Remarks by

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The Importance of Community Banks to the U.S. Financial System and Economy

at the

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Introduction

Good afternoon, and thank you for the invitation to speak to you today. I would like to thank Secretary Schneider and the Conference of State Bank Supervisors for hosting this annual event.

As you may know, the FDIC is the lead federal supervisor for the majority of community banks in the United States. Since I was sworn in as Chairman in 2012, we have placed a high priority on understanding and supporting the community banking sector.

We kicked off a research program in 2012 that began with the publication of a comprehensive study of community banks –the first of its kind.

Our researchers subsequently explored a wide range of community bank topics, including core profitability, consolidation, ownership structure, branch banking, rural depopulation, and Minority Depository Institutions. We shared our findings with the industry and the public through our research publications, two community banking conferences, and our Advisory Committee on Community Banking.

In 2014, we added a stand-alone section of our *Quarterly Banking Profile* to provide current financial results just for community banks, which might otherwise be obscured by the results of much larger institutions.

Through our Advisory Committee on Community Banking, the FDIC Board receives regular input from bankers. And we have worked diligently to address the concerns they raise, provide technical assistance, and tailor our supervisory approach to the size and complexity of each institution.

Today, I would like to summarize some of the most important results of our community banking initiative.

I'll also discuss the historic origins of U.S. community banks, their unique niche in our financial system, the impact of three decades of industry consolidation, their strong performance in the post-crisis environment, their key challenges, and the outlook for the future.

What is a Community Bank?

In our 2012 study, FDIC researchers developed a definition for "community bank" that is not strictly based on asset size.[1] Our definition relies on three key, common-sense characteristics of a community bank: careful relationship lending, stable core deposits, and a local geographic area of business that the bank understands well.

At the end of 2016, 92 percent of FDIC-insured institutions met this definition.

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

Community banks have always carried out the banking core functions: gathering core deposits and making loans to individuals and small businesses. But unlike larger noncommunity banks, community banks have the local focus to give the detailed attention critical to the small business sector.

This is particularly evident here in Illinois. Illinois is home to 432 community banks, which represent 94 percent of all institutions chartered in the state. These banks play a key role in financing the Illinois agricultural industry and other segments of the small business sector that generate jobs for the state.

Why Are Community Banks So Important in the U.S. Financial System and Economy?

The U.S. economy has long been characterized by a high degree of entrepreneurial activity. The origins of our banking industry are closely connected to this history.

In the early days of our country, the U.S. banking industry was based exclusively on state-chartered institutions. Even after the introduction of national banks in the 1860s, the scale of financial institutions was for the most part limited by legislative restrictions on branching and on the crossing of state boundaries. The small scale and limited geographic reach of the typical 19th century American bank was well-suited to serving small businesses and small communities across the growing nation.

Eventually, investment banks and money center banks began to play a larger role in corporate cash management and in undertaking international banking transactions. But despite the many changes that have taken place over the past 150 years, traditional community banks remain vitally important to our financial system and our economy.

Community banks specialize in serving small businesses, which still account for the majority of new jobs. Small business lending is an essential part of community bank portfolios, particularly at the smallest banks.

Community banks hold 43 percent of all small loans to businesses and farms in the United States – more than three times their 13 percent share of industry assets. And they serve markets that tend to be neglected by larger noncommunity banks.

As of 2014, community banks held more than three-quarters of total deposits in 1,244 counties, or about 40 percent of all U.S. counties. In around half of those counties, the *only* FDIC-insured institutions operating a physical office are community banks.

30 Years of Consolidation in U.S. Banking

With the introduction of the national charter, and with continued growth in state-chartered banks, the number of U.S. financial institutions rose rapidly during the second half of the 19th century.

The total number of U.S. banks rose from approximately 1,500 in 1860 to more than 10,000 in 1900 and more than 30,000 at their peak in the early 1920s.

The thrift industry followed a similar trajectory, with the number of building and loan associations rising rapidly after the Civil War to approximately 5,500 in 1900 and peaking at almost 12,000 in the early 1920s.

Even today, more than half of the community banks in operation were originally established between 1880 and 1929. The median age of community banks is 94 years, compared to 39 years for noncommunity banks.

But since the early 1920s, the banking and thrift industries have undergone two major waves of consolidation.

The first phase of this consolidation took place among smaller commercial banks, many of which operated in rural areas. Nearly 6,000 banks failed or temporarily suspended operations in the 1920s, before the Great Depression. But the Depression would lead to another 9,000 failures and suspensions between 1930 and 1933 alone, just prior to the introduction of federal deposit insurance.

Overall, between 1920 and 1945, the number of banks and thrifts declined by about half.

The number of banks and thrifts remained relatively constant during the next 40 years, with more than 18,000 charters in operation as late as 1985. Since then, the banking industry has experienced another sustained consolidation that has reduced the number of federally insured depository institutions by two-thirds to 5,787.

Almost all of this net consolidation can be accounted for by a decline in the number of very small institutions, those with assets less than $100 million.

Does this mean that the smallest banks have been the *least* successful group since 1985? It does not. The fact is these smallest banks have been more resilient than any other asset-size group.

Banks that in 1985 had less than $100 million were *more likely* to survive through to 2016 than any other asset-size group. Two-thirds of surviving community banks thrived and moved to a larger asset-size group. In fact, the median asset size of community banks has more than quadrupled since 1985, from $40 million to more than $170 million.

Over the past decade, consolidation has reduced the number of community banks by 31 percent. But many of these banks were acquired by other community banks. This was the case for more than two-thirds of all community banks that merged or failed between 2007 and 2016, and 87 percent of community banks with assets less than $100 million.

In other words, community bank consolidation has largely occurred within the community bank sector, arguably resulting in a smaller – but more sustainable – community bank sector over the long term.

Factors Driving Industry Consolidation

The degree of consolidation over the past 30 years has led to questions about why this is happening and what it portends for the future of community banking.

One major factor driving consolidation has been a volatile financial environment that resulted in two major financial crises that in turn triggered two waves of bank and thrift failures since the early 1980s. More than 2,700 institutions have failed since 1985, a dramatic increase from the annual rate of failure for the period between 1945 and 1980.

Another major factor driving consolidation since the mid-1980s has been the removal of constraints on intrastate and interstate branching and banking. State and federal prohibitions on branch banking and interstate banking were largely dismantled in the 1980s and early 1990s, facilitating the consolidation of existing charters within and across bank holding companies.

About 14,000 banks and thrifts have closed through voluntary mergers, liquidations, and intra-company consolidations since 1985. Almost 2,000 of these charters eventually ended up as part of the four largest U.S. banking organizations, whose share of industry assets has grown from 11 percent in 1985 to 42 percent in 2016.

During this same period, growth in non-bank competitors may have also helped to drive consolidation in banking.

The banking industry's share of total financial sector liabilities has fallen by more than half since 1980, from 40 percent to just 18 percent. This market share was largely assumed by market-based financial intermediaries, including money market mutual funds, finance companies, and asset-backed issuers. Yet each of these non-bank competitors has declined in relative terms since the financial crisis while banks' share has stabilized.

New technologies also continue to spawn potential competitors to traditional banks.

In the 1990s, there was much talk about how credit scoring would render relationship banking obsolete. But while automated underwriting has made inroads in certain standardized products, such as business credit cards, their share of total small business credit remains small.

More recently, there is interest in mobile and online lending vehicles.

While there is appeal to the convenience and low cost of mobile and online lending in certain situations, community banks are also investing in new technologies to complement their traditional relationship-based lending with these services that their customers are becoming accustomed to using.

Amid all of the institutional and technological changes we have seen during the past 30 years, community banks remain the single-most important source of credit for small businesses and of banking services in general to non-metro areas.

Despite the rise of new competitors and the long-term consolidation in banking, no single competitor has emerged that can replicate or replace the mix of services that community banks provide.

Community Bank Performance in the Post-Crisis Period

As part of our community bank research, we have been able to measure the overall progress community banks have made during the post-crisis period in terms of credit quality, loan growth, income growth, and profitability.

Noncurrent loans held by community banks rose sharply in the wake of the crisis, and merger-adjusted loan growth declined for three consecutive years – from 2009 to 2011. However, as credit quality improved, loan growth staged a strong recovery. Total loans and leases held by community banks have grown by more than 8 percent in each of the past three years — extending to many segments of the loan portfolio. This growth has exceeded the pace of nominal growth in the U.S. economy.

Post-crisis comparisons between community and noncommunity banks are instructive. While community banks lost half of their share of industry loans in the 20 years leading up to the crisis, their share has remained unchanged, on net, in the nine and a half years since the onset of the crisis.

In each of the past four years, community bank loans have grown faster than loans held at noncommunity banks in: 1- to 4-family mortgages, commercial real estate loans, and commercial and industrial loans. In each of the past *three* years, annual growth in community bank net income has equaled or exceeded growth at noncommunity banks.

While community bank profitability, as measured by pre-tax return on assets, has recovered to its highest levels since the onset of the crisis, it remains somewhat short of the highs posted in the pre-crisis years.

The data are very clear on the reasons for this shortfall in overall community bank profitability. It is clearly *not* attributable to a surge in noninterest expenses or a drop-off in noninterest income. Instead, it is entirely attributable to the compression of net interest margins that has occurred after nearly nine years of historically low short-term interest rates.

Net interest income is the foundation of community bank profitability. It has traditionally accounted for around 80 percent of net operating income for community banks, versus two-thirds at noncommunity banks.[2] But the net interest margin for community banks today is lower than it was prior to the crisis.

This decline in net interest margin has progressed over time as the period of zero or near zero interest rates has persisted. It far exceeds any other factor in holding back a full recovery in community bank profitability in the post-crisis period. No other factor comes close.

Low interest rates and compressed margins have also been identified as the most important factors holding back *de novo* bank activity in recent years. A recent study by economists at the Federal Reserve Board shows that 75 to 80 percent or more of the post-crisis decline in *de novo*, or new, banks can be explained by economic factors alone – including low interest rates.[3]

This observation is corroborated by bank price-to-book ratios, which hovered near 1-to-1 for most of the post-crisis period, before jumping to around 150 percent with the rise in bank share prices that started last fall.

Our expectation is that rising interest rates and higher price-to-book multiples will encourage more applications for deposit insurance for new institutions, while discouraging the acquisition of existing banks as their relative price increases. In fact, during the past year, we have seen increased interest in *de novo* applications. The FDIC has approved eight applications for deposit insurance during that period.

Banking industry consolidation can be expected to continue in the years ahead. But given the influence of low interest rates and slow economic growth on this consolidation, we expect that the pace will slow as economic factors normalize.

Challenges to Community Banks Going Forward

While community banks largely have recovered from the crisis and are exhibiting solid financial performance, there are challenges ahead. Among the more important challenges are:

- The costs of regulatory compliance;
- Responding effectively to changes in information technology; and
- Managing succession planning and recruitment.

Compliance

Smaller banks have relatively fewer resources to devote to regulatory compliance. As the primary federal regulator of the majority of community banks, the FDIC is especially aware of

[2] *FDIC Community Banking Study* (2012), p. 4-4, https://www.fdic.gov/regulations/resources/cbi/study.html.
[3] Adams, Robert M., and Jacob Gramlich, "Where are All the New Banks? The Regulatory Burden in New Bank Formation," *Review of Industrial Organization*. Vol. 48, No. 2. March 2016, pp. 181-208, https://link.springer.com/article/10.1007/s11151-015-9499-3.

the effect regulatory costs have on those institutions, particularly smaller banks and those located in rural communities.

The federal banking agencies are currently following through on burden-reduction commitments we made in our report to Congress earlier this year pursuant to the Economic Growth and Regulatory Paperwork Reduction Act, or EGRPRA.[4] These commitments are the result of an outreach program that included six public meetings across the country with bankers, as well as our review of written comments received on 12 separate categories of regulation.

Areas of focus in the EGRPRA report included expanding the asset threshold for eligibility for the 18-month examination cycle, reducing the content required in quarterly Call Reports, increasing appraisal thresholds, and simplifying small bank capital rules. We have already taken steps in each of these areas to reduce burden, and we are working to do more.

Effective since February 2016, the safety-and-soundness examination frequency for qualifying banks with assets less than $1 billion is 18 months. The threshold had previously been $500 million. Approximately 83 percent of all insured banks qualify for the 18-month cycle.

The FDIC joined with the other agencies in finalizing a new, streamlined Call Report for most institutions with less than $1 billion in total assets. The new Call Report reduced by about 40 percent the number of data items that must be reported, and we expect that further streamlining will be possible. For example, in June 2017, the agencies proposed further Call Report changes that would remove, raise the reporting threshold for, or reduce the reporting frequency of, approximately 7 percent of the remaining data items in the Call Report for small institutions.

The agencies also have addressed comments regarding the availability of appraisers. We have issued an "Interagency Advisory on the Availability of Appraisers" that clarifies previous guidance and explains options banks have to address temporary appraiser shortages, especially in rural areas.[5] This includes the ability to apply for a waiver of certified and licensed appraiser requirements for areas with a demonstrated shortage of appraisers. The FDIC is committed to gaining a better understanding of issues with appraisal availability and is currently participating in meetings with state banking commissioners and bankers is selected rural states, to help shed light on this topic.

The agencies also proposed changes to the appraisal rules to raise the appraisal threshold for commercial real estate transactions from $250,000 to $400,000, and sought comment on whether

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[4] Joint Report to Congress Economic Growth and Regulatory Paperwork Reduction Act, March 2017, https://www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf.

[5] Advisory on the Availability of Appraisers (FIL-19-2017), May 31, 2017, https://www.fdic.gov/news/news/financial/2017/fil17019.html.

the appraisal threshold for residential real estate should be raised.[6] Currently, we are reviewing the comments received on that proposal.

Finally, the agencies recently proposed changes to simplify and clarify certain of the more complex aspects of their capital rules in response to comments from community banks.[7] These include changes to the treatment of High Volatility Commercial Real Estate and to the regulatory capital deductions regarding mortgage servicing assets, deferred tax assets, investments in the capital of other financial institutions, and minority interest. The agencies are also seeking comment on whether there may be further, more fundamental, ways to simplify capital requirements for small banks.

The FDIC has long had a focus on tailoring not just regulations, but our supervisory processes, in recognition of the challenges facing smaller institutions. One important interagency initiative in this respect is an examination modernization effort to explore ways that we can expand the use of technology in our exam work so that we can conduct a greater proportion of our examination activities off of bank premises.

Information Technology

Another significant challenge for community banks is coping with the pace of change in information technology (IT). These challenges include maintaining strong cybersecurity and making important business decisions about how best to deliver financial services to customers. Just as with regulatory compliance, small banks have fewer resources to devote to these IT challenges.

During the past few years the FDIC has significantly increased its efforts to improve awareness of cyber risks and cybersecurity practices at financial institutions. One of these efforts is a video program developed by the FDIC that introduces a series of "Cyber Challenges" institutions can use to evaluate their ability to restore operations after a cyber event.[8] The Cyber Challenge exercise and other videos on cybersecurity and information technology, available on the FDIC website, provide important information to help directors and management of community banks carry out their responsibilities.

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[6] Federal Banking Agencies Issue Notice of Proposed Rulemaking to Exempt Commercial Real Estate Transactions of $400,000 or Less from Appraisal Requirements, https://www.fdic.gov/news/news/press/2017/pr17055.html. Specifically, question 17 states: "As discussed earlier, the agencies have articulated several bases for declining to propose an increase in the residential threshold. The agencies request comment on whether there are other factors that should be considered in evaluating the current appraisal threshold for 1-to-4 family residential properties."

[7] Agencies Propose Simplifying Regulatory Capital Rules, https://www.fdic.gov/news/news/press/2017/pr17071.html.

[8] Cyber Challenge: A Community Bank Cyber Exercise, https://www.fdic.gov/regulations/resources/director/technical/cyber/cyber.html.

The federal banking agencies have also issued a cyber tool for institutions to use to self-assess their cyber readiness.[9] In addition, the agencies have increased their focus on examinations of the technology service providers on which many banks rely.

Succession Planning

Finally, we have heard from many small institutions that recruitment and succession planning are becoming more challenging.

A 2015 FDIC study of community bank ownership and management structure found that large proportions of closely-held community banks faced uncertainty in terms of their management succession plans.[10] Our data indicated that 85 percent of closely-held community banks were owned by groups with family ties. Just half of the closely-held, FDIC-supervised community banks covered by our research had identified a viable successor to their current CEO. And supervisors said that less than two-thirds of the banks were well-positioned to recruit qualified management from outside the bank.

These results indicate that it can be difficult to persuade the next generation to follow the lead of the current CEO and continue to run the institution after the CEO retires. And it does not appear likely that the challenges of succession and recruitment will solve themselves. Instead, this is an area in which community bankers and regulators must proactively work together.

In regard to recruitment of staff, one avenue that some banks have found useful is internships — building on contacts with local colleges or universities. Some universities have established dedicated academic banking programs. The FDIC will soon be making available on its website a directory of such programs, which may be useful to banks that wish to explore establishing connections with universities to help with issues related to recruitment. We are also exploring options with the American Bankers Association to establish an online clearinghouse through which banks can connect with colleges and universities seeking to place students with an interest in banking in internships and permanent jobs .

Community Banking Initiative Technical Assistance Program

Helping community banks meet the challenges they face is an important part of the FDIC's Community Banking Initiative. When we asked our Advisory Committee on Community Banking how best we could help, they told us that they would value a virtual version of the Directors' Colleges that we deliver throughout our regions. So we prepared a virtual curriculum with six video modules covering topics directors most often tell us they want to learn more

[9] FFIEC Releases Cybersecurity Assessment Tool, https://www.ffiec.gov/press/pr063015.htm.
[10] John Anderlik, Richard A. Brown, and Kate Fritzdixon, "Financial Performance and Management Structure of Small, Closely Held Banks," FDIC Quarterly, Volume 9, No. 4, 2015, https://www.fdic.gov/bank/analytical/quarterly/2015-vol9-4/article1.pdf.

about, including interest-rate risk, troubled debt restructurings, the Bank Secrecy Act, and corporate governance.[11]

We also prepared six videos targeted to new directors to introduce to them to the responsibilities of their new role. Finally, we developed a series of technical assistance videos targeted to senior management that cover topical issues, such as appraisals and evaluations, Fair Lending risk, the allowance for loan and lease losses, and cyber incident response.

All of these materials have been made available on our Directors' Resource page on fdic.gov.

They are specifically intended to keep the directors, officers, and employees of smaller institutions better informed about regulatory change and better able to manage its costs.

Encouraging *De Novo* Banks

Finally, encouraging the formation of *de novo* banks is a top priority of the FDIC. I want to emphasize that the FDIC is committed to working with, and providing support to, *any* group with an interest in starting a community bank.

We have designated professional staff in each regional office to serve as subject matter experts for deposit insurance applications. These individuals are points of contact who can respond to questions from FDIC staff, other banking agencies, industry professionals, and prospective organizing groups.

We have reduced from seven years to three years the period of enhanced supervisory monitoring of newly insured depository institutions. The FDIC had established the seven-year period during the financial crisis in response to the disproportionate number of newly insured institutions that were experiencing difficulties or failing. In the current environment, the FDIC determined it was appropriate to return to the three-year period.[12]

Since last fall, the FDIC has held outreach meetings in each of our six regional offices around the country to ensure that interested parties and industry participants are well informed about the FDIC's application process and the tools and resources available to assist organizing groups.

The FDIC also issued a publication entitled "Applying for Deposit Insurance – A Handbook for Organizers of *De Novo* Institutions" that is intended to help organizers become familiar with the deposit insurance application process and understand the path to obtaining deposit insurance.[13]

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[11] The Directors' Resource Center Technical Assistance Video Program is available at https://www.fdic.gov/regulations/resources/director/video.html.
[12] FDIC Rescinds De Novo Time Period Extension; Releases Supplemental Guidance on Business Planning, https://www.fdic.gov/news/news/press/2016/pr16027.html.
[13] "Applying for Deposit Insurance – A Handbook for Organizers of *De Novo* Institutions," https://www.fdic.gov/regulations/applications/handbook.pdf.

We understand the importance of establishing new community banks with strong business plans without undue delay.

And we remain committed to working with organizing groups to get their applications approved so they can begin serving the financial needs of their communities. As I indicated earlier, during the past year, the FDIC approved eight applications for deposit insurance for new community banks.

The Future of Community Banking

In conclusion, as the banking industry has expanded and then consolidated during the past century, and as large bank and non-bank competitors have risen in prominence, community banks have continued to fill a vital niche in our financial system.

Their role is inextricably connected to the small business sector where most new jobs are created. And community banks have been essential in providing banking services to local communities that often are not served by larger banks or non-bank financial institutions.

We should not underestimate the continuing challenges community banks face: low interest rates, regulatory compliance, information technology, succession planning, and recruitment. But the underlying strength of community banking also should not be underestimated.

The strong post-crisis performance of community banks underscores their vitality and the critically important role that they play and will continue to play in the financial system and economy of the United States.

I assure you that the future of community banks will continue to be a top priority for the FDIC.

Thank you.