

Remarks by Martin Gruenberg, Chairman, Federal Deposit Insurance Corporation to the  
Exchequer Club, Washington, DC

May 15, 2013

Good afternoon. I appreciate the invitation to speak here today.

In my remarks I would like to focus on three key areas of focus for the FDIC. The first is a brief overview of the current state of the banking industry. The second is a discussion of the progress that the FDIC has made on our Community Banking Initiative. The last topic that I intend to address is our work in implementing the new authority provided to the FDIC to resolve systemically important financial institutions, particularly as it relates to the progress being made on international coordination on resolution planning efforts.

### **Overview of the Banking Industry**

Let me begin with an overview of the banking 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.

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.

We expect to release updated numbers for the first quarter of 2013 at the end of this month.

### **FDIC Community Banking Initiatives**

I would next like to discuss our efforts 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.

Comprehensive research covering the community banking is critical, 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 the FDIC's website, and we are already seeing other researchers making use of them and extending this work further in the years ahead. 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 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.

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

We have had an 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.

In April, the FDIC released the first in a series of technical assistance videos to provide useful information to bank directors, officers, and employees on areas of supervisory focus and proposed regulatory changes. This first installment was designed to provide new bank directors with information to prepare them for their important fiduciary role. Three of the videos address the roles and responsibilities of a director and the other three videos provide information about the FDIC's Risk Management and Compliance Examination processes.

A second installment, to be released by June 30, 2013, is a virtual version of the FDIC's Directors' College Program that regional offices deliver throughout the year. The initial curriculum will consist of six modules covering interest rate risk, third party relationships, corporate governance, the Community Reinvestment Act, information technology, and the Bank Secrecy Act.

A third installment, to be released by year-end, will provide virtual technical training for bank officers and employees. These videos will provide more in-depth coverage of important supervisory topics and focus on management's responsibilities. The training program will include Fair Lending, appraisals and evaluations, interest rate risk, troubled debt restructurings, the allowance for loan and lease losses, evaluation of municipal securities, and flood insurance.

For complex rulemakings, the FDIC will continue to provide overviews and instruction in a variety of formats, including videos. These will be modeled on videos that the FDIC recently released on the capital rulemaking process.

I refer you to our web page on the FDIC Community Banking Initiative for a more complete summary of our activities in this area.

### **International Coordination on Resolution Authority**

I would now like to address one final, and critical, area of focus for the FDIC - the significant progress being made on a cross border basis to coordinate with foreign jurisdictions on our resolution strategy for a systemically important financial institution. It is a key part of our overall effort of the FDIC to address our new responsibilities under the Dodd-Frank Act. I want to focus specifically on this work because addressing this issue as a threshold matter requires international cooperation. As we looked at the foreign operations of our major companies, it very quickly became apparent that the substantial majority of the foreign assets of our major firms was located in the UK. We estimate that nearly 70 percent of the on- and off-balance-sheet foreign assets of our major firms are in the United Kingdom. So, as a threshold for us, if we wanted to think realistically about managing an orderly resolution of one of our companies, we had to establish a cooperative relationship with our UK counterparts.

It was perhaps by sheer good fortune that, among the major industrial countries, the U.S. and the UK were already in the forefront of establishing new authorities to deal with the systemic resolution issues. In addition, the leaders of the key agencies our two countries have been very much focused on this issue and have made it a priority. So when we sat down to engage with our counterparts at the Bank of England and the Financial Services Authority, we found leadership at both agencies already very much engaged and focused on this issue and very receptive to cross-border cooperation.

In addition, when we sat down with our UK colleagues to talk about how we might handle the failure of one of these companies, they essentially outlined for us a strategy based on taking control of the failed company at the parent level, while keeping subsidiaries open and operating essentially for the same reason as we had, quite independently, come to a similar conclusion. The fact that we independently hit upon a strategy, that has come to be called the single point of

entry, that we both felt held the greatest potential for viably carrying out this responsibility was an enormous facilitator of bilateral cooperation on these issues, so that now it's fair to say that we're doing joint resolution planning on our institutions of mutual interest.

The Financial Stability Board of the G-20 has identified 28 global Systemically Important Financial Institutions (SIFIs) in the world. Of those 28, eight are in the United States four are in the UK. So of the 28 global SIFIs, 12 are in our two jurisdictions. Establishing a close cross-border working relationship between the U.S. and the UK is not only a threshold issue for our two respective national jurisdictions, but it also gets you a significant way down the road in beginning to come to grips with the international challenges posed by these G-SIFIs. Our cooperative relationship is such that the FDIC and the Bank of England were able to produce a joint paper in December of last year outlining the work that we've done together. That study is posted on the FDIC web site, and I invite you to take a look at it.

In addition to our cross-border work with the UK authorities, we have been engaging actively with the Swiss authorities. As you know, Switzerland is the home country for two of the global SIFIs, both with significant operations in the United States. The Swiss authorities are also working off of the single point of entry approach as their key resolution strategy. So that relationship is also working out quite well, and I think there is actually potential for the U.S., the UK and the Swiss to collaborate together on cross-border resolution. Between those three jurisdictions you have 14 of the 28 global SIFIs.

We have also engaged actively with the European Commission, which is very much focused on the issue of cross-border resolution. As you may know, the EC has proposed a directive which would ensure that the national authorities of the EU member states have broad resolution powers. In addition, EC officials have indicated that sometime this summer they plan to release a proposal to create a EU-wide resolution authority. So we clearly have a very strong interest in engaging with the European Commission.

I met late last year with Michel Barnier, the European Commissioner responsible for financial regulation. Out of that meeting, we had an exchange of letters agreeing to establish a joint working group between the European Commission and the FDIC made up of senior executives of our respective organizations. The focus of that joint working group is going to be resolutions as well as deposit insurance issues. I think we at the FDIC have a great mutual interest on both of those issues with the EC, and I think they feel the same way. That agreement provides that a joint working group meet at least twice a year, once in Washington and once in Brussels. The first meeting of the group actually took place at the FDIC in February, and the meeting in Brussels will take place later this year. We expect there to be video conferences and other exchanges in between.

Our agreement with the EC also provides for the exchange of detailees between the FDIC and the EC as a way for both organizations to get a better understanding of the operations of the other. Earlier this year we hosted a detailee from the European Commission to work at the FDIC, and we currently have a detailee from the FDIC at the EC. We think that this has terrific value for both of us, and that it is a very promising development that we've been able to establish this kind of close working relationship with the European Commission.

Finally, as you may know, Japan is planning to enact legislation to significantly expand the resolution authorities of its regulatory agencies. We have been engaging with Japan at the staff level, and I am hopeful later this year to have a principal level meeting with the Japanese authorities.

From this broad perspective, if we can develop effective working relationships with the UK, the Swiss, the European Union and Japan, we will have engagement with the key home and host jurisdictions for 27 of the 28 G-SIFIs and will thereby lay the foundation for making significant progress on these critical cross-border issues. From our standpoint, if we are able to develop a strategy that we think would realistically allow us to manage an orderly resolution of a SIFI and combine that with effective working relationships with our international counterparts, we believe this would represent the cornerstone for developing the capability to manage an orderly resolution of a systemic financial company.

## **Conclusion**

In conclusion, I would summarize three main 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. And finally, there has been substantial and meaningful progress on the international arena both on the understanding of resolution issues and establishing a framework for cross border coordination.