

CONFERENCE OF STATE BANK SUPERVISORS

# **Community Banks and Capital**

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**Assessing a community bank's need and access to capital in  
the face of market and regulatory challenges**

**December 2011**

## **About this Paper**

The following paper is intended to provoke a policy discussion on the availability and inhibitors to capital formation at community banks. The paper does not offer specific solutions, as we believe meaningful solutions require a dialogue between all interested parties. Our hope is that the paper serves to define the issue of capital formation at community banks and raises the awareness of its importance to the financial system. The Conference of State Bank Supervisors (CSBS) views this as a fundamental issue to ensuring the diversity of our banking system. This diversity helps to ensure financial stability and access to credit throughout the United States.

## **Acknowledgements**

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## **The Critical Support of Capital**

In recent years, the availability of capital for community banks has become a significant source of concern. Ironically, this follows a period when capital was relatively plentiful. In particular, the late 1990's and early 2000's saw: (1) a significant increase in the funding and chartering of de-novo institutions, (2) significant availability of follow-on capital, particularly in the form of trust preferred securities, and (3) strong performance and valuations at institutions that drove up acquisition multiples and fueled additional investment interest.

From 2000 to 2008, state and federal authorities chartered 1,400 new banks with approximately \$23 billion in capital. With the onset of the financial crisis and through its aftermath, however, the capital window slammed shut. Interest in de-novos waned on the part of investors and regulators alike. Trust preferred securities failed to provide a source of additional capital and became an obstacle to recapitalizing troubled institutions. Finally, trading multiples collapsed with asset quality, eliminating both the interest and appetite for acquisitions.

As a result, community banks seeking capital to shore up balance sheets or enable growth faced a very uncertain future. During this time, even the federal government looked like an acceptable partner as banks applied for capital from the Troubled Asset Relief Program (TARP). As everyone knows by now, TARP was no longer about "troubled assets," as it was presented to Congress, it was about capital support. Why?

Capital demonstrates support and belief in a business, not only specifically, but systemically. An investor makes a capital investment if it believes it will achieve an acceptable return on that investment and will have principal returned at some point in the future. In 2008, the banking system lacked market confidence, leaving only the federal government to demonstrate this support and belief in our financial system.

After the financial system was largely stabilized in early 2009, the community bank segment continued to struggle as the economy endured a severe recession. Some community banks scrambled for capital to enhance the ability to absorb losses and weather the storm. This proved more challenging than most expected, finding resistance from investors and unexpected regulatory hurdles.

Government capital support has proven to be problematic on several levels. The well-intentioned Small Business Lending Fund (SBLF), a targeted capital program recognizing the unique role of community banks, fell far short of its objectives. For a variety of reasons, ranging from program design and implementation to bankers' fears of accepting public capital, only \$4 billion of the \$30 billion authorized by Congress was disbursed. Likewise, while the original TARP program seeded capital in hundreds of community banks, the bridge nature of the funding, as reflected in a dividend that rises over time, is likely to create problems in the future. Banks that have been paying 5% dividends since 2008 will see an increase to 9% in 2013 if they are unable to repay. The impending problem further elevates the importance of capital access. As noted in a recent report by Special Inspector General of the Troubled Asset Relief Program (SIGTARP):

*"Compared to larger banks, community banks may have an uphill battle to exit TARP. Community banks do not have the same access to capital as the larger banks ... Community banks need a clear exit path out of TARP that is put into action well before a scheduled rise in the TARP dividend."*

The solution to this problem must include private capital sources. Our experience to date suggests this will be easier said than done.

This paper explores barriers to private capital flows, including the forces of the market and government policy. This paper will also offer solutions to ensure capital is attracted to a diverse banking system, which is critical to a diverse and vibrant economy. These solutions were crafted based on the views of state bank regulators after receiving the varying perspectives of the industry, consultants, and attorneys.

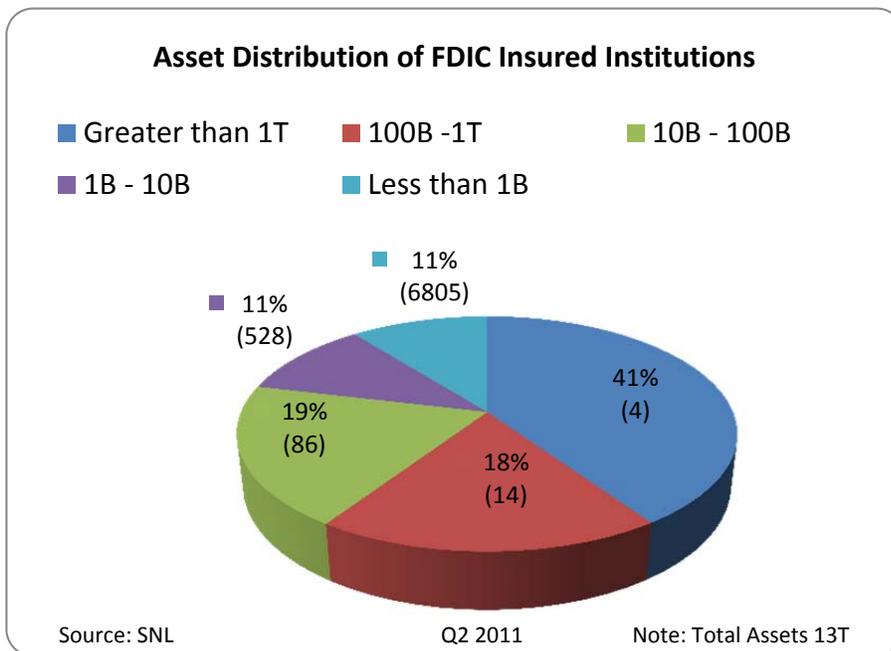
**Appreciating a Diverse Banking System**

The U.S. banking system reflects the diversity of the U.S. economy. The economy includes the largest multi-national firms, as well as small businesses comprised of “mom and pop” businesses and entrepreneurs taking the latest innovation to the market. While the U.S. has created products and services unimaginable to previous generations, it still boasts a vibrant, innovative and efficient agricultural industry, ranging from the family farm to large corporations.

The U.S. has more than 7,400 commercial banks and thrifts. Over the past decade, the number of banking institutions has declined while the concentration of assets among the largest institutions has increased. The top four banking institutions, each with assets in excess of \$1 trillion, control 40% of the industry’s assets. Despite this asset dominance, there are more than 6,800 institutions with assets less

than \$1 billion. One-third of these banks have elected the Sub-S treatment under the tax code. While the industry has consolidated, the U.S. still benefits from a diverse banking system which is critical to our diverse and complex economy.

Community banks play a valuable role in the U.S. economy. The fact is community banks do business in ways far



different from larger institutions. In community banking, both the borrower and the lender maintain a stake in the long-term outcome of the transaction. Community banks place a greater emphasis on long-term customer relationships, incorporating soft information that is not easily quantifiable. As opposed to transactional banking, relationship lending also typically involves more than simply transferring funds from lenders to borrowers. Community banks often add value by integrating accounting, business planning, and tax planning. Relationship lending is typically preferable for small business, agricultural lending, and retail customers.<sup>1</sup> Until consumers and businesses have a complete lack of regard for this type of service, community banks remain valuable.

According to the FDIC, banks with assets less than \$1 billion represent less than 11% of banking assets, but provide nearly 40% of small business loans.<sup>2</sup> Likewise, during the recent financial crisis, community banks played a critical role in ensuring access to credit and providing a safe haven for nervous depositors. The diversity of the banking system proved to be an extremely important asset.

### **People and Vision Always Matter**

To attract capital, investors demand confidence in the prospects for the organization and the ability to generate an acceptable return. Investors are typically not interested in cleaning up the problems of the past. They are interested in the effective deployment of new capital.

Bank management must be able to articulate a powerful story of economic opportunity. They must also be able to demonstrate their ability to manage this risk. While risk management is generally thought of as a “regulatory” term, it is fundamentally about providing a return on capital.

While painful, it is healthy to acknowledge that some banks which struggled with the ability to raise capital actually lacked the management and economic story to build confidence with investors. That story, which was so compelling during the de-novo craze of the 2000’s, falls upon more critical investor ears in a stressed or even tranquil economic environment. In light of this investor reality, the boards of banks struggling for capital need to have this honest discussion:

1. Do we have the management in place to execute a profitable vision?
2. Have we fully recognized our problems?
3. Are the economics of the local economy compelling?
4. When the need for capital is evaluated in the context of survival, can capital be too expensive?

To the extent additional equity is required, bank boards need to honestly assess the ability of the existing management team to raise capital. Prior institutional leadership may significantly compromise a bank’s appeal to new investors.

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<sup>1</sup> On the Uniqueness of Community Banks, by Scott Hein, Tim Koch, and Scott MacDonald, Federal Reserve Bank of Atlanta Economic Review, First Quarter 2005.

<sup>2</sup> Remarks by FDIC Acting Chairman Martin J. Gruenberg to the American Banker Regulatory Symposium, Washington, DC, September 19, 2011.

The bank's management may also unrealistically assess the actual need for capital and the cost. This is worth an independent review from the Board of Directors. The Board is ultimately responsible for the solvency of the organization. They owe it to the shareholders to ensure the institution is sufficiently capitalized through an economic cycle and can survive a stressed environment.

### **Deal Size Matters**

Community banks confronting the prospect of raising capital in the market face significant challenges, not the least of which is deal size. Capital offerings for less than \$20 to \$30 million are often too small for many institutional investors regardless of structure or investment thesis. Institutional investors have fixed costs to cover and deal size minimums. They simply cannot monitor an unlimited number of small investments, no matter how promising. At the extreme, banks seeking capital report investors who express interest in buying the entire institution, but not participating in a limited raise. This problem is complicated significantly by federal law and regulatory restrictions which further limit ownership stakes. This is discussed in greater detail in the "Regulatory and Legislative Issues" section. These considerations significantly restrict market access for banks with less than \$1 to \$1.5 billion in assets, which is approximately 9 out of every 10 banks in the United States.

Investors are also concerned with a smaller bank's ability to respond to regulatory obligations. This is a long-term issue which has only been fueled by the passage and extended public debate about the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). As investors vote with their money on the regulatory burden issue, policymakers should take notice that this is a very real issue with a potentially adverse economic impact.

Private investors must be able to define a clear exit strategy. This could be selling to a larger institution or an initial public offering. To achieve this, the bank must have and be able to build upon its franchise value. Extending on the dialogue above regarding "the story," there were institutions created in the 2000's that were built around under-priced and poorly underwritten deals, and funded largely by brokered deposits. These institutions may have created short-term shareholder value, but did not create franchise value. Since 2008, the FDIC has had to pay-out the deposits for 22 banks that failed to secure a bidder during the resolution process. The hard truth is that these banks did not create anything of value worth selling to another bank. As costly and unfortunate as all bank failures are most of them have created something of value to another bank. This is the way the system was designed to work. The private sector steps in with the assistance of an industry-funded, government solution.

### **Regulatory & Legislative Issues**

#### Federal Reserve Board Implementation of the Bank Holding Company Act

In 2008, during the heat of the financial crisis, the FRB revised its Policy Statement on Equity Investments in Banks and Bank Holding Companies. The policy states that an investor can own up to 24.9% of the outstanding voting shares of a bank and obtain a seat on its board of directors without being deemed in control. The policy permits an investor to have two directors without being deemed to

control the target provided that: (1) another company controls the target and (2) the non-controlling investor's representation is not disproportionately larger than its equity investment.

Secondly, the FRB allows an investor to own up to 33% of the total equity of a bank if the investment does not include ownership of 15% or more of any class of voting securities of the target. Therefore, an investor can own 33% of the total equity in a bank if the shares comprise only non-voting shares, or it can own a mix of non-voting and voting shares adding up to 33% of the total equity provided the mix does not include voting shares which equate to 15% ownership of a bank. It is important to note that, in accordance with the Bank Holding Company Act, non-voting stock, which is convertible to voting stock in the hands of the transferee, counts as voting stock.

The third aspect of the policy statement deals with passivity requirements and essentially allows investors to have a more active role in communicating with management on governance matters and the structure and functioning of the institution.

While the revisions made in 2008 were intended to open up capital for banks, the restrictions present a significant hurdle for community banks. The 24.9% limitation severely complicates the "small deal" problem described in the previous section. Community banks and investors report the level makes it difficult to reach an acceptable minimum deal threshold desirable for many investors. As a result, a bank must seek multiple investors. This makes the regulatory approval process more complex. Further, restrictions on "acting in concert," designed to restrict the ability to maneuver around the 24.9% limit, further complicate the effort. The bank must assure itself that the investors have not coordinated regarding the investment, while keeping all parties at the table throughout the process and supportive of the proposed strategy and objectives. As one state bank commissioner observed sarcastically about the Fed's policy statement: "We sure wouldn't want anyone in control of the institution or wanting the same thing."

Federal policy toward capital investments in banks demonstrates a level of caution regarding potential investors in a bank. Regulators have a legitimate interest in ensuring investors are consistent with the public trust of an insured depository. However, to the extent that this hesitation centers on a belief these investors are only seeking an opportunity for significant returns, policymakers need to appreciate these investors face significant financial risk. Investors are seeking opportunities to invest in financial institutions at depressed prices, due to weaknesses in the system and a very challenging economic environment, which will likely continue for some time. Fundamentally, this is how capitalism works.

#### Dodd-Frank Act

*Trust Preferred Securities.* Through the 2000's, trust preferred securities proved to be an easily accessible source of capital for community banks. In 1996, the FRB approved the inclusion of minority interest in the form of trust preferred securities in a bank holding company's tier 1 capital. Bank holding companies could tap the market and downstream the capital into the bank. This provided needed capital for organic growth or acquisition, while not diluting the interest of stockholders.

As the economy suffered and bank conditions deteriorated, many banks were compelled to raise capital. While the economic environment caused this to be challenging, the existence of trust preferred securities as part of the holding company's capital structure proved to be an additional inhibitor. Prospective investors had little interest in shoring up an institution where some investors retained a priority position and would not share equally in any loss of capital. The structure of the trust preferred securities provided no incentive for the investor to convert to common equity. Additionally, the pooling of issuances made pursuing investor consent for a conversion impractical.

While trust preferred securities provided ready capital for community banks during times of economic expansion, they proved to be an inhibitor of capital creation during periods of stress. Given the losses incurred by investors and the poor performance of these securities, the market no longer supports this product. Further, Dodd-Frank requires the federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for depository institution holding companies, which shall be no less than those generally applicable for insured depositories. This effectively eliminates the tier 1 capital treatment trust preferred securities received at the holding company level. As a result of market forces and legal changes, trust preferred securities are no longer a pipeline to the capital markets for community banks.

*Source of Strength.* The Dodd-Frank Act also requires the federal banking agencies to issue rules implementing source of strength requirements for bank holding companies. Historically, source of strength has typically been more akin to a doctrine than a legal or regulatory requirement. Conceptually, the holding company of a bank should be in a position to support the bank. In too many instances during this crisis when the regulators looked to the holding company to support the bank, the holding company lacked the capacity to do so. The mandates in Dodd-Frank appear to require more prescriptive measures on what it means to serve as a source of strength. This has the potential to fundamentally reshape the industry especially for single bank holding companies.

### Basel III

With the global nature of this crisis, regulators from around the world sought to promote a stronger banking sector. In December 2010, the Basel Committee on Banking Supervision released "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems." A significant part of this document is focused on strengthening the global capital framework. The key aspects of this plan include:

1. Introducing a leverage ratio requirement. U.S. banks have always had this requirement, but this is new in terms of international standards.
2. Requiring the predominant form of tier 1 capital to be common shares and retained earnings.
3. Establishing a 2.5% capital conservation buffer above the regulatory minimum. Banks operating between the minimum and the minimum plus the buffer are constrained in the percentage of income which can be distributed to investors.

4. Instituting a countercyclical buffer to be deployed when supervisors detect excess aggregate credit growth leading to a build-up of system-wide risk. The intent is to enhance the capital buffer against future potential losses. The buffer of up to 2.5% of risk weighted assets will be pre-announced up to 12 months before the effective date. Removal of the buffer, presumably during a period of stress, will be effective immediately.

The table below compares the various capital measures internationally, domestically, current and future.

	Tier 1 Leverage	As a % of Risk Based Assets		
		Common Equity	Tier 1	Total Capital
Current International Standard	None	2.00%	4.00%	8.00%
Current U.S. Standard (well capitalized)	5.00%	None	6.00%	10.00%
Future International Standard	3.00%	4.50%	6.00%	8.00%
Future Standard w/Conservation Buffer	3.00%	7.00%	8.50%	10.50%

Given relatively high capital standards in the U.S., the anticipated impact of Basel III capital standards on U.S. banks is limited. Larger institutions will be most immediately impacted as they seek to improve the quality of capital. With implementation of the new standards occurring between January 1, 2013 and January 1, 2019, institutions will have ample time to meet the new standards.

However, the industry will need to carefully analyze how the federal regulators implement the international framework in the U.S. It is possible the regulators could seek ways to ensure the U.S. maintains higher capital standards than the rest of the world. How the regulators implement the counter-cyclical buffer should be of particular interest. As outlined above, community banks have limited sources to raise capital. The deployment of a counter-cyclical buffer with a 12 month advance notice may be challenging for a bank which has few options to increase capital other than through earnings.

### **Areas for Potential Solutions**

#### Internal Prioritization

It is incumbent upon banks to take stock of the reality in which they operate. The regulatory expectations of risk management including risk identification, stress testing<sup>3</sup> and capital planning have increased. The requirements for the quality and quantity of capital are being raised, while access to the capital markets has been constrained. This may be a tough reality, but it is not insurmountable.

As a first step, banks need to make an honest self-assessment of their management ability and economic prospects for the areas they serve. As discussed above, these are key factors for any investor.

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<sup>3</sup> The Case for Stress Testing at Community Banks, Conference of State Bank Supervisors, October 2010.

These are board level decisions to be made by the representatives of current stockholders. Boards must be prepared to deal with the fact that management may not want to have this discussion. However, there is a fiduciary responsibility to engage in this dialogue.

All institutions need to face the prospect of having to raise capital. It is possible to create a scenario of internal and external factors for nearly any bank which would cause it to be short on capital. This is more than just a problem bank or weak economy scenario. Some banks may simply have the opportunity and desire to grow, but lack sufficient capital. Banks need to understand these risks and the realistic options for capital. For many community banks, given their size, management ability, and economic prospects, they may need to be prepared to “pass the hat” around the board room table. Knowing this fact should certainly have an impact on the composition of the board, as well as the risk tolerance and selection of the bank.

#### Action at the Federal Level

There is a need for changes at the federal level. Legal and regulatory policies and approaches should facilitate capital investment in banks. The current environment has revealed a policy approach and process which is too exacting and not responsive to community banks.

*Customized Approach.* The regulatory process must be customized to appropriately recognize the unique challenges of community banks in the capital markets. The suggestion that approving a certain application would establish a precedent that could be exploited by a large, systemic institution is misguided. On balance, community and regional banks present significantly less systemic risk to the financial system. A clearly articulated regime for community banks will avoid the inappropriate application of an approach to larger institutions. This approach also recognizes the risk presented by an individual approval is limited and manageable.

The federal approval process needs to expedite applications which are designed to provide a private solution to a troubled situation. There needs to be recognition the bank, the state regulator, or private investors have orchestrated a private solution, which is beneficial to the markets in which the bank operates. Ultimately, this saves the Deposit Insurance Fund and the industry money.

*The Bank Holding Company Act.* This may be the time to evaluate the effectiveness of the Bank Holding Company Act relative to market conditions and the overall structure of the industry. For a law that was seemingly passed to prevent an undue concentration in banking, the application of the law in the current environment seems to be fostering it. The Senate Report accompanying the Bank Holding Company Act articulates that “adequate safeguards should be provided against undue concentration of control of banking activities.”<sup>4</sup> As the law and rules are currently written, investors that would provide the capital necessary to support a diverse universe of banks are not willing to inject capital for fear of becoming subject to the enhanced regulatory requirements of the BHC Act. Accordingly, the best option for smaller institutions is mergers and acquisitions, which has resulted in the steady decrease of independent commercial banks across the country. There must be other options for smaller institutions,

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<sup>4</sup> S. Rep. No. 1095, 84th Cong., 1st Sess. (1955).

otherwise the Senate's sentiments will become a self-fulfilling prophecy: "[t]he dangers accompanying monopoly in this field are particularly undesirable in view of the significant part played by banking in our present national economy."<sup>5</sup>

Addressing issues with the BHC Act should benefit the more than 6,800 banks with assets below \$1 billion. These institutions have been squeezed out of suitable capital raising options by the BHC Act, yet still manage to form the backbone of the American economy during a time of significant economic turmoil. The importance of these banks is just as significant today as it was upon the passage of the BHC Act, when the president of the Independent Bankers Association of America stated:

*"The Bank Holding Company Bill, just passed by the Senate, and passed last year by the House, gives marked hope for the continuation of our unique American system of banking. Independent banking has played an important part in the development of this country, not only in developing the metropolitan centers, but the small towns and villages that are so essential to the country's well-being. Our old system of banking with diffused ownership and management has been a part of our Democratic system; to concentrate banking in a few hands would be dangerous to the political future of this country. It would be hard to maintain a political democracy without a democratic economy."*

The requirements of this Act cannot impede the policy goals it sought to address. A bifurcated approach should be used to ensure that the dangers of bank control by non-banks are mitigated, yet allow for reasonable investments.

## **Conclusion**

The financial crisis and current economic challenges have reminded the industry and policymakers of the importance of capital to sustain a financial system. While this reminder is driving enhanced expectations for capital, it should also serve to highlight the challenges community banks have in raising capital. The industry has a responsibility to recognize this and account for it in the bank's risk analysis and capital planning. Federal policymakers must also recognize this challenge and ensure that policy and process do not exacerbate the problem.

This issue deserves attention as fundamental to ensuring a diverse banking system, where institutions of all sizes with varied business models can compete and thrive. It is in our national interest to ensure the regulatory structure and public policy encourages the flow of monetary and human capital to the banking system.

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<sup>5</sup> Id.