions survived the entire period, for an attrition rate of 94 percent. So what happened to all the banks that exited the industry during this period? For community banks, 12 percent of them failed, 32 percent merged with other companies and 18 percent of them consolidated within their own company. For the other banks, the non-community banks, 8 percent failed, 22 percent merged with other companies and 60 percent consolidated within their own organization. This shows how important the relaxation of branching restrictions was to large organizations during this period, particularly during the 1990s. Another thing we did was look at lending specialties identifying institutions with a single specialty mortgage lending, consumer lending, commercial real estate, commercial and industrial (or C&I) lending, and agricultural lending. About 55 percent of community banks met the definition for a single specialty in one of these areas, according to our definition. The remainder were multi- or had no particular specialty. As you can see, the mortgage lenders and ag lenders made a substantial share of community banks throughout the process, although mortgage specialist tailed off a little bit in the years leading up to the crisis. By our definition, the C&I specialists have declined from 10 percent at the beginning of the period to just over 2 percent by the end. Consumer specialists also declined from about 9 percent to just one-half of 1 percent by the end of this period. The big increase, as you can see, is the red line, commercial real estate—real estate specialist. They rose as high as 30 percent of the population of community banks in 2007 before falling back to 26 percent by the end. A major question arises with this definition of commercial real estate for this specialty group. That relates to the portion of commercial real estate loans that are secured by owner-occupied properties. There is reason to believe that at least some of these loans are essentially commercial loans where owner-occupied real estate has been secured as collateral. If so, the implications would be significant. If you simply assume that all of these owner-occupied CRE loans were in fact commercial and industrial loans and made that switch in this data, you would move 19 percent of community banks—that's 1,800 institutions—from the commercial real estate category to the C&I category. This would bring C&I specialists up to about 21 percent of community banks, on a par with mortgage specialists as the largest single category. The truth is probably somewhere in the middle, but this is an issue we need to explore more fully as we go through our study. We hope to hear more about it from you today. We looked at differences in the prevalence of the single-specialty groups between community banks and non-community banks. This chart shows their shares at year-end 2010. There are two surprising results here. The first is that commercial real estate and C&I specialists were even more prevalent among non-community institutions as among community banks. The second result is that specialists in mortgage lending turn out to be more prevalent among community banks. Paradoxically, I think this result may be driven somewhat by the extreme concentration in mortgage originations, where just five institutions make up 60 percent of all mortgage originations. That's not very many to feed the 9 percent in the red here. We looked at the relative profitability of the same community bank specialty groups. This chart compares their annual pretax return on assets averaged over five-year periods trying to reduce some of the noise in the data here. Now for the specialist groups, the mortgage lenders, the consumer lenders, C&I lenders and the ag lenders, they are grouped fairly closely together. They generally average an ROA between 100 and 150 basis points in the middle years of this period, the quiet period. They fell below 100 basis points in the late 1980s, and they've also seen their performance deteriorate in the last five years of the analysis. Within this group, the ag specialist consistently had the highest average ROA while mortgage lenders were more at the lower end of the spectrum. But what really stands out is the red line, commercial real estate specialists. They way underperformed the industry in the late 1980s and early 1990s and again in the last five-year period. In between, they just barely outperformed the rest of the community banks. Here we will go a little further into structural change among the specialty groups, and this is for all institutions. Looking at their share of total bank failures during each of the five-year intervals. The first chart, mortgage specialists, they accounted for more than 400 failures between 1986 and 1995. A period when over 2,000 banks and thrifts failed in all. Eight mortgage specialists failed between 1996 and 2005, but that was enough to represent still almost 20 percent of all failures during the quiet period. As total FDIC-insured failures rose after 2006, they included 24 mortgage specialists, but that was only 7 percent of the total. Let's bring in the AG specialist and the C&I specialists. We see that they contributed double-digit failure totals only in the early years, before 1995. C&I failures were particularly prevalent in the late 1980s. Finally, the CRE specialists, they also contributed a significant numbers of failures in the late 1980s and early 1990s. But what really stands out is the number and share of commercial real estate specialists that failed in the last five-year period. They made up fully two-thirds of bank failures during the most recent five-year period. Clearly this is a portfolio concentration that was particularly vulnerable to the historic disruption we saw in the U.S. real estate markets during that period of time.

We will finish up with some performance comparisons between community banks and all other banks, with a breakdown of the income statement to try to help identify areas of relative earning strength and weakness between the two groups. At a high level, we see that average pretax ROA was not so different for these groups before 1992. After that, the non-community institutions consistently outperformed community banks, by this measure any way, with an annual pretax ROA that averaged 35 basis points higher between 1993 and 2006. Earnings fell sharply for both groups during the recent crisis, but by 2010 we saw that non-community institutions once again with an ROA advantage of 68 basis points. Now to better understand these trends, we have broken down bank net income into four main components. Net interest income, provisions for loan losses, noninterest income, and noninterest expense. These are all expressed on the same scale as a percent of average assets. In terms of net interest income, community banks appear to have had the advantage, at least after 1992. Between 1993 and 2006, their net interest income averaged almost 50 basis points higher than that of the other banks. Community banks also had a small but consistent advantage in terms of provision expenses. They had lower loan losses on average every year. It's when you get to the noninterest income that you see a large and consistent advantage for non-community institutions averaging almost 140 basis points a year since 1993—it is huge compared with the other charts. Finally, in terms of noninterest expense expressed to average assets, the ratio for community banks has held steady. Over time it's just under 3 percent of assets. But what was an advantage for community banks that averaged 55 basis points per year during the 1990s has dwindled to actually be a slight disadvantage over the last five years as the large bank expenses have declined as a percent of assets. Now another earnings metric that is frequently cited to measure relative competitiveness is the efficiency ratio, the ratio of non-interest expense to net operating revenue. Being an economist, I've always thought this should be called the inefficiency ratio because higher numbers are worse from the standpoint of earnings. Both groups saw their efficiency ratios improve—that is, declined—in the 1990s. But community banks began to see their ratio deteriorate after 2000, particularly in the latter half of the decade as you see in the blue line. Other banks saw theirs remain steady or even improve a little. This has led to the emergence of what some call an efficiency gap between community institutions and other institutions that has grown to 15 full percentage points by the end of 2010. This is clearly an area for additional research. We need to look more closely at the expense side, the numerator of the ratio, as well as the income side, which makes up the denominator. Both income side and expense side factors have contributed to the emergence of this gap over time. And that brings us to the remainder of our research agenda for this project. I think Art gave you an overview. We are looking more closely at the cost structure and economies of scale. We will look more deeply at the relative success of community bank business models. From there, the project heads up several interesting directions, including performance metrics. We're not sure the ones we have are the best to look at. The connections that community banks have to their local community and to the small-business economy and special topics like rural depopulation, the use of technology and lessons of the recent crisis. Thank you for taking this whirlwind tour with us this morning of the data. I look forward to your questions later on and the remarks of the other panelists. Thank you.

ART MURTON

Thank you, Rich. Now we will hear from Professor Koch. While he's getting ready, let me attend to one housekeeping task. There are question cards at your table. So if you have questions and you want to write them, there are staff available to take them. We will also have mics available during the Q&A. Thank you.

TIMOTHY KOCH, Professor of Banking and Finance, University of South Carolina

Thank you, Art and Rich I appreciate the opportunity to be here with you today. I represent the academic community in some of my comments. I will start by saying we have not been particularly good in our research on community banks. Most of our research is focused on the larger organizations, and so I think what the FDIC is trying to do here as an initial project should stimulate some good thinking by academics as well as regulatory staff on some of these topics. Those of you who are community bankers in the audience, I'd like you to pay particular attention to some of the comments I have, which are more general in nature and more philosophical rather than a critique of the specific data. There are some materials. I think you have a copy. I want to talk about the philosophical characterization of a community bank before you look at the numbers. The implication is maybe we should segment the data a little differently. Conceptually, when I think of community banking and I talk to community bankers—and again, I'm an academic, not a community banker—they all emphasize this personal high-touch relationship. You heard Rich talk about the difference between relationship banking and transaction banking. What makes a relationship strong? Because that's what community bankers are marketing. I reference customers, employees, and stockholders. I will talk about each of these and then what it means in terms of the data. Community bank customers like to know who their bankers are on a personal level. You deal with the same people time and time again. I can't count the number of times I've heard customers say I don't want to go back and re-educate another banker because they shifted somebody new into my relationship and I now have to educate that new banker on my company or personal financial condition. Community bankers try to have less turnover in their staff.

Employees. There is a different treatment of employees. We will talk a little bit about that, but we will look at the frequency with which community banks have stock ownership plans, a way to get some of the buy-in at a significant level in the community bank, and stockholders. Rich mentioned different business models. I think we can start with size, but the key emphasis on community banking and the difference in the risk management practices and performance differences are going to be driven by their business model. When we think about the traditional community bank—this is what Rich modeled in his example: emphasis on capital adequacy, reliance on core deposits, originate and hold loans—they are not necessarily in the securitization business. They hold sufficient liquid assets and net interest income is the principal source of their revenue. Rich mentioned they compete in limited geographic markets. Clearly this is the case. They get in trouble oftentimes because they move out of their comfort zone in the geographic markets they are traditionally serving. Finally, there's a strong link between ownership and management. So what are the implications now for data analysis? My first point here is size does matter, but it's not the only thing. My academic friends and I often do exactly what we say. We define community bank by assets, assume they are all the same, and then model them accordingly. We could have large banks that have a community orientation emphasis on relationships. Larger, over $1 billion. Most of the smaller ones have that. But you could have smaller institutions that aren't really community banks. You have to tie it to the business model and some of the other things. So what is the business strategy? That's important. It is a focus on long-term relationships. If you look at my commentary—I've done some work with some banks on the coast of South Carolina. The clear objective when they formed their charter was to flip it. Put the capital together, grow the thing to a minimal size and then hope some larger organization takes them out and everybody moves on to do the deal again. Is that a true community bank? I know the FDIC has looked at the data. Rich mentioned growth has been a factor in some of the problem banks. Philosophically, are banks living up to the business plan that they developed when they were first chartered? Are they consistently trying to adjust those plans and grow for later? South Carolina and our good friends in Atlanta have experienced perhaps Ground Zero for some of the failures because so many of those banks they did charter didn't follow a traditional model and ultimately got in trouble. Finally, something we don't pay enough attention to, and I would hope the regulators and the FDIC can get access to some of this data which researchers can't. That is the conjecture that closely held organizations probably manage risk differently. I will show you some data on the next chart. This is from the FDIC's website. This goes just through September of this year, but on the far right you can see currently we have 2,333 S Corporation banks. That is the trend from the year 2000 to 2011. So what's an S. Corp. bank? One hundred or fewer stockholders—I think banks were allowed to do this initially in 1997. By the way, I have a research paper on this because I believe this is a critical-enough issue. If you have concentrated ownership. Think of the extreme where you have a family-owned, family-run bank. If that organization represents a significant portion of that family's net worth or income, don't you think they would probably manage their risk a little differently? That institution's risk is a little different than the bank that was chartered with the intent of flipping it. Maybe got private equity or some other financing. What is the implication? You can't really label all banks of the same size as the same. Different community banks follow different business models; and consistent with that business model, they follow different risk metrics and risk exposures. So in an ideal world, a traditional community bank with an emphasis on core deposits, holding loans etc., will have a far different risk profile than perhaps a bank with a different model. So you get 2,300 S. Corp. banks. We also have mutual organizations. We don't have stockholders. What I show you in this chart is the distribution of bank ownership. This again is September 2011 data. My good friends at Finpro gave me access to S&L data. You can see that over 30 percent of the banks are S. Corp.; and mutuals, on the far left, control not surprisingly fairly a small fraction of assets because they are typically closely held, small organizations. Mutuals in the middle. Just under 10 percent of the organization, again a small percentage of the assets. On the far right you have others. Conjecture again—those two groups on the left probably follow different risk management practices than the ones on the right. There is a size distribution of combining S. Corps and mutuals. The percentage of assets in the red and the percentage of banks in the blue—to go to the far right—not surprisingly again is our percentage of just the totals for S Corps and mutuals. So this is just the smaller entities. You have a couple of very large organizations on the right that dominate the asset holdings. But back to the important slide. Look at the percentage of banks under a $100 million or $300 million in terms of the constructs. What's the implication of all of this? I want to go back to one of the charts. If you have a copy of what Rich presented, turn to page 20. I like what the FDIC is trying to do in their research analytics. My suggestion will be let's pare the data down into more refined categories. You look at page 20, that lower chart of the CRE specialist. Tracking percent of failures. What do you think those numbers would look like if we took out the CRE-based banks with the business model of put in a lot of capital, fund it with Home Loan Bank advances and other purchased money? Invest in commercial real estate assets. I'm thinking of downtown Atlanta. If we pull out that bank statement, or that business model segment, what percentage of the failures would be commercial real estate-related for traditional core community banks. I think it would be far different. So let me just leave it at that. I look forward to hearing some of your comments and thoughts on what is a community bank and the other panel. Thank you.

ART MURTON

Great. Thank you, Tim. Now we will hear from Kevin Moore.

KEVIN MOORE, Senior Vice President, Federal Reserve Bank of Kansas

City

Thank you, Art. It's my pleasure to be here today with you from the Federal Reserve. I will take a similar approach to Tim; and that before I touch on the numbers that the FDIC presented, I will come at it from more of a practical sense. I'm not an economist. I'm not even an academic. I'm just a lowly bank supervisor. So from that perspective, I will give you just a sense of my own experiences. I grew up in a small town in Iowa. I married my high school sweetheart and her father was a pharmacist with his own business. He was on the local Board of Directors of the bank. So I had first-hand knowledge before I ever got into a career of the tight linkages between community banks and the businesses they support. So I had a passion before I even knew what career I was going to take on. For the last 29 or 30 years, I've been at the Federal Reserve in Kansas City. Because of that, my focus is almost entirely on community banks. I do have an opinion to offer on the subject. Similar to Tim, I will touch on some characteristics that I think are community banks and then I will tie some of those back to the FDIC charts. I will touch on my own views of the future of community banking and I know that will be touched on later in the day... Similar to Tim and the FDIC, I think that most community banks—when I think about them and the ones we supervise—have a limited geographic footprint. They may be in multiple states or have a branch network, but by and large, they have much more limited geography than regional and larger institutions. As Tim pointed out, local decision-making is key. And I hear that from a lot of larger institutions, but it's really on a different scale than what community banks offer. The tight linkages that exist between management and ownership are very strong in community banks, and many times they are one and the same. You hear personalized service. I was meeting with a large institution earlier this week and they were saying we are community-focused. “We have this personalized service…” but I've been to community banks where the president is out doing livestock inspections. I don't think the large regional and very large institutions have their presidents out getting their boots dirty. So I think there is a dynamic that’s quite different for community banks and that's important to differentiate. As Tim said, community banks make loans and they hold them. And they renew them. And they collect them. And they do not by and large engage in the security markets and securitization efforts that have gone on with the larger institutions. I think that is a clear distinction, particularly when you think about the rule-writing that is coming out, particularly on the consumer side having to document the ability to repay a loan. I scratch my head for community banks because they are holding these loans. They've documented that and done the underwriting. Those rules were not written for them. They were really written for the large guys who are doing securitization. An important distinction. Their balance sheet and income statement clearly focus on lending and use of core deposits.

I wish I could say all community banks are relationship lenders. But unfortunately they are not. Those that have been successful, though, I do think almost a one-to-one correlation. But for those that have failed or are in danger of failing, I can point out the majority of those did not follow that business model. They moved away from that, and that's unfortunate. You see more CDs with community banks than you do with larger institutions. Large institutions generally are able to grab more of the money market accounts for funding purposes. As was pointed out by the FDIC, the noninterest income levels for community banks do not have the scale of operation and many don't have trust operations or broker dealer operations and so forth. Basically they are there to take deposits and make loans; and because of that, the investment portfolio for community banks is a secondary source, and I'm saying way down the totem pole of sources of income. In larger institutions, they have more robust capital market activities, broker dealer operations and so forth, and are able to garner much more income out of the investment portfolio and it’s less of a source of liquidity for them. As was pointed out to this morning, community banks—both from a challenge, but also serving the needs of their community—by and large are going to concentrations. I will talk about this in a minute because I don't think it's a bad thing, but certainly, CRE concentrations have been a challenge for some institutions. We have a lot of institutions that have managed themselves extremely well through the crisis who had asset concentrations and it’s their support to their communities that create those. I do think there's a key difference between rural banks and those in metropolitan areas. I think some of the statistics bear that out. If you look at growth—organic growth— certainly banks that are in metropolitan areas or that were rural banks and branched into those markets are the ones that maybe got themselves in trouble, but rural banks that are more captive to their communities—as was said this morning, ebb and flow with the local economy—that if they stay in their geographic footprints, more often than not they are successful. So my points on size, I do think it's important. But I do think it depends on your purpose. From a supervision standpoint, as you heard from Chairman Bernanke this morning, the Fed is trying to focus some of our messaging toward the institutions that the guidance is meant to apply to. I think the FDIC does that as well. We have a threshold of $10 billion and less for community banks. That's a very rough number. There are certainly banks under $10 billion that don't meet what I would consider to be community banks. But, frankly there are some over $10 billion that have a very strong community bank orientation. But when you deliver the supervisory message to industry, that size factor is important. We do use that as a way for us to differentiate our supervision and our approach to supervision for small institutions relative to the larger ones. Frankly, with the advent of Dodd-Frank, you can see many benchmarks within that legislation that point out the supervision emphasis on the larger institutions. So I would like to tie back just a little bit to the FDIC's data because, while I think the size is important, we in Kansas City focus on $1 billion or less when we do research. It's a nice round number. It indicates the challenges that community banks have. They don't have the size and scale and, even indexed over time, it's a relatively small bank. That gives us the same sort of trends and pictures that the FDIC charts point out. In fact, if you use $1 billion or less—if I did my math correctly—95 percent of the FDIC's banks in their survey are $1 billion or less. So I think if you are trying to do it rough and dirty, I think that billion dollars and less does have meaning. In Kansas City, when we want to focus on what is the impact of smaller institutions or how do the really small community banks perform, we will break it down to $250 million or less even today. That's getting back to the $100 million and less Rich was talking about earlier. It depends what your focus is. For the research agenda that the FDIC has taken on, I think their approach is logical. The billion and less as a starting point and take out banks that are specialty banks, bankers banks, credit card banks and banks that don't have core deposits and loans and don't meet my definition of a community banks. So I think those are appropriate adjustments.

In terms of bank performance, just a couple of comments, I think Rich had a nice chart that showed 64 percent of the earnings or the assets of community banks are average in loans. That's very indicative of what we see in our portfolio and the majority of the deposits, 79 or 80 percent, was roughly core deposits for community banks. So that is consistent with my understanding and my experience working with that sector. I did want to make another comment on commercial real estate and other concentrations. As I said, if you are going to support your local community and your local community is in ag or tourism, you will have concentrations. As the supervisor, I know a lot of banks have worked really hard to reduce their concentration risk, particularly those that have commercial real estate. I'm not up here to say that's a bad thing, but I'm not here to say you should not have a concentration. I think the key is how you manage your risk. I think many institutions that fail or are in serious trouble today did not fully appreciate the concentration risk. They did not take into account the construction and land development exposures in a down market. And now everybody is. In the ag sector, it can't get any better. So my warnings to banks is about managing their risks appropriately in that sector, but the same holds true. We had a good time in real estate in the commercial side and now ag is doing well. But my point to banks—and I'm sure the FDIC would echo this— you need to have a strong risk management framework; and if you do, you hold appropriate levels of capital, you can manage concentration risk. You keep your ownership involved, your management team involved, you understand where your risks are, you can manage through those risks. I think that's important for the community bank model, because I often hear community banks can’t do real estate lending, so they must be in trouble and they have to sell out. I don't necessarily buy into that. So with that, I will launch into just a couple of more things on the future of community banking.

In Kansas City, we do a survey every three years, and we survey our community banks. We do the billion-dollar threshold, so it certainly is not encompassing of the entire country or all the population of institutions in our district. But we surveyed them to try to get a handle on the concerns. Last year we did the survey and asked them what their top concerns are. The number one concern of community banks in our district was regulatory issues. Regulatory burden, rule writing, Consumer Financial Protection Bureau, the unknowns with that entity—84 percent. That percentage was in the 30 percent when we did the survey back in the early 2000s. It has gone up every year and we are almost at 100 percent. That is something we obviously need to address and I would hope either between the FDIC, the Federal Reserve or even the OCC, as we continue to look at guidance that needs to be applied, that we right-size that guidance and make sure we cater to the right audience because regulatory burden is a big deal. As high as I am on the community bank model, I appreciate the challenges that small banks have in complying with regulations. The other risk that was highlighted in our survey is also important on one is where will I get my earnings from? As Chairman Bernanke said, if you're commercial real estate concentrate, your ability to navigate and move into other areas, there may be opportunities for some. But I'm a little nervous that some of our real estate lenders will not be commercial and industrial lenders. I'm not certain that's a great thing. But that's a challenge that banks are looking at and certainly the low interest rate environment and lack of loan demand, whether they are community bank or a large bank that's a challenge. Then the last two things we heard about were noninterest income—the impact of the Durbin amendment, even for smaller institutions—and then security risk or IT risk. I can say that as a regulator we have big concerns in the IT area, so I can appreciate that the community banks do as well. With that I will conclude. Thank you again for your participation.

ART MURTON

Great thank you Kevin. Now we will hear from Chris Whalen.

CHRIS WHALEN, Senior Managing Partner, Tangent Capital Partners

Thank you, Art. I want to thank the members of the FDIC for including me in today's program. Many of you may know me as a staunch critic of large banks and it will gladden your hearts to know that I recently stepped off as an employee of Institutional Risk Analytics so I can go back to business and investment banking and create funds to help little banks raise capital. We will be focused on the whole industry, but I'm very mindful of how regulatory burden is impacting smaller community banks. At IRA, we rate every bank in the country. If you have an FDIC certificate, we rate you every quarter. We have the best coverage of any rating agency, and because we look at the entire population, we can see the trends. So let me go through a couple of questions that occurred to me while we were going through the slides and see if I can't help frame some areas for future research and maybe even think of some new metrics to use in assessing community banks.

The end of 2009 was really the trough for the industry. If you look at all of the factors we assess in our ratings process, the combination of charge-offs, provisioning, and other factors that were affecting all banks, they really reached a crescendo at the end of 2009. It needs to be mentioned, however, that was also when the FASB changed the accounting rules and we moved nearly $4.5 trillion worth of assets out of the F bucket at the end of 2009 into the B bucket in the first quarter of 2010. Isn't that remarkable? People say the Fed is the most powerful agency in Washington. However, no, it's the FASB. And they are in Connecticut.

So are small banks improving? Clearly. We have almost 3,600 banks that we currently rate A or A+. At the worst part of the crisis, that number was well below 3,000. You had a lot of movement among what I call the righteous, but the biggest movement was among the largest banks. So let me ask you a basic question. Are large banks really more profitable and more efficient than small banks? I don't think that's true. Let me give you an example. If you look at Bank of America and JPMorgan, the federal regulators allowed them to count transaction balances as core deposits. That is your money. They are just holding it until they send it to someone else. Is that really a core deposit? No. You little bankers in the audience want something to do this year, go talk to the federal regulators about changing that because all of a sudden JPMorgan and Bank of America will not be able to leverage what are essentially transaction trust balances. They will only be able to leverage their core deposits and their market funding, and they would get smaller, a lot smaller. Another interesting question that comes along in that same regard is efficiency. Are large banks really more efficient than small banks despite the labor intensity of credit underwriting, scale, all those issues? I don't think so. If you take the profitability from servicing out, if you take the fact that the top four banks have an effective cartel in the secondary market for loans and small community banks have to sell their production to one of those four banks in order to get half of their money back so they can go make another loan, not the principal amount but the profit, the little bank has to give up more than half of their profit on an underwriting to JPMorgan or Wells Fargo, did those big banks earn those profits? No. That's someone else's work. So two key aspects, the size of large banks that are artificially inflated because they are big servicers. They gather all sorts of payments and tax payments, but they are not really deposits. They are just sitting on the float until they have to send that money to someone else. They are not the same as a core deposit that a small bank raises from a real customer that they actually know. The other issue is if you strip out some of the profits that come from securitization, mortgage banking servicing, all of these elements really are part of the core business of underwriting lending deposit taking, I think you could make a very strong argument that the big banks are not nearly as efficient as they pretend to be. So if we are going to look at metrics to try and measure the difference between a small bank and a big bank, what should we look at? One of the key things we do at IRA, in addition to taking the FDIC data each quarter and running nominal performance metrics, Basel II metrics, that sort of thing, is we actually calculate economic capital. Economic capital basically says how much risk are you taking and how well are you paid for it, and it will not surprise anyone in this room to know that the largest banks typically have a minus sign on risk-adjusted return on capital. Why? They are very big. They have large derivatives books. They have very large unsecured credit card books, consumer, etc., and very big spreads. But these are high-risk activities. It's not nearly the same as the community bank or lending money to someone they know, retaining that credit on the balance sheet and being able to manage the credit going forward in time. In fact, if you look at the risk-adjusted returns for small banks, they are in double digits. Even during the crisis, many of those 3,000 banks were still AA+ in our rating schema. We are still turning out the risk-adjusted returns. That's not too bad. In fact, even the regional banks have significantly higher risk-adjusted returns than the top 20. That is where I'm focusing my attention this year. Another aspect I would suggest that Art and his colleagues look at, in addition to economic capital, is the degree to which a bank is correlated with the financial markets. We call this beta in the world of Wall Street. Why is beta important? Well, think of the difference, we will use the example of AIG. The difference between ensuring the risk of a ship sinking and the difference of underwriting credit default swaps on mortgage bank securities. Or say directors and officers, liability insurance, which is another popular area. Two totally different kinds of risk. One is correlated to the real world, weather, other events that may cause the ship to sink, and the other is almost entirely correlated to the financial markets. Large banks tend to take an awful lot of risk in the financial world, which has nothing to do with the real economy. In fact, they are totally disconnected. I think that's a crucial differentiating factor between a small bank that's 90 percent core funded and one of these money centers, that if you strip out the servicing balances, are not half market funded; they are more like 2/3 or three-quarters market funded. Very different business model. Isn't it? Another point that occurred to me looking at the fine work that the FDIC personnel did was when you are an analyst and you're looking at data, especially when you are going back several business cycles—I don't believe in business cycles, but let's pretend for a minute—You have to ask yourself what was going on at that time. What was the business model at the average bank, large bank, small bank? The last ten years' mortgage banking gain on sale was the mother's milk for many large institutions. And remember they were buying production from other banks, other nonbanks and running it through the pipeline in the federal guarantee or private credit enhancement and going off to the next deal. The amount of risk that the top five, six banks had even today as a result of securitization activities, as a result of not putting together New York state trusts properly, delivering the notice to the trustee in good order, we are not done with this by a long shot. When the banks are forced to settle the claims that are being made against them for all of these activities, will they still be more profitable than small banks? Not on your life. So I think there are many rich areas of research that the FDIC can look at in the next few months, and hopefully longer than that. But I think a key thing that everyone has to keep in mind as they do this work is to have context. Be aware of the changes in the markets and the business model going forward. Now good or bad, I think the model in the next few years at least will look an awful lot like 20 years ago. I think you will see a lot more banks that might have sold a loan or gone to get a guarantee for loans in the past to keep that credit. There are not that many opportunities to underwrite good loans; so if you find a good customer, you want to keep them. I would like to see community banks, perhaps with the help of the regulators, eventually evolve the model where we can have an institution perhaps sell an interest in a note to an investor but keep the services. We would have no foreclosure problems if the local banks were still the agents for the credit. They could go down to the courthouse or, even better, they could go talk to the borrower. Because the biggest problem we have today—whether you listen to Chairman Bernanke talking about the mortgage market or anyone else—is that the key issue of know your customer, which the community banks embody, is violated by large banks. I have two loans. One was originated by Bank of New York and sold to Lehman Brothers. I'd love to find it and buy it back. And I've never heard from these people. I have a second with JPMorgan Chase. Never heard from them. Now, maybe they don't want to talk to me. Maybe they are still pissed off. But the fact of the matter is they don't know who I am. They have no current information on my income. Except what they get from the credit rating agencies, and more importantly, they are not even trying to bank me. They are not calling me up saying “Hey, Mr. Whalen, what else do you need? “ A community banker would have already done that. I think that's the key difference I would like to leave you with. I will look forward to the Q&A. At the end of the day, the Wall Street model that we saw in the last 20 years was a mirage. There are no economies of scale in banking. You know your customer or you don't. And when you have large banks that rely on credit scoring and statistics to make credit decisions, you know that eventually when the boom is over, they will be in trouble. Or as my good friend Eric said to me a long time ago, “The FICO scores will turn to dust in their hands.”

It may interest you to know by the way, that Eric is running for the Senate. He just had the Republican primary back home. With that, I will conclude and look forward to your questions. Thank you.

ART MURTON

Thank you, Chris. I suspect the banks may know who you are now.

Now we have some time for Q&A. We have some questions that have been submitted, but we are also happy to take them from the floor. There will be microphones going around. So if anyone has a question they would like to start with.

QUESTION

I'm Cam Fine, president of the ICBA, the Independent Community Bankers of America. This was terrific. I love your idea of getting deeper into research, and Chris, you are my new hero. Music to my ears. You were saying exactly what we have been saying for several years. I would like Chris… I would like any of the panelists to comment on how you see the privately held bank going forward in the future. Thank you.

CHRIS WHALEN

I really enjoyed the comments that were made before. I believe it was Kevin talking about S. Corps. He's absolutely right. There are two risk management models in this world. One is well documented and pedantic, typically for large organizations and those that are supervised by federal regulators, and then you have the paranoid and nimble, which is what entrepreneurs live with. People who have multiple generations of family in a bank—or they have maybe most of the family's net worth in a bank—will watch more carefully. It's often a source of sadness to me because the recent boom has turned what should be low-beta, very boring businesses into trading vehicles. It was mentioned before banks that are set up just to take Home Loan Bank advances and make commercial real estate loans. That is not a sound model. I think that there is a lot of value in the private model. But let me say this, I did not talk about the Volcker Rule at all. Everybody worries about the Volcker Rule with respect to customers in the brokerage side of the house, but what about the chief investment officer? What do large banks invest in? They invest in bank paper. All of the kids that have been laid off by the Volcker Rule in the last few weeks, I'm hiring them. But the problem is now JPMorgan, instead of having 20 people who each had a hundred million dollar equity, they have all been fired. Instead of the CIO of that bank being in the market every day trading those securities, even adding a little liquidity to the market makers for banks who are generally smaller dealers. Let's face it, it's a niche for our industry. Now there is no one to call. This is something I think regulators, especially Chairman Bernanke, have to think about because going back to the point of private bankers, it will be private equity. In fact, I'm seriously thinking about starting a private equity fund for this reason.

TIMOTHY KOCH

On the negative side, for the privately held, too many of those institutions have limited access to capital beyond what they currently have allocated. Unless we somehow open the spigots, their growth opportunities are restricted. The other comment I hear frequently is sometimes the succession plans of these organizations don't bode well for future growth. If they can overcome those two hurdles, I think there's a long-term future that's very strong for the privately held.

RICH BROWN

I think ownership structure, access to capital and success in raising capital are some of the next questions we need to explore. The data gets a little bit harder in terms of accurately classifying and identifying the capital raises, but it's a very productive line and the next place we are headed.

KEVIN MOORE

I think the data is difficult to get at the privately held. Subchapter S. is one way to look at it, but that's not the entire population. There are certainly a lot of locally owned C. Corp. type banks that it's difficult to get the data around, but I think it warrants the research. As Tim said in his comments, there's a big difference between banks that have been locally owned and managed and been in the family for years. Their decision-making processes are quite different than banks that have used TRUPs and other avenues to grow using outside capital. And the risk profiles of those institutions, I think the data would show are measurably different.

CHRIS WHALEN

Let me interject something here because it's very important. All of the deregulation of the last 20 years has been about market efficiency, right? Lower spreads, better service for consumers. That's not always true because, as we've taken the spread out of the investment banking world, we've made it almost impossible for firms to have the analysts that follow banks. What you have seen is a shrinkage of the coverage of the industry by sell-side firms and buy-side firms both. This has helped my company because we cover every bank. What we have learned working with some of our government clients is there are thousands of public banks in the U.S., but only about 10 percent of that group are actually listed on an exchange. They're all 33 Act filers because they have hundreds, sometimes thousands, of shareholders. They trade in the pink sheets, but they have no support from dealers. There is no research support at all. So these are significant issues because efficiency is not always good. When you take the spread out of a product as you all know—and we are in a zero-rate environment now—you can't invent any services in the spread, you can't have research analysts and extra people and a dealer who might actually follow your company.

ART MURTON

We have a question in the back.

QUESTION

I noted that the GAO just issued a study that said the Collins amendment will only have a modest impact on the capital ratio of banks, which I have some difficulty digesting. It will be interesting to hear from each of you the different ownership forms whether they be mutual, sub S., closely held and the rather restrictive convention we now have with the Collins amendment limiting capital raising to either common and/or permanent deferred.

ART MURTON

Would anyone like to address that?

CHRIS WHALEN

I think we already touched on this. We still don't have guidance from the regulators as to what we are going to do going forward as far as exactly your issue, tier 1, tier 2. There are a lot of small banks out there that have tier 2 deficiencies and are going to have to figure out how to do it. Right now if you look in the marketplace, I'm aware of probably over a dozen efforts by smaller dealers to raise money for smaller banks. These are typically well below $10 billion in assets. These are private placements, and this is tough. It really is. It's almost high yield because, if you look at the equity valuations of the industry today, what is the implied cost of equity capital from small banks, assuming they had a publicly traded equity? It's well over 10 percent. Are these banks doing 10 percent return on equity right now? No. So they will be forced into a preferred type instrument simply because they can't issue common equity at a price that makes sense to them. That I think is the big quandary.

ART MURTON

OK. Let me take a couple of questions that have been submitted. Two related ones. Looking out five years, what do you see as the community bank business model? And related to that is, what products should the banks consider to meet the needs of the baby boomers retiring?

TIMOTHY KOCH

I think somebody said it in one of the comments, Maybe it was you, Kevin. Given the economic times, given the regulatory environment, I see that in five years, the community banks will be traditional banks. We will build fortress balance sheets. They will be core funded. You will try and get as many loans as you can. But quite frankly, for those of you in the business, it isn't one of the hardest things to do today to find out where your assets are coming from. You will hold more liquid assets. That' clearly part of the regulatory guidance. Keep your capital ratios up. And generate that return on equity like 5 to 6 percent. That is a harsh view, but it is going to be a tough five years to generate true returns, and a different way of saying what Chris just said, to justify investing in a community bank will be tough until some of this wears off. And the economy grows again as the chairman suggested would be beneficial. We need that to get returns back to where they historically have been.

KEVIN MOORE

I agree with Tim. I think the balance sheets are definitely going to get stronger. I think banks are going to hold more capital. Everything you read about the big banks and the fear of the rules trickling down to the smaller institutions, I think that is going to drive many community banks to preserve more of their capital. Because we are so closely tied in the community bank sector to the economy in many of these communities, as the economy improves, the small opportunities will improve. By contrast, what's going on with the big banks, I think there are opportunities for community banks. Big banks have a bad reputation right now; and to me, there's opportunity for community banks that can make a service difference. Maybe not pricing difference, but certainly a service and quality of operation difference from the larger banks. I think they have the opportunity to build back the portfolios that they've lost over the last couple of years. The other thing I would add is technology. I don't know big banks have scale, but there are many, many technology opportunities available to community banks to be more efficient in the sense of not necessarily opening a new branch as a means to get in front of bank customers. Everyone knows the demographics are changing with customers and that's an opportunity for community banks they should continue to pursue.

RICH BROWN

Kevin, I agree with you. I think people are going to be surprised at the extent to which the intermediation in our economy migrates back to the banking sector or migrates back to community banking organizations. We've seen this migration off the bank balance sheets into off-balance sheet structures that turned out to be pretty risky, pretty unstable. They've shut down to a large extent and a lot of that financing is not taking place right now. It has been a difficult period for the banking sector to reassume its traditional role in providing some of that. As the sector and the balance sheets get cleaned up, we see continual improvement from quarter to quarter in terms of the financial condition of the banking industry. I think you are going to be surprised in what we saw the last decade. This disintermediation was temporary and it will be reversed in loans and things like mortgages, consumer loans, commercial and industrial loans that we thought was a thing of the past.

CHRIS WHALEN

What was interesting about this comment is that community banks have an enormous advantage here. Look at HSBC's acquisition of Household Finance. Was that a normal business for a bank to get into? A business where you knock on somebody's door and collect a loan every month, unsecured, mobile homes, motorcycles, whatever it was. No, they are fleeing that business. Asset-based financing. Large banks are fleeing that business. They can't underwrite the credits. A community banker can underwrite the credit. He will know that guy. I remember a couple of years ago I was testifying in front of the Senate Banking Committee and Chuck Schumer asked me “Chris, don't you think we should let credit unions into small-business lending?” I said, “No, Senator, absolutely not.”

They don't have the skills to do it. But small community banks certainly do.

But his example was a company near my house in New York; a little delivery service; sole proprietor; owns two trucks; was no longer able to get financing to take down oil in Terrytown, New York. That was not a traditional banking business. That was a factor, nonbank business with somebody who understood that industry, had dirty fingers from oil on his hands, and was willing to lend to people in the business. I think you will see that comeback, but community bankers can also do some of that business too because they have the underwriting skills.

TIMOTHY KOCH

If I could add one comment, and again, this will reflect on the fact that I'm a teacher. The last two years I've taught seniors in finance and accounting, and I was surprised at how sophisticated they are in the use of mobile banking products, which is what ties them to their banking organization. All you community bankers out there think of what that means for you if you are not competing in that space. We talk about what the future five years from now, I believe you have to have competitive products on the technology front for the next generation of customers, or you will lose them. I don't care if you are in a rural market or a metropolitan market. I think it will happen. So invest now.

ART MURTON

We have another question. When will de novo activities start to pick up?

RICH BROWN

The only answer is not yet.

CHRIS WHALEN

It will pick up when it makes sense. When both the regulators and the business community start to figure out what the model is, it will come back. There are a lot of institutions that probably need to be bought in the next couple of years. I would not be surprised if we resolve another couple hundred banks. We still have over 1,000 banks that we rate F. So half of them will cure. They will come back. Another half will get merged. That's not necessarily a bad thing. We create a lot of banks in this country and we will. Before this crisis, we created more banks in Texas then they created in all Western Europe.

KEVIN MOORE

It is going to be a while because there is a strong correlation between what you call young banks or whatever the terminology is but something older than a five but less than ten years of age. There's a high propensity of those that did get into trouble. As a lesson learned and for someone who used to be in the application business at the Federal Reserve, I think the problem with de novos is they strayed from their business plan. A lot of them in more recent times raised a lot of capital. That wasn't the issue. But they deviated from the business plan. So as a regulator supervising those institutions, if we get back into that business, I think we need to work closely with bank management and send out red flags when banks begin to deviate into areas that are not their expertise. But I think by and large that happened too often for some of the de novo banks, and it will be a while before we get back to that business because we have some other problems to correct. It will come back. It always has, and I think it will again. We are by nature in this country an entrepreneurial country and business and de novo banks are part of that.

ART MURTON

Let me just add that I think we have some lessons to learn from this crisis in terms of the types of business models that were chartered. I think one bad thing about having a banking crisis is having a banking crisis. The good thing is you have more data. We now have two of these and we can see what kind of business models were allowed to operate and what their success and failure rates were. I think it's incumbent on us to take a hard look at that so we can help guide all of these as de novo activity picks up. So we are looking forward to doing that.

TIMOTHY KOCH

I want to say I'm less confident than the rest of my panelists here. Let me toss this thought out. Haven't you been to conferences recently where generally a consultant will get up and say a community bank has to be a billion dollars in size to survive, or think about consolidating? So a lot of these so-called experts are moving the minimum size larger to argue that you can compete. How is that consistent with more de novos? How much capital are you really going to have to start with and what is that business plan that will make it work? I'm not convinced.

ART MURTON

Right. We've heard that billion-dollar number and that's one of the things we are going to be looking at in our study. We've heard that claim being made. I think some of the numbers that Rich put up today suggest that may not be the case. I think we need to really look into that and question that assumption. That's what we are going to be doing. Kevin, you probably have some views on whether banks under a billion will be around.

KEVIN MOORE

I would just add that I appreciate Tim's comment, and certainly it's more challenging for smaller banks. But I'm sure the FDIC would say the same thing. I have a lot of banks I supervise that are $100 million or $200 million. They didn't have any issues in the crisis and have managed themselves extremely well. How they manage their compliance burden and all of the other issues that we hear about, I'm not quite certain. They have very good people. That does not mean they don't have challenges finding succession for that management team. But I'm not an advocate that a size factor is a driver for how big you should be. I think it depends on the people you have, the business model, and the level of risk. What bothers me is that banks are getting out of business that is core to community banks, like mortgage lending. Banks are getting out of mortgage lending because they don’t think they can comply with escrow arrangements and other things. That's unfortunate. I think the rule writers need to go back and look at that. But I think most institutions are finding ways to address compliance. We as regulators have a responsibility to—the FDIC, OCC, the Fed, whoever it is—we have a responsibility to work with our institutions. We have multitudes of training programs that we provide to our own staff, and I see no reason why we can’t leverage that for the benefit of our institutions and so forth. So, it's not going away, but I don't think size is a factor for community banks.

CHRIS WHALEN

What we have to do is solve the equation between all of the capital out there and putting them together with people who have a coherent business model and are going to execute it. I can't think of anything more exciting today than creating a de novo with new technology, a Greenfield corporation, and I'm not slighting all of you out there who have older institutions, but imagine creating a brand-new bank today with modern systems, doesn't have to deal with legacy issues, and has a good management vision and you put that together with capital. Let's focus on the revisions to Reg A because we are talking about billion-dollar banks. How much capital does a billion-dollar bank have, more or less $100 million? Where is Reg A now, five? We need to get Reg A offering up to $50 million, and then we can raise all the capital all those little banks need.

ART MURTON

Great. Let me take a question first from this side and then from that side of the room.

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QUESTION

[Inaudible]

RICH BROWN

Well, it’s a very good question. We saw a very competitive period during the middle part of the last decade. There was a lot of competition for loans, for loan growth. So growing the balance sheet was really the way that revenue growth took place in the middle of the last decade. For the community banks and for the non-community banks, there were a lot of off-balance-sheet sources of revenue. The trading, the servicing, the trust as well as servicing and interchange. Service charges and interchange. Both of those have run into trouble. The growth in the loan book can’t take place now because the balance sheets have been disrupted by the recession. And so that source of growth is not there. The margins are still tight. Again, with this interest rate environment, the margins have not improved that much. They've improved a little bit. But with regard to the noninterest income, the market-based revenue for some of the larger institutions is really not there the way that was before, and that's probably a good thing because it led to a lot of trouble before. So for both classes of institutions, revenue growth is a primary challenge, but it will not always be that way. As for lending opportunities, we will be surprised at the lending opportunities that will occur just down the road here. Balance sheets have been cleaned up significantly. Capital has been raised, problem loans have been charged off and I think that's the most important thing to understand—for the industry—getting it ready to take advantage of some of the opportunities when they present themselves. We are not there yet, but it's close.

QUESTION

[Inaudible]

RICH BROWN

I think certainly from the lending side, it will. From the noninterest side, as Chris mentioned, how you generate revenue in today's low interest rate environment is kind of a question and is the model that has been disrupted and how it sorts itself out. I don't have as clear of an idea as Chris does.

CHRIS WHALEN

We've done economic capital modeling for the whole industry going back almost 30 years. It's pretty clear that the competition, technology, money market funds, whatever you want to look at, did press margins down. It reminds me of the auto industry, where you have intense competition by some participants that are more or less indifferent to the cost of capital. In other words, they are making cars, but not making money. In the same way, I think we heard earlier about business models that were created for short-term purposes or to be acquired, which really weren't clearly thought out and stable in the medium and long-term sense. I just don't know what we will see going forward. If we do see a renaissance in lending, [it may be] more of a focus back on traditional banking. Maybe even seeing small banks get back into things like credit cards and other services. I think you could expand margins a little. But I'm not sure if we can get away from this global competition in terms of both technology and cross borders that is going to help us get returns back where they were, say, 15 years ago.

QUESTION

[Inaudible]

CHRIS WHALEN

Half of where we were during the peak. So the righteous will be in the low teens. I won't mention any names. I don't want to get in trouble. But the average in the industry I think will be in high single digits for a while. If you look at the most recent quarterly, it's pretty much there. Return on equity, yes.

QUESTION

[Inaudible].

CHRIS WHALEN

That's up to Chairman Bernanke.

All I can say to you is read the conference call with Jamie Dirmon for

JPMorgan, where he informed everyone they are not doing any unsecured lending with banks. That to me was horrific. We have got to convince the good people at the Fed that a half-point Fed fund rate would not be the end of the world because that's the only way we rebuild repo and it's the only way we start getting banks to lend money to one another because why would you do it. It's more trouble than it's worth.

ARTHUR MURTON

We will take a question from over here and then to the middle of the room.

QUESTION

My name is Robert Ray, I'm President and CEO of [inaudible] bank. We are a mutual bank. I'm very happy to say we are celebrating our 125th anniversary this year, which predates the FDIC by 50 years.

I'm also very thankful for Dr. Koch acknowledging the differences in the business models and the benefits they represent. My question is for Art in terms of the CRE lending and the return on that product and the concentrations. My understanding of CRE lending combines many different types of properties, specifically ADC lending, and it compares that and includes apartment lending and maybe financing for existing properties that have cash flows. Has that data—part of my question is my understanding that most of the bank failures that I have seen focused on CRE lending and, specifically ADC lending—has any of that data been disaggregated? And is it possibly a misnomer to allocate all these different forms of lending into one bucket and perhaps lead to the wrong conclusion that the problem is CRE lending versus ADC lending?

ART MURTON

Thank you. There were some questions asking a similar question and I think Tim Koch touched on this. Certainly Rich can elaborate, but we will be looking to meet that CRE category there. There are many subcategories in there and the performance of those narratives. We are going to be trying to take that apart and see what is the riskier part of that, what is the safer part of that. I think that's a very good question.

RICH BROWN

For the record, to be a CRE specialist you have to have 10 percent of your assets in construction loans or 30 percent in the combination of the categories that you mention— construction, nonfarm nonresidential secured or multifamily secured. So either of those will make you a CRE specialist. I would add also that we looked at the single specialist. Many institutions have a specialty that meet those CRE criteria, but also have a specialty in some other area, whether it be mortgage or C&I; and those were not excluded from the analysis that we showed you. If you just take it on the basis of noncurrent rates and charge off rates, you are absolutely correct that the construction component was especially vulnerable in this cycle. We saw record highs of noncurrents—even though the noncurrent rate has come down—it's still higher as of our last quarterly report than it was at the peak of the last crisis, when we had a major real estate problem. So I think you are right about the leading edge. It is not confined solely to the construction portfolios. Anything real estate-related in this cycle has encountered a great deal of distress by looking further into it. It is something we must do.

ART MURTON

We have just under five minutes, so I think I will take a couple of more questions. I saw one in the middle and one over there.

QUESTION

[Inaudible]

CHRIS WHALEN

The risk obviously is that the bank has to have a certain amount of business from a customer before the customer is profitable. Is it in the interest of the bank to bank everyone in the community they can; and even if it's, in that way of the classic model? I think that's wonderful by the way, because if you look at the bottom 20 percent of our society, who are typically not banked immigrant workers, migrants, whatever. This is what they need. They need a place to cash a check and a piece of plastic they can buy groceries. If banks figure out a way to make that work at the lowest possible cost, I think you will hear nothing but cheering in Washington. So I salute you. I think that's a great initiative.

ART MURTON

We have a question in the middle of the room.

QUESTION

How can we think about institutions actually serving those markets? In the last study the FDIC did for unbanked populations, about 30 million people were un- or underbanked. There is a huge segment of institutions, CDFI banks and minority banks serving those markets. So from a policy perspective and from a capital rating perspective, how do we think especially about that segment of the population on the banks? I say that in the context of bank holding companies and securities which are being de-emphasized. I suspect that the sources of capital available to those institutions are reducing quite dramatically. Is it something that we can do on a macro basis to help those institutions better serve those underserved pockets?

ART MURTON

One thing we will be doing and we talk about in looking at the studies is looking at the differences in the models and trying to answer those questions. Certainly including business models centered around community institutions and so forth. I don't know if anyone wants to add anything?

MALE SPEAKER

I can.

MALE SPEAKER

OK.

ART MURTON

I'm sorry I have to cut it off. It's 11:00 o'clock. I want to thank everyone for their questions. I want to ask you for joining me to thank this panel for their very thoughtful remarks.