

Chapter 5: Regulatory Change and Community Banks

The period 2008 through 2019 was one of intense regulatory activity, much of which affected community banks. So numerous were the new regulations that keeping current with them would have challenged any bank, but especially a small bank with limited compliance resources. Some of these regulatory actions created new obligations for banks, but many of them benefited banks. Some applied only to specific classes of banks (such as national banks or federal thrifts), many applied only to specific activities or products, and some were technical clarifications or changes to the scope of various exemptions or exceptions. A common feature of these rules, however, is that the affected banks needed to understand them. Putting aside any consideration of the substantive effects of these rule changes, their large number and scope make clear that merely being knowledgeable about changes in bank regulation can be, by itself, an important and potentially daunting task for any bank.

Regulatory changes notwithstanding, community banks *in aggregate* have exhibited strong financial performance since the crisis, as noted in Chapter 1 of this study, and aggregate community bank loan growth has been strong. Yet as will be discussed in this chapter, the pace of regulatory change and the volume of actions make plausible the idea that some community banks, and particularly the smaller institutions among them, may have elected to exit particular business lines, or even the banking industry itself, partly because of costs associated with regulatory compliance. The pace of regulatory change may have been one among a number of factors contributing to three post-crisis developments: a high proportion (compared with other time periods and other banks) of small mortgage lenders that reduced their residential mortgage holdings, the record rates at which community banks were exiting the banking industry in the years leading up to 2019, and an apparent increase in the target asset size of new small banks as reflected in their initial equity.

Not included in the chapter is an analysis of the public policy goals of banking laws and regulations or how well they have been achieved. Implicit to the presentation, however, is the belief that a thriving community bank sector is worth preserving. If policy makers share that belief, bank regulation should achieve statutory goals in a way that accommodates, to the extent appropriate, the business models of community banks.

In analyzing the effects of bank regulation on community (or other) banks, it is important to recognize that the conclusions reached are not definitive, given three inherent challenges: decisions in banking are driven by many factors other than regulation; community-bank aggregates may mask behavioral responses within segments of the industry; and the goals of regulation extend far beyond the effects on banks. For details on these three challenges, see Box 5.1.

Box 5.1 Three Big Challenges to Pinning Down the Effects of Bank Regulation on Banks

The three most significant challenges to any attempt to determine the effects of bank regulation on banks of any size are as follows:

First, bank decisions are driven by many factors other than regulation. Those include decisions related to staffing and operations, the extent of involvement in particular business lines, or even entry into or exit from the banking industry itself. The many factors besides regulation that bear on these decisions could include the state of loan demand, interest rates, or the ability to attract stable retail deposits; changes in technology; changes in customer demographics; challenges with arranging for appropriate management succession; or consolidation of businesses in a bank's market area.^a

Second, community bank aggregates may mask behavioral responses within segments of the industry. For example, a particular type of lending may display a steady upward trend for community banks in the aggregate, but a more complete picture might reveal that regulatory developments caused some smaller community banks to exit that type of lending, with the lending then migrating to larger community banks. Another example might be an aggregate flat trend for noninterest expense, which *might* mean no increase in regulatory compliance costs, or it might reflect changes in bank behavior in response to regulation, with banks reallocating staff time or product mix, or adopting new technologies, to avoid an increase in noninterest expense.

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^a For a discussion of how business consolidation may affect banks, see Brennecke, Jacewicz, and Pogach (2020).

Box 5.1, continued from page 5-1

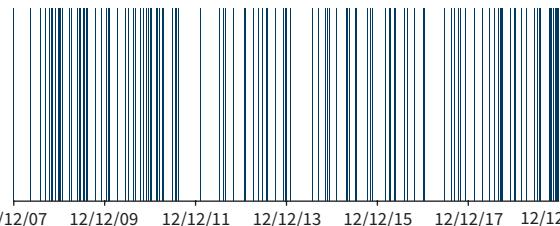
A third difficulty in quantifying the effects of bank regulation is that the goals of regulation extend far beyond the effects on banks. A partial list of statutory goals underlying the development of the U.S. bank regulatory framework includes promoting the financing of government activities, providing for a national currency, promoting a reliable payments system, ensuring sound and lawful bank operations, promoting financial stability, protecting bank depositors or other creditors while limiting the cost of the federal banking safety net and determining who bears that cost, protecting bank customers from unfair practices or illegal discrimination, combating money laundering, avoiding monopoly or undue concentration, promoting lending, and supporting credit to underserved communities. Moreover, the very existence of a large body of bank regulation has given rise to the statutory and policy objective of simplifying regulation and ensuring that it is appropriately tailored to small, regulated entities.

In short, not only do bank regulations have potentially wide-ranging effects outside the banking industry, but the narrower effects on banks themselves can be difficult to pin down. This suggests that gaining perspective on banking trends requires a holistic perspective. The FDIC conducts a significant amount of banker outreach, meets regularly with its Community Bank Advisory Committee, and benefits from public comments on its rules, including those received as part of the Economic Growth and Regulatory Paperwork Reduction Act process. Given the important challenges and caveats associated with the analysis, this chapter should be viewed as part of an ongoing dialogue about community bank regulation and not as a source of firm and final conclusions.

The remainder of the chapter begins with a brief review of the level and trend of noninterest expense ratios at community banks, since that category would typically include direct expenses associated with regulatory compliance. That review is followed by an overview of the major changes to federal regulations and programs affecting community banks, starting with the three broad categories of rules and programs most directly tied to the 2008–2013 banking crisis: deposit insurance and other federal financial dealings with banks, capital adequacy rules, and residential mortgage and servicing rules. The chapter continues with observations about community-bank exit and entry as possible indicators of overall effects

Chart 5.1

Selected Federal Regulatory Actions Applicable to Community Banks



Source: Agency websites.

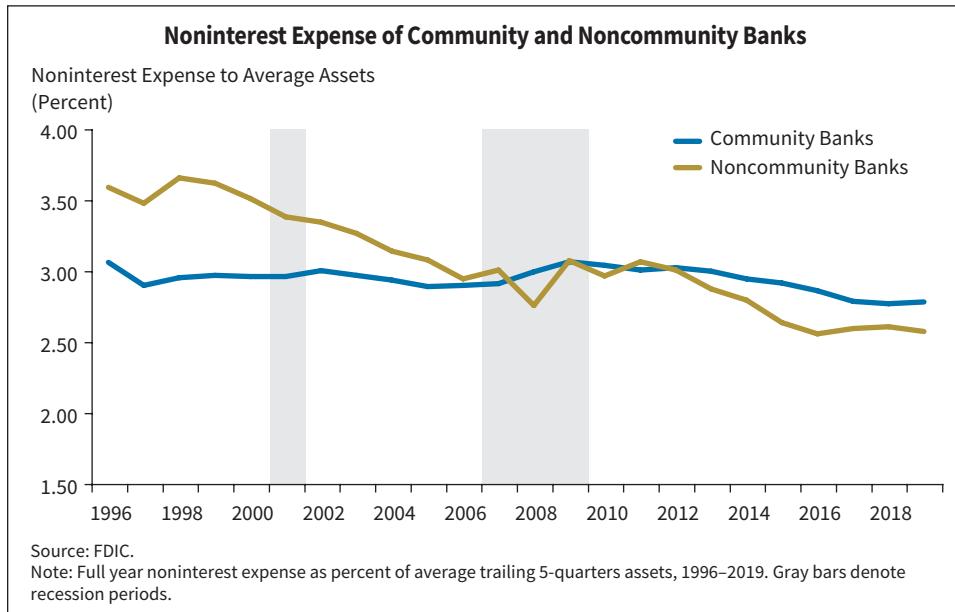
Note: Bars mark the announcement dates of 157 substantive final rules or federal programs affecting community banks that were issued by the FDIC, Federal Reserve, OCC, CFPB, Treasury, or FinCen. Rule changes depicted include burden reducing rules and federal financial support programs benefitting banks. The chronology starts with the creation of the Federal Reserve's Term Auction Facility in December 2007 and ends at year-end 2019.

of regulatory changes. A summary follows, to be followed in turn by a brief discussion of regulatory changes that have occurred as a result of the COVID-19 pandemic. An appendix—elaborated on in the next paragraph—extends the chapter.

Appendix B contains a chronology and a brief description of selected federal rules and programs that applied to community banks and were put in place from late December 2007 to year-end 2019. The chronology is limited almost entirely to substantive final rules and federal programs of the FDIC, Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency, Consumer Financial Protection Bureau, and the Department of the Treasury, including rules of the Financial Crimes Enforcement Network (FinCEN). The appendix generally does *not* include the following: Call Report changes; changes to accounting standards; tax changes; supervisory guidance; statements of policy; changes in state laws or regulations; ministerial rules such as inflation adjustments, rules issued in connection with changes in regulatory authority from one agency to another, or technical changes to agency procedures; or rules that apply exclusively to large or internationally active banks. Rules issued by multiple agencies, and rules issued as both interim final and final, are counted only once.

Even with these restrictions, the appendix lists 157 final rules and programs applying to community banks, an average of 1 every 28 days during the 2008–2019 period (Chart 5.1).¹

¹ Rules finalized after 2019 are not covered in this chapter or its appendix, apart from a reference in a concluding text box to selected pandemic-related regulatory actions taken in 2020.

Chart 5.2

Noninterest Expense Is Highest at Small Community Banks

The assessment of the effects of regulatory changes will benefit from a preliminary examination of trends in noninterest expense. Noninterest expense includes expenses for salary, premises, legal and consulting fees, information technology (including ensuring the security of that technology), and a variety of other noninterest expenses. Direct expenses associated with regulatory compliance often fall within this category, and therefore changes in, or levels of, noninterest expense relative to banks' overall revenue and cost structures may provide indirect evidence of regulatory effects.

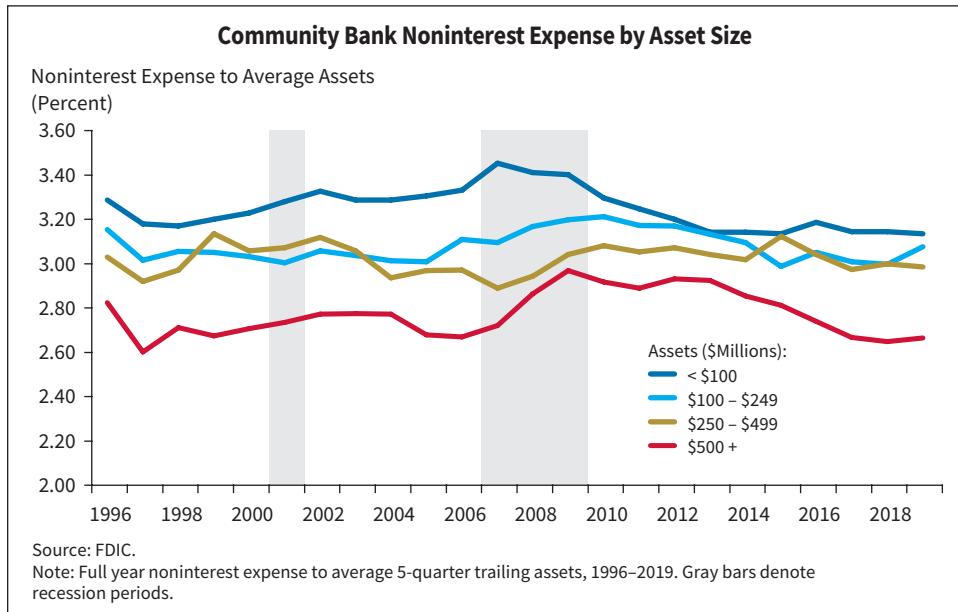
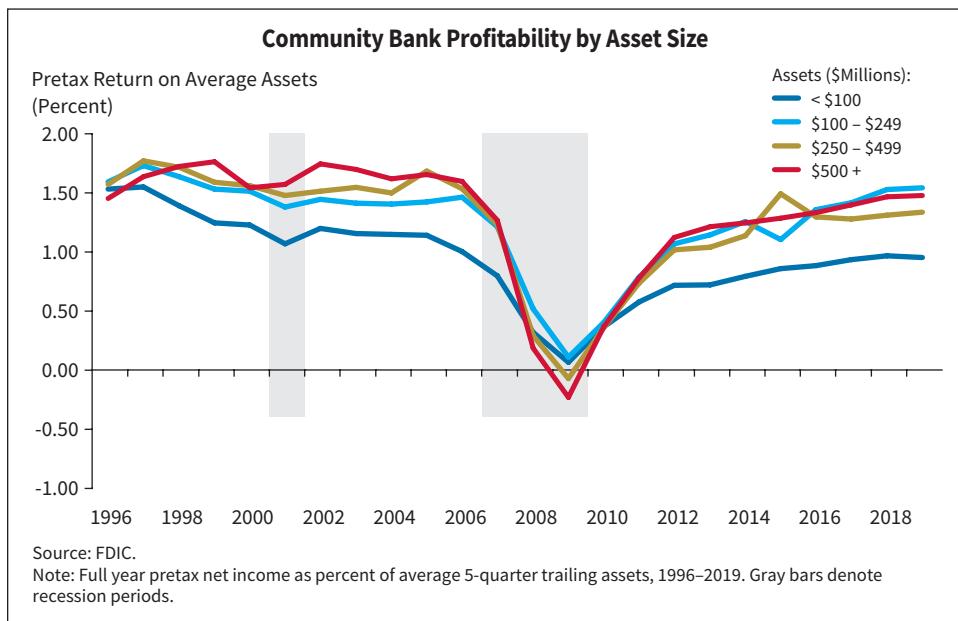
There are four important caveats to the discussion of noninterest expense. First, much of noninterest expense would be necessary to conduct a banking business even in the absence of regulation, so changes in the level and trend of noninterest expenses may reflect changes in the way banks do business that are unrelated to regulation. Second, the portion of noninterest expense attributable to regulatory compliance is unknown to researchers, and even bankers may have difficulty estimating these costs.² Third, as noted above, banks may respond to changes in regulation by changing their behavior to avoid regulatory

costs, so that the effects of the regulatory change may not be evident in noninterest expense. Finally, banks may incur regulatory compliance costs that do not show up in noninterest expense. For example, bank staff time devoted to compliance may divert time from other strategic or revenue-generating activities.

Chart 5.2 depicts the trend in noninterest expense ratios at community versus noncommunity banks. The chart shows that notwithstanding the regulatory developments since 2008, community banks' aggregate noninterest expense ratios declined modestly. The chart also shows that community banks' noninterest expense ratios have been slower to decline than those of noncommunity banks. This may reflect a community bank business model involving more direct interaction with customers, in addition to fixed costs that are a higher percentage of small banks' cost-structures given their smaller asset size. Both of these factors may impose practical limits on how much noninterest expense ratios can be reduced. Thus, to the extent that there was an increase in expense arising from regulatory change, the effect may be greater relative to the overall cost structure of a typical community bank than to that of a large noncommunity bank.

As indicated in Chart 5.3, community banks are not a homogenous group with respect to their noninterest expense ratios. Smaller community banks have had substantially higher noninterest expense ratios than larger community banks. Noninterest expense ratios at

² Call Reports include line items for legal expense, consultant expense, and accounting and auditing expense, but reporting thresholds are such that many small banks need not report these items, and just as with other noninterest expenses, it is not possible to determine the portion of these expenses that banks would need to incur even in the absence of regulation.

Chart 5.3**Chart 5.4**

community banks with assets less than \$100 million, which at year-end 2019 constituted about 24 percent of all community banks, averaged 48 basis points higher during the years 1996–2019 than for community banks with assets greater than \$500 million.³ Smaller banks' higher expense ratios have a substantial negative effect on these banks' profitability: in 2019, noninterest expense ratios at community banks with assets less than \$100 million were 47 basis points more than the ratios at community banks

³ Income and expense items in basis points are relative to average assets.

with assets above \$500 million, while small banks' pretax return on assets was 53 basis points lower (Chart 5.4).

Charts 5.3 and 5.4 indicate that higher overhead and lower profitability at smaller community banks are not new developments of the post-crisis period. The charts make clear, however, that if higher noninterest expenses were the outcome of a regulatory change, that cost would weigh relatively more heavily on smaller banks. For example, in considering the profitability effects of a *hypothetical* (emphasis added) increase in bank staff that generates no

additional revenue, Feldman, Heinecke, and Schmidt (2013) estimated that “the median reduction in profitability for banks with less than \$50 million in assets is 14 basis points if they have to increase staff by one half of a person.”

None of this information bears on either the core profitability of community banks, or the variation over time in community bank profitability caused by economic factors, as discussed, for example in Fronk (2016). Instead, the discussion here highlights that the profitability of community banks in general, and smaller community banks in particular, reflects a higher proportion of noninterest expense in their cost structures and, given their smaller asset size, a greater sensitivity of profitability to any given increment of noninterest expense, including an increment to expense that might be necessary as a result of a change in regulation.

Deposit Insurance and Other Federal Financial Dealings With Banks Changed in Important Ways as a Result of the Financial Crisis

The regulatory actions that were the most immediate response to the 2008 financial crisis were those pertaining to the federal banking safety net that supported banks during the crisis, and that in some cases permanently benefited small banks relative to large banks. Many community banks borrowed from the Federal Reserve's Term Auction Facility (TAF), in which the Federal Reserve lent to banks against a broader range of collateral than was accepted at the Discount Window. Many community banks also participated in the U.S. Treasury's Capital Purchase Program (CPP), in which the Treasury invested in subordinated debt or preferred stock of viable banks and bank holding companies. In addition, community banks benefitted from the 2008 temporary increase in the standard deposit insurance limit to \$250,000 (which was made permanent in 2010), and from the FDIC's Temporary Liquidity Guarantee Program (TLGP), whose two components were guarantees of holding company obligations, and temporary unlimited deposit insurance coverage of noninterest-bearing transaction accounts.⁴

⁴ A list of debt issuances guaranteed by the FDIC during the crisis pursuant to the Temporary Liquidity Guarantee Program can be found at https://www.fdic.gov/regulations/resources/tlgp/total_debt.html. The amount of noninterest-bearing transaction accounts guaranteed by the FDIC for the institutions that opted in to the Transaction Account Guarantee program can be found on Call Report schedule RC-O, memorandum item 4.

A subsequent important change in deposit insurance arrangements was the statutory change in the assessment base from domestic deposits to assets minus tangible equity capital. Since large banks tend to obtain a greater proportion of their funding from non-deposit sources than do small banks, the change in the assessment base shifted some of the cost of deposit insurance assessments from small banks to large banks. For second quarter 2011, when the changes to the assessment base became effective, assessments for banks with less than \$10 billion in assets were 33 percent lower in the aggregate than first quarter assessments, and those banks' share of total assessments decreased from about 30 percent to about 20 percent.

The allocation of the cost of building and maintaining the Deposit Insurance Fund (DIF) changed in other ways. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) increased the minimum reserve ratio of the fund from 1.15 percent to 1.35 percent, required that the reserve ratio reach that level by September 30, 2020, and required that the FDIC offset the effect of the increase on small banks. To implement these requirements, the FDIC imposed surcharges on large banks, generally those with assets greater than \$10 billion. As of September 30, 2018, the reserve ratio exceeded the required minimum of 1.35 percent, and the surcharges were suspended. Furthermore, to implement the Dodd-Frank Act requirement that the FDIC offset the effect of the increase on small banks, the FDIC awarded \$765 million in assessment credits to small banks for the portion of their regular assessments that contributed to growth in the reserve ratio between 1.15 percent and 1.35 percent. The FDIC remitted the final remaining assessment credits to small banks on September 30, 2020. The FDIC also made significant changes in deposit insurance pricing intended to more accurately reflect risk, so that a less risky bank does not subsidize activities of a riskier bank that could increase loss to the DIF. These changes were not statutorily required but reflected the FDIC's historical experience with the risk characteristics of failed banks.

The Federal Reserve also made important changes in its financial dealings with banks. The Federal Reserve announced in October 2008 that it would begin to pay interest on depository institutions' required and excess reserve balances. In 2016, the Federal Reserve implemented a statutory requirement by reducing the dividend paid to large banks (with assets greater than \$10 billion) on their Federal Reserve bank stock from 6 percent, to the lesser

of 6 percent or the most recent ten-year Treasury auction rate before the dividend, while smaller banks' dividend rate remained at 6 percent. This latter change affects only banks that are members of the Federal Reserve System.

Changes in Capital Regulation Were Mainly but not Only About Implementation of Basel III

The most important change to capital adequacy regulation during the 2008–2019 period was U.S. implementation of a version of the Basel III capital framework. However, other important regulatory capital changes occurred during those years, including temporary capital relief measures during the 2008 financial crisis and risk-based capital changes implemented in response to a change in the accounting for certain securitized assets. Another important change was the statutory increase in the asset size threshold for the Federal Reserve's Small Bank Holding Company Policy Statement, from \$500 million to \$1 billion and then again to \$3 billion. Bank and thrift holding companies subject to that policy statement are not subject to consolidated leverage- or risk-based capital requirements.⁵ A 2019 rule implemented a statutory requirement to allow qualifying banks to opt in to a community bank leverage ratio framework, in which they are exempt from risk-based capital requirements if they operate subject to a higher leverage requirement than otherwise applies to

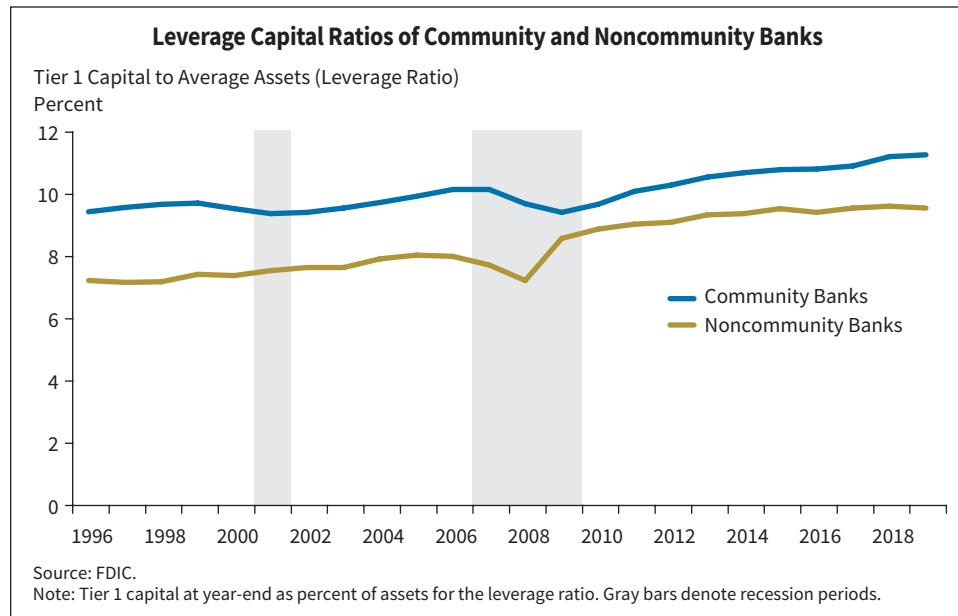
them. The rule and its associated statute were intended to relieve extremely well-capitalized banks of the burden of calculating risk-based capital requirements. As of first quarter 2020, slightly less than 40 percent of the 4,327 eligible banks in the United States had chosen to adopt the community-bank leverage framework.

Under Basel III, Community Banks Built Capital More Than Noncommunity Banks, and Grew Their Loans Faster as Well

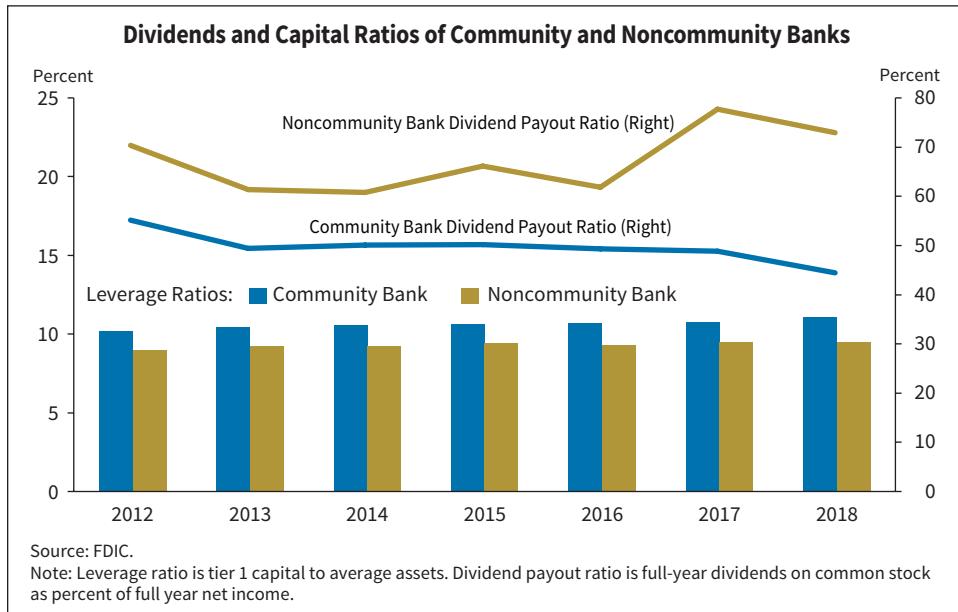
The U.S. banking agencies proposed the Basel III rule in 2012 and finalized it in 2013, with an effective date for most banks of January 1, 2015, and a phase-in period scheduled to end January 1, 2019 (year-end 2012 through year-end 2018 is referred to here as the Basel III response period). Broadly speaking, the new rules (1) increased the numerical level of *risk-based* capital requirements by 2 percentage points while leaving leverage requirements for most FDIC-insured institutions unchanged; (2) changed certain risk weights; and (3) restricted the recognition in regulatory capital of certain assets, and of certain debt instruments (Trust Preferred Securities) that were formerly included in regulatory capital for bank holding companies.

As background, banks must maintain capital at a specified minimum ratio of their assets. For community banks, *this simple leverage ratio requirement was not changed by Basel III.*

Chart 5.5



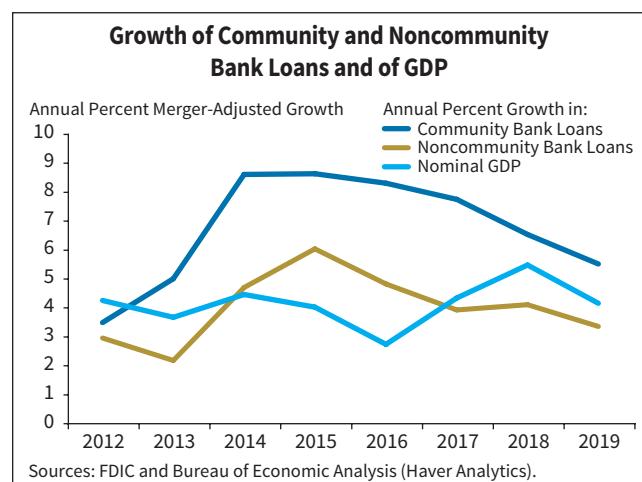
⁵ The Small Bank Holding Company Policy Statement does contain exceptions whereby some bank holding companies with assets less than the size threshold may be subject to consolidated capital requirements.

Chart 5.6

Throughout 2012–2019, community banks also had to ensure their capital exceeded specified ratios of so-called *risk-weighted assets*. Basel III increased the required risk-based ratios and changed some of the methods for calculating risk-weighted assets, and as a result, many banks held more capital. Because of its simplicity, the leverage ratio is the easiest way to describe how much capital banks hold, and it is used throughout this analysis to describe capital trends during the Basel III response period.

At year-end 2019, both community banks and noncommunity banks had leverage ratios higher than at any time since data were reported in this format, and about 2 percentage points higher than their banking crisis lows (Chart 5.5). Some of the increase in leverage ratios depicted in the chart is likely attributable to banks' rebuilding capital from the losses experienced in the crisis, and some is likely attributable to Basel III.

Chart 5.5 shows that during the Basel III response period, community banks had higher leverage ratios, and increased those ratios more, than did noncommunity banks. Chart 5.6 shows that dividend policies were an important driver of these trends. From 2013 forward, community banks' dividend payout ratios never exceeded 50 percent. The payout ratios of noncommunity banks were never less than 60 percent, partly explaining why noncommunity banks' leverage ratios remained at least a full percentage point less than the comparable ratios of community banks. Chart 5.7 shows that during 2012–2018, while community banks grew their capital more than

Chart 5.7

noncommunity banks, they also grew their loans on a merger-adjusted basis faster than noncommunity banks and faster than nominal GDP. Charts 5.6 and 5.7 illustrate the important point that higher or increasing capital ratios do not automatically imply lower loan growth, because banks can increase their capital ratios by growing capital rather than by reducing loan growth.

New Basel III Regulatory Capital Deductions Did Not Affect Most Community Banks

With these broad comparisons to noncommunity banks for context, we now turn to a more specific discussion of Basel III relative to community banks. As indicated in Table 5.1, Basel III was proposed in 2012, published as a final rule in 2013, and phased in for community banks from January 1,

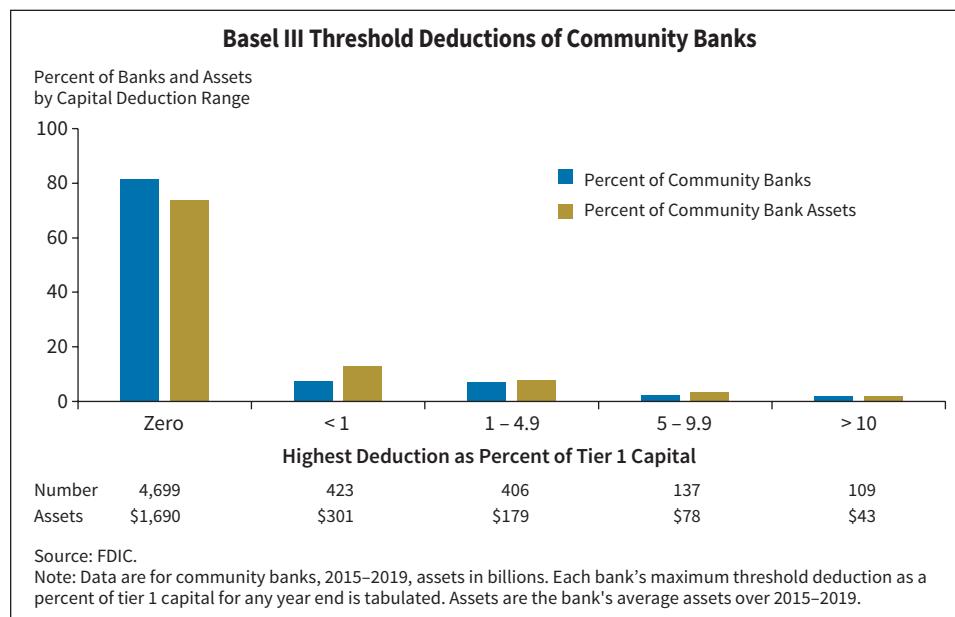
Table 5.1 Median Leverage Ratios of Community Banks, 2012–2018

Date (Year End of Each Year)	2012	2013	2014	2015	2016	2017	2018
Leverage Ratio (Percent)	9.90	10.12	10.25	10.40	10.46	10.54	10.87

Abbreviated Basel III chronology for banks not subject to the advanced approaches:
 August 2012: proposed rule
 July 2013: final rule published
 January 1, 2014–December 31, 2014: old rule in effect
 January 1, 2015–January 1, 2019: Basel III phase-in period*
 *Certain originally scheduled deductions from regulatory capital were subsequently eliminated.

Source: FDIC.

Chart 5.8



2015 to January 1, 2019. Table 5.1 tracks the year-by-year median leverage ratios of community banks during this time. Roughly speaking, by year-end 2018 the median community bank was operating with \$11 in tier 1 capital per \$100 in assets, up from \$10 per \$100 in 2012. Historical experience has been that banks with more capital have lower failure rates, as discussed, for example, in *Crisis and Response: An FDIC History, 2008–2013*.⁶ All else equal, this aspect of Basel III should make community banks more resilient in periods of stress.

In addition to requiring a higher level of regulatory capital, Basel III tightened limits on the capital recognition of deferred tax assets and mortgage servicing assets, and introduced limits on the recognition of investments in the capital of other financial institutions.⁷ An important part of the phase-in referenced in Table 5.1 was the gradual

introduction of these deductions from regulatory capital, known as “threshold deductions.” As Chart 5.8 indicates, these deductions did not affect most community banks: 80 percent of community banks never had a threshold deduction in any year-end through 2019. The chart also indicates that the deductions were material for some institutions, amounting (for example) to more than 10 percent of tier 1 capital for 109 institutions at some point during the years 2015–2019.

Healthy Community Banks Increased Capital Ratios by Retaining Earnings and Raising Capital, While Weaker Banks Were More Likely to Curtail Loan Growth

It is interesting to know how community banks effected the increase in capital ratios during the Basel III response period. Broadly speaking, a bank that increases its capital ratios must increase its capital by a larger percentage amount than it increases its loans or other assets. Some banks might do this by maintaining growth in their loans

⁶ See page 123 of *Crisis and Response*.

⁷ Mortgage servicing activity of community banks is discussed in the next section of this chapter.

Table 5.2 Components of Community Bank Capital Ratio Changes, 2012–2018

Community Banks That Were:	End of 2012				6-Year Total (Percent of 2018 Leverage Assets)			6-Year Growth (Percent)			End of 2018
	Number	Assets (\$ Billions)	Leverage Ratio (Percent)	PDNA (Percent of Tier 1 Capital)	Inflow: Net Income	Inflow: Capital Raise	Outflow: Common Dividends	Tier 1 Capital	Leverage Assets	Loans	
Less Than Well Capitalized	97	28	5.04	210	2.44	4.33	-0.60	157	26	40	10.23
Well Capitalized With:											
Low PDNA	2,992	767	10.70	8	6.36	0.75	-2.97	48	40	62	11.25
Medium PDNA	878	251	10.50	30	5.47	0.55	-2.63	36	28	43	11.16
High PDNA	339	102	9.03	87	4.00	1.44	-2.11	40	7	20	11.87
Well Capitalized Low PDNA With:											
High RBC	2,631	652	11.04	8	6.38	0.65	-2.97	44	38	61	11.54
Med RBC	323	107	8.75	9	6.25	1.20	-2.95	71	54	65	9.73
Low RBC	38	8	8.25	5	6.32	1.74	-2.81	96	66	72	9.71

Source: FDIC.

Note: Only includes community banks reporting at every year end from 2012 through 2018 that made no acquisitions. “Leverage assets” refers to “total assets for the leverage ratio” from Call Report schedule RC-R. Well capitalized banks are grouped in two ways. Past due and nonaccrual (PDNA) loan ratio - defined as 90 days past due, nonaccrual, and other real estate owned - grouped by less than 20 percent of tier 1 capital (Low PDNA), 20 percent to 50 percent of tier 1 capital (Med PDNA), and greater than 50 percent of tier 1 capital (High PDNA). High risk-based capital (High RBC) is tier 1 capital to risk-weighted assets greater than 12 percent, medium RBC (Med RBC) is tier 1 capital to risk-weighted assets between 10 and 12 percent, and low RBC (Low RBC) is tier 1 capital to risk-weighted assets below 10 percent. While net income, external capital raises, and outflows in the form of dividends on common stock are important factors explaining the change in equity capital from one time period to the next, they are not the only factors. The three inflow and outflow columns in this table are not intended to permit a complete reconciliation of the change in capital ratios from 2012 to 2018.

or other assets while retaining more of their earnings or raising capital externally, while others might not be willing or able to increase their capital but instead might grow their loans or other assets more slowly. Table 5.2 details the drivers of changes in capital ratios during 2012–2018 for 4,306 institutions that were community banks in 2012, that reported in every year-end through 2018, and that did not acquire another bank. Analyzing trends for this population of banks allows a focus on the capital management decisions of banks in continuous existence during the Basel III response period.

Before discussing Table 5.2 in any detail, it may be helpful to summarize the conclusions it appears to suggest. While community banks as a group increased capital in response to Basel III, healthy community banks do not appear to have curtailed loan growth in order to do this. For healthy banks, even those with relatively lower initial capital, earnings retention and capital raises were sufficient to increase capital ratios while maintaining strong loan growth. Banks with higher levels of troubled assets or that were less than well capitalized, generally had lower

earnings available for retention. These banks generally had a greater need than other banks to increase their capital ratios. They did so with a combination of more substantial capital raises and slower loan growth than other banks.

In more detail, Table 5.2 depicts the 2012 and 2018 leverage ratios of various groups of banks, along with the inflows during the full six years from income and capital raises, and the outflows from dividends, expressed in units of the 2018 leverage ratio. Thus, for example, the 97 banks in row 1, which were less than well capitalized in 2012 under the old rules, increased their leverage ratios from about 5 percent to about 10.2 percent during the six years, with about 4.3 percentage points of the 5.2 percentage point increase contributed by capital raises. Another way of accounting for the increase in leverage ratios is that it reflects faster growth of capital than of assets, and these growth rates, along with that of loans, are also reported. Thus, for example, these 97 banks grew their loans 40 percent during the six years and their assets 26 percent, but roughly doubled their leverage ratios because their capital increased by 157 percent.

The next three rows segment the 4,209 well-capitalized community banks by the ratio of noncurrent loans and leases plus other real estate to assets as of year-end 2012. The two groups with higher levels of troubled assets started the period with lower leverage ratios, earned less income over the period, and grew their leverage ratios through a combination of higher capital raises, somewhat lower dividends, and somewhat slower loan growth. Some of the banks in these two groups may have been subject to supervisory directives to limit growth at some point during the six years.

The last three rows limit the focus to 2,992 well-capitalized community banks with low levels of troubled assets. Their approaches to capital management during the six years were more likely to reflect “pure” responses to Basel III, without a separate motive to build capital coming from high volumes of troubled assets or supervisory directives. The table segments these generally healthy banks by their initial tier 1 risk-based capital ratios. Banks in the low and medium capital groups were those that had chosen to manage to lower capital ratios, but then may have had an impetus from Basel III to increase those ratios in order to maintain what they viewed as an appropriate cushion above the new Basel III requirements. The importance of the last three rows is that while the banks in the two lower capital groups did increase their leverage ratios more than the banks in the higher capital group,

they did so with earnings retention and comparatively higher capital raises, while maintaining higher rates of loan growth than any other subset of banks considered in the table.

Institutions Resulting From Community Bank Mergers Generally Had Lower Capital Ratios Than Before the Mergers

Table 5.3 provides information about the capital effects of mergers during acquisition years. The table shows that acquirers generally had lower leverage ratios than the banks they acquired, especially toward the end of the 2012–2019 period; that acquirers raised capital and paid dividends at rates that exceeded community bank averages during acquisition years; and that on a merger-adjusted basis, leverage ratios of the resulting entities were typically lower than before the acquisition. Higher dividends and capital raises may reflect anticipated merger-related benefits such as those derived from eliminating duplicative overhead costs over time. With regard to the reduction in leverage ratios, it is possible that acquirers tended to have greater focus on growth and return-on-equity than did the non-acquiring banks depicted in Table 5.2. Whatever the reason, the effects of acquisitions on community bank leverage ratios ran directionally counter, albeit modestly, to the general increase in leverage ratios reported in Table 5.2.

Table 5.3 Leverage Ratios, Capital Ratios, and Dividends in Community Bank Mergers, 2013–2019

Year	CBs Acquiring During Year			CBs Acquired During Year			Year-Ago Leverage Ratio (Merger-Adjusted Percent)	One Year Change in Leverage Ratio (Merger-Adjusted, Percentage Points)	Acquiring Banks' Capital Raise (Percentage Points)	CB Average Capital Raise (Percentage Points)	Acquiring Banks' Average Dividend Payout Ratio (Percent)	CB Average Dividend Payout Ratio (Percent)
	Number	Leverage Assets (Billions, as of Prior Year End)	Leverage Ratio (Percent, as of Prior Year End)	Number	Leverage Assets (Billions, as of Prior Year End)	Leverage Ratio (Percent, as of Prior Year End)						
2013	146	\$95	9.46	164	\$31	9.67	9.51	0.01	0.42	0.17	57	50
2014	166	\$137	10.20	186	\$39	10.00	10.15	-0.16	0.46	0.19	83	49
2015	196	\$198	10.05	219	\$46	10.40	10.12	-0.31	0.45	0.18	65	50
2016	191	\$194	10.38	204	\$47	10.28	10.36	-0.24	0.61	0.22	70	50
2017	146	\$151	10.28	169	\$47	10.60	10.36	-0.07	0.73	0.32	76	47
2018	178	\$254	10.07	201	\$55	10.89	10.22	-0.05	0.75	0.25	54	45
2019	157	\$220	10.55	171	\$53	12.02	10.84	-0.60	0.69	0.29	81	51

Source: FDIC.

Note: CB = Community Bank. Leverage assets is “total assets for the leverage ratio” from Call Report schedule RC-R. Change in leverage ratio is the difference from the prior year (for example, in the last row, -0.60 signifies that the year end 2019 leverage ratio for the acquiring banks was 10.24 percent). Capital raise is sum of net sale of stock and other transactions with stockholders, in percentage points of leverage assets as of the year end for the row. Dividend Payout Ratio is dividends on common stock as a percent of net income during acquisition year. Table includes affiliated and unaffiliated acquisitions but no failed bank acquisitions. For this table, a community bank is a bank that meets the community bank definition at any of the year ends from 2013 to 2019.

Many Important New Regulations Dealt With 1–4 Family Residential Mortgage Lending and Servicing

Between July 2008 and November 2019, largely in response to laws enacted to address abuses in subprime and alternative residential mortgage lending and mortgage servicing, federal agencies issued 36 distinct substantive final rules governing various aspects of 1–4 family residential mortgage lending and mortgage servicing (in this chapter, any reference to “mortgages” refers to 1–4 family residential mortgages). The peak of this rule-writing activity occurred in January 2013, when the Consumer Financial Protection Bureau (CFPB) issued six substantive final rules (five alone and one jointly with other agencies) addressing residential mortgage lending and servicing. Changes to the residential mortgage and mortgage servicing rules, based on their sheer number and scope, have a strong claim to being viewed as the most important of the post-crisis regulatory changes.

Broadly and collectively, the mortgage rules addressed matters including but not limited to: (1) establishing disclosure, registration, and qualification standards for mortgage loan originators, and the bases on which mortgage originators could be compensated; (2) defining high-cost mortgages and capping or prohibiting certain fees and loan terms for them, and requiring borrowers for those mortgages to receive housing counseling; (3) establishing ability to repay standards with which a defined class of Qualified Mortgages was presumed to comply; (4) requiring appraisals, including—for certain higher-priced mortgages—a physical inspection of the interior of the property; (5) excepting small rural lenders from certain requirements; and (6) providing that, on a time-limited basis, mortgages sold to the federal housing enterprises were deemed Qualified Mortgages.

The servicing rules, among other things: (1) prohibited a number of specific mortgage servicing practices; (2) prohibited foreclosures while an application for a mortgage modification was under review; (3) required servicers to inform borrowers who missed two consecutive payments about loss-mitigation options to retain their homes; and (4) included exceptions from certain requirements for servicers that service 5,000 or fewer loans that they or an affiliate originated. For context regarding the importance of the small servicer exemption, CFPB (2019) estimated that as of year-end 2015, 95 percent

of servicers that were depository institutions serviced 5,000 or fewer loans.⁸

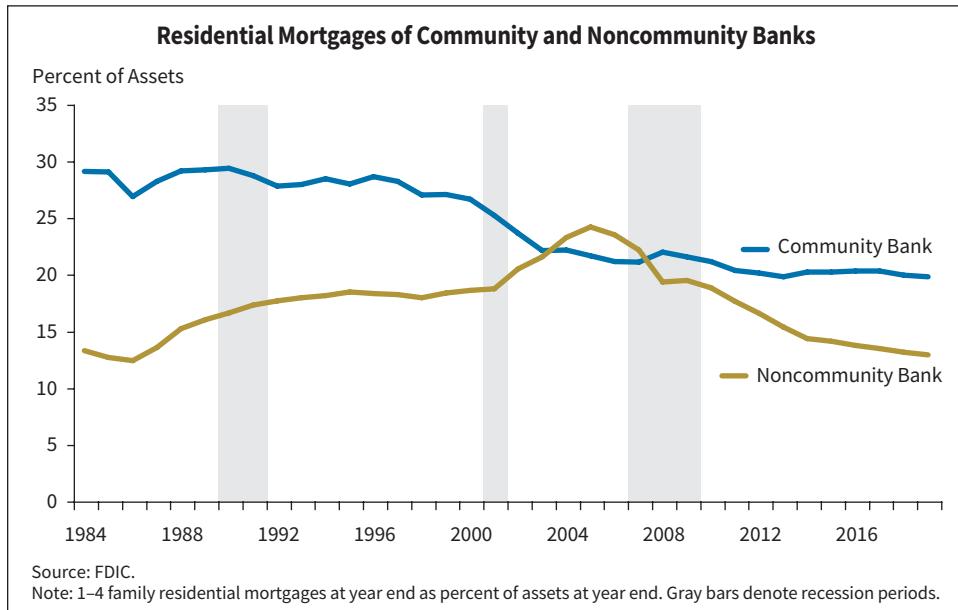
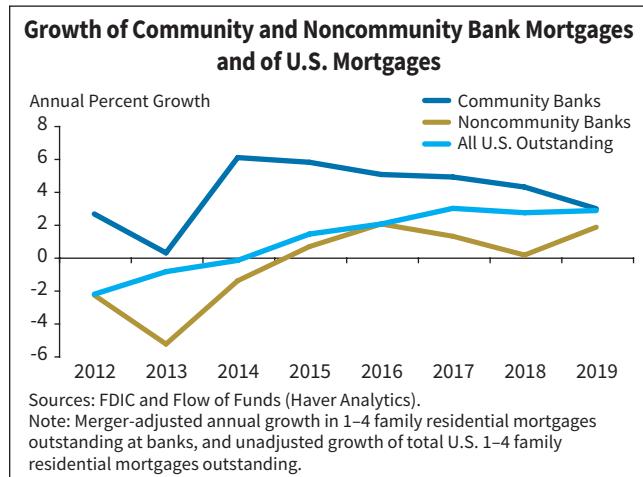
Community Banks’ Mortgage Growth Has Outpaced Growth of U.S. Mortgages Outstanding and Growth of Mortgages of Noncommunity Banks

Community bank mortgage lending since the banking crisis needs to be considered in the context of broader mortgage trends. First, the bursting of the pre-crisis housing bubble left an imprint in the data that still existed at year-end 2019: the total volume of outstanding 1–4 family residential mortgages in the United States declined for seven years starting in 2008 and, while slowly recovering, as of year-end 2019 it remained just below the 2008 peak of \$11.3 trillion. Second, at year-end 2019 the housing government-sponsored enterprises (GSEs) and GSE mortgage pools held 63 percent of outstanding U.S. 1–4 family residential mortgages, a historic high. It is possible that the Qualified Mortgage safe harbor for loans sold to GSEs contributed to the growth of GSE holdings. Third, at least among the largest originators and servicers of 1–4 family residential mortgages, the share of nonbank firms increased in the years before 2019.⁹

Despite the generally subdued backdrop for aggregate residential mortgage lending during the post-crisis period, and notwithstanding the new regulations, community banks as a group continued to grow their residential mortgage portfolios. As of year-end 2019, over 99 percent of community banks reported some level of 1–4 family residential mortgages, a percentage that has held steady for many years. As Chart 5.9 shows, between 2011 and 2019, the dollar weighted average mortgage loan to asset ratio of community banks held steady at about 20 percent and was only slightly down from its 2005 level of 22 percent shortly before housing prices reached their pre-crisis peak. This steady trend contrasts sharply with the decline in the same ratio for noncommunity banks. And, notably, between 2012 and 2019, the merger-adjusted growth of residential mortgage loans on the balance sheet at community banks far exceeded the merger-adjusted growth of mortgage loans of noncommunity banks and the overall growth of U.S. 1–4 family residential mortgage loans outstanding (Chart 5.10).

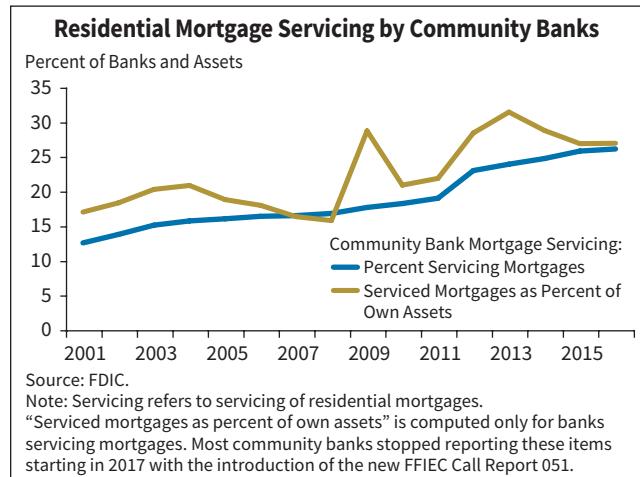
⁸ See page 106 of CFPB (2019).

⁹ Shoemaker (2019).

Chart 5.9**Chart 5.10**

Moreover, the percentage of community banks that service 1–4 family residential mortgages owned by others (a category that includes mortgages those banks originated and sold to a GSE with servicing retained) increased more or less steadily from 2001 to 2016, the last year most institutions reported these data, going from about 11 percent of community banks in 2001 to about 26 percent in 2016 (Chart 5.11).¹⁰ Data that were still being reported in 2019 provided no indication that community bank mortgage servicing had dropped off after 2016. Specifically, the percentage of community banks reporting servicing

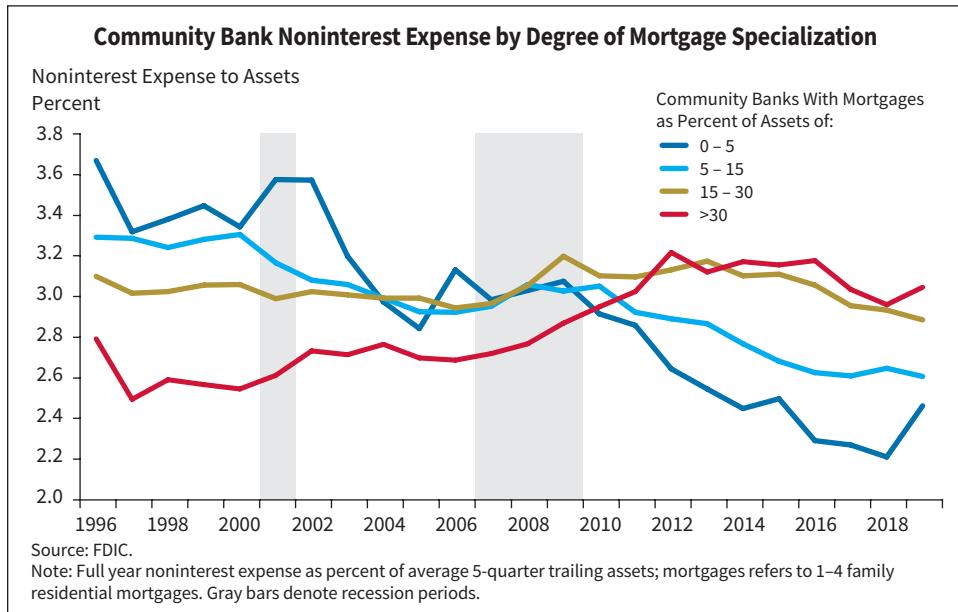
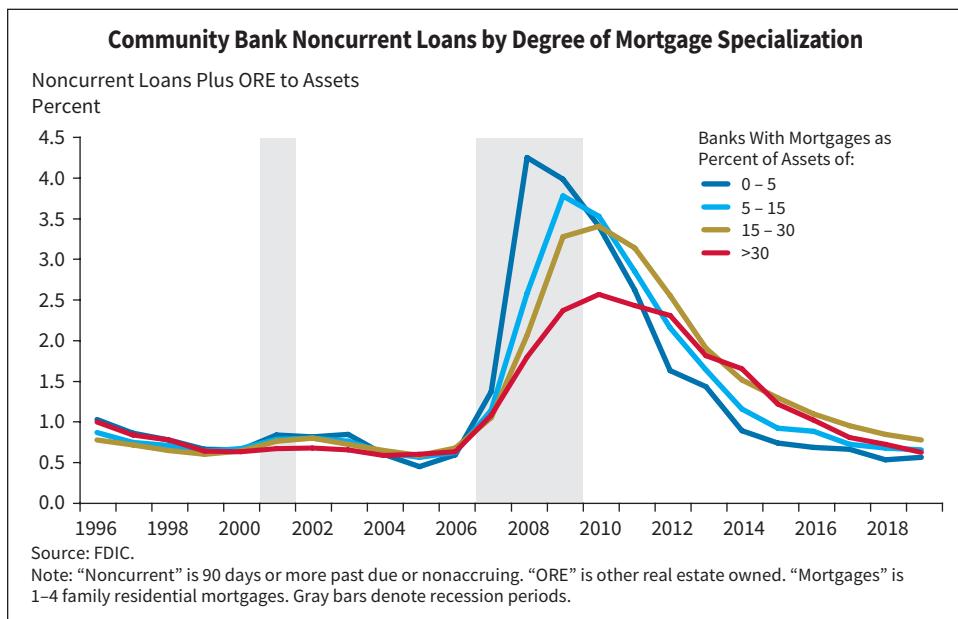
¹⁰ Most community banks began reporting using the FFIEC 051 Call Report form in 2017. That form does not include the mortgage servicing information depicted in Chart 5.11.

Chart 5.11

fees of any kind, including mortgage servicing fees, stood at 35 percent through 2019, slightly above its 2016 level.

Noninterest Expense of Mortgage Specialists Increased Relative to Other Banks After the Banking Crisis

The relatively robust continued participation of community banks in mortgage lending and servicing depicted in Charts 5.9–5.11 should not be taken to suggest that the mortgage and servicing rules had no effects on community banks. As noted above in Box 5.1, aggregate banking trends can mask developments affecting subsets of the industry. We consider—and find some evidence that may be consistent with—two effects. One is the possibility

Chart 5.12**Chart 5.13**

that the new mortgage and servicing rules caused banks in the mortgage–lending business to incur greater expense for regulatory compliance. The other is the possibility that the desire to avoid such increased expense caused some banks, particularly those with smaller mortgage programs, to reduce or exit mortgage lending.

It seems probable that banks with a substantial commitment to mortgage lending would be most likely to stay in the business and absorb whatever additional compliance costs are necessary, and probable also that any

associated increase in noninterest expense could be most readily observed for them.¹¹ Chart 5.12 depicts noninterest expense trends at community banks segmented into four groups according to residential mortgage lending concentration relative to assets. Banks with residential mortgage concentrations greater than 30 percent of assets

¹¹ The author is indebted to Nathan Hinton and Kevin Anderson, whose internal FDIC research in 2016 analyzed noninterest expense of community bank mortgage specialists compared with community banks having other degrees of residential mortgage concentration. Their research included preparing charts similar to Charts 5.12 and 5.13 in this chapter.

are deemed mortgage specialists. The chart depicts an inversion in noninterest expense ratios across the groups over time. The two highest mortgage concentration groups had the two lowest expense ratios pre-crisis, but post-crisis they had the two highest expense ratios. Mortgage specialists had the lowest noninterest expense ratios pre-crisis, and from 2014 to 2019 had the highest.

The post-crisis inversion of the relationship between noninterest expense ratios at mortgage specialists and other banks is optically consistent with the hypothesis that mortgage-related compliance costs increased as a result of the post-crisis regulations, but other factors may have been as or more important. Mortgage specialists may have been more likely to focus on building technological capabilities to compete with online and mobile technologies pursued by others in this segment. Also, as indicated in Chart 5.13, increases in noncurrent loans and other real estate during the crisis, while not as pronounced at banks with higher concentrations in residential mortgages as they were at other banks, lingered longer. Higher levels of these troubled assets at banks in the two highest mortgage concentration groups for much of the post-crisis period may be part of the reason that the noninterest expense ratios of these two groups stayed higher than at other banks during the period 2013–2019.

An Unusually High Percentage of Small Mortgage Lenders Reduced Their Mortgage Holdings in the Years After the Banking Crisis

We next consider the possibility that some banks reduced or exited the mortgage business to avoid regulatory compliance costs associated with the new rules. The results of banker surveys suggest this possibility. In one survey (American Bankers Association (2016)), for example, 33 percent of respondents in 2014, and 24 percent of respondents in 2015, stated that regulation was having an “extreme negative impact” on their residential mortgage lending business. Other surveys and anecdotal reports stated that many community banks were considering exiting mortgage lending altogether.

The results shown in Charts 5.9–5.11 make clear that community banks, in the aggregate, have by no means exited residential mortgage lending. Nevertheless, it is possible that some community banks may have done so, and Call Report data will help us explore this possibility.

The analysis will shed only indirect light on the subject. Call Reports of most small banks do not contain data on mortgage originations (Box 5.2 discusses the limitations—for our purposes—of Home Mortgage Disclosure Act data on mortgage originations).¹² Since mortgages can stay on a bank’s balance sheet for many years, declines in outstanding mortgage balances or mortgage interest income from one year to the next may mean the bank exited the business, or may mean more mortgages paid off that year than were originated, or that mortgages were sold rather than held. Given these limitations, the analysis will view sustained annualized reductions in mortgage balances over a period of years as an imperfect proxy for a strategic decision to scale back or exit mortgage lending. The analysis evaluates whether substantial annualized reductions in mortgage balances were more likely for banks that either were small in absolute size, or had small mortgage operations relative to their size. This approach is intended to evaluate the idea that increases in regulatory compliance costs may have made it less economical to operate a small mortgage business.

Box 5.2 Home Mortgage Disclosure Act Data: Findings and Coverage Limitations

Unless banks are exempt under Regulation C, they must report originations of 1–4 family residential mortgages pursuant to the Home Mortgage Disclosure Act (HMDA). Research on mortgage trends based on HMDA data generally does not find aggregate reductions in originations of purchase residential mortgage loans among reporting banks during the post-crisis period (see, for example, Bhutta and Ringo (2016)).

Among the banks exempt from HMDA reporting, however, are those that do not have a home office or branch in a metropolitan statistical area, and those that originated fewer than 25 home purchase loans in either of the two preceding years. This exclusion of small and rural mortgage lenders from reporting serves to limit the usefulness of HMDA data for purposes of this chapter.

For the current HMDA reporting criteria, see Federal Financial Institutions Examination Council, “A Guide to HMDA Reporting: Getting it Right,” at <https://www.ffiec.gov/hmda/pdf/2020guide.pdf>.

¹² Call Report schedule RC-P requires reporting of mortgage originations by banks with assets exceeding \$1 billion or banks that originated more than \$10 million of mortgages in each of the two preceding quarters. Call Report form FFIEC 051, filed by most community banks, does not include schedule RC-P.

Table 5.4 Changes in Mortgage Holdings of Community Banks, 1995–2019

Date Range (Year End of Each Year)	Annualized Change in 1–4 Family Mortgage Loan Portfolio	Number of Community Banks	Share of Community Banks (Percent)	Average Community Bank Assets (Millions \$)	Past Due and Nonaccrual Loans and Other Real Estate Owned as a Share of Assets (Percent)	Share of Community Banks With Positive Growth in Other Loans (Percent)
As of December 31, 2013						
2013–2019	Increase	4,371	69	353	1.43	91
	-0.1 Percent to -4.9 Percent	938	15	253	2.16	79
	-5.0 Percent to -9.9 Percent	339	5	234	4.13	63
	Less Than -10 percent	362	6	223	2.45	60
As of December 31, 2007						
2007–2013	Increase	4,665	61	239	0.86	70
	-0.1 Percent to -4.9 Percent	1,514	20	250	1.14	44
	-5.0 Percent to -9.9 Percent	693	9	229	1.25	38
	Less Than -10 percent	444	6	246	2.32	37
As of December 31, 2001						
2001–2007	Increase	6,095	71	177	0.66	92
	-0.1 Percent to -4.9 Percent	1,277	15	143	0.74	80
	-5.0 Percent to -9.9 Percent	509	6	169	0.85	70
	Less Than -10 percent	436	5	211	1.08	60
As of December 31, 1995						
1995–2001	Increase	8,433	81	123	0.88	93
	-0.1 Percent to -4.9 Percent	830	8	114	1.08	81
	-5.0 Percent to -9.9 Percent	359	3	143	1.35	80
	Less Than -10 percent	311	3	125	1.96	65

Source: FDIC.

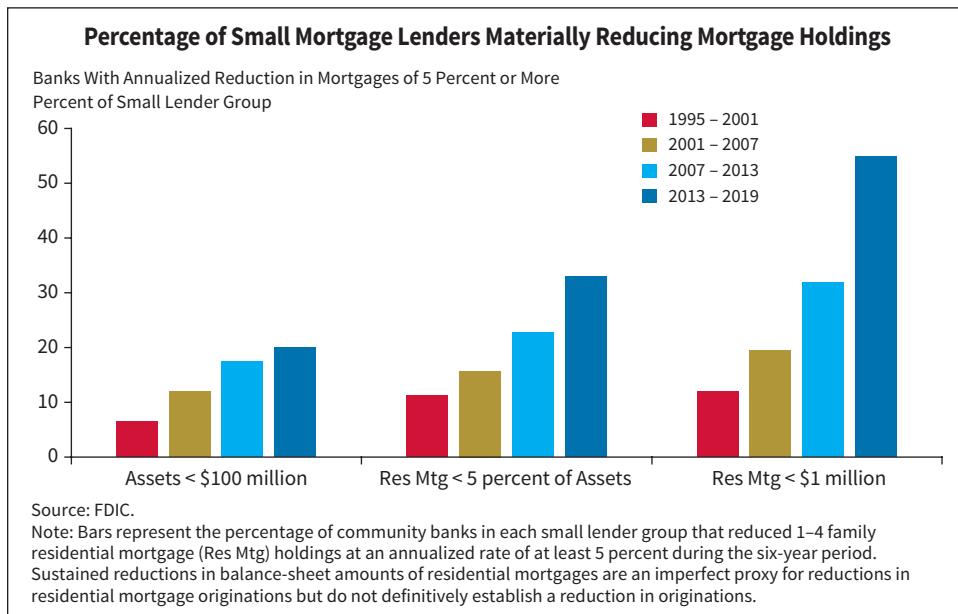
Note: Table does not include community banks that stopped reporting in 1996, 2002, 2008, or 2014 or that did not hold 1–4 family mortgages at year ends 1995, 2001, 2007 or 2013. For such banks no annualized change in mortgage holdings could be calculated. Mortgage changes are annualized so that cumulative changes during the full date ranges would be larger.

Table 5.4 considers four six-year periods, and groups the community banks existing at the beginning of each of the four periods according to their annualized percentage change in residential mortgages during that period, or during their remaining existence, whichever was shorter. Thus, for example, a bank in the mortgage growth category corresponding to annualized reductions of 10 percent or more would have reduced its mortgages by well over 50 percent if it existed for all six years of a period, a reduction that quite possibly reflected its exit from the business. Banks that reported no mortgages at the start of a period, or that stopped reporting within one year of the start of a period are not included, since no annualized change in mortgages could be computed for them.

Table 5.4 indicates that with regard to community bank reductions in mortgage holdings, there are a number of

similarities between the post-crisis period and earlier periods. For example, in both the six post-crisis years starting in 2013 and the six pre-crisis years starting in 2001, about 26 percent of community banks had annualized reductions in mortgage holdings. In all four of the six-year periods, community banks that reduced mortgage holdings tended to have higher levels of noncurrent loans and other real estate. In all periods except for the banking crisis, the majority of community banks with annualized reductions in mortgages had annualized increases in their other loans. This suggests that the reasons for the reductions in mortgage loans may often have been specific to that business line rather than to bank-wide or local economic issues. Examples of issues specific to mortgages in the post-crisis period could include, for example, risks associated with holding long-maturity assets on balance sheet in a low interest rate

Chart 5.14



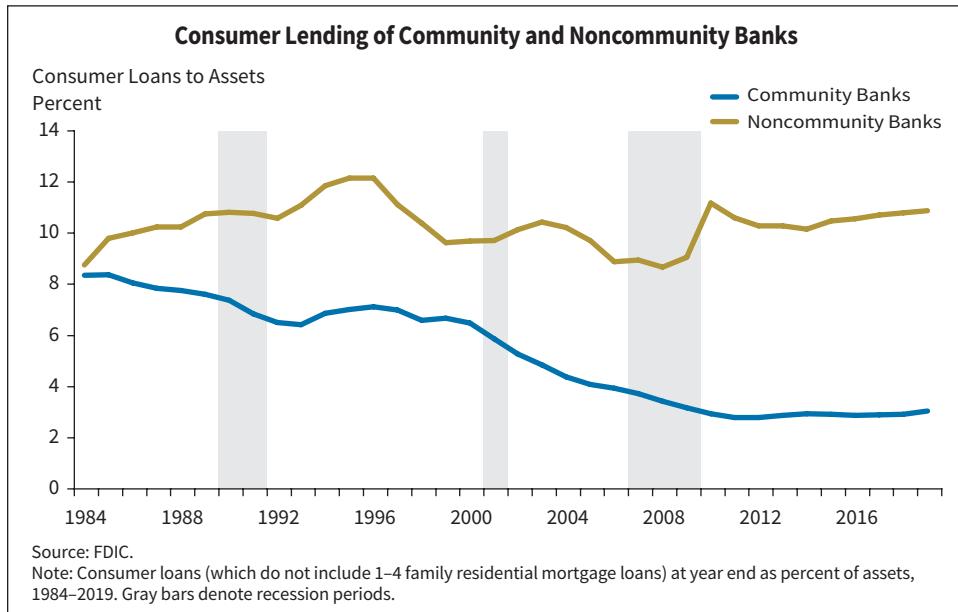
environment. Similar to the overall picture suggested by Charts 5.9 and 5.10, however, the overall picture suggested by Table 5.4 does not support the idea that unusual numbers of community banks *in the aggregate* were exiting mortgage lending during the post-crisis period.

Table 5.4 does, however, suggest that during the post-crisis period, the size distribution of banks that were reducing their mortgage holdings became skewed toward smaller banks. Specifically, during 2013–2019 the average asset size of community banks with annualized increases in mortgage holdings was \$353 million, exceeding by at least \$100 million the average asset size of community banks that reduced their mortgage holdings. In the other three periods, in contrast, no systematic differences in asset size are evident in the table between banks that were reducing their mortgages and those that were increasing them.

In fact, Chart 5.14 indicates, during the post-crisis period small mortgage lenders reduced their mortgage holdings with greater frequency than in any previous period. To anticipate the discussion, the chart suggests that operating a small mortgage program or making mortgages as an occasional customer accommodation may be becoming less economical over time. The chart gives information about three possible definitions of a small mortgage lender, and the patterns are robust to the definition used: community banks with assets less than \$100 million, those with mortgages less than 5 percent of assets, and those with total mortgages outstanding less than \$1 million. The chart reports the proportion of banks in each of these small-

lender groups that subsequently reduced their mortgage holdings at an annualized rate of 5 percent or more during the period. The proportion of small lenders substantially reducing their mortgages increased with each successive six-year period, and has been much higher during the post-crisis period even than during the 2008–2013 banking crisis. During the post-crisis period, moreover, while about 11 percent of all community banks had annualized reductions in mortgages of 5 percent or more (Table 5.4), over 30 percent of community banks with mortgages less than 5 percent of assets, and over 50 percent of community banks with mortgages less than \$1 million, had annualized reductions of this magnitude.

In short, during the post-crisis period small mortgage lenders had sustained material reductions in mortgage lending more frequently than larger community bank mortgage lenders did, and more frequently than small mortgage lenders had in previous periods. There may be many reasons for a bank's balance-sheet holdings of mortgages to exhibit a sustained decrease, including increased sales to the GSEs (as noted above, increased sales to GSEs may themselves be driven by regulatory considerations given the Qualified Mortgage safe harbor for such loans, or by a desire to avoid the interest-rate risk associated with holding mortgages on the balance sheet). Nonetheless, the strong connection between reduced mortgage holdings and banks' asset size and scope of mortgage operations suggests there may be factors at work that are making it less economical for a bank to have a small mortgage lending function. The factors that most

Chart 5.15

readily suggest themselves are changes in financial and information technology (including increased competition from nonbank entities) that promote commoditization of retail lending, and regulatory compliance costs resulting from the large volume of new mortgage rules. It is not possible to draw firm conclusions about the relative importance of these factors.

Many Important New Rules Addressed Consumer Credit and Retail Payments

Another important group of rules implemented in the 2008–2019 period addressed the broad category of consumer credit and retail payments. Appendix B identifies and summarizes 27 distinct final rules in this category, rules that, broadly speaking, created rights and protections for consumers, and obligations for lenders, related to credit cards and other consumer credit, the use of credit reports, customer overdrafts, gift and prepaid cards, remittances, and retail foreign exchange.

Although consumer loans constituted less than 3 percent of community bank assets throughout the post-crisis period (Chart 5.15), almost all community banks have at least some consumer loans and need to be aware of changes to consumer regulations.

Requirements specific to credit card lending applied to a relatively small set of community banks. About 16 percent of community banks reported credit card loans

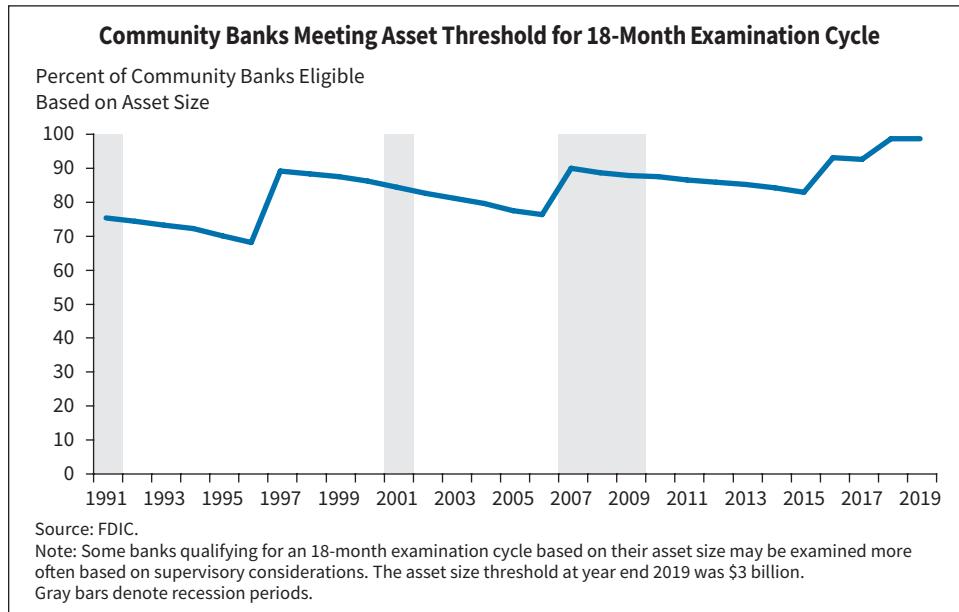
in 2019, down from about 30 percent in 2001. And even for community banks that did report credit card loans, throughout the 2001–2019 period those balances totaled less than one-half of 1 percent of those banks' assets.

New disclosure and opt-in requirements regarding overdraft programs are likely relevant to most community banks. Starting in 2015, institutions with assets of \$1 billion or more that offer one or more consumer deposit account products have had to report overdraft charges on consumer accounts. The percentage of community banks in this size group reporting overdraft fees declined from 83 percent in 2015 to 77 percent in 2019, while the amount of such fees (for banks reporting them) decreased modestly during the same period, dropping from 11 basis points of deposits to 9 basis points of deposits.¹³ Downward pressure on service charges appears to be a long-term trend. From 2001 through 2019, deposit service charges at community banks decreased from 38 basis points of deposits to 19 basis points of deposits; the corresponding decrease at noncommunity banks was from 67 basis points to 28 basis points.

International remittance transfers, which historically had been exempt from federal consumer protection laws, became subject to a disclosure and consumer

¹³ The overdraft fees reported by this category of institutions are reported on Call Report schedule RI, memorandum item 15. a), "Consumer overdraft-related service charges levied on those transaction account and nontransaction savings account deposit products intended primarily for individuals for personal, household, or family use."

Chart 5.16



protection regime, although institutions making fewer than 100 remittances per year were exempt from these requirements. At mid-2019, about 10.5 percent of community banks reported providing more than 100 international remittances per year, up slightly from 9 percent at mid-2014.¹⁴

Numerous Other Regulations Were Finalized During the Years 2008–2019

This brief overview of the remaining rules listed in Appendix B may be taken as a reminder that there were many important rule changes during 2008–2019 with which community banks had to be familiar.

The Federal Banking Agencies Implemented Important Changes to Safety-and-Soundness Regulations

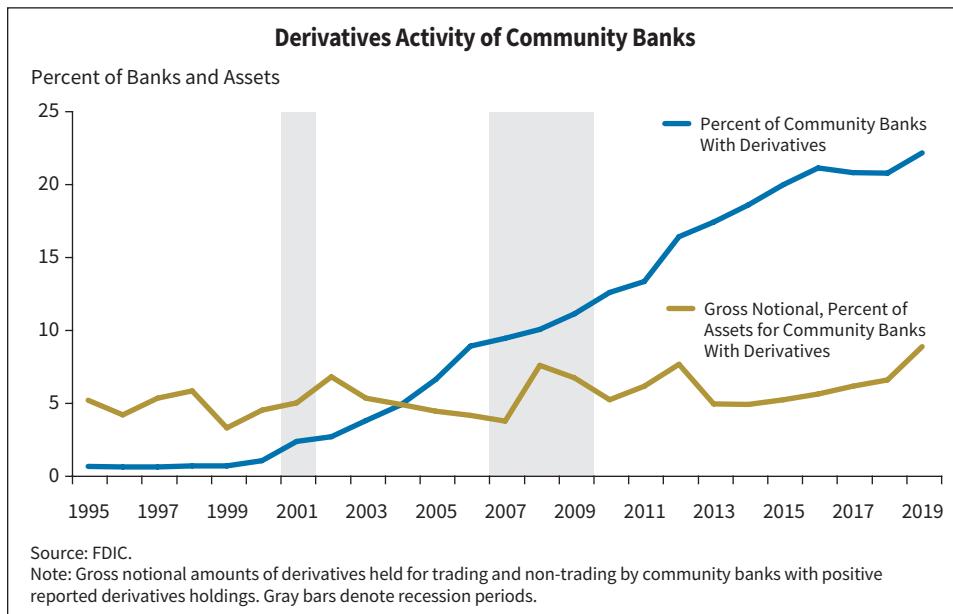
There were a number of regulatory changes to safety-and-soundness rules affecting small banks during the period 2008–2019, many of them statutory. Derivatives exposures were incorporated into the national bank legal lending limit; regulations governing banks' permissible investments were de-linked from credit ratings; a portion of reciprocal deposits was excluded under certain circumstances from being defined as brokered deposits; and the maximum asset threshold for eligibility for an 18-month examination cycle (rather than a 12-month

cycle) was increased from \$500 million to \$1 billion and later to \$3 billion. As of year-end 2019, more than 98 percent of community banks met the asset size threshold for an 18-month examination cycle (Chart 5.16). In 2019, the loan size threshold above which federally related mortgage loans require an appraisal was increased from \$250,000 to \$400,000 for residential mortgages and from \$250,000 to \$500,000 for commercial mortgages.

Other important safety-and-soundness rule changes affected community banks to varying degrees. Risk retention rules, which require securitizers to retain a 5 percent loss exposure to assets they securitize unless one of numerous exceptions applies, likely directly affect few community banks, but those interested in becoming active securitizers would need to be knowledgeable about these rules. The Volcker Rule's statutory prohibition on proprietary trading and ownership or sponsorship of hedge funds or private equity funds was finalized in 2013, and in 2018 it was statutorily rescinded for most banks with assets below \$10 billion. Similarly, company-run stress testing requirements for banks with assets greater than \$10 billion were implemented in 2012, but the asset threshold was statutorily raised in 2018. Very large community banks or those considering acquisitions that would cause them to exceed \$10 billion in assets would have needed to comply with or consider these stress-testing requirements.

¹⁴ These data are reported only on the June 30 Call Report.

Chart 5.17



Bank Secrecy Act and Law Enforcement Responsibilities Increased

Banks have responsibilities to take actions and provide information in support of law enforcement, and three rules put in place since 2008 increased these responsibilities. One was a requirement that U.S. financial firms that participate in designated payment systems (a group that includes most banks) establish and implement policies and procedures that are reasonably designed to prevent payments to gambling businesses in connection with unlawful internet gambling. The second established specific suspicious activity reporting and information collection requirements on providers of prepaid access devices such as cards, although the requirements generally exempted small balance products (balances below \$1000). The third was the customer due diligence rule, which requires financial institutions to identify and verify the identity of the beneficial owners of companies opening accounts, understand the nature and purpose of customer relationships in order to develop customer risk profiles, and conduct ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.

Some Rules Were Related to the FDIC's Responsibilities for Resolving Failed Banks

Some rules were driven by the FDIC's resolution responsibilities. A 2008 rule introduced the requirement

for institutions to disclose to their deposit sweep customers how their sweeps would be treated by the FDIC in the event of the bank's failure. Another 2008 rule, amended in 2017, requires that banks in a troubled condition, upon written notice from the FDIC, be able to provide specified information regarding their Qualified Financial Contracts (or QFCs, which include swaps, securities financing transactions, and repurchase agreements) to the FDIC on request as of the end of a business day. The QFC rule does not appear to have had any ancillary effect of dampening community banks' use of derivatives: on the contrary, the proportion of community banks that hold derivatives increased fairly steadily from about the year 2000 through 2019 (Chart 5.17).

The Dodd-Frank Act Made Two Important Changes to the Pricing of Bank Products and Services

The mortgage and consumer credit rules described above contain a number of fee limits or regulatory requirements that are triggered by levels of fees or interest rates. Two other notable rules from the 2008–2019 period dealt with the pricing of bank products or services. In 2011 the Federal Reserve implemented the Dodd-Frank Act's limits on the interchange fees of banks with assets greater than \$10 billion, an asset size group that has included some community banks. Also in 2011, the Dodd-Frank Act's repeal of the statutory prohibition against banks' paying interest on demand deposits took effect.

Some Rules Affect Bank Competition and Industry Structure

Some rules reflect statutory goals for the avoidance of undue concentration or anti-competitive practices in banking. One such rule from the 2008–2019 period implemented the Dodd–Frank Act’s prohibition on acquisitions if the resulting company would have more than 10 percent of all U.S. financial institution liabilities. Another rule from 2019 eased restrictions on management interlocks by permitting a management official to serve at two unaffiliated banks unless both have more than \$10 billion in assets, or unless both operate in the same geographic area.

Significant Requirements Took Effect Regarding Financial Reporting and Auditing

A significant development during the 2008–2019 period was a 2009 FDIC rule applicable to insured institutions with assets exceeding certain thresholds. Consistent with the Sarbanes–Oxley Act, the rule, among other things: (1) requires disclosure of an institution’s internal control framework and material weaknesses; (2) requires management’s assessment of compliance with laws and regulations; (3) clarifies the independence standards applicable to accountants; (4) establishes a variety of requirements regarding audit committees; and (5) establishes criteria for institutions to comply with the requirements at a holding company level. For a holding company’s insured subsidiaries to be able to satisfy the audit requirements at the holding company level, the assets of the subsidiaries must be at least 75 percent of the holding company’s consolidated assets. Institutions covered by the rule are generally those with at least \$1 billion in assets for purposes of internal control assessments and at least \$500 million for purposes of other requirements.

More recently, in 2019, the federal banking agencies expanded the eligibility of institutions that could file the most streamlined version of the Call Report, the FFIEC 051, to include insured depository institutions with total assets of less than \$5 billion that do not engage in certain complex or international activities.

Other Regulations Addressed Flood Insurance, Back-Office Functions, and Other Matters

Appendix B documents 13 other rules (or in a few cases interagency questions and answers) from the 2008–2019 period dealing with assorted other consumer protection

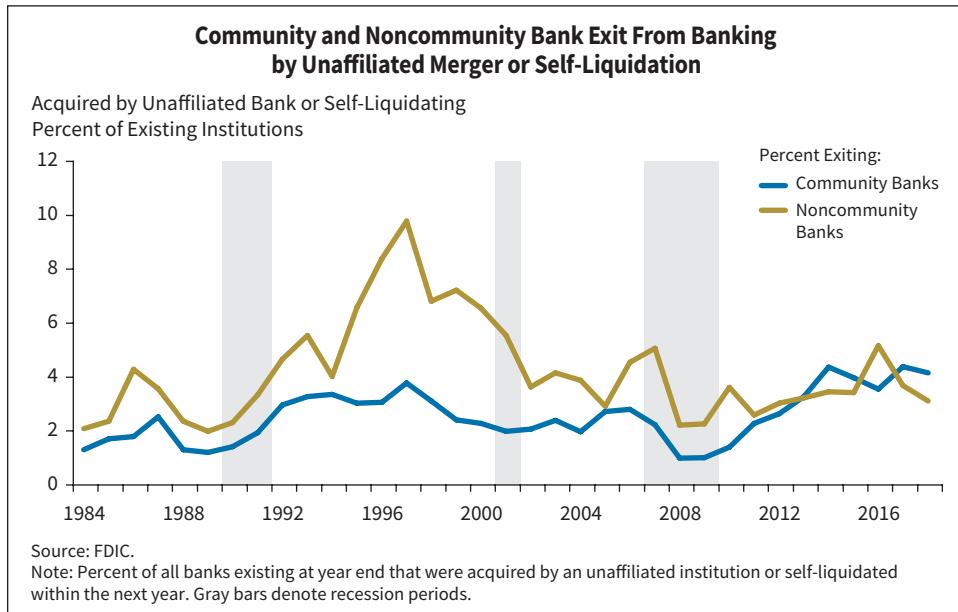
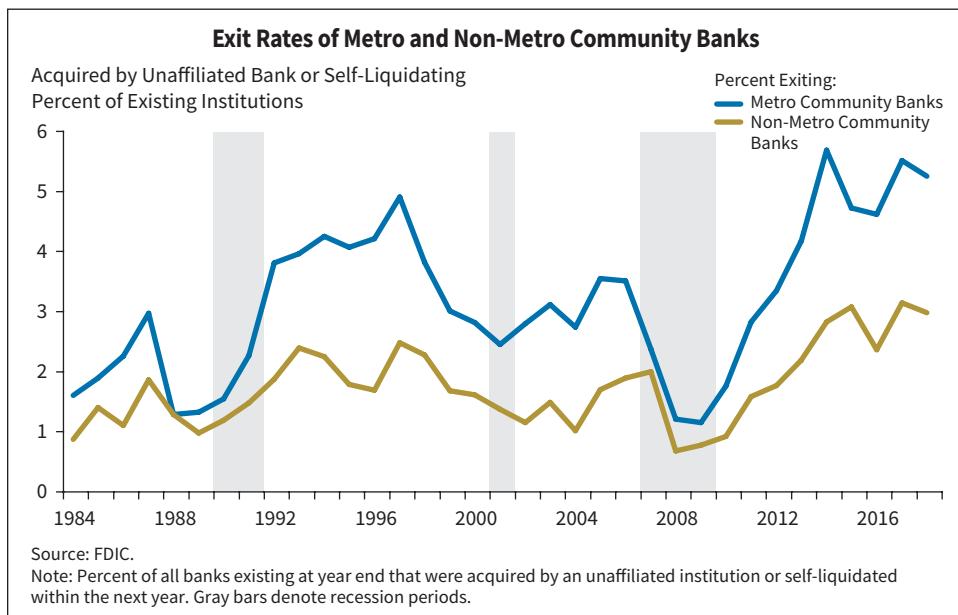
and community development matters. Among the more significant of these were two rules that together implemented the flood insurance provisions of the Biggert–Waters Act, which among other things clarified when banks could and should accept private flood insurance policies. Several rules during the 2008–2019 period addressed back-office functions, including issues arising from the banking system’s ongoing migration from paper-based to electronic payments. These included rules dealing with paper and electronic check processing and dispute resolution, funds availability, the settlement cycle for securities transactions, and other matters.

Community Bank Exit and Entry May Have Been Affected by the Pace of Regulatory Change

This analysis of regulatory changes has focused on individual rules and individual balance-sheet and income-statement categories, thus far without consideration of the possible totality of effects. Trends in bank exit and entry may shed light on such total or cumulative effects. Rates of exit from the banking industry, and entry into it, can be viewed as high-level indicators of how bankers view the economic prospects of banking franchises given a wide range of factors, including regulatory changes.

A previous section of this chapter showed that smaller community banks have had higher proportionate noninterest expense than larger community banks and that any given increment of overhead expense would weigh more heavily on their bottom lines. Accordingly, it is not unreasonable to think that changes in regulatory requirements that involve a significant learning curve, legal or consulting fees, or additional staff time could tend to depress small-bank profitability relative to other banks, with the indirect result of encouraging some small banks to exit the banking industry, or of discouraging the chartering of new small banks.

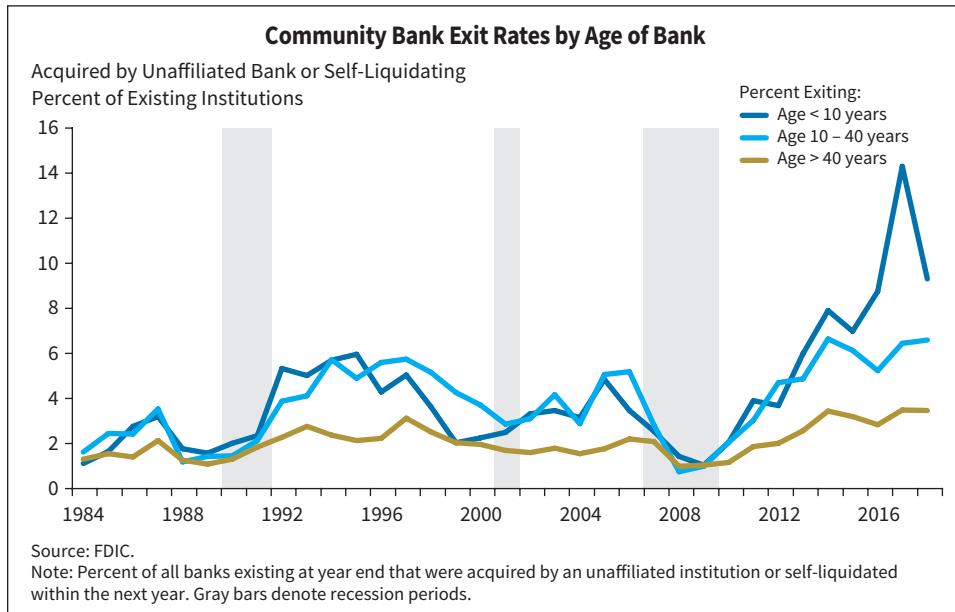
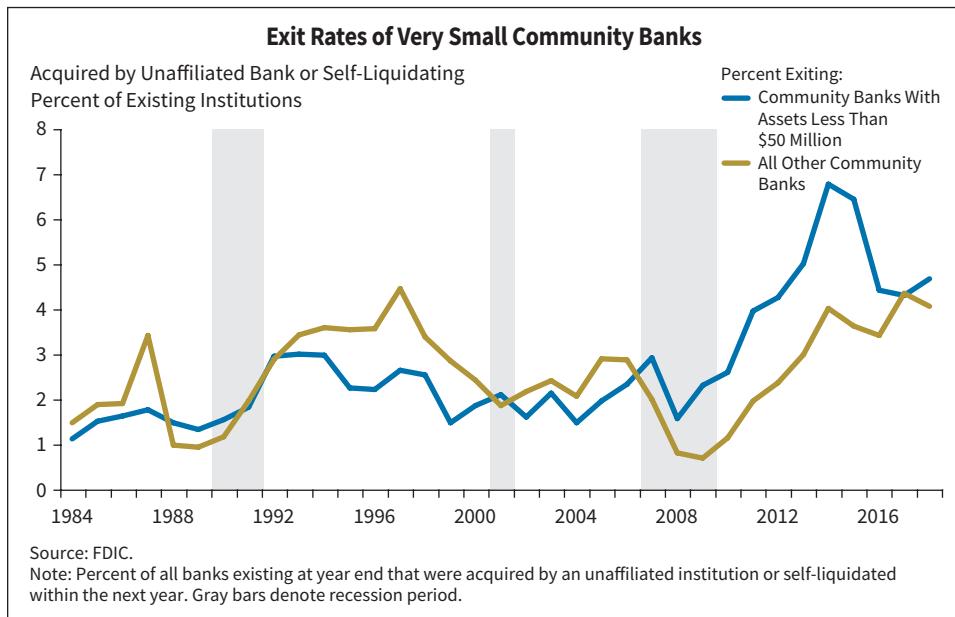
As Chapter 2 notes, banking consolidation has been underway since the 1980s, with the most rapid rate of consolidation occurring in the late 1990s. But whereas the consolidation of the 1990s had been driven by the ongoing relaxation of branching restrictions, a relaxation that resulted in consolidation of many multi-bank holding companies under a smaller number of charters, a new and important factor in the decline in the number of institutions since the 2008–2013 banking crisis was the relative dearth of new charters. Chapter 2 also notes that

Chart 5.18**Chart 5.19**

consolidation is not purely a community-bank trend—for in fact noncommunity banks have consolidated at faster rates than community banks—and in addition that when community banks have been acquired, the acquirers have mostly been other community banks.

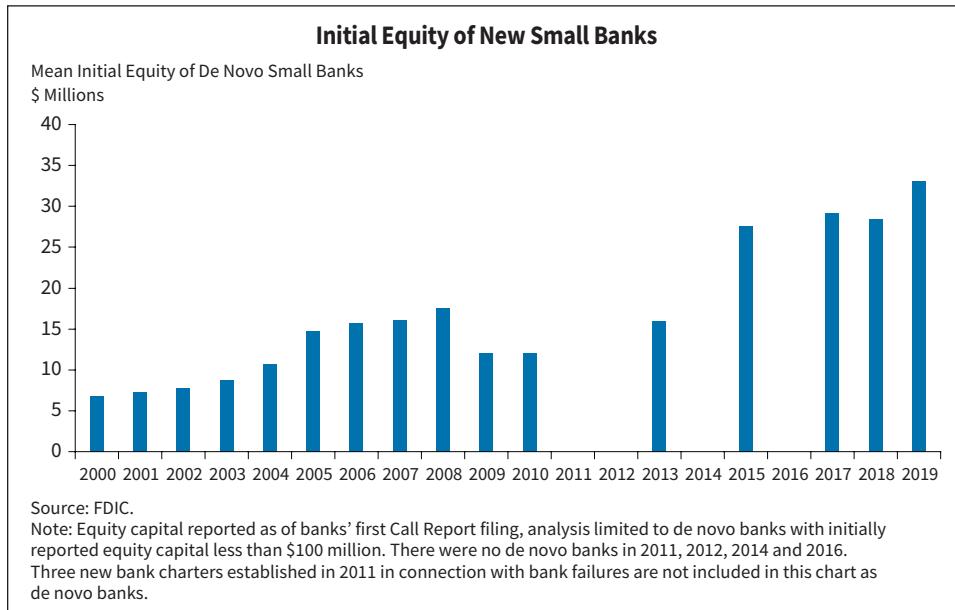
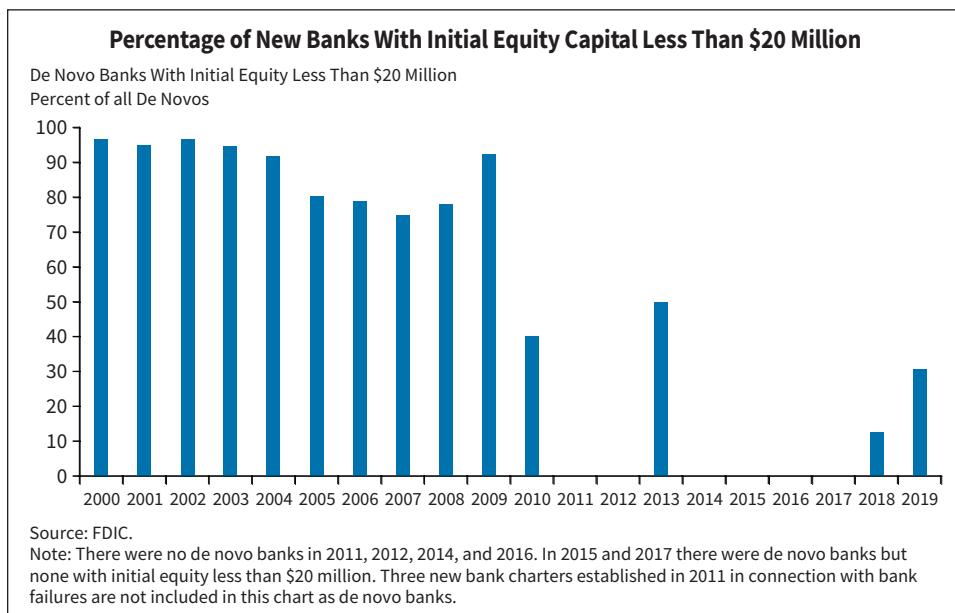
The two post-crisis developments with which this section of the present chapter is concerned are the historically high proportion of community banks exiting the banking industry in the years 2014–2019, and an apparent increase in the target asset size of new small

banks as reflected in their initial equity. Chart 5.18 depicts the annual percentages of community banks exiting the banking industry, either through acquisition by an unaffiliated institution or by self-liquidation. This type of exit would seem to reflect a decision by bank ownership that the bank's continued existence as an independent entity was no longer financially advantageous. The chart shows that community banks were exiting the banking industry at the fastest rates since 1984 (although, as the chart also makes clear, not as fast as exit rates sometimes observed for noncommunity banks), with an average exit

Chart 5.20**Chart 5.21**

rate between 2014 and 2019 of just over 4 percent, compared with the previous high of 3.7 percent in 1997. Post-crisis exit rates were particularly high for metro banks (Chart 5.19); for young banks (Chart 5.20—for this chart, young banks are defined as those less than ten years old; accordingly, they were chartered shortly before or during the 2008–2013 banking crisis); and for the very smallest banks (Chart 5.21). These charts also make clear, however, that for community banks that are rural, older, or larger in size, post-crisis exit rates also were at or near historic highs.

Regulatory factors also have been asserted to affect entry into the banking industry. Many commentators have stated that the decline in the number of new charters after the 2008–2013 banking crisis was caused partly by the regulatory environment, while other commentators have emphasized economic factors. Adams and Gramlich (2014), for example, contains an analysis of economic factors underlying chartering activity. Rather than re-examining an issue that has been studied at length elsewhere, we consider how market perceptions have

Chart 5.22**Chart 5.23**

changed as reflected by initial investment in new banks. Chart 5.22 provides indirect evidence that the target asset size of new small banks increased during the post-crisis period. The chart displays the mean equity reported in the first quarterly financial reports of new banks, as a proxy for the owners' initial capital investment. New banks with initial equity of more than \$100 million are not included, since their relative infrequency and large size would mask patterns of interest for smaller banks. Mean initial equity for these smaller banks increased, somewhat abruptly

and discontinuously, from \$11.8 million during the period 2000–2010 to \$29.6 million starting in 2015.

The marked rise in initial equity is not attributable to inflation, which was muted, or to changes in regulatory capital requirements, for those requirements had not changed enough to explain a change in initial capital of this magnitude. Inasmuch as initial equity is intended to allow the bank to achieve and support its planned asset size, it appears reasonable to suppose that the relatively few new banks chartered after the crisis had higher

projected asset sizes than new banks chartered before the crisis. The trends in Chart 5.22 suggest that proponents of new banks believed that the scale of operations needed to make a new bank successful had increased in the post-crisis period. An increase in the target size of new banks, in turn, could plausibly be associated with scale economies, attributable at least partly to regulatory compliance costs.¹⁵

The preceding discussion should not be taken to imply that new small banks can no longer be chartered or cannot be successful. As indicated in Chart 5.23, in 2018 and 2019 some banks were chartered with initial equity of less than \$20 million, a level of initial equity that had characterized the overwhelming majority of new banks chartered in the years 2000–2009.

Summary

Bankers have sometimes characterized the regulatory costs they incur as being difficult to attribute to any one set of rules, but as the cumulative effect of many rules. The review in this chapter and its appendix of a partial list of regulatory actions taken by six federal agencies (often implementing statutory mandates from Congress) from 2008 through 2019 makes clear that merely keeping current on banks' regulatory requirements as they evolve cumulatively through time is a daunting task for anyone, and certainly for a small bank with modest staff and resources.

Regulatory compliance costs may be one of a number of factors contributing, for example, to higher rates of exit from the banking industry by community banks; to an apparent increase in the target asset size of new small banks; or to a pronounced increase in the proportion of small residential mortgage lenders that are reducing their residential mortgage holdings. Most likely other factors are also very important contributors to these trends, and we draw no conclusions about the importance of any of these other factors compared with changes in regulatory compliance costs. Business consolidation is occurring in many industries, not just banking, and larger companies

in those industries may tend to favor larger banks. Keeping pace with new technologies also may be easier for larger banks. Challenges in arranging for appropriate management succession, sometimes in situations involving the generational transfer of family-owned banks, in which the following generation is not interested in taking on the operation of the family's bank, have been cited by some bankers as a factor that may influence some banks to seek an acquirer. Commoditization of retail lending also likely favors larger financial firms whose average cost structures are lower and that deploy new technology.

A shared characteristic of some of the important factors driving developments in banking—changes in customer demographics, in the nature of marketplace competition, in technology, and in regulation—is that all are factors external to a bank that can cause the bank to have to change the way it does business. All may involve a need for evolving capabilities, consultants, or other specialized staff, and all may involve relatively higher fixed costs or generally greater challenges for smaller institutions. Such factors evolve continually, making it hard from financial data alone to know whether—and in what degree—to attribute any particular trend to changes in regulation, or to one or more of the other factors.

Finally, it is important to emphasize that this study views regulations only through the lens of their effects on community banks; a discussion of the policy goals Congress has sought to achieve with its statutes, or how well the regulations have achieved those goals, is beyond the scope of the analysis. Observations in this study about the effects of rules on community banks should thus not be taken as criticisms of those rules. The overall thrust of the analysis, however, does support the idea that if the societal benefits of a thriving community banking sector are to be preserved, it is important that regulations achieve their public policy goals in ways that accommodate, to the extent appropriate, the business models and learning curves of smaller institutions with limited compliance resources.

¹⁵ See Jacewitz, Kravitz, and Shoukry (2020) for a recent analysis of bank scale economies.

Box 5.3 Regulatory Developments During the COVID-19 Pandemic

A brisk pace of regulatory activity has continued during the pandemic, with a focus on rules and programs that encourage and facilitate banks' provision of financial services to their customers. An important statutory backdrop for some of the pandemic-related rules was the Coronavirus Aid, Relief, and Economic Security (CARES) Act, a \$2.2 trillion economic relief package signed into law on March 27, 2020. Examples of pandemic-related rules and federal programs affecting community banks include:

- Establishing the Federal Reserve's Paycheck Protection Program Liquidity Facility to provide liquidity to banks to support their participation in the PPP;
- Extending the regulatory capital transition period for banks adopting the Current Expected Credit Loss Accounting Standard;
- Temporarily reducing the Community Bank Leverage Ratio threshold to 8 percent as required by the CARES Act;
- Modifying capital rules to neutralize the regulatory capital effects of banks' participating in the PPP, and establishing a zero-percent risk weight for those loans as required by the CARES Act;
- Deferring certain required real-estate appraisals and evaluations for up to 120 days after loan closing; and
- Modifying FDIC deposit insurance premiums to mitigate the effects of banks' participating in the PPP.