Oral Statement of

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President

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before the

Subcommittee on Oversight and Investigations

United States House of Representatives

Overland Park, Kan.
Aug. 23, 2010

Materials for the Oral Statement before the congressional
Subcommittee on Oversight and Investigations

Chairman Moore and members of the Committee, thank you for the opportunity to testify at this timely hearing on the future of community banks.

Over the past 20 years, as the banking industry has consolidated into fewer and larger banks, a perennial question has been, "Is the community bank model viable?" The short answer is, yes. The longer answer is, yes, if they are not put at a competitive disadvantage by policies which favor and subsidize the largest financial institutions. I have worked closely with community bankers my entire career, through good and bad economic times. I know their business model works.

There are more than 6,700 banks in the country, and all but 83 would be considered community banks based on a commonly used cutoff of $10 billion in assets. In the Tenth Federal Reserve District, we have about 1,100 banks, and all but 3 would be considered a community bank. A lower threshold of $250 million, which focuses on a far more homogeneous group, includes about 4,600 institutions or about two-thirds, of all banks. My submitted materials and remarks now are directed toward this group of banks, which serve Main Street in communities across the country.

Community banks are essential to the prosperity of the local and regional economies across the country. The maps I provided show that community banks have the majority of offices and deposits in almost a third of all counties nationwide. However, their presence and market share are most substantial among Midwestern states, where their role is particularly crucial in rural areas and smaller cities. It is the economies in these states that would suffer most significantly without their presence. Why?

Community banks have maintained a strong presence despite industry consolidation because their business model focuses on strong relationships with their customers and local communities. Community banks serve all facets of their local economy including consumers, small businesses, farmers, real estate developers, and energy producers. They know their customers and local markets well; they know that their success depends on the success of these local firms; and they recognize that they have to be more than a gatherer of funds if they hope to prosper. These factors are a powerful incentive to target their underwriting to meet specific local credit needs. And it gives their customers an advantage of knowing with whom they will work in both good and difficult economic times. Larger banks are important to a firm as they grow

and need more complicated financing, but in this region, most businesses are relatively small and their needs can be met by that local bank.

It is said that a community with a local bank can better control its destiny. Local deposits provide funds for local loans. Community banks are often locally owned and managed – through several generations of family ownership. This vested interest in the success of their local communities is a powerful incentive to support local initiatives. It is the very "skin in the game" incentive that regulators are trying to reintroduce into the largest banks. It's the small community's version of "risking your own funds" that worked so well in the original investment banking model, and kept partners from making risky mistakes that would result in personal bankruptcy back then, and government intervention more recently.

There is no better test of the viability of the community bank business model than the financial crisis, recession, and abnormally slow recovery that we've experienced over the past 2½ years. The community bank business model has held up well when compared with the megabank model that had to be propped up with taxpayer funding. Community bank earnings last year were lower than desired but on par with those of larger banks. However, community banks generally had higher capital ratios that put them in a better position to weather future problems and support lending.

This is an important point to note as the decline in overall bank lending, particularly to small businesses, is a major concern. Data show that community banks have done a better job serving their local loan needs over the past year. Community banks, as a whole, increased their total loans by about 2 percent as compared to a 6 percent decline for larger banks. In addition, community banks have had either stronger loan growth or smaller declines across major loan categories. Business lending in particular stands out, with community bank loans dropping only 3 percent as compared with a 21 percent decline for larger banks.

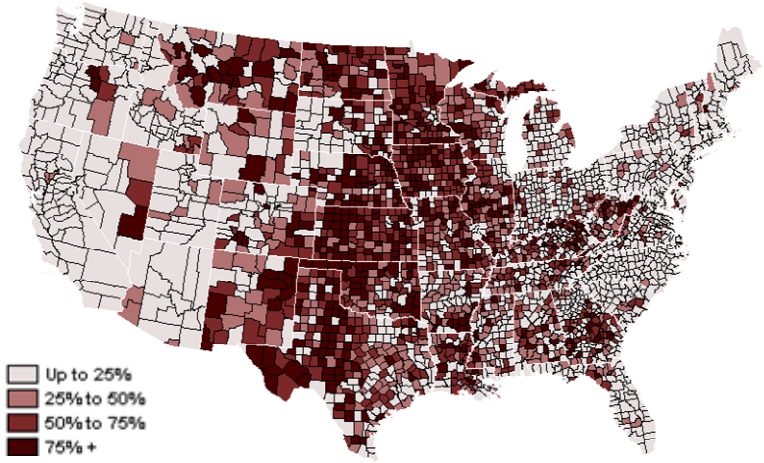
Of course, some community banks made poor lending and investment decisions during the housing and real estate boom of the mid 2000s. Unlike the largest banks, community banks that fail will be closed or sold. For community banks that survive, it will be a struggle to recover. Commercial real estate, particularly land development loans, will be a drag on earnings for some quarters yet. Nevertheless, for those that recover, a business model that continues to focus on customer relationships will be a source of strength for local economies.

Thus, community banks will survive the crisis and recession and will continue to play their role as the economy recovers. The more lasting threat to their survival, however, concerns whether this model will continue to be placed at a competitive disadvantage to larger banks. Because the market perceived the largest banks as being too big to fail, they have had the advantage of running their business with a much greater level of leverage and a consistently lower cost of capital and debt. The advantage of their too-big-to-fail status was highlighted during the crisis, when the FDIC allowed unlimited insurance on non-interest-bearing checking accounts out of concern that businesses would move their deposits from the smaller to the largest banks. As outrageous as it seems, in many cases it is easier for larger banks to expand through acquisitions into smaller communities. This occurs because smaller banks tend to focus on their local markets and therefore often face significant antitrust restrictions to in-market mergers. This policy ignores the fact that the largest 20 banking organizations in the United States now control just less than 80% of the industry's total assets.

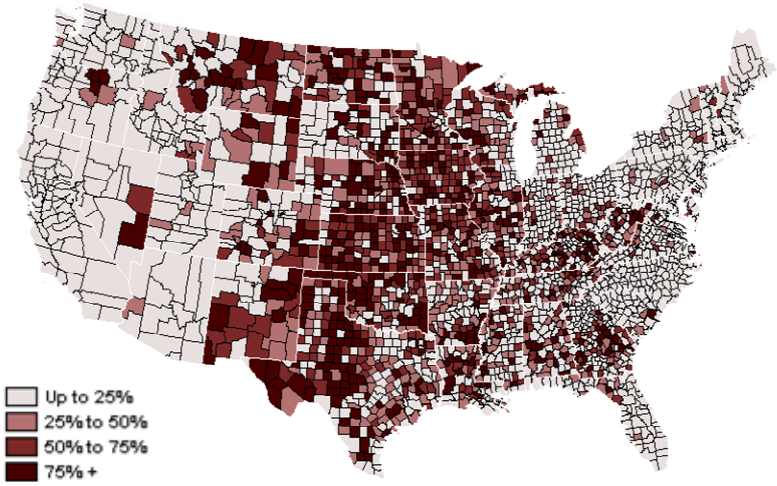
Going forward, the community bank model will face challenges. Factors such as higher regulatory compliance costs and changing technology will encourage community bank consolidation. And despite the provisions of the Dodd-Frank Act to end too big to fail, community banks will continue to face higher costs of capital and deposits until investors are convinced it has ended. But community banks have always faced such challenges. They have survived and prospered. If allowed to compete on a fair and level playing field, the community bank model is a winner.

Community Bank Market Share and Location

(Banks With Less Than $250 Million in Assets)



Percentage of Offices owned by Community Banks



Percentage of Deposits Held by Community Banks

- Community banks hold substantial market share, particularly in the Midwestern states.
- The top map illustrates by county the percentage of bank offices that are owned by community banks. In almost 30% of all counties nationwide, community banks have the majority of banking locations.
- The bottom map illustrates by county the percentage of deposits that are held in offices of community banks. In 28% of all counties, community banks have the majority of commercial bank deposits.
- Despite their dominance in more rural areas, over 40% of community bank offices and 46% of deposits are located in a Metropolitan Statistical Area (MSA). Large banks, in contrast, have 60% of their offices and 54% of their deposits in MSAs.
- The community focus of smaller banks is evidenced in the smaller number of offices; only 43% of community banks have 3 or more offices, compared to 90% of large banks.

Source: FDIC Survey of Deposits (June 2009)

Community Bank Summary Statistics

	Tenth District Community Bank (< $250 Million)	Tenth District Large Banks (>$250 Million)	All U.S. Community Bank (< $250 Million)	All U.S. Large Banks (>$250 Million)
Number of Banks	888	209	4618	2100
Total Assets	75,276,479	202,391,030	487,642,819	11,466,514,181
Total Loans	46,923,733	123,003,177	312,833,579	6,325,023,491
Total Deposits	62,969,382	157,693,608	410,752,663	7,796,175,536
Total Equity Capital	7,978,993	18,119,249	52,157,996	1,245,154,944
Return on Average Assets (2009)	0.59%	0.25%	0.04%	0.06%
Return on Average Assets (March 2010)	0.79%	0.95%	0.41%	0.52%
% Nonaccrual Loans & Other Real Estate Owned	2.89%	4.94%	4.12%	4.15%
Capital Ratio	9.92%	8.09%	10.08%	8.10%
% Change in Lending**	0.64%	-11.14%	1.88%	-6.12%
% Increasing Lending**	52.29%	34.20%	53.15%	39.42%
% Agricultural / Total Loans	23.85%	7.55%	13.67%	1.25%
% Commercial Real Estate / Total Loans	30.84%	41.87%	38.25%	22.82%
% Commercial & Industrial / Total Loans	14.92%	17.65%	14.22%	16.80%
% Residential / Total Loans	20.85%	14.94%	23.74%	22.68%

* Source: Report of Condition and Income (March 2010)

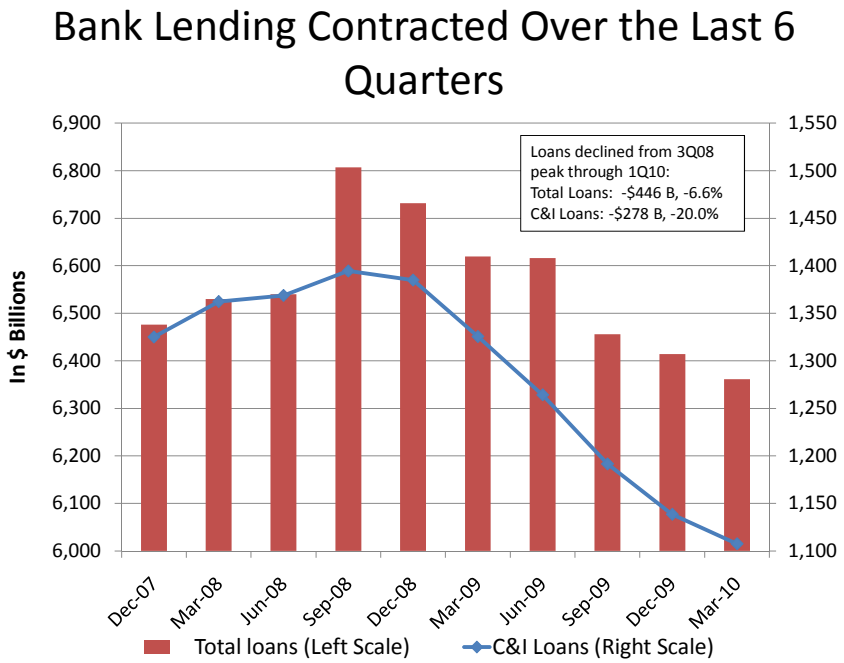
*Capital Ratio – Tier 1 capital as a percentage of total assets.

*Agricultural Loans - Agricultural production loans and real estate loans secured by farmland.
* Commercial Real Estate Loans - Real estate construction and development loans, loans secured by commercial real estate properties, loans secured by multi-family properties, and loans to finance commercial real estate not secured by real estate.
*Commercial & Industrial Loans - Commercial and industrial loans
*Residential Loans - Residential mortgage loans (first and second lien).

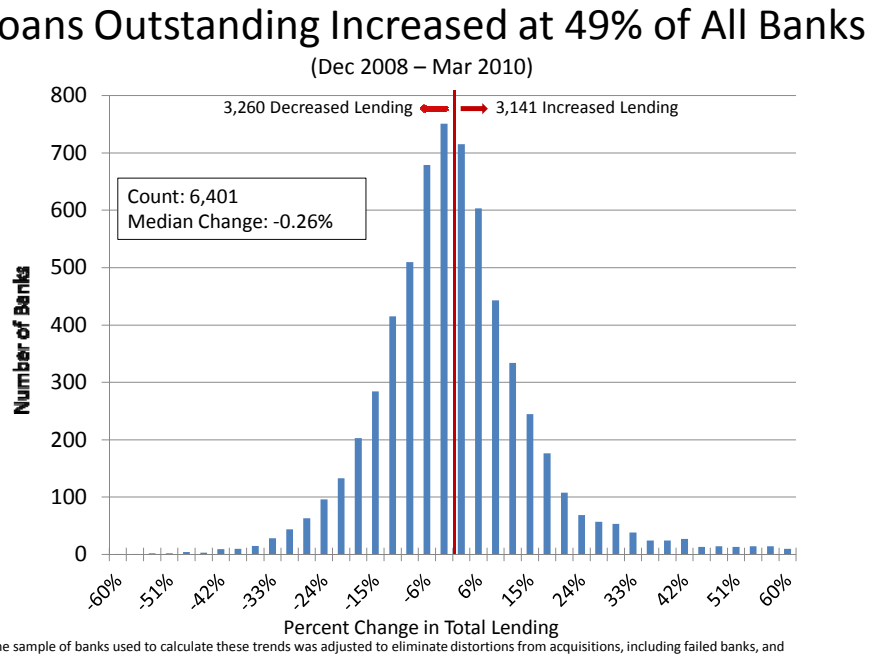
**Note: The sample of banks used to calculate these trends was adjusted to eliminate distortions from acquisitions, including failed banks, and the accounting changes for credit card loans that took effect in 2010.

- Community banks have performed as well or better than large banks over the last 15 months; earnings and problem asset ratios, while clearly impacted by economic conditions, were on par with larger banks while capital ratios were generally higher.
- Community banks in the Tenth District (20% of all community banks) performed better than the average for all community banks, with stronger earnings, fewer problem assets, and only slightly less capital.
- For both the district and nationwide, community banks increased their outstanding loans over the last 15 months, while larger banks reported declines.
- Over 53% of all community banks increased their lending over the last 15 months, compared to less than 40% of larger banks.

Source: Reports of Condition and Income (1st Quarter 2010)



Source: Reports of Condition and Income, excludes impact from FAS 166/167 in 1Q10

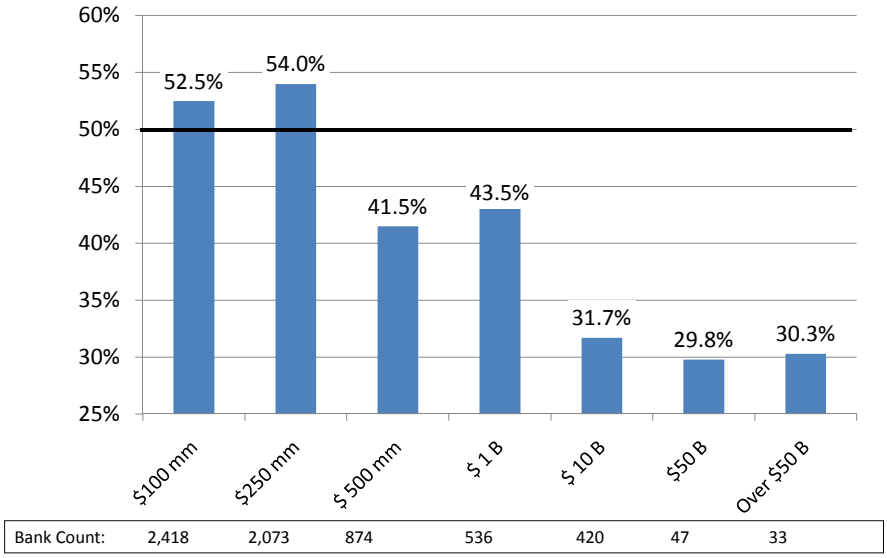


Note: The sample of banks used to calculate these trends was adjusted to eliminate distortions from acquisitions, including failed banks, and the accounting changes for credit card loans that took effect in 2010.

- Lending for the banking industry has declined since the peak at September 2008. Total loans have declined almost 7%, while commercial and industrial (C&I) loans have declined by 20%.
- Reductions in lending were not uniform across banks. Almost half of all banks increased their loans outstanding over this 15-month period. While total loans outstanding dropped in aggregate for the industry, the median change at all U.S. banks was actually a decrease of 0.26%.

Over Half of Community Banks Increased Lending

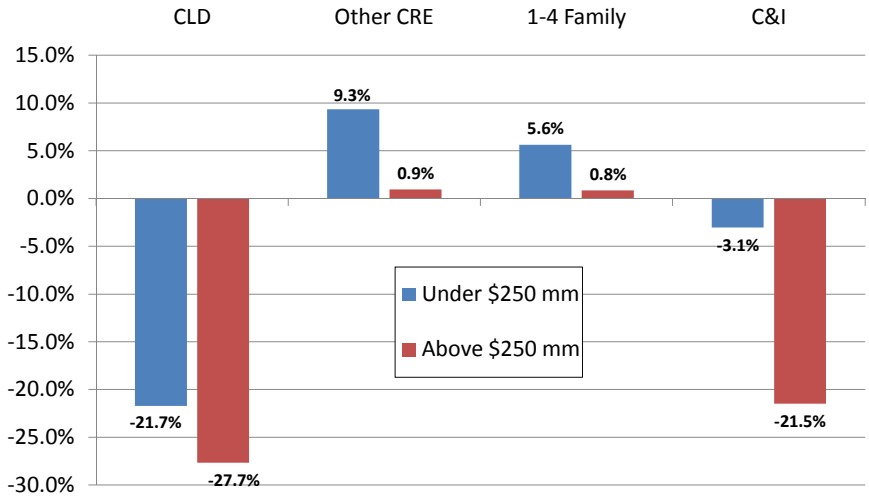
(Dec 2008 – Mar 2010)



*Note: The sample of banks used to calculate these trends was adjusted to eliminate distortions from acquisitions, including failed banks, and the accounting changes for credit card loans that took effect in 2010.

Changes in Lending Varied by Loan Type

(Dec 2008 to Mar 2010)



Source: Reports of Condition and Income

- There were also differences in lending across different sizes of banks. A majority of community banks increased their outstanding loans over this period, while a much smaller number of larger banks reported increases. Only 30% of banks over $10 billion increased outstanding loans.
- Changes in loan volume varied widely by loan type. Construction and land development (CLD) outstanding loans dropped across all sizes of banks, reflecting stressed real estate conditions. For commercial and industrial (C&I) loans, volume changes were relatively smaller for community banks compared to a decline of 21.5% for larger banks.