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The State of Rural Banking: Challenges and Consequences

Testimony before the Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Financial Institutions and Consumer Protection

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Introduction

Thank you, Chairman Toomey, Ranking Member Merkley, and members of the committee for the invitation to appear before you today. My name is Sarah Edelman, and I am the Director of Housing Policy at the Center for American Progress. Thank you for holding a hearing on this important topic.[i]

Consumers living in rural areas rely on community banks to meet their credit needs. These banks provide vital support to the small businesses, farmers, and homeowners that make rural economies function. However, for decades, the number of community banks serving these areas has been declining.[1]

This decline long precedes the financial reform measures put into place after the 2007 financial crisis.[2] There are many reasons for this trend including slowing population growth in rural areas, changes in the financial market, and changes to interstate banking rules that made it easier for banks to consolidate.

I plan to make the following points in my testimony today:

- Many rural economies are in trouble. Community banks can, and should be, an important partner in revitalizing rural economies.

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[i] This testimony is based primarily on an issue brief published earlier this year by the Center for American Progress about financial reform and community banking and recent testimony provided by the Center to the House Subcommittee on Economic Growth, Tax and Capital Access. The full issue brief is attached: David Sanchez, Sarah Edelman and Julia Gordon, "Do Not Gut Financial Reform in the Name of Helping Small Banks," Center for American Progress: July, 2015 available at https://www.americanprogress.org/issues/housing/report/2015/07/07/113119/do-not-gut-financial-reform-in-the-name-of-helping-small-banks/. For the testimony, see: Julia Gordon, Testimony before the U.S. House Committee on Small Business Subcommittee on Economic Growth, Tax and Capital Access, "Financing Main Street: How Dodd Frank is Crippling Small Lenders and Access to Capital," September 17, 2015, available at http://smbiz.house.gov/uploadedfiles/9-17-2015_gordon__testimony.pdf.

- Rolling back financial regulation is not the right approach to support community banks. Deregulation of the banking sector increases risk to the broader economy and to community banks.

- A comprehensive approach is needed to support rural communities and the banks that serve them.

Community banks provide a vital source of credit for consumers living in rural areas

For many families living in rural areas, access to lending is severely limited. For generations, community banks have served as important partners to small businesses, family farms, and families seeking to buy or refinance a home. Often, the only source of credit for rural consumers is their local community bank.[3] Approximately one out of every five counties in the United States is served exclusively by community banks – and three quarters of these counties are located in rural areas.[4]

While community banks hold a diminishing share of the banking sector's total assets – 14 percent in 2011, according to the FDIC – they continue to make nearly half of all small business and agricultural loans.[5] Lending to small businesses and farmers remains a core part of the community bank business model, even as larger banks have shifted away from this type of lending.

In the wake of the recession, there is a great need for capital in rural communities. The small business and mortgage loans community lenders offer in rural communities will play an important role in supporting economic recovery and a recovery in the housing market.[6] Even as the broader housing market is recovering, some rural housing markets are seeing conditions further deteriorate. The percentage of mortgaged homes with negative equity in nonmetropolitan rural counties increased from an average of 11 percent in the second quarter of 2011 to 20 percent in the first quarter of 2015.[7]

Without home equity, small business owners and entrepreneurs have fewer reserves to draw upon to make investments in their existing business or to start a new one. Through investing in local businesses, community banks can help to stimulate economic recovery in rural areas.

Financial reform legislation is not responsible for the decline in the number of community banks

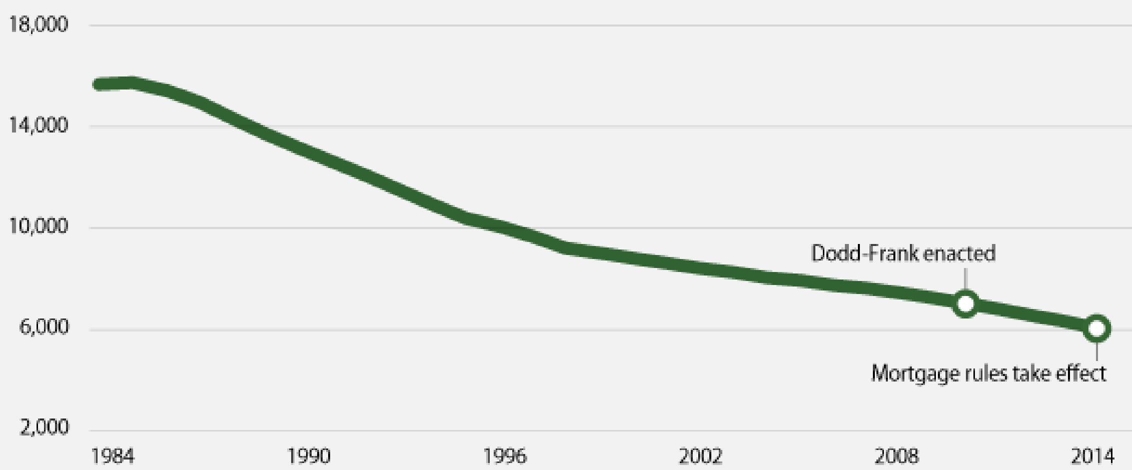
Despite the important role community banks[8] play in counties across the country, the number of them has declined precipitously for over a generation.[9] This 30-year decline has very little to do with post-crisis financial regulation. Factors causing the decline include an increasingly complex financial services sector where the size of the banking institution matters for profitability, economic challenges in the communities these banks tend to serve, and changes in interstate banking laws that make it easier for bank mergers and consolidation to take place.

The number of community banks has declined at a rate of about 300 per year over the past 30 years, mostly through consolidation with other banks, according to the FDIC.[10] This decline began far before the 2007 financial crisis and the subsequent Dodd Frank Wall Street Reform and Consumer Protection Act. The decline has continued at about the same pace since regulators began implementing the law.[11]

FIGURE 2

Financial reform is not causing the declining number of community banks

Number of U.S. community banks



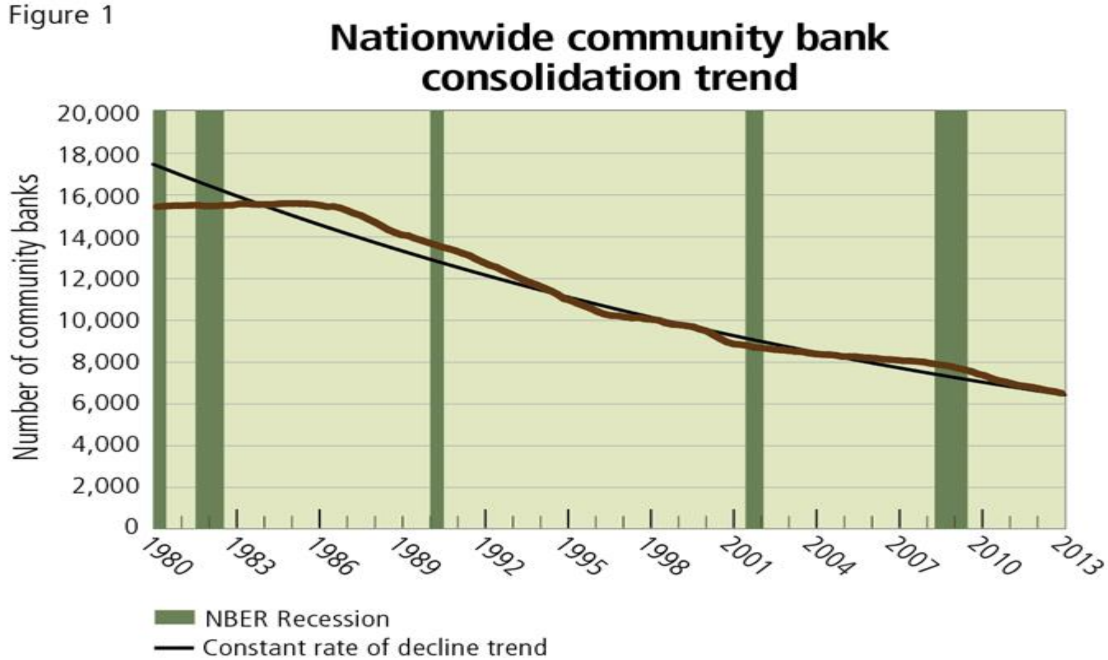
Source: Federal Deposit Insurance Corporation, "Historical Community Banking Reference Data," available at https://www.fdic.gov/regulations/resources/cbi/data.html (last accessed May 2015).

The number of locally-owned community banks has also declined, particularly in rural areas from approximately 80 percent in 1976 to approximately 20 percent in 2007.[12]

While the number of bank offices operating outside of metropolitan areas appears to have been stable during the same period, the offices are typically owned by out-of-county or out-of-state banks which may be less likely to consider "soft data" when making loans, such as the applicant's reputation for financial responsibility within the community.[13]

Over the past 30 years, more than 80 percent of banks that have exited the market have not failed, but rather, have merged with an unaffiliated bank or consolidated with another chartered bank, sometimes within the same organization.[14] Many banks took advantage of changes in interstate banking rules in the 1980s and 1990s to expand their scale and geographic footprint through mergers and consolidations. Others consolidated because they were at risk of failure.[15]

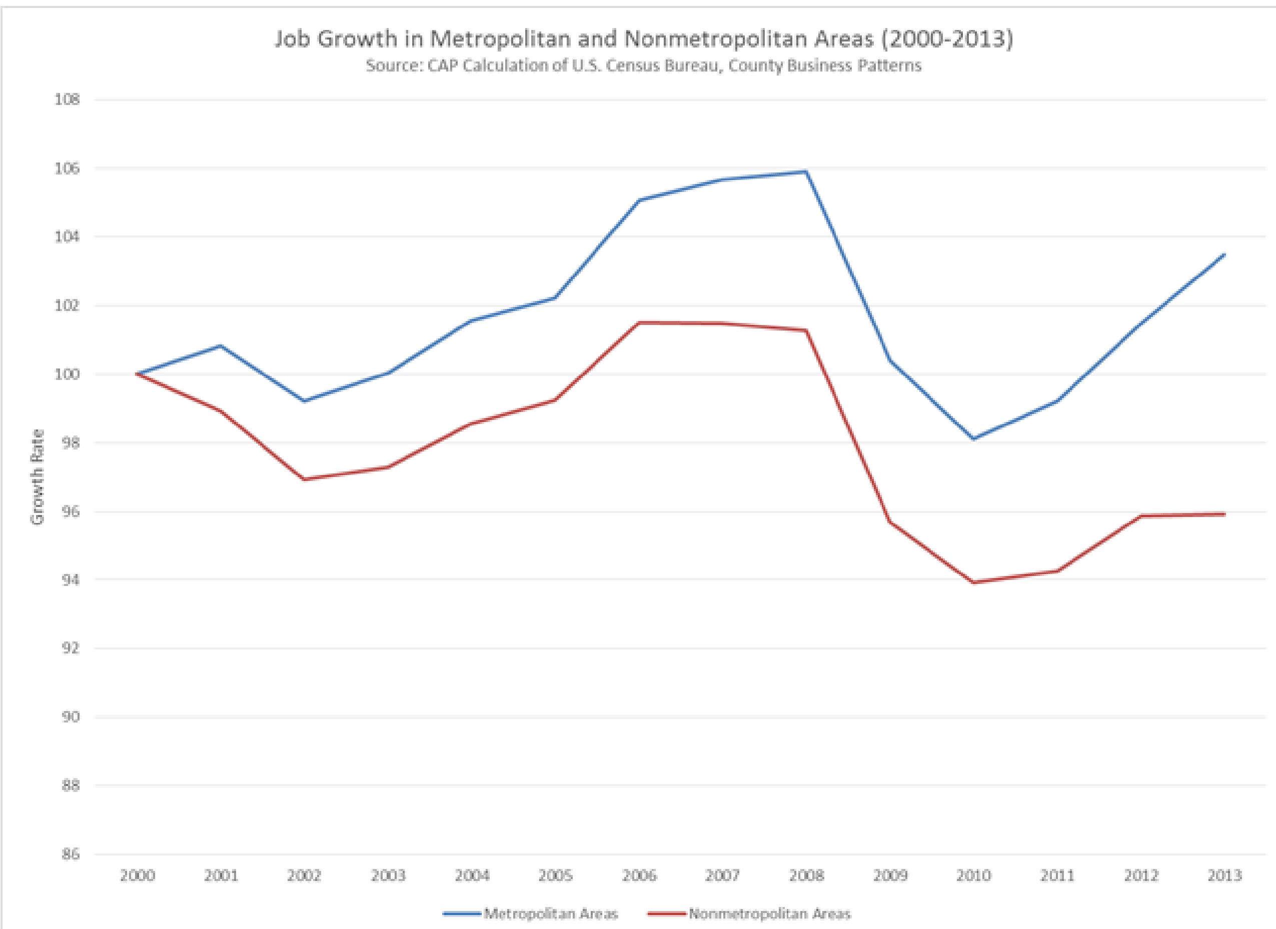
Figure 1



Source: Minneapolis Federal Reserve "Assessing Community Bank Consolidation."[16]

Why are there fewer community banks now than there were in the 1980s? First, the financial market has become more complex in recent decades. Large banks can benefit from the economies of scale that make certain operations more efficient, while small banks cannot. The Government Accountability Office, or GAO, has concluded that, "larger banks generally are more profitable and efficient than smaller banks, which may reflect increasing returns to scale."[17] These advantages are particularly evident in mortgage lending, where technology can make it much easier for a bank to make and service a loan.[18]

Community banks are also victim to the population loss and economic challenges afflicting rural communities. For example, eighty-six percent of rural counties in the Great Plains experienced population loss between 1980 and 2010.[19] As jobs become more concentrated in metropolitan areas, many young people are leaving rural areas for these job centers.[20] Further, employment in urban centers has generally recovered more quickly than in rural areas, and rural workers earn about 20 percent less than those in urban areas.[21] Unlike a larger bank that may have branches across many types of geographies, a community bank may be more vulnerable in the case of a local economic downturn or if its local customer base declines.



Finally, it is true that smaller institutions may have a more difficult time managing the cost of complying with regulation, as the resources required to report to state and federal regulators require a greater share of the bank's resources. However, many of these compliance costs long precede the Dodd-Frank Wall Street Reform Act. As described in greater detail below, regulators have been very careful to make sure community banks have the flexibility they need to meet the new financial regulatory requirements.

Despite all of the challenges described above, community banks have performed relatively well in recent years. Both smaller and larger community banks originated a larger share and number of home purchase mortgages today than they did in 2010.[22] Last year, community banks increased their lending volume at almost twice the rate of larger banks.[23] Data from the FDIC also show that the performance and financial health of community banks has experienced consistent improvement over the past five years.[24]

Gutting financial reform would do little to help community banks and may further undermine community banks

Policymakers should continue to monitor the implementation of financial regulatory requirements to ensure that compliance is as simple as possible. However, undermining financial reform in the name of helping small banks in rural areas is not the right approach. Returning to pre-crisis regulatory standards would ultimately put more banks at risk of failure.

Most of the bank failures that have occurred over the past 30 years have occurred during a financial or economic crisis.[25] Community banks are no exception to this trend and have had failure rates comparable to other types of banks.[26] According to Richard Brown, the former chief economist of the FDIC, "To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future consolidation."[27]

The Great Recession negatively impacted the community banking sector. While generally community banks did not engage in the type of predatory residential mortgage lending that brought down larger banks, many community banks also failed in the wake of the financial crisis. During the bubble years, some community banks aggressively expanded their commercial lending, often in the form of construction loans. When the financial crisis and subsequent recession caused home prices to decline, these banks suffered crippling losses and many failed.[28] Between 2008 and 2011, 419 of the 481 depository banks that failed were small banks.[29]

The long-term health of community banking depends on a healthy economy and a stable financial market. Strong regulation helps banks of all sizes establish a sturdy foundation and will help prevent future financial crises, and the loss of more community banks.

Moreover, regulators have already taken steps to ensure that community banks are able to continue lending in a safe way. Recognizing that community banks may need more flexibility to serve rural and non-metropolitan markets, regulators have already provided small banks with a series of exemptions from the new mortgage rules:

• Small banks have greater underwriting flexibility when making Qualified Mortgage, or QM, loans—those that are eligible for the highest level of protection from legal challenges—because if small banks hold the loans on portfolio, they are not bound to the fixed debt-to-income ratio limit that applies to larger lenders.[30]

• Small institutions serving rural or underserved areas can get QM protection for loans that require a balloon payment, although the general QM definition bans balloon loans.[31]

• The CFPB recently expanded the definition of small institutions, as well as the rural definition, so that more banks now qualify for a variety of mortgage rule exemptions, including more flexibility to make QM loans.[32] Under the new definitions, roughly 93 percent of all institutions engaged in mortgage lending are eligible for these exemptions[33].

• Small institutions serving rural or underserved areas are exempt from requirements that they maintain escrow accounts for higher-cost loans.[34]

• Small creditors are exempt from most mortgage-servicing rules.[35]

• An array of mission-oriented lenders, such as Community Development Financial Institutions and state housing finance agencies, are fully exempt from the entire CFPB Ability-to-Repay requirement.[36]

There are also various opportunities for small banks to weigh in with regulators about the regulatory process. The CFPB, the FDIC and the Federal Reserve have all formed community bank advisory councils since the financial crisis. Moreover, the CFPB has to permit small businesses, including community banks, to weigh in on rulemaking efforts before proposed rules are released for public comment. The voices of community banks are well represented and regulators continue to be responsive to their concerns.

These exemptions may actually help to make community banks more competitive relative to larger banks serving the same communities. Rolling back regulations for bigger institutions in the name of helping small banks may erode this competitive advantage while exposing all banks to greater risk of failure.

A more sensible approach

Instead of pursuing sweeping deregulatory legislation that will do little to help small banks, policymakers should take a more comprehensive approach.

First, regulators are the best positioned to work with community banks to help ensure that regulatory compliance is as simple and straightforward as possible. As new regulations are fully implemented, the CFPB, FDIC, and other regulators should continue to communicate with small banks and to monitor for any challenges that may arise. To the extent the data suggest specific policy changes that can help community banks address compliance costs without weakening consumer protections or endangering their safety and soundness, policymakers should pursue these reforms in a targeted and careful way. Otherwise, rolling back financial regulation will simply expose consumers, communities, or our banking system to greater risk.

More attention should also be directed toward helping community banks upgrade technological systems. Improved technology could help bring down compliance costs and reduce the cost of lending in the long-run. The recent CFPB e-closing pilot provided helpful learning about ways technology can be used to improve efficiency and generate savings for consumers and banks alike.[37] More research is needed to identify best practices among community banks and ways the government may be able to support technological innovation among community banks.

Finally, the federal government has served as an important partner to rural communities and community banks over the years. Lending programs through the United States Department of Agriculture, or USDA, and Small Business Administration, or SBA, help to ensure that the credit needs of rural businesses and homeowners are met.[38] In addition to these lending programs, both agencies can partner with community banks to help them serve their communities. While Congress has said it will fully fund critical lending programs in the coming year, lawmakers have proposed serious cuts to the agencies responsible for administering them.[39] Undermining the capacity of USDA and SBA to manage these programs is a bad idea for consumers in rural areas as well as for taxpayers. These agencies should be fully funded to help ensure that lending programs are available for prospective homeowners and small businesses in rural communities.

The Federal Housing Finance Agency can also take steps to support more lending in rural areas. The FHFA is currently working to finalize the proposed duty to serve rule, a rule mandated by the Housing and Economic Recovery Act of 2008 that requires Fannie Mae and Freddie Mac to help ensure that the credit needs of underserved and rural markets are met.[40] FHFA should encourage Fannie Mae and Freddie Mac to work more with community lenders in rural areas and to help design products that meet the needs of consumers in rural communities.

Conclusion

Community banks play an important role in rural communities. Over the last generation, there has been a significant decline in the number of these banks. Changes in the underlying market are largely responsible for their decline. However, in recent years the community banks that are serving rural communities have become stronger and are doing more consumer lending. Going forward, regulators and federal agencies should continue to partner with community banks to help them revitalize local economies.

Endnotes

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[2] Ibid.
[3] Federal Deposit Insurance Corporation, "FDIC Community Banking Study," December 2012, p. 3-5, available at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.
[4] Ibid, p. I.
[5] Ibid
[6] Forthcoming, Michela Zonta and Sarah Edelman, "The Uneven Housing Recovery," Center for American Progress: October, 2015.
[7] Ibid.
[8] There is no one definition for a small or community bank, but many analysts use asset size, such as a threshold of $1 billion or less, to characterize such a bank. The FDIC uses a definition that takes into account a bank's lending and deposit-taking activities, as well as the geographic location of its branches. Through its definition, the FDIC eliminates certain specialty institutions and institutions that operate on more of a national scale.
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