JEB HENSARLING, TX, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: March 15, 2013

Subject: March 20 Subcommittee on Financial Institutions and Consumer Credit Hearing on "State of Community Banking: Is the Current Regulatory Environment Adversely Affecting Community Financial Institutions"

The Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on "State of Community Banking: Is the Current Regulatory Environment Adversely Affecting Community Financial Institutions," at 10:00 a.m. on March 20, 2013, in Room 2128 of the Rayburn House Office Building. This will be a one-panel hearing with the following witnesses:

- Mr. Richard Brown, Chief Economist and Associate Director, Division of Insurance and Research, Federal Deposit Insurance Corporation (FDIC)
- Ms. Doreen Eberley, Director, Division of Risk Management Supervision, FDIC
- Mr. Bret Edwards, Director, Division of Resolutions and Receiverships, FDIC
- Mr. John T. Rymer, Inspector General, FDIC
- Mr. Lawrance L. Evans, Jr., Director, Financial Markets and Community Investment, U.S. Government Accountability Office (GAO)

Understanding Issues that Impact Community Banks: FDIC Community Banking Study

In December 2012, the FDIC issued its Community Banking Study,[1] which was commissioned by FDIC Chairman Marty Gruenberg to examine the evolving challenges and opportunities facing community banks. The study shows that community banks hold the majority of banking deposits in U.S. rural counties and that there are more than 600 counties – or almost one out of every five U.S. counties – that have no other physical banking offices except those operated by community banks. The study also shows the positive impact community banks have on entrepreneurship. As of 2011, community banks held 14 percent of banking industry assets, but made 46 percent of the industry's small-denomination loans to farms and businesses. To set the context for the study, the FDIC first created a definition for the term "community bank." According to the study, the process of designating a community bank consists of the following five steps: (1) aggregate all charter-level data reported under each holding company into a single banking organization; (2) exclude any banking organization where more than 50 percent of total assets are held in certain specialty banking charters; (3) include organizations that engage in basic banking activities as measured by the total loans-to-assets

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[1] Federal Deposit Insurance Corporation, "Community Banking Study," December 2012, *available at* http://www.fdic.gov/regulations/resources/cbi/study.html.

ratio and the ratio of core deposits to assets; (4) include organizations that operate within a limited geographic scope; and (5) include organizations with assets below $1 billion in 2010 regardless of whether the limitations on banking activities and geographic scope are met. The study also addresses structural changes taking place in the banking industry, the geography of community banking, the varying financial performance of community and noncommunity banks, community bank balance sheet strategies, and capital formation at community banks.

The Difficulty in Tracking Compliance Costs

The FDIC study also addresses regulatory costs for community banks. The FDIC concluded that measuring the effect of regulation remains an important question that presents substantial challenges. The study summarizes interviews the FDIC conducted with nine community bankers on the impact of regulatory compliance costs on their banks. Most of the participants stated that no one regulation or practice had a significant effect on their institution; rather, it was the cumulative effects of all regulatory requirements that weighed down their bank. However, several bankers identified certain laws as being particularly burdensome, including the Home Mortgage Disclosure Act, Unfair and Deceptive Acts and Practices, Fair Lending, Bank Secrecy Act, USA Patriot Act, Privacy Notices, and Electronic Funds Transfer Act.

The bankers interviewed also stated that they do not track regulatory compliance costs within their banks' internal cost structures because it is too time-consuming, costly, and so interwoven into their operations that it would be difficult to break out the specific costs. They did, however, note that they can identify direct costs associated with regulatory compliance, such as compliance personnel salaries, employee training, consulting fees, external and internal audit fees, and specific software and hardware costs.

A majority of the bankers interviewed also reported that their banks are increasingly relying on third-party consultants and service providers to assist with interpreting and implementing new or changing rules and regulations, citing their inability to understand and implement regulatory changes within required timeframes and their concern that their method of compliance may not pass regulatory scrutiny.

Consolidation in the Community Bank Sector

If compliance costs increase past the point of economic sustainability, many smaller institutions may merge with larger entities. Already, many community banks have disappeared during the consolidation trend of the past three decades. The FDIC's Community Banking Study found that the number of federally insured banks decreased from nearly 18,000 in 1984 to over 7,000 in 2011. Of the banks that exited the industry during that time frame, 17 percent failed, 49 percent merged with an unaffiliated bank, and another 32 percent consolidated with other charters within their existing bank holding company. Banks that closed the study period with assets greater than $10 billion directly or indirectly absorbed 57 percent of the charters that exited the industry between 1984 and 2011.

Industry observers predict that if community banks are subjected to over-regulation, consolidation will continue. Community banks face particularly difficult challenges in raising new capital and dealing with the increased expense of complying with new rules, accounting standards, and reporting requirements. Some commentators have therefore argued that Congress should reject a "one size fits all" regulatory policy and instead adopt a tailored policy that gives attention to the special requirements of community financial institutions.[2]

Understanding Bank Failures During the Financial Crisis: FDIC and GAO Reports

Financial institutions find themselves facing not only more regulations but more aggressive enforcement by regulatory agencies, which further increases compliance costs. According to trade associations that represent community banks and credit unions, supervisory agencies have been more vigorous in their examinations, less tolerant of minor compliance infractions, and quicker to downgrade examination ratings. As a result, more banks and credit unions have been subject to enforcement actions in recent years. Defending against negative supervisory findings and implementing the required remediation absorbs management time and financial resources.

This hearing will provide Members an opportunity to learn more about the impact of regulatory enforcement efforts on distressed banks and their communities. Following a rash of bank failures concentrated in certain states, some questioned whether the FDIC's procedures for resolving troubled banks were appropriate in light of economic conditions and whether those procedures were consistently applied. P.L. 112-88, introduced by Representative Westmoreland, addressed these concerns by directing the Office of Inspector General of the FDIC (FDIC OIG) and the GAO to thoroughly study and report on a wide range of policies and procedures used by the FDIC in its supervision of troubled and failing institutions. In addition, the law instructed the GAO to analyze underlying economic causes and effects of the high level of bank failures during the financial crisis. Both the FDIC OIG and the GAO were required to issue their reports no later than January 3, 2013 and to testify before Congress within 150 days after the date of publication.

Specifically, P.L. 112-88 instructed the FDIC OIG to address the following: (1) the effect of loss-sharing agreements; (2) the significance of losses; (3) the consistency of procedures used by examiners for appraising collateral values; (4) the factors examiners consider when assessing capital adequacy; (5) the success of FDIC field examiners in implementing FDIC guidelines for commercial real estate workouts; (6) the impact of cease and desist orders on troubled institutions; (7) the FDIC's procedures for evaluating potential private investment in insured depository institutions; and (8) the impact of the FDIC's policies on private investment in insured depository institutions. The law further instructed the GAO to address the causes of the recent rash of bank failures and to evaluate the impact of these failures on local communities.

[2] *See, e.g.,* William M. Isaac & Robert H. Smith, "Viewpoint: Burying Small Banks Alive," *American Banker,* Apr. 1, 2011, available at http://www.americanbanker.com/bankthink/regulations-are-burying-small-banks-alive-1035395-1.html; Barbara A. Rehm, "Editor at Large: It's Time to Right-Size Regulation," *American Banker,* Mar. 24, 2011, *available at* http://www.americanbanker.com/issues/176_57/community-bank-regulation-1034870-1.html?zkPrintable=true.

Also, to address the impact of fair value accounting, the GAO was required to suggest potential solutions for the cyclical nature of asset write downs and depository institution failures.

The FDIC OIG released its report in January 2013.[3] The report addressed some of the reasons that banks failed during and after the financial crisis, and noted ways the financial regulators could have acted earlier and provided greater supervisory attention to troubled institutions that failed. The OIG also found that the FDIC should place additional emphasis on monitoring commercial loan extension decisions to ensure that acquiring institutions do not inappropriately reject loan modification requests as shared-loss agreements (SLAs) approach termination. The report concluded that the FDIC needs to formulate a better strategy for mitigating the impact of impending portfolio sales and SLA terminations on the FDIC's Deposit Insurance Fund (DIF) so that the FDIC will be prepared to address the potentially significant volume of asset sale requests. The OIG made seven recommendations as part of its report.

The GAO report, which was also issued in January 2013, studied the 414 insured bank failures that occurred between January 2008 and December 2011.[4] The report discusses (1) the factors that contributed to the bank failures in states with the most failed institutions between 2008 and 2011 and what role, if any, fair value accounting played in these failures, (2) the use of SLAs in resolving troubled banks, and (3) the effect of recent bank failures on local communities. The GAO analyzed call report data, reviewed inspector general reports on individual bank failures, conducted econometric modeling, and interviewed officials from federal and state banking regulators, banking associations, financial institutions, and market experts. The GAO also coordinated with the FDIC OIG on its study. The GAO did not make any recommendations in its report, but plans to continue to monitor the progress of the ongoing activities of the accounting standard setters to address concerns with the loan loss provisioning model.

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[3] Federal Deposit Insurance Corporation Office of the Inspector General Report to Congress, "Comprehensive Study on the Impact of the Failure of Insured Depository Institutions," Report No. EVAL-13-002, January 2013, *available at* http://www.fdicoig.gov/reports13%5C13-002EV.pdf.

[4] U.S. Government Accountability Office, "Causes and Consequences of Recent Bank Failures," GAO-13-71, January 3, 2013, *available at* http://www.gao.gov/products/GAO-13-71.