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STATEMENT OF

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on

THE STATE OF COMMUNITY BANKING: CHALLENGES AND OPPORTUNITIES

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Chairman Brown, Ranking Member Corker, and members of the Subcommittee, I welcome the opportunity to speak with you today about the state of community banking.

Community banks provide vital services in their communities; making loans to customers they know, in markets they know. Community banks are essential providers of credit to small businesses, and through the recent financial crisis, community banks have maintained steadier levels of total loan balances than their larger competitors. As our economy recovers from the most severe recession since the 1930s, a thriving community banking sector is important to help support the credit needs of local households and business borrowers.

As the supervisor of 4,414 community banks,[1] the FDIC has a keen appreciation for the important role community banks play in the national economy. The FDIC's bank examiners work out of duty stations located in 85 communities across the country. They know the community banks in their areas and are familiar with the local conditions facing those banks. Many have seen more than one previous economic down cycle and recognize the critical role that community banks play in credit availability.

Over 90 percent of all FDIC-insured institutions are community banks, and they hold close to 11 percent of aggregate industry assets. Community banks have branches in nearly all towns and urban areas, and about two-thirds of all branches in rural areas are community bank branches. Through fast, localized decision-making, personal service,

[1] Throughout this testimony, for purposes of data analysis, community banks are defined as banks and thrifts with total assets of less than $1 billion. The FDIC supervises a *total* of 4,715 banks. All data are as of December 31, 2010.

and a strong local presence, community banks serve the loan and deposit needs of consumers and small businesses in periods of both economic expansion and contraction.

In my testimony, I will describe the performance of community banks as of year-end 2010, identify some of the challenges and opportunities we see for community banks, and discuss some of the actions that the FDIC has taken to help smaller institutions navigate the downturn. Finally, I will discuss the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) on community banks.

The Financial Performance of Community Banks

After an extremely challenging 2009, community banks reported improving performance in 2010. Just as in the broader economy and in the aggregate performance of larger banks, 2010 shows signs of marking the beginning of a turnaround for community banks.

A number of community banks still face headwinds in the form of legacy problems in their real-estate loan portfolios. These headwinds are reflected in aggregate financial performance that continues to be weaker than pre-crisis levels. Thus, while community bank earnings rebounded from the aggregate loss reported in 2009, the average return on assets remained low and lags that of larger banks. Asset quality deterioration appears to have leveled off, but volumes of troubled assets and charge-offs remain high. In addition, community banks continue to have high concentrations of commercial real estate loans, a market segment that remains weak in many areas of the country. A more detailed discussion of community bank performance follows.

Earnings

Community banks earned $4.7 billion in 2010, in contrast to the net loss that was reported for 2009. Fewer institutions reported annual losses in 2010 than in the previous year, and two-thirds of community banks had earnings improvement in 2010, compared to only 40 percent in 2009. Most community banks set aside smaller provisions for loan loss in 2010 than they did the previous year, and lower funding costs helped net interest margins rise slightly.

The average return on assets (ROA) for community banks in 2010 was 0.33 percent. While this was a clear improvement over the prior year's loss, it was only half the overall banking industry's ROA of 0.66 percent, indicating that community bank performance continues to trail that of larger banks. The difference in performance may be attributable in part to large banks' more diversified revenue sources and to differences in asset composition – community banks are more dependent upon interest income from loans than their larger competitors are, and community banks have higher loan-to-asset ratios than large banks.

Asset Quality

Asset quality is not recovering as quickly at community banks as at larger banks. The ratio of noncurrent[2] loans to total loans for community banks fell very slightly during the fourth quarter, to 3.46 percent, and was flat compared to a year ago. Noncurrent rates and net charge-off rates for community bank loan portfolios remain lower than average industry rates, but this is a function of the differing mix of loans between small and large

[2] Noncurrent loans are loans that are 90 or more days past due or have been placed on nonaccrual status.

institutions. The retail loans that make up a larger portion of big banks' portfolios, such as credit card loans, have relatively high noncurrent rates. However, these loans are also recovering more quickly than the commercial real estate (CRE) loans that make up a larger part of community banks' portfolios.

The noncurrent rate for construction and development (C&D) loans at community banks remained stubbornly high at 12.88 percent in the fourth quarter and reflects the ongoing distress in the real estate development sector. Noncurrent rates also rose during the fourth quarter for one-to-four family residential real estate loans and nonfarm nonresidential real estate loans, but declined for commercial and industrial (C&I) loans.

Net charge-offs increased during the fourth quarter, but were lower than a year ago (net charge-offs are typically higher in the fourth quarter than in the preceding three quarters). Most community banks reported declines in net charge-offs compared to fourth quarter 2009. Community banks set aside more in provisions for loan losses than they charged off during the quarter, suggesting that community banks will continue to work through their asset quality problems in 2011.

As a result of the protracted credit quality problems, community banks' levels of other real estate owned (ORE) and restructured loans have increased. ORE represented 1.05 percent of assets at community banks and restructured loans made up another 1.19 percent. Troubled assets – ORE, restructured loans, delinquent, and noncurrent loans – represented about five percent of assets.

Commercial real estate markets have been hard-hit in the crisis, and it is no surprise that community banks with rapid growth or exceptionally high concentrations of

CRE lending, and especially C&D lending, have suffered disproportionately. C&D loans and nonfarm nonresidential real estate loans comprise 38 percent of community bank loan balances, but during the fourth quarter represented 50 percent of their loans charged-off, almost 60 percent of their noncurrent loans, and close to three-fourths of their ORE. Given that real estate markets continue to struggle in many regions across the country, troubled CRE-related assets will continue to strain community banks' asset quality and earnings throughout this year.

Lending by Community Banks

As I stated earlier, community banks play a vital role in credit creation across the country and small businesses especially rely on community banks for loans when large institutions and non-banks curtail their lending activity. This has been borne out by loan originations over the past several years, as community bank loan balances have increased by about three percent on a merger-adjusted basis since second quarter 2008. Over the same period, overall industry loan balances *fell* by more than 7 percent. It is also noteworthy to point out that community banks held almost 39 percent of small loans to businesses (C&I and CRE loans in amounts under $1 million and agricultural and farmland loans under $500,000) at the end of 2010, which represents about three times the community banks' share of total industry loans.

Funding and Capital

Consistent with their focus on providing traditional banking services to retail customers, community banks rely heavily on deposits to fund their balance sheets. Fourth quarter domestic deposits were equal to more than 80 percent of assets at community banks, compared to less than 60 percent of industry assets. Close to three-fourths of community bank deposit accounts are in accounts under the insurance limit of $250,000. Community banks held $53 billion in non-interest bearing transaction accounts over $250,000 temporarily insured under the Dodd-Frank Act at the end of the fourth quarter. Again, the local focus and convenience offered by community banks provides them with a viable platform for gathering deposits, while delivering essential depository and payment services to consumers and small businesses.

Community banks have maintained capital ratios higher than the industry averages. Risk-based capital ratios rose for the fourth straight quarter and the community bank leverage ratio was just below the two-year high.

Consolidation

At year-end 2010, there were 874 fewer FDIC-insured institutions with assets under $1 billion than at year-end 2007, as continuing consolidation and a number of failures have reduced the community bank population. From year-end 2007 through year-end 2010, the share of industry assets represented by community banks has declined from 11.4 percent to 10.8 percent, while the share of industry assets represented by the largest banks (those with total assets greater than $100 billion) has increased from 54.6 percent to 59.1 percent. However, consolidation of community banks is not primarily a result of the recent crisis, but is the continuation of a long-term trend precipitated by competition, technological advances, and innovation in the financial services industry.

Challenges and Opportunities for Community Banks

The most important challenge facing community banks at present is improving their operating performance amid the lingering effects of the financial crisis and recession. A large number of financial institutions have an elevated level of problem assets, which strains earnings and can divert management's attention from executing longer-term strategic initiatives. Moreover, communities across the country continue to suffer from high unemployment and slow job creation, and loan demand remains weak. According to the latest Federal Reserve Senior Loan Officers' Opinion Survey, only twelve percent of small banks in the survey reported increased demand for C&I loans. Tepid business expansion and continuing high unemployment are also making it difficult for businesses and consumers to service existing loans and for financial institutions to work out problems.

Many community banks remain vulnerable to additional real estate market declines as a result of their significant holdings of commercial real estate assets, both as loans and as ORE. Many institutions that relied heavily on C&D lending in the years leading up to the recession continue to be exposed to declining home prices. At the same time, commercial real estate markets remain weak in most areas.

In spite of the obstacles, and high concentrations of commercial real estate loans, many community banks weathered the financial storm well because of sound underwriting practices and corporate governance, in addition to a keen understanding of their local market and economy. As a result, those institutions are poised to respond quickly and prudently once credit demand returns. These banks know their customers well and in turn, their customers know them, trust them, and appreciate their personal attention and responsiveness at the local level.

Community banks could also begin to see a narrowing of the cost advantage that larger institutions had previously enjoyed. Many of the reforms that are being implemented in response to the financial crisis are aimed at improving lax underwriting practices, particularly in the residential mortgage lending field. Community banks for the most part, did not relax their standards. That made it difficult for them to compete during the years of expansion leading up to the crisis. As both nonbanks and larger institutions are required by the Dodd Frank Act to tighten standards, the community banks may see an improvement in their ability to originate good quality mortgage loans at competitive interest rates.

The FDIC and Community Banks

Throughout the real estate and economic downturn, the FDIC has advocated for policies that will help community banks and their customers navigate this challenging period and mitigate unnecessary losses. We share community banks' desire to restore profitability, strengthen asset quality, and serve the credit needs of local markets. The FDIC has worked closely with banks as they have taken steps to raise capital, enhance their loan workout functions, and revise strategic plans to remain competitive in the financial services industry. Through our regional and field offices, the Corporation actively communicates with the community banks we supervise and provides recommendations for addressing operational and financial weaknesses as appropriate.

The FDIC has joined several interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers, and to clarify outstanding guidance. For example, the federal bank regulatory agencies issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* on November 12, 2008, which encouraged banks to prudently make loans available in their markets. The agencies also issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 12, 2010, to encourage prudent small business lending and emphasize that examiners will apply a balanced approach in evaluating loans. This guidance was issued subsequent to the October 30, 2009 *Policy Statement on Prudent Commercial Real Estate Workouts* that encourages banks to restructure loans for commercial real estate mortgage customers experiencing difficulties making payments. The CRE Workouts Guidance reinforces long-standing supervisory principles in a manner that recognizes pragmatic actions by lenders and small business borrowers are necessary to weather this difficult economic period.

The FDIC also joined the other banking agencies in issuing the *Interagency Appraisal and Evaluation Guidelines* on December 2, 2010, to clarify expectations for real estate appraisals. Clarification of these guidelines was important for the industry given changes in property values over the past several years. We also actively engage with community banks at the state level and nationally through various trade associations, which helps our agency articulate its supervisory expectations on important issues through a variety of forums. We also sponsor training events for community banks including regional and national teleconferences on risk management and consumer protection matters, as well as Directors Colleges to help bank directors better understand the supervisory process.

Potential Impact of the Dodd-Frank Act

Some community bankers have pointed to uncertainty about the effect of new regulations under the Dodd-Frank Act as a potential obstacle to their continued profitability.

However, much of the Dodd-Frank Act should have no direct impact on community banks, while certain changes in the Act provide real benefits. For example, those provisions of the Act that impose additional capital and other heightened prudential requirements on the largest financial institutions are aimed at reducing systemic risks. If properly implemented, those and other provisions of the Act should do much to return competitive balance to the marketplace by restoring market discipline; ensuring appropriate regulatory oversight of systemically important financial companies; and having rules that apply to all providers of financial services, not just insured depository institutions. In fact, as noted above, there are immediate, tangible benefits that the Dodd-Frank Act confers on community banks.

First, the deposit insurance coverage limit was permanently increased to $250,000. In addition, the law provides a guarantee of all balances in non-interest bearing transaction accounts above $250,000 until the end of 2012. These changes help to address one of the main sources of competitive imbalance, by giving community banks access to federally insured or guaranteed funding in larger amounts, without having to pay a fee to deposit brokers or consultants.

The Dodd-Frank Act also changes the assessment base used to calculate premiums paid to the Deposit Insurance Fund (DIF), from one based on deposits to one based on total assets. Because community banks generally rely more on deposits as a funding source than do larger banks, the Dodd-Frank Act effectively shifts a greater proportion of DIF assessments to larger banks. In aggregate, banks with assets under $10 billion should see their assessments decline by 30 percent. The final rule implementing the new assessment base took effect on April 1st.

To provide for a more stable DIF going forward, the law increases the minimum DIF reserve ratio to 1.35 percent. But it extends the period in which the DIF must be recapitalized to 2020, and also requires that the assessments needed to increase the DIF from the old minimum ratio of 1.15 percent to the new minimum ratio of 1.35 percent should be collected entirely from banks with total consolidated assets of $10 billion or more. Thus, community banks' deposit insurance assessments will not need to rise in order to meet the new target.

There are other important, if less tangible, ways that the Dodd-Frank Act should help create a more level playing field between community banks and their larger competitors.

Most – but not all – of the high risk mortgage lending that precipitated the recent crisis originated outside of insured banks. The Dodd-Frank Act requires these non-bank lenders to adhere to federal consumer protection laws and places them under federal supervision for the first time. The Consumer Financial Protection Bureau established by the Dodd-Frank Act will likely reduce the unfair competitive advantage that non-bank competitors have long enjoyed as under-regulated – and often unregulated and unsupervised – financial services providers.

Importantly, section 171 of the Dodd Frank Act, the Collins Amendment, places a risk-based capital floor under the so-called advanced approaches. The floor will ensure that capital requirements for the largest banks and their bank holding companies are no lower than the level of capital required of community banks that hold similar exposures. In addition, under section 165 of the Act, large bank holding companies are subject to heightened capital standards (that is, beyond the standards required of smaller institutions), to account for the greater risk that large bank holding companies pose to the financial system. These provisions of the Dodd Frank Act are consistent with developments taking place in the Basel Committee on Banking Supervision which, with the support of the U.S. banking agencies, has announced its intention to develop heightened capital standards for the largest banks.

Finally, the most fundamental reform in the Dodd-Frank Act is the new orderly liquidation authority for large bank holding companies and systemically important non-bank financial companies, which ends "Too Big to Fail." The FDIC regularly carries out a prompt and orderly liquidation process using its receivership authority for insured banks and thrifts that are facing insolvency. The Dodd-Frank Act for the first time gives the FDIC a similar set of receivership powers to close and liquidate systemically-important financial firms that are failing. Just as important, the Act mandates that systemically important financial institutions maintain credible, actionable resolution plans that facilitate their orderly resolution if they should fail. If the FDIC and the Federal Reserve Board do not find an institution's resolution plan to be credible, we can compel the divestiture of activities that would unduly interfere with the orderly liquidation of the company. The FDIC Board adopted a proposed rulemaking for public comment last week and as Chairman Bair said at the Board meeting, "This is a big step forward in ending 'too big to fail.'"

It has been well-documented that the cost of funds for the largest banks has been lower than that for smaller banks. In fourth quarter 2010, the average cost of funding earning assets for banks over $100 billion in assets was 0.67 percent, compared to 1.24 percent for community banks. Not all of this difference is due to the perception that the largest banks are too big to fail. Their product mix and access to capital markets in the U.S. and overseas help to lower their funding costs in low interest rate environments, such as the one we are in.

Using the tools provided under the Dodd-Frank Act, we can break this cycle of subsidized risk taking and create a financial marketplace that is both more stable and more competitively balanced. Much of the regulatory cost of the Dodd-Frank Act will fall, as it should, directly on the large institutions that create systemic risk. The leveling of the competitive playing field will help preserve the essential diversity of our financial system, and prevent any institution from taking undue risks at the expense of the public.

The FDIC understands why community banks are wary. We recognize the concerns community bankers have in understanding how new legislation and regulations will affect their operations. The FDIC is required or authorized by Congress to implement some 44 regulations, including 18 independent and 26 joint rulemakings. Community banks should be, and are, taking an active interest in these new regulations as they are developed.

We are implementing the provisions of the Dodd-Frank Act as transparently and expeditiously as possible. Not only is the FDIC following the normal steps used in any rulemaking process, we are also holding public roundtables to discuss issues such as our systemic resolution authority and required resolution plans, the new deposit insurance assessment provisions and core/brokered deposits. In addition, we document meetings between senior FDIC officials and outside parties that are related to the implementation of the Dodd-Frank Act.

The FDIC also is focused on how other provisions of the Dodd-Frank Act could impact community banks. For example, we are extremely concerned that, under proposed regulations, community banks may not actually receive the benefit of the interchange fee limit exemption explicitly provided for in the law. We sent a comment letter to the Federal Reserve Board detailing these concerns and encouraging the Federal Reserve to consider the practical implications of its proposed rule on community banks.

We also have engaged the FDIC's Advisory Committee on Community Banking on the Dodd-Frank Act and other issues. At the January 20 meeting of the committee, there was a discussion of ways to ease the regulatory burden on small institutions. Among the ideas discussed at that meeting were identifying which regulatory questionnaires and reports can be streamlined through automation, reviewing ways to reduce the total amount of reporting required of banks, and ensuring that community banks are aware that senior FDIC officials in the regions and in Washington are available and interested in receiving their feedback regarding our regulatory and supervisory process.

The FDIC is particularly interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. We continuously pursue methods to streamline our supervisory process through the use of technology and other means to reduce any possible disruption associated with examination activity. While we maintain a robust examination process, we are sensitive to banks' business priorities and strive to be efficient in our work.

To this end, we have established as a goal for the first quarter of 2011 to modify the content of our Financial Institution Letters (FILs) - the vehicle used to alert banks to any regulatory changes or guidance - so that every FIL issued will include a section making clear the applicability to smaller institutions (under $1 billion). In addition, by June 30 we plan to complete a review of all of our recurring questionnaires and information requests to the industry and to develop recommendations to improve the efficiency and ease of use and a plan to implement these changes. The FDIC also has challenged its staff to find additional ways of translating some of these ideas into action. This includes launching an intensive review of existing reporting requirements to identify areas for streamlining.

At the beginning of this year, we initiated a dialogue with our field and regional staffs to reinforce the FDIC's balanced approach to bank supervision. In this effort, we are reminding examiners to work cooperatively with financial institutions and to be aware of the great challenges that face community banks. Moreover, we will be engaging in a dialogue with bankers at each examination in 2011 to solicit bankers' views on aspects of the regulatory and supervisory process that may be adversely affecting credit availability.

Conclusion

Community banks remain an essential part of the financial system, and the FDIC is committed to a regulatory structure that will support a vibrant, competitive community banking sector and a level playing field between large and small banks. Throughout the financial crisis and recession, community banks continued providing credit even as larger banks pulled back. We need a thriving community banking sector to support an economic recovery and fulfill the credit and depository needs of households and businesses on Main Street.

Thank you. I am pleased to answer any questions.