TESTIMONY OF

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On behalf of

AMERICANS FOR FINANCIAL REFORM

Re

"EXAMINING THE STATE OF SMALL DEPOSITORY INSTITUTIONS"

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AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

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Mr. Chairman and members of the committee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.

Community banks can bring unique benefits to the communities they serve. The qualities that generally characterize community banks – deep roots in a particular locality, an emphasis on relationship as opposed to transactional banking, and a business focus on traditional lending and deposit gathering activities – can create special advantages for both prudential risk management and customer service. They also create a special affinity for small businesses. Community banks hold almost half (45%) of small loans to business, despite accounting for less than 15% of total banking assets. The health of community banking is thus a valuable focus for this Committee.

At the same time, community banking is still banking, and the basic principles of banking regulation apply. While community banks today are not large enough to create the kinds of risk to the financial system seen in the 2008 crisis, the failure of a community bank holding publicly insured deposits will still directly impact the deposit insurance fund. Furthermore, a consumer who is victimized by an unfair business practice is equally harmed whether this practice occurs at a community bank, a mid-size bank, or a large Wall Street bank.

Thus, in making regulatory decisions, policymakers should seek to preserve the special benefits of community banking without undermining the core regulatory goals of prudential soundness and consumer protection, either for community banks or for other larger institutions who may also seek regulatory accommodations.

There is no contradiction in these goals. Permitting unsound practices that bring temporary profits at the expense of later losses or bank failures does not serve the long-term health of community banking. This is particularly true since bank failures lead to additional costs to the deposit insurance fund that must be paid by assessments on healthy and successful community banks. And permitting a minority of institutions to compete by foregoing consumer protections does no favors to those institutions that make the effort to treat consumers fairly.

In my testimony today, I would like to make several broad points. The first point concerns size. Community banks are small. 99.7% of community banks have fewer than $5 billion in assets, and these banks hold 94% of community banking assets.[1]

Furthermore, the economic problems in the community banking sector appear most concentrated among the smaller entities in community banking. In terms of long-term structural change, the entire decline in the number of banks over the last three decades has occurred among banks with fewer than $1 billion in assets, particularly those with less than $100 million. The number of FDIC-insured banks with fewer than $1 billion in assets has declined by two-thirds since the mid-1980s, while the number of banking institutions with more than $1 billion in assets has increased by a third.

More recent profit trends show that there is a continuing divergence in the fortunes of the smallest banks and the rest of the sector. In 2013, over 97% of banks with more than $1 billion in assets had returned to profitability. In contrast, approximately 9% of banks with fewer than $1 billion in assets were unprofitable last year, a rate more than three times higher than for larger banks. The problem was most acute among the very smallest banks, those with fewer than $100 million in assets, where over 13% were unprofitable. The general pattern of a divergence by size has remained in place during the first half of this year. During the first six months of 2014, not a single bank with more than $10 billion in assets registered a loss, but more than 12% of banks with less than $100 million in assets did.

It may seem obvious that community banks are small. But it is a point worth making, since we often see larger banks seek regulatory accommodation when there is little evidence that these larger banks either share the unique characteristics of community banks or face the kind of economic issues seen among smaller banks. The data above suggest that measures aimed at assisting community banks should generally be limited to those banks with fewer than $5 billion in assets, and should focus most on those banks with fewer than $1 billion in assets.

The second point I would like to make concerns community banks and the regulatory response to the 2008 global financial crisis. Community banks were obviously not the central contributor to the 2008 crisis. This is not because community banks cannot create systemic risk. Two of the largest systemic banking crises in the last century, the Great Depression and the 1980s Savings and Loan crisis, were driven by the failures of relatively small community banks. But community banks alone are too small a share of today's financial system to create a systemic crisis of the scale seen in 2008. Key players in that crisis were large Wall Street dealer banks, large

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[1] All the data on community banks and bank profitability by size in this testimony is based on information from the FDIC Quarterly Banking Profile, available at https://www2.fdic.gov/qbp/index.asp , and the 2012 FDIC Community Banking Study, available at https://www.fdic.gov/regulations/resources/cbi/study.html. The classification of community banks was performed by the FDIC using a functional (i.e. not size-based) definition of community banking.

commercial banks and thrifts that played a key role in securitization markets, and non-bank mortgage originators.

This suggests that the regulatory response to the crisis, particularly those responses aimed at systemic risk, should focus on these kinds of entities. And for the most part, it has. Most new areas of Dodd-Frank regulation have been ‘tiered’, either in statute or through regulatory action, so that they have their greatest impact on banks that are significantly larger than community banks. Examples include new derivatives rules which generally exempt banks with under $10 billion in assets from mandatory clearing and margining, new prudential requirements instituted by the Federal Reserve under Section 165 of the Dodd-Frank Act, which are limited to bank holding companies with over $50 billion in consolidated assets and apply most stringently to ‘advanced approaches’ banks with in excess of $250 billion in assets, and new supplementary leverage ratio rules that generally apply to ‘advanced approaches’ banks and are most stringent for banks with over $700 billion in assets.

But as I’m sure others on this panel will point out, this does not mean that the financial crisis has had no effect on the oversight of community banks. It has. The financial crisis taught many hard lessons about credit risk, securitization risk, and the significance of consumer protection. These are lessons that apply in all areas of banking. The failures to properly underwrite and manage risk that we saw during the crisis affected community banks as well. Over 450 banks failed between 2008 and 2012, more than three times the total number that failed over the 15 years prior to the financial crisis. The great majority of these were community banks. At one point during this period the deposit insurance fund showed an aggregate deficit of over $20 billion. The U.S. Treasury and the U.S. taxpayer are the final backstop for any lasting deficit in this fund. Regulators are applying, and should apply, what they have learned about oversight of lending, securitization, and consumer protection to ensuring the soundness of community banks.

Regulators have applied the lessons of the crisis to community banks in several ways. In prudential regulation, this has occurred through the mechanism of FDIC supervision and through the new Basel capital rules. These changes have resulted in stronger prudential oversight of commercial and residential real estate lending, as well as securitization holdings, and a more stringent definition of capital. While motivated by the financial crisis, these changes are not mandated by the Dodd-Frank Act. They would likely have occurred in any case as a response to the crisis experience.

The creation of the Consumer Financial Protection Bureau was, of course, a result of the Dodd-Frank Act. The CFPB is intended to address consumer fraud and abuse by the financial industry. The CFPB does not directly supervise banks with under $10 billion in assets, although its rules do apply to them. An exemption of community banks from new consumer rules would clearly be inappropriate, as it would create a two-tier system of consumer protection that would allow practices that have proven exploitative and dangerous to continue in one segment of banking.

My final point addresses some ways in which policymakers can accommodate the needs of community banks in regulatory implementation. First, regulators should explore additional technical assistance aimed at lowering the fixed costs of regulatory reporting for community banks. Regulation, particularly regulation that involves extensive reporting or analysis requirements, generally creates a fixed cost for initial compliance, with the marginal costs of additional regulated transactions much lower thereafter. A smaller bank generally has fewer transactions to spread these fixed costs over. Technical assistance aimed at assisting community banks in creating shared infrastructure for standardized reporting and analysis would be helpful in reducing these initial fixed costs, particularly for the smallest community banks which might otherwise need to hire consultants or additional employees. The FDIC has already placed significant technical assistance on their web site and should explore additional ways to provide such assistance or help small banks create mutual resources for regulatory compliance.

Second, policymakers should be attentive to the ways in which stronger regulation of larger banks, especially the very largest banks, is necessary to help level the playing field in financial services. As members of this committee know, regulators themselves admit that the problem of 'too big to fail' has not been solved. The fact that markets permit the largest banks to operate with lower capital levels and funding costs than community banks is likely related to the understanding that the unsolved TBTF issue may lead to greater government support in the event of bank failure. Legislative efforts to mandate higher capital levels for the largest banks, such as the bill introduced by Senators Brown and Vitter, are valuable in this area, as are regulatory rules that scale capital requirements by bank size.

There is another, related, difference between community banks and large Wall Street banks. Large banks are more heavily engaged in complex financial market activities whose risks have in many cases not been well understood and for which both regulators and private counterparties have permitted inappropriately low levels of prudential safeguards. Examples of such activities are large-scale broker-dealer and derivatives activities with associated large trading books and collateral accounts, central roles in originate-to-distribute securitization, and reliance on wholesale money markets. Efforts by regulators to make the capital and liquidity costs of these financial market activities reflect their true risks are a key component of new financial regulations. Reforms in this area should also help local relationship-oriented banking become more competitive with large-scale transactional banking.

Thank you for your time and attention. I look forward to taking questions.