Remarks by FDIC Chairman Martin J. Gruenberg
To the FDIC Community Banking Conference
"Strategies for Long-Term Success"
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Introduction

Good morning and welcome to today's FDIC Community Banking Conference.

The FDIC is the lead federal supervisor for the majority of community banks in the United States, and the future of community banking has long been a major priority for us.

In 2012, the FDIC released its Community Banking Study[1]. This was the first systematic review of the community bank experience in the United States over the past 30 years.

In the study, we introduced a new research definition of community banks that was not based solely on asset size, but on the business model – relationship lending funded by stable core deposits focused on a local geographic area that the bank understands well.

At that time we also held a conference to assess the impact of the financial crisis on community banks. It seems to us, four years later, with the crisis largely behind us, to be an appropriate time to hold a conference to focus on the future of community banks.

The conference today will consider four key issues for community banks: the business model; supervision; the challenges and opportunities posed by information technology; and the significance of ownership structure and succession planning.

I would like to begin this conference by making two points.

First – you have heard me say this before, but I think it bears repeating -- community banks play a critically important role in the financial system and economy of the United States.

As FDIC research has documented, community banks today account for about 13 percent of the banking assets in the United States. They also account for about 44 percent of all the small loans to businesses and farms made by all banks in the United States. Even that may understate the importance of community banks because most of the small business lending done by large banks is credit card lending. When it comes to a lender actually having first-hand knowledge about the small business seeking a loan, that lender is going to be a community bank.

The FDIC also found that for more than 20 percent of the 3,100 counties in the United States, the only banks operating in those counties are community banks. That means that for thousands of rural communities, small towns, and urban neighborhoods, the only physically present banking institution is a community bank.

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

The bottom line is that community banks matter in terms of access to basic banking services and credit for consumers, farms, and small businesses across the United States.

Second, for all the challenges community banks face – and we will be discussing a number of them during the course of this conference – community banks have emerged from the worst financial crisis since the Depression and most severe recession since World War II with substantial strength.

As the FDIC has documented in our *Quarterly Banking Profile*, community banks have been outpacing the industry as a whole in terms of both earnings growth and loan growth across a range of asset categories, including residential mortgages, commercial and industrial loans, and loans secured by commercial real estate[2].

In short, the community bank business model has proven itself to be resilient and adaptable even under a challenging set of economic conditions.

It is important that the narrative about community banks be balanced and positive. The narrative should recognize the critical importance and substantial strengths of community banks in the United States while acknowledging the challenges going forward.

I would like to use the remainder of my time this morning to do three things: First, share our research results showing the resilience of the community banking sector after 30 years of industry consolidation. Second, discuss the solid performance of community banks in what has been a relatively challenging post-crisis economic environment. And finally, outline the priorities for the FDIC in regard to our supervision of community banks that may be responsive to some of the challenges that lie ahead.

Historical Perspective on Banking Industry Consolidation

It is fair to say that banking industry consolidation is not a post-crisis development; it is a long-term process that began 30 years ago.

During that time, the total number of federally-insured bank and thrift charters has declined by nearly two-thirds, from more than 18,000 in 1985 to just under 6,200 at the end of last year.

Almost a quarter of this net consolidation can be attributed to the more than 2,700 institutions that have failed since 1985. Most of those failures occurred during the thrift crisis of the late 1980s and early 1990s, and then the recent crisis beginning in 2008.

Even more important has been the voluntary consolidation of charters that has taken place across or within banking organizations.

Annual rates of voluntary consolidation peaked in the mid- to late-1990s as a result of changes in state and federal laws that permitted intrastate and interstate branching. As states repealed unit banking laws prohibiting branching within state borders, and the Congress passed legislation

[2] FDIC, *Quarterly Banking Profile*, https://www.fdic.gov/bank/analytical/qbp/.

permitting branching across state borders, banking organizations consolidated banking subsidiaries into branch networks, dramatically reducing the number of bank charters.

Some have looked at the reduction in the number of bank charters over the past 30 years as evidence that community banks are disappearing in the United States and that the community bank business model is no longer viable. However, a more careful look at the data suggests a very different conclusion.

First, virtually all of this net consolidation has taken place among banks with assets less than $100 million.

Thirty years ago there were more than 13,600 banks in the United States with assets less than $100 million. Today there are fewer than 2,000. This decline in banks with less than $100 million accounts for all of the net decline in the number of bank and thrift charters since 1985.

However, for institutions with assets between $100 million and $1 billion, there are approximately the same number of institutions today as 30 years ago, and as a group they hold a higher volume of assets than they did in 1985.

For institutions with assets between $1 billion and $10 billion, most of which can reasonably be considered community banks, there are more banks today than there were 30 years ago and they also collectively hold a higher volume of assets than they did then.

Applying our research definition of community banks, we find that consolidation has actually taken place at a faster pace among non-community banks than among community banks over time. In fact, among institutions operating at the end of 2005, community banks have experienced a total rate of attrition around half that of non-community banks.

What happened?

First, those institutions that held less than $100 million in assets back in 1985 actually turned out to be the most resilient of any other size group over the ensuing 30 years. A higher percentage of those institutions are still operating today than those that started out in any other size group.

How did they manage this?

Mostly, they managed to succeed, and grow, and to continue to operate as independent community banks, but on a somewhat larger scale by merging with other community banks. Among community banks that have failed or merged since 2005, two-thirds were acquired by other community banks and continue to function as relationship lenders. Among failed and merged community banks with assets less than $100 million, 85 percent were acquired by other community banks. In all, the median size of institutions meeting our community bank definition has increased more than four-fold since 1985, from $38 million to $176 million.

Approximately 93 percent of FDIC-insured institutions currently meet the FDIC's research definition of a community bank – the highest percentage in at least 30 years.

As I mentioned earlier, these institutions account for 13 percent of banking assets, but hold 44 percent of the industry's small loans to farms and businesses, making them the credit lifeline for entrepreneurs and small businesses of all types. As of June 2015, community banks held more than 75 percent of deposits in more than 1,100 counties in the United States, approximately one third of all counties; and as I mentioned earlier, for one-fifth of the counties in the United States, community banks are the only banks with a physical presence.

Assertions have been made that community banks need to be of a certain size to be viable. I would note that FDIC research on this issue has found that most of the economies of scale for community banks are realized by the time they reach $100 million in assets[3]. Some additional gains are realized at $200 million and $300 million in assets, but beyond that, our research has not identified significant benefits. I would note also that most of the institutions with assets below $100 million in assets remain highly viable and important to the communities they serve.

In summary, community banks have evolved, changed, and grown to meet the needs of their customers and the challenges of the market.

They have succeeded to a remarkable degree. As I indicated, they continue to play a critically important role in the U.S. financial system and economy, and they have demonstrated their resilience in the aftermath of the recent financial crisis and recession.

Challenges Facing Community Banks – The Post-Crisis Economic Environment

So what are the key challenges facing community banks in the post-crisis period?

As I indicated, the conference today will focus on what we believe are four core issues: the community bank business model; supervision; information technology; and ownership structure and succession planning. We have four panels that will engage on each of these issues in depth.

There is a fifth challenge I would like to comment on briefly that at least in the short term is perhaps the most significant of all - the economic environment in which community banks have operated in the aftermath of the financial crisis.

The economic recovery we have experienced since 2009 has helped the vast majority of community banks to address their problem loans, strengthen their balance sheets, and increase their earnings. Yet, compared to previous economic expansions, this one has been marked by below-average rates of economic growth and exceptionally low interest rates.

One of the by-products of this economic environment has been a steady and substantial decline in community bank net interest margins. During the 10 years leading up to the crisis, the average

[3] Stefan Jacewitz and Paul Kupiec, "Community Bank Efficiency and Economies of Scale," FDIC, December 2012, https://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf (published under the FDIC Community Banking Initiative).

net interest margin for community banks was 4.04 percent. But by 2015, the average had fallen to 3.57 percent.

This decline is particularly significant for community banks, which derive a greater share of their net operating revenue from net interest income than larger institutions.

In explaining the current state of community bank profitability, margin pressure by far dominates all other factors – including overhead expenses. Community banks have actually been relatively successful in adapting to a low interest rate environment and maintaining margins but this remains an ongoing challenge.

There also is evidence that downward pressure on margins in the low interest-rate environment has led to reduced interest by potential applicants to form new banking institutions – a subject I will return to shortly. A recent paper by economists at the Federal Reserve suggests that economic factors alone – including the long period of zero interest rates – explain at least three quarters of the post-crisis decline in new bank charters.[4]

FDIC Priorities for the Future

As we consider the challenges facing community banks going forward, there are three areas of activity by the FDIC that I believe can be helpful – tiered supervision, technical assistance, and the promotion of *de novo*, or new, community banks.

Tiered Supervision

The first step is a renewed commitment to the principle of **tailored supervision**.

By tailored supervision, we mean smaller, less complex institutions are supervised and regulated differently from larger, more complex banks.

For example, the FDIC examines small, well-rated community banks every 18 months, while larger, more complex institutions are examined on a continuous basis throughout their annual examination cycle.

Before a community bank examination is started, examiners engage in a pre-exam planning process to determine the scope or breadth of the examination and to identify exam functions that can be automated or performed more effectively outside the bank. This reduces the number of hours spent on-site and enables tailoring of the on-site examination to the risks an institution presents.

The FDIC also takes a tailored approach to supervisory policy.

[4] Robert M. Adams and Jacob P. Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation," Federal Reserve Board, Finance and Economics Discussion Series 2014-113, December 16, 2014, http://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.

When we say policy, we mean the FDIC's framework of regulations, guidance, and examination policies and procedures.

We do this by adjusting regulations and guidance to account for the size, complexity, and risk profile of the institutions to which they apply. We have used input from the industry received through the notice-and-comment process, for example, to specifically address the concerns of smaller institutions in finalizing the rules on proprietary trading and the Basel capital standards.

Since 2010, the FDIC has added a statement of applicability to each of its Financial Institution Letters to clarify whether the guidance is applicable to banks with total assets under $1 billion. This allows community bankers to focus their efforts on the supervisory policies that apply to them.

And, as you know, for more than a year, the three banking agencies have been undertaking a review of the rules and regulations they have issued over the past 10 years as required by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA).[5] The agencies held six public outreach sessions around the country in 2014 and 2015 and issued notices seeking written public comment on a wide range of rules and regulations, including new regulations issued through the end of 2015.

We received a large number of constructive comments in response to which the agencies have already taken actions.

With the support of the banking agencies, at the end of last year the Congress enacted a statutory change raising the asset-size threshold from $500 million to $1 billion under which well-rated and well-managed banks can qualify to be examined on-site every 18 months instead of every 12 months. Earlier this year, the three agencies implemented the statutory change through an interim final rule which resulted in the rule taking immediate effect rather than waiting for the conclusion of the 60-day comment period.[6]

Working through the Federal Financial Institutions Examination Council (FFIEC), the banking agencies are currently considering ways to improve Call Reports and simplify the reporting process.[7] The agencies issued a Federal Register Notice removing certain reporting requirements from the Call Report.[8] An interagency working group also is assessing the feasibility of introducing a separate small bank Call Report for institutions below a specified asset-size threshold.

The FFIEC also has established a working group to consider adjustments in the asset thresholds for real estate appraisals. The agencies also will be considering ways to reduce the burden and

[5] For more information, see https://www.fdic.gov/EGRPRA/.
[6] FDIC, "Federal Banking Agencies Expand Number of Banks and Savings Associations Qualifying for 18-Month Examination Cycle, February 19, 2016, https://www.fdic.gov/news/news/press/2016/pr16011.html.
[7] Federal Financial Institutions Examination Council, "FFIEC Announces Initiative to Streamline Reporting Requirements for Community Banks, September 8, 2015, http://www.ffiec.gov/press/pr090815.htm.
[8] Office of the Comptroller of the Currency, Department of the Treasury, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, "Proposed Agency Information Collection Activities; Comment Request," http://www.ffiec.gov/press/PDF/2015xInitialF_%20Notice090715final.pdf.

complexity of complying with risk-based capital requirements, an issue that received extensive comment in the EGRPRA process.

The agencies will submit a final report on the EGRPRA review by the end of this year. Our intention is to pursue these and other issues raised during the course of the review and not wait for the issuance of the final report to take action.

Technical Assistance

The FDIC also has continued to build on our **technical assistance program,** which is designed to provide information that can help bankers and their board members address hot-button regulatory and accounting issues.

As you may know, the FDIC has a Community Bank Advisory Committee made up of 15 bankers from around the country that meets with our board members three times a year for a full day to review issues impacting community banks.[9] I believe the members of the committee are all here today and I look forward to our meeting tomorrow. The advisory committee has underscored in our meetings the value the members place on the technical assistance provided by the FDIC as a way to facilitate regulatory compliance and ultimately reduce cost.

Two years ago we asked the committee what was the best way for the FDIC to provide technical assistance. The answer was that providing the information online through videos that bank management and directors could access on their own time and at their own convenience would be the most effective.

We took that recommendation to heart and dedicated a team to develop a series of technical assistance videos on key risk management and consumer compliance issues. Our technical assistance video series now includes 25 videos covering topics such as interest rate risk, the Bank Secrecy Act, cyber security, vendor management, and flood insurance. All of the videos can be accessed on the FDIC website – fdic.gov -- click on the “Community Banking Initiative” on the right side.[10]

As part of this effort, we introduced a virtual version of the FDIC's Directors' College Program that the FDIC regional offices deliver throughout the year.

There have been more than a quarter million views on the technical assistance videos. For those of you who have not yet made use of them, I do recommend them. And keep checking back as we are adding new videos regularly. For example, later this year we will be introducing a new video on corporate governance.

I should note in this regard that during the past few years the FDIC has significantly ramped up its efforts to improve awareness of cyber risks and practices at financial institutions.

[9] For more information about the FDIC Advisory Committee on Community Banking, see https://www.fdic.gov/communitybanking/index.html.
[10] FDIC, The Directors’ Resource Center Technical Assistance Video Program, https://www.fdic.gov/regulations/resources/director/video.html.

One of these efforts is a voluntary, self-assessment cyber tool issued by the FFIEC that institutions can use to assess their cyber-readiness.[11]

Another is a video program developed by the FDIC that introduces a series of "Cyber Challenges" institutions can use to evaluate their preparedness to respond and restore operations as a result of a cyber-event.[12] The Cyber Challenge exercise also is available free to all institutions on the FDIC website, and a copy is included in the Community Bank Resource Kit we distributed to you today.

This type of timely, targeted technical assistance can help community bankers stay current with regulatory issues at a minimal investment of time and money.

Promoting the Creation of De Novo Community Banks

Finally, we need to find ways to facilitate the process of establishing new community banks.

The entry of new banks has helped to preserve the vitality of the community banking sector during this 30-year period of consolidation. De novo institutions fill important gaps in our local banking markets, providing credit and services to communities that may be overlooked by larger institutions.

But we have seen the number of de novo applications decline to a trickle in recent years.

As I described, research has shown that most of this decline in chartering activity can be attributed to the challenging economic environment of the post-crisis period. We expect chartering activity to pick up as economic conditions continue to normalize.

We have seen indications of increased interest in de novo charter applications in recent quarters.

I want to emphasize that the FDIC welcomes applications for deposit insurance, and we clearly have a role to play in facilitating the establishment of new institutions.

In November 2014, we issued a list of answers to frequently asked questions to ensure our policies for approving these applications were made clear. [13]

In September 2015 we hosted a training conference regarding de novo applications to help promote coordination of state and federal regulatory review processes. I would note that while the FDIC approves applications for deposit insurance by new institutions, it is the decision of the federal or state regulator to grant that institution a banking charter.

[11] Federal Financial Institutions Examination Council, Cybersecurity Assessment Tool, https://www.ffiec.gov/cyberassessmenttool.htm.
[12] FDIC, "Cyber Challenge: A Community Bank Cyber Exercise," Directors' Resource Center Technical Assistance Video Program, https://www.fdic.gov/regulations/resources/director/technical/cyber/purpose.html.
[13] FDIC, "FDIC Statement of Policy on Applications for Deposit Insurance: Q&As," November 2014, https://www.fdic.gov/news/news/financial/2014/fil14056a.pdf.

We have designated subject matter experts and applications committees in the FDIC regional offices to serve as points of contact for deposit insurance applications. We also are in the process of planning outreach meetings with the banking industry to ensure that they are well informed about the FDIC's application approval processes and the tools and resources available to assist them.

And I am announcing today that the FDIC will reduce from 7 years to 3 years the period of heightened supervisory monitoring for de novo institutions. The 7-year period was established during the financial crisis in response to the disproportionate number of de novo institutions that were experiencing difficulties or failing. In the current environment, and in light of strengthened, forward-looking supervision, it is appropriate to go back to the 3-year period.

I should note that establishing even a small community bank is a challenging endeavor. Developing a sound business plan, raising the needed financial resources, and recruiting competent leadership and staff takes work and we want to ensure that every new institution that is established is in a position to succeed.

But we are very committed to working with, and providing support to, any group with an interest in starting a community bank. To that end, we are developing a handbook to guide applicants through the review process.

There is ample room for new community banks with sound funding and well-conceived business plans to serve their local markets.

It is essential that they have a clear path to approval.

Conclusion

In conclusion, I am looking forward to a spirited and informative discussion today of some of the key issues impacting the future of community banks. I also am looking forward to hearing more feedback from the members of the FDIC Community Bank Advisory Committee in our meeting tomorrow.

Let me to leave you with these final thoughts.

Community banks are the very core of the U.S. financial system.

They are the vehicle through which a large segment of consumers, small businesses, and communities gain access to credit and banking services

As the primary federal regulator for the large majority of community banks, the FDIC sees the continuation of a strong community banking sector in the United States as essential to the functioning of our financial system and economy.

We understand that the recent period has been uniquely challenging for community banks.

I hope my comments here today have conveyed both the FDIC's commitment and our sense of optimism with respect to the future of community banking.

Thank you.