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INFORMED OPINION

Capital Spigot for Small Banks Is Too Tight

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While debate rages about the effectiveness of the legislative and regulatory response to the financial crisis and the implications for community banks, a quieter but equally threatening force is at work.

Market evolution in recent decades has made it harder and harder for smaller institutions to access capital. Meanwhile, regulatory restrictions impede alternatives that could fill the void. This confluence of trends lacks the immediacy of current regulatory battles, but addressing the problem is equally critical to ensuring a vibrant community banking system.

Recent experience has provided ample evidence of the importance of a diverse banking system. Community banks played a stabilizing role, continuing to lend while some of our largest banks were brought to their knees. In the aftermath, however, the outlook feels eerily familiar. Concentration in our largest institutions grows, while the decline in the number and market share of community banks grinds on.

There appears to be a consensus that this trend is detrimental for communities or the banking system. In recognition, key provisions of Dodd-Frank included a tiered approach based on size. For example, banks under $10 billion of assets were exempted from the Durbin cap on debit interchange fees, and they are not subject to the oversight of the Consumer Financial Protection Bureau.

Now, as the statute is being put into practice, its critics and regulators alike express concerns about creating an outsized burden on smaller institutions. These concerns are important as even the strongest community bank, weighed down by unnecessary costs, is challenged to offset the scale economies of larger institutions, not only in compliance, but systems, infrastructure and other areas.

At the same time, I have confidence that community banks can be successful. I see it every day. Quality management teams operating close to their customers can adapt, respond and compete if they are not overly hamstrung.

Underneath the surface, however, community banks face a longer-term challenge in capital availability. For decades, capital has shifted steadily from individuals to institutions. Mutual funds, pension funds, hedge funds and institutional players have come to control the preponderance of capital. These institutions operate on a scale basis and demand bigger deals. Size matters more each day, for any industry.

Following the adage that "he who has the gold rules," the market has responded. As an example, the average NASDAQ IPO in the 1990s was $35 million. The average IPO in 2009 and 2010 was over $250 million. Microsoft was a big IPO 25 years ago at $60 million. Facebook recently raised over a billion privately in days.

Community banks are not NASDAQ tech companies, and IPOs have never been the exclusive or even traditional funding avenue. The issue, however, is that capital markets broadly, public or private, share the same characteristics.

In most industries, private capital (particularly private equity capital) has helped to fill the void. Unfortunately, bank regulatory policy is not exactly welcoming.

While investments are being made, the pace is agonizingly slow, in part because institutional investors fear being deemed a bank holding company and required to serve as an ongoing source of capital strength for the bank. To avoid this risk, they confine themselves to "non-control investments," typically 24.9% or less of the voting securities of an institution. This practice makes an already limited opportunity for investing in community banks even smaller.

Concern that others participating in the same raise could be deemed to be "acting in concert" further complicates the challenge. Multiple investors are restricted from combining and leveraging their efforts for fear of constituting a de facto single investor for purposes of the Bank Holding Company Act. At the end of the day, investments in institutions with assets less than $1 billion to $2 billion become too small for most institutional investors to make sense.

While I recognize the rationale for the restrictions related to control and the need to protect against abuse, it is undeniable that the impact on smaller institutions is outsized and has become increasingly constraining. When the Bank Holding Company Act was passed in 1956, roughly 90% of U.S. public stock was held by individuals. Today, individuals account for less than 30%. Again, this is not simply a public equity problem, but the data is illustrative.

The Federal Reserve modified its guidance for non-control equity investments in 2008 for institutions of all sizes, elevating the ownership percentage that an investor could hold without being deemed a "control investor." Another worthy step would be revisiting these issues with an eye toward the unique challenge that percentage limits create for small institutions. Remedies would likely require legislation, but ironically, Dodd-Frank may provide the template with its tiered approach.

For example, allowing institutional investors to control 49% of a regulated $1 billion or $2 billion bank could provide important expansion capital, market discipline and strategic assistance without overly compromising governance or oversight and sowing the seeds of a systemic disaster.

Community banks play a critical role in local economies. Their future is important and worthy of the focus being paid by legislators and regulators. Amidst the ongoing regulatory burden discourse, we would be well served to review the underlying capital environment and respond to market evolution. Otherwise, lack of access to capital will be every bit as burdensome to small banks as the many regulatory issues dominating today's debate.

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