Remarks by Martin J. Gruenberg, Chairman, FDIC to the
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Introduction

It is a pleasure to be with you today at the 2013 ICBA National Convention. In my remarks today, I thought I would focus on two important topics. The first is the current financial condition of the banking industry as reflected in our recent *Quarterly Banking Profile.* And second, I wanted to report to you some of the results of the FDIC's community banking initiatives conducted over the past year.

The U.S. Banking Industry Continues to Recover

Let me start with the condition of the industry.

We have now seen three consecutive years of gradual but steady improvement in the financial condition of the banking industry in the United States following the financial crisis. Industry net income has now increased on a year-over-year basis for 14 consecutive quarters. Annual income for the industry in 2012 was just over $141 billion – the highest level of annual earnings since 2006 and the second highest ever.

We now have seen 10 consecutive quarters of improving credit quality for the industry. Delinquent loans and charge-offs have been steadily coming down now for over two years. Importantly, loan balances for the industry as a whole have now grown for six out of the last seven quarters. In the fourth quarter of last year, loans grew by nearly $120 billion. The largest single category for growth was in commercial and industrial lending, but we also saw increases in consumer loans, farm loans, and even real estate loans. These positive trends have been broadly shared across the industry, among large institutions, mid-size institutions, and community banks. So I think it is fair to say that we continue to see a gradual but steady recovery in the U.S. banking industry that has now been sustained over three years.

The internal indicators for the FDIC also have been moving in a positive direction over this period. We had 51 banks fail in the United States last year, down from 92 failures in 2011 and 157 in 2010. If present trends hold, it is likely that we're going to see substantially fewer bank failures this year. The problem bank list at the FDIC – institutions that had our lowest supervisory CAMELS ratings of 4 or 5 – peaked in March of 2011 at 888 institutions. By the end of last year the number of problem banks had fallen to 651, which marks another substantial improvement.

Meanwhile, the Deposit Insurance Fund, which was more than $20 billion in the red at its low point just three years ago, is now almost $33 billion in the black. By law, the FDIC is required to build up the reserve ratio for the Deposit Insurance Fund to 1.35 percent of insured deposits by 2020. We are now at over 0.4 percent, and we are very much on track to meet this statutory requirement.

When I mention the progress that has been made, I frequently get the question, "So, when will we be able to reduce deposit insurance premiums?" The bad news is that premiums will probably not be coming down anytime soon, because we still have a significant way to go to build up the fund to meet our statutory requirement.

But the good news is that we also don't anticipate the need for any assessment increases either. Taken together, I think it is fair to say this is a positive story for the banking industry as a whole. It reflects the work that the industry has done over the past three years in terms of strengthening capital and liquidity positions and the structure of balance sheets, so that banks are in a stronger position to serve the needs of borrowers.

Digging out of the aftermath of the financial crisis we went through, followed by the deepest recession since World War II, has been an enormous challenge for the banking industry. The economic recovery, I think it is fair to say, has been slow and modest thus far, with economic growth right around the two percent mark.

Our sense is that if we can maintain even that modest level of growth, the industry will continue to work its way out of the aftermath of this crisis and the ensuing recession. We still have elevated levels of problem loans and problem banks here in the U.S., and more work to do in repairing balance sheets, but we have now sustained a positive direction for an extended period of time. I think the improvement in bank balance sheets points to the real possibility of a more virtuous cycle for the financial system going forward.

FDIC Community Banking Initiatives

I would like to devote the balance of my remarks to the efforts we have undertaken at the FDIC over the past year or so to focus on the important role of – and particular challenges faced by – community banks.

Over the past few years, a great deal of attention has been placed on the large, complex financial institutions that really were at the heart of the crisis. But the crisis and the recession have clearly had significant consequences for community banks that are still very much in evidence. As the lead federal supervisor for the majority of community banks in the United States, we at the FDIC felt we had a particular responsibility coming out of the crisis not just to carry out our supervisory responsibilities, but to try to take a careful look at what's happened to community banks in the United States over the longer term and the role they play in our financial system.
I would like to share with you what we have been doing on this issue both in terms of research and from a supervisory perspective.

First, not enough good research has been done on community banking issues. We surveyed the work that has been done on community banks over the years, and found that there really was no comprehensive study of the sector covering the last 25 years or so. This type of research is essential, in my view, to formulating policies that are well-informed as to the particular challenges community banks have faced and the trends that will shape the sector in coming years.

Our Research Division assembled 27 years of banking data and developed a new research definition of the community bank that is based not just on size but on the characteristics that define community banking, namely: traditional relationship lending, reliance on stable core deposit funding, and a focus on a limited geographic community. By these standards, most banks with under $1 billion in assets do indeed qualify as community banks. But we also found another 330 institutions with assets between $1 and $10 billion that also met our community bank definition in 2011.

Our study, our data and our definitions are all available on ***fdic.gov***, and we hope that other researchers will make use of them and extend this work further in the years ahead. Today, I would like to share with you what I see as some of the most important findings of the study.

Community banks made up about 14 percent of U.S. banking assets in 2011, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. What this tells you is that community banks play a role in our financial system that actually has consequence far beyond their share of total industry assets. By its nature, small business lending is often labor-intensive and highly customized, which is the kind of lending that community banks really are set up to do. By contrast, the very largest institutions are generally are not so interested in such a customized approach, and are looking to provide more standardized products that they can offer on a larger scale.

So it's really not at all clear whether U.S. small businesses would have sufficient access to the type of credit they need if there were not a strong community banking sector to fill this critical niche in our financial system. And that has implications not just for the banking system, but for the economy and job creation as a whole.

It's really a critical point that I think has not been well appreciated.

The study also found that of the more than 3,200 counties in the United States, more than 600 of them – almost 20 percent of the total – have no FDIC-insured banking offices except those operated by community banks. There are literally thousands of communities across the country – in rural areas, small towns and urban neighborhoods – which would have no access to an FDIC insured bank but for community banks.

So from the standpoint of both filling a critical niche in our financial system and providing access to mainstream financial services in communities all over our country, community banks are in some measure irreplaceable. There is an important public interest from the FDIC's perspective in having a strong, vital community banking sector in the U.S. financial system. These initial findings lead naturally to another question that many community bankers have been asking, and that is: What will be the future for community banks in the United States? Will the pressures of competition, particularly from the larger institutions, and the pressures for consolidation be so great that community banks will be unable to continue carrying out their traditional role in our financial system and economy?

These are questions we looked at closely, and I would like to share three basic findings with you. By any measure, we still have a very substantial community banking sector in the United States.

Community banks continued to make up around 92 percent of all FDIC-insured institutions as of 2011, up from 87 percent in 1984.

Six out of every seven of these community banks have assets less than $500 million.

Despite the historic challenges they have faced as a result of the recent crisis, the vast majority of community banks came through this crisis in pretty good shape. We have also learned a great deal about business models that proved highly vulnerable to the stresses of the crisis, and those that held up under the stress.

The FDIC Inspector General conducts a material loss review for every failed bank, which it delivers to the FDIC Board and ultimately makes available to the public. When the FDIC Board asked the IG to go back and identify key attributes of institutions that failed during the crisis, his report cited three common factors:

- rapid growth;
- concentrations in high-risk assets – particularly commercial real estate and construction and development loans; and
- reliance on volatile brokered deposits.

These factors were cited in failing bank cases that came before the FDIC Board throughout the crisis.

What's striking is that these are not characteristics that generally reflect how community banks in the United States do business. The fact is that most community banks engage in careful, generally conservative, relationship lending; generally rely heavily on stable core deposits; know their customers well; and manage their business very carefully. Thousands of institutions that followed this basic approach came through this episode in reasonably good shape.

As for the post-crisis period, there are those who are suggesting that smaller institutions will not be able to make it, and will be forced to merge in order to achieve economies of scale and remain competitive. Our study didn't find much evidence to support that contention.

Our analysts found that while average costs generally declined as size increased, most of these economies of scale were already realized once the institution reached a size of $100 to $300 million or so, depending on its lending specialty. This finding is consistent with the experience of FDIC bank supervisors in the field, who have found that community banks can be viable at virtually any size so long as they build stable business relationships and stick to their local markets and areas of lending expertise.

None of this is meant to deny that fact that the industry has experienced enormous consolidation over the past 25 years, and that consolidation will likely continue in the future. But it is important to look at the forces that drove this historic consolidation, and ask how important they might be going forward. Around half of the institutions that left the industry during the study period did so via voluntary mergers. The other half were almost entirely made up of failures and intra-company consolidations within existing holding companies.

To the extent that most of the failures took place during the two major banking crises of the past 27 years, it is clear that safe and sound banking will be essential to limiting the future pace of industry consolidation. In addition, it seems clear that the wave of voluntary combinations that drove consolidation over the past 25 years was related in significant measure to the relaxation of restrictions on intrastate branching and interstate banking that took place before 1995. Before that time, unit banking laws in some states and restrictions on the ability to branch across state lines resulted in an artificially high number of bank charters, which were in many cases essentially run as branches within the holding company structure.

With the elimination of branching restrictions in the 1980s and early 1990s, and with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, consolidation of banking charters was sure to take place.

And it did. Between 1984 and 2011, the total number of federally-insured bank and thrift charters declined by 59 percent. But the thing to keep in mind is that the one-time statutory changes that spurred a significant portion of that consolidation are now well behind us. Most of the consolidation that will result from those changes has already taken place.

It seems to me that if we could manage to run our financial system over the next 20 years so that we have fewer crises and fewer failures, the pace of consolidation over the coming decade or two may not be nearly as fast as we've seen over the past 20 years, particularly in the community bank model. And we think that the basic business model that community banks adhere to remains not only viable but also quite critical to the functioning of the banking system in the United States.

Supervisory Initiatives

This study is really only part of our effort to better understand the community banking sector and address issues of concern to community bankers.

We continued our ongoing dialogue with the FDIC Community Bank Advisory Committee, and conducted roundtable discussions with community bankers in each of the FDIC's six supervisory regions across the country. We undertook an Examination and Rulemaking Review with the goal of identifying ways to make the supervisory process more efficient, consistent, and transparent. We initiated a Regulatory Calendar on the FDIC website to alert stakeholders to critical information as well as comment and compliance deadlines relating to changes in federal banking laws and regulations. The Calendar includes notices of proposed, interim and final rulemakings, as well as guidance affecting insured financial institutions.

In response to concerns about pre- and post-examination processes, FDIC supervisors developed a web-based tool that generates a pre-examination document and information request tailored to a specific institution's operations and business lines. We're also improving how information is shared electronically between bankers and examiners.

Supervisory staff conducted outreach sessions during the year to provide technical training and opportunities for discussion on subjects of interest to community bankers. One example is the

Director and Banker Colleges hosted in each region. These Colleges are held in conjunction with state trade associations, and address topics of critical interest to community bankers With these specific steps comes a wide range of other initiatives to achieve more effective two-way communication between supervisors and the industry, which is really the foundation of effective and efficient supervision.

I refer you to our web page on the FDIC Community Banking Initiative for a more complete summary of our activities in this area. One of the areas emphasized by bankers is technical assistance. We are planning several initiatives in this regards that we will announce later this year.

Conclusion

In conclusion, I would like to make two points. The banking industry has now had a sustained recovery over the past three years and there is reason to believe it will continue. We believe that the community banking model remains quite viable and there will be a strong community banking sector in the U.S. financial system for the foreseeable future.