

TESTIMONY OF

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COMMISSIONER

LOUISIANA OFFICE OF FINANCIAL INSTITUTIONS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

“THE STATE OF COMMUNITY BANKING: CHALLENGES AND OPPORTUNITIES”

Before the

FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION SUBCOMMITTEE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

Wednesday, April 6, 2011, 3:00 p.m.

Room 538 Dirksen Senate Office Building

## **Introduction**

Good afternoon, Chairman Brown, Ranking Member Corker, and distinguished Members of the Subcommittee. My name is John Ducrest, and I serve as the Commissioner of Financial Institutions for the State of Louisiana. I am also the Chairman of the Conference of State Bank Supervisors (CSBS). It is my pleasure to testify before you today on behalf of CSBS.

CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands. State banking regulators supervise, in cooperation with the Federal Deposit Insurance Corporation and Federal Reserve, over 5,600 state-chartered insured depositories. Further, the majority of state banking departments also regulate a variety of non-bank financial services providers, including mortgage lenders. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to state banking and financial regulators and represents its members before Congress and the federal financial regulatory agencies.

Today's hearing comes at a critical time for the community banking system. Community banks are currently operating in a very challenging business and regulatory environment. I thank you, Chairman Brown, and the Members of the Subcommittee for holding such a timely hearing. Understanding the current challenges and opportunities facing community banks is an important part of understanding the overall health of the economy. Even more importantly, the subject of today's hearing logically leads us to significant questions about the longer-term prospects for the community banking business model.

In my testimony I will discuss my perspectives as a state banking regulator on the critical role community banks play in economic development, job creation, and market stabilization. I

will also address the current regulatory environment in which they operate. Additionally, my testimony will identify concerns that my state banking commissioner colleagues and I have about the impact of regulations and policies on community banks. Finally, I will provide some recommendations aimed at strengthening the community banking system.

### **Why Community Banking Still Matters**

Over the past several months, my fellow state regulators and I have heard the very loud concerns of community bankers regarding their future. These concerns come from the feared trickle-down effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act and other regulatory actions deemed necessary to address identified weaknesses in the banking system. This will undoubtedly add to the compliance burden being shouldered by the industry. While consumer compliance is significant, in this context, compliance also includes bank secrecy, corporate governance, accounting rules, and reporting requirements. In addition, community banks are facing an uncertain future as the structure and role of larger institutions in the economy is evolving and the future of mortgage finance is being debated.

We believe these concerns are very real and are worthy of our collective attention. This should be a serious, national concern. In our view, the viability of the community bank model has significant systemic consequences, which if left unaddressed will cause irreparable harm to local economies and erode critical underpinnings of the broader economy.

The challenges the community banking system is facing are already having an impact upon local economic development, as some local economies remain stalled or even eroded by more limited credit availability. As you meet with bankers in your office and in your state, I encourage you to ask them about the loans which are not being made. While some banks are not positioned to lend due to their financial condition, many banks are not making residential real

estate loans due to the increased compliance burden. In addition, commercial real estate (CRE) loans are not being made due to the stigma of an entire asset class. We cannot accept this as collateral damage in the interest of consistency and national policy.

### Small Business Lending

The vital role small businesses play in the national economy is widely recognized. Small businesses are often considered the “engine” of the U.S. economy and drive employment across the nation. Small firms:

- Represent 99.7% of all employer firms in the United States;
- Employ half of all private sector employees;
- Pay 44% of total U.S. private payroll;
- Generated 65% of net new jobs over the past 17 years;
- Made up 97.5% of all identified exporters and produced 31% of export value in FY 2008; and
- Produce 13 times more patents per employee than large patenting firms.<sup>1</sup>

Just as small businesses are recognized as critical to the health of our national economy, the U.S. banking system remains the most important supplier of credit to small businesses in the country. While the volumes are large, banks with over \$50 billion in assets allocate only 24% of their loan portfolios to small business loans. Banks with less than \$10 billion in assets invest 48% of their loans in small business (See Exhibit 1). There is a very significant difference in the type of small business lending conducted by the smaller banks. In general, lack of extensive financial data for smaller firms makes it more difficult for lenders to ascertain if a small business is “creditworthy.” This makes community banks particularly well suited for small business lending. The largest banks tend to rely upon transactional banking, in which hard, quantifiable

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<sup>1</sup> U.S. Small Business Administration, Advocacy Small Business Statistics and Research, Frequently Asked Questions, <http://web.sba.gov/faqs/faqindex.cfm?areaID=24>.

information drives performance and products are highly standardized. Community banks, however, engage in relationship banking, involving the use of soft information which is not readily available or quantifiable. Synthesis of soft information requires more human input, usually acquired by direct exchanges between the lender and the borrower, and relies upon lenders empowered with decision making authority.<sup>2</sup> These types of loans are economically significant at the local level, providing jobs and economic activity. Collectively, they are significant for the national economy as well.

#### Maintaining the Availability of Credit

In addition to providing critical financial support to small businesses, community banks have also proven a reliable source of credit for individuals in smaller communities. The nation's largest institutions have a tremendous presence in metropolitan areas, but may not provide services to residents of small or rural areas (See Exhibit 2). Community banks, with their geographically-focused service areas, provide the necessary financial products and access to credit for residents of rural and smaller communities. While community banks are essential to the very existence of some communities, I would highlight that the value of the relationship lending model provides needed services and credit to businesses and consumers in communities of all sizes.

Through strong and weak economic conditions and in times of crisis, community banks provide much-needed stability to the financial system by continuing to make credit and financial services available to individuals and small businesses. For example, during the crisis in the capital markets, the nation's largest banks all but ceased all lending activity to preserve capital to

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<sup>2</sup> Hein, Scott E., Timothy W. Koch, and S. Scott MacDonald, "On the Uniqueness of Community Banks," Economic Review (First Quarter, 2005).

remain solvent. Community banks, however, continued to make credit available to individuals and businesses and helped prevent a complete collapse of the U.S. economy.

In my home state of Louisiana, we have experienced firsthand the role that community banks play in providing economic stability during times of crisis. In the wake of Hurricane Katrina, community banks were the leaders in re-opening their doors in the affected areas of the state. Specifically, locally-based institutions quickly re-opened at alternative locations in order to restore and reinforce public confidence in the state's banking system, provided valuable information about conditions in the affected areas, and provided much needed assistance through their lending activities to the rebuilding efforts in the affected areas. My department worked with our regulated depository institutions to assist the evacuees in their greatest time of need, by encouraging these institutions to institute extraordinary measures, such as: waiving fees for customers and non-customers seeking traditional banking services; increasing credit limits, ATM and debit card withdrawal limits and lines of credit limits for customers; extending repayment terms on loans, easing credit extension terms for new loans, and restructuring existing debt; and working with other institutions to pool resources in order to provide cash, the most essential item in the immediate aftermath of Hurricane Katrina. In general, the financial services industry reacted quickly and aggressively to work with their customers in any way possible to restore the availability of credit and cash in the affected areas of Louisiana.

### Diversity

The recent financial crisis has reminded us all of the necessity of having a strong, stable and diverse banking industry in the United States. A diverse banking industry characterized by banks of varying sizes, complexities, specialties and locations ensures consumers have access to credit and banking services in every corner of the country and around the globe and through

every part of the business cycle. Despite the recent collapse of the capital markets and the ensuing recession, the United States still boasts approximately 7,600 insured depository institutions, ranging in size from \$1.3 million to over \$1.6 trillion in assets.

The past few decades, however, have been marked by a decrease in the total number of insured financial institutions and stunning consolidation of the industry's assets into the largest institutions. In the last 25 years, we have lost 12,362 banks. This represents 62% of the total as of December 31, 1985 (See Exhibit 3). While a significant portion of consolidation may be market driven, we do not believe all of the drivers and long-term impact of consolidation are fully understood. As the industry consolidates, the system is increasingly dominated by the largest institutions. In the last 10 years, the top 5 banks have increased their market share from 24% to 42% of total assets. This industry consolidation raises concerns because of the critical role many smaller institutions play in the communities and states in which they operate.

To ensure a diverse industry, the community banking system must be able to thrive alongside of, and compete with, other banks, regardless of size. A generally agreed upon, but rapidly approaching outdated, definition of a community bank is an insured depository institution with \$1 billion or less in assets. Perhaps a better definition is an institution with a local focus and scope of activities, with the corresponding experience and expertise to excel at relationship lending. A community bank is to a local business what Wall Street is to a Fortune 50 company: not just a lender, but a financial and business adviser.

A strong community banking system is absolutely critical to the well-being of the United States economy. As discussed above, a diverse financial system characterized by strong community banks ensures local economic development and job creation, provides necessary capital for small businesses, and provides stability and continued access to credit during times of

crisis. Therefore, it is critical that policies and decisions made in Washington, D.C. carefully consider the impact on smaller banks and the communities they serve. Put simply, how community banks are impacted by Dodd-Frank and other regulatory measures is too important not to understand.

### **The Current Environment for Community Banks**

Despite indicators that the national economy and some of the nation's largest financial institutions are showing signs of improvement, community banks continue to operate — or in too many cases, struggle to survive — in a very challenging environment. The nation's biggest banks have returned to profitability faster than smaller banks. As of the 4<sup>th</sup> quarter of 2010:

- Only 12.15% of banks over \$10 billion in assets remain unprofitable.
- In contrast, 21% of institutions under \$1 billion in assets remain unprofitable.

During the collapse of the capital markets, the nation's largest institutions were granted unprecedented and extraordinary government assistance through a variety of programs and policies to not only remain solvent but to facilitate a return to economic health. Community banks have not received the same extraordinary assistance, and have been operating under an economic recession largely not of their making. In addition, the regulatory environment for community banks has proven unforgiving for miscalculations of risk. Since the start of the crisis in 2008, 348 banks have failed. The overwhelming majority of these banks have been community banks. Most of these failed institutions have been acquired by other community banks, while banks with assets greater than \$100 billion have bought only 7% of the failed banks. While failures are disruptive at the local level, it is important to note that the regulatory and resolution process for this part of the industry worked. The community banking system is healing itself. We must ensure there is a structure and policies in place which encourage the active participation of community banks in the market. In my state and in my communities, I see



needs that will not be met by the biggest institutions. Therefore, we must create an environment that does not drive people and capital away and attracts new entrants to the market. Increasingly, I am hearing a desire from community bankers to merge or sell their institution because they are overwhelmed by regulatory burden and the perception of a federal system which no longer supports their business model. The model of other concentrated banking systems, like Japan, where collapse was followed by long-term stagnation, should be better understood before we continue down the perhaps irreversible road of further consolidation.

CSBS appreciates that the Dodd-Frank Act was drafted with an eye to preserving the community banking system. CSBS views the Dodd-Frank Act as a reaffirmation of the importance of the dual-banking system and all that it entails: a system of regulatory checks and balances that serves as a counterweight to consolidation both of regulatory authority in Washington, D.C. and of influence into a handful of money-center banks; a diverse and competitive industry marked by charter choice and innovation; and access to credit for individuals and businesses in every corner of the country. However, we also understand that uncertainty about the impact of Dodd-Frank, especially when combined with a challenging business environment and general concerns about the direction of regulation, could create a sense of a crushing regulatory environment.

CSBS believes that community bank-oriented Dodd-Frank provisions such as the change in the deposit insurance assessment base which favors smaller, less-risky community banks and the elevation of deposit insurance coverage to \$250,000 for individual accounts are critical for community banks. Additionally, the coordination that Dodd-Frank requires among state and federal regulators, such as the newly created Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC), serve the important goals of

improving regulation efficiently and giving voice to a community bank regulatory perspective. Earlier this year, the CFPB signed its first information-sharing memorandum of understanding with CSBS and several state banking departments, a positive indicator that the CFPB intends to leverage the work of state regulators in protecting consumers and in bringing efficient compliance supervision to the community banking system.

Finally, CSBS appreciates the bill attempts to address the problems created by providing explicit government guarantees for a cadre of mega-banks considered “too big to fail.” Addressing—and hopefully eliminating—the competitive advantages created by the perception and reality of being “too big to fail” has direct consequences for community banks. However, whether, and to what extent “too big to fail” has truly been rectified remains unclear. From the standpoint of state banking regulators, evaluating the success of efforts to eliminate “too big to fail” means looking at:

- Whether the cost of funds for institutions becomes more competitive, regardless of the institution’s size. Currently, mega-banks enjoy a significant advantage in this area and are able to obtain funds at a much more affordable rate than community banks, giving them a clear operational advantage to the majority of the nation’s banks. As demonstrated by Fannie Mae and Freddie Mac, a funding advantage and perceived federal guarantee can translate into market dominance.
- The efficacy of Dodd-Frank’s resolution regime for large complex financial institutions. In a properly functioning, market-driven industry, bank resolutions must be allowed to occur when an institution becomes insolvent. Dodd-Frank did put a resolution regime in place, but until an institution that was once considered “too big to fail” is resolved in an orderly manner, such a regime will remain an empty threat to the biggest banks, and more importantly their investors and creditors, as they operate without fear of consequences for risky actions.

- Whether the banking industry in the United States remains diverse, with institutions of all sizes operating in communities around the nation by regular chartering of de novo institutions to fully serve the dynamic U.S. economy.
- Application of the Dodd-Frank concentration limit. This concentration limit, if implemented successfully, will do much to prevent banks from becoming “too big to fail” and will help ensure a competitive industry.
- Whether the ratings agencies consider being systemic or too big to fail a sign of strength and safety and a reason for a higher rating.
- Whether the cost of being systemic must be real and encourage an overall reduction in risk to the economy. Regulatory policy should clearly dissuade institutions from becoming too big to fail.

The Dodd-Frank Act was a sweeping overhaul of financial regulation and will require significant commitment, time and resources to fully implement. As a result, we are still unaware of the full scope of the impact of Dodd-Frank will have upon the industry as a whole, and community banks specifically. For example, we share our federal counterparts’ concerns about the impact of the interchange fee provision could have upon community banks. As we discussed in a comment letter to the Federal Reserve Board, we do not fully understand the full impact this provision could have. In the near-term, given the condition of the industry, we fear near-term negative consequences for earnings and further impediments to the long term viability of the community banking model (See Exhibit 4).

The financial crisis and recession exposed weaknesses in risk management and supervisory practices which need to be addressed. These include:

- Concentrations;
- Loan underwriting;
- Funding sources, such as brokered deposits and wholesale funding;
- Capital standards; and
- Standards and expectations for de novo institutions.

Unfortunately, the potential solutions to these issues only increase the concern of community bankers. A broad brush approach, bright line limitations, and a checklist of risk management requirements will surely over-tax the industry. We need to ensure that regulatory policy in these areas does not further undermine the very industry it is attempting to strengthen. FDIC Chairman Bair's recent comments about community banks and CRE lending reflect this sentiment:

"I believe that supervisory policies need to reflect the reality that most community banks are specialty CRE lenders and that examiners need to focus on assuring quality underwriting standards and effective management of those concentrations. Though hundreds of small banks have become troubled or failed because of CRE concentrations, thousands more have successfully managed those portfolios. We need to learn from the success stories and promote broader adoption of proven risk-management tools for banks concentrated in CRE."<sup>3</sup>

### **Recommendations to Address Concerns and Preserve Community Banking System**

The economic crisis, the resulting recession, and now enhanced regulatory burden have combined to create an incredibly challenging operating environment for community banks. More consideration must be made by policymakers to understand the long-term impact our decisions and actions have upon the community banking system. To that end, I have a few suggestions for implementing a revamped regulatory regime while still encouraging the success of the community banking system.

First, there must be continued coordination and consultation between federal and state regulators to best understand how local and national economies will be impacted by new regulations. I believe the most effective system of financial supervision is one characterized by both state and federal financial regulation, what my colleague from New York, Superintendent of

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<sup>3</sup> Remarks by FDIC Chairman Sheila C. Bair to the ICBA National Convention, San Diego, California, March 22, 2011 <http://www.fdic.gov/news/news/speeches/chairman/spmar2211.html>.

Banks Richard Neiman, refers to as “cooperative federalism.” A system of supervision based on cooperative federalism allows for comprehensive, effective and efficient supervision of the banking industry. Key components of a state/federal supervisory system are the proximity of state regulators to the entities we supervise, and our ability to identify emerging threats or trends in the banking industry, as well as the ability of federal regulators to implement regulations on a national scale and applicable to all market participants.

Second, more analysis is needed to fully understand and appreciate the valuable relationship between community banks and small business. My fellow state regulators and I know anecdotally that the community banking system is at peril, and therefore the small business sector in the United States is also in jeopardy. However, the lack of data and analysis in this area has failed to provide a clear enough understanding to appreciate industry diversity and a viable and competitive community banking system. Significant resources at the federal level exist to perform such analysis and would provide tremendous benefit to the national economy, but also to your state and local economies. Across the country, different communities benefit from unique community banks that are specifically tailored to meet their needs. Gathering data to better understand and appreciate the business models of community banks will provide greater appreciation for this significant issue on a greater scale and will provide clear justification for a national priority to ensure public policy enables and does not overly burden community banking.

Finally, CSBS recommends that Congress and the federal regulators investigate ways to tailor regulatory requirements to institutions based upon their size, complexity, geographic location, management structure, and lines of business. The current “one size fits all” approach to regulation, both in terms of safety and soundness and compliance supervision, has fallen harder on community banks and driven dramatic consolidation and bifurcation of the banking industry.

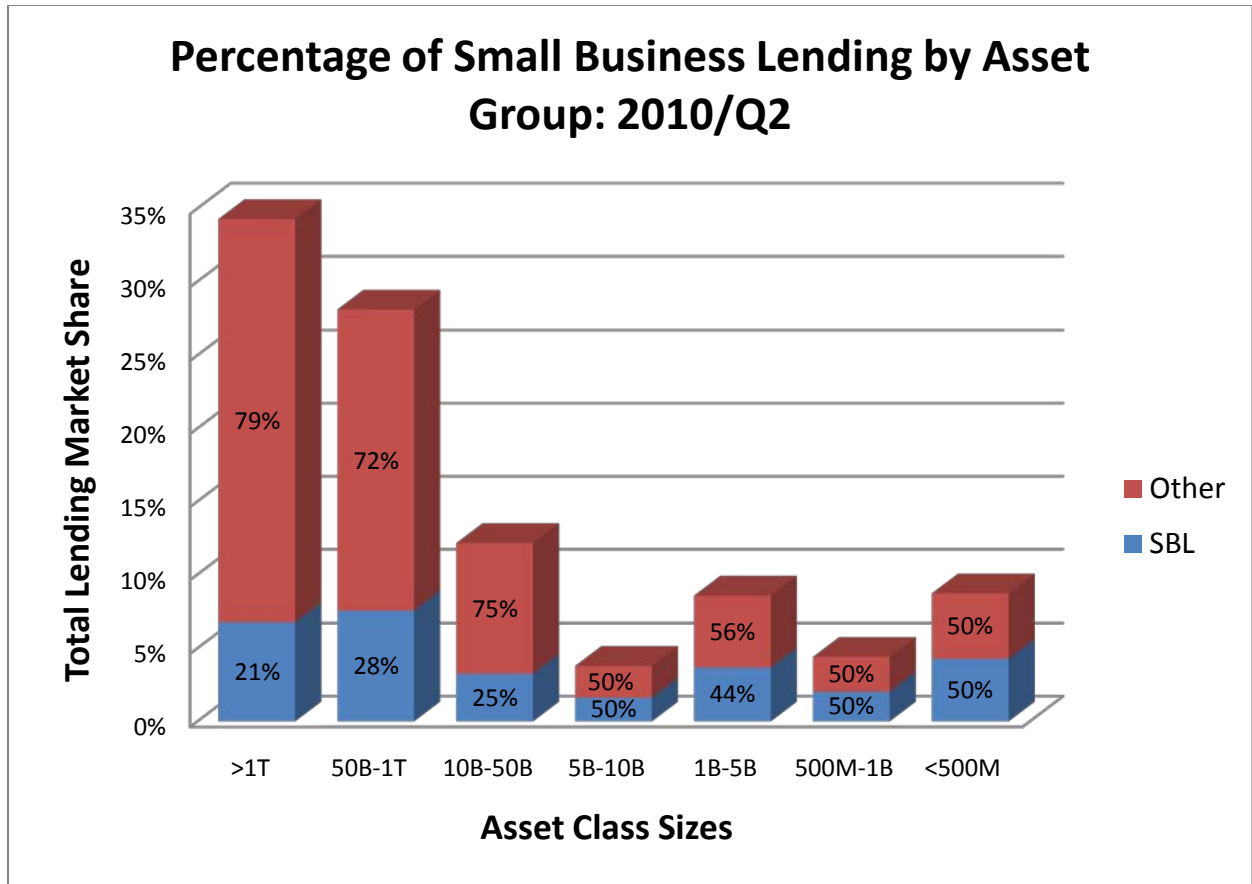
Perhaps it is time to explore a bifurcated system of supervision. After all, a bank with a single branch in one state has a dramatically different business model than Bank of America or Citigroup, so it should not be held accountable to the same supervisory structure as institutions which employ thousands of people and operate in hundreds of nations.

### **Conclusion**

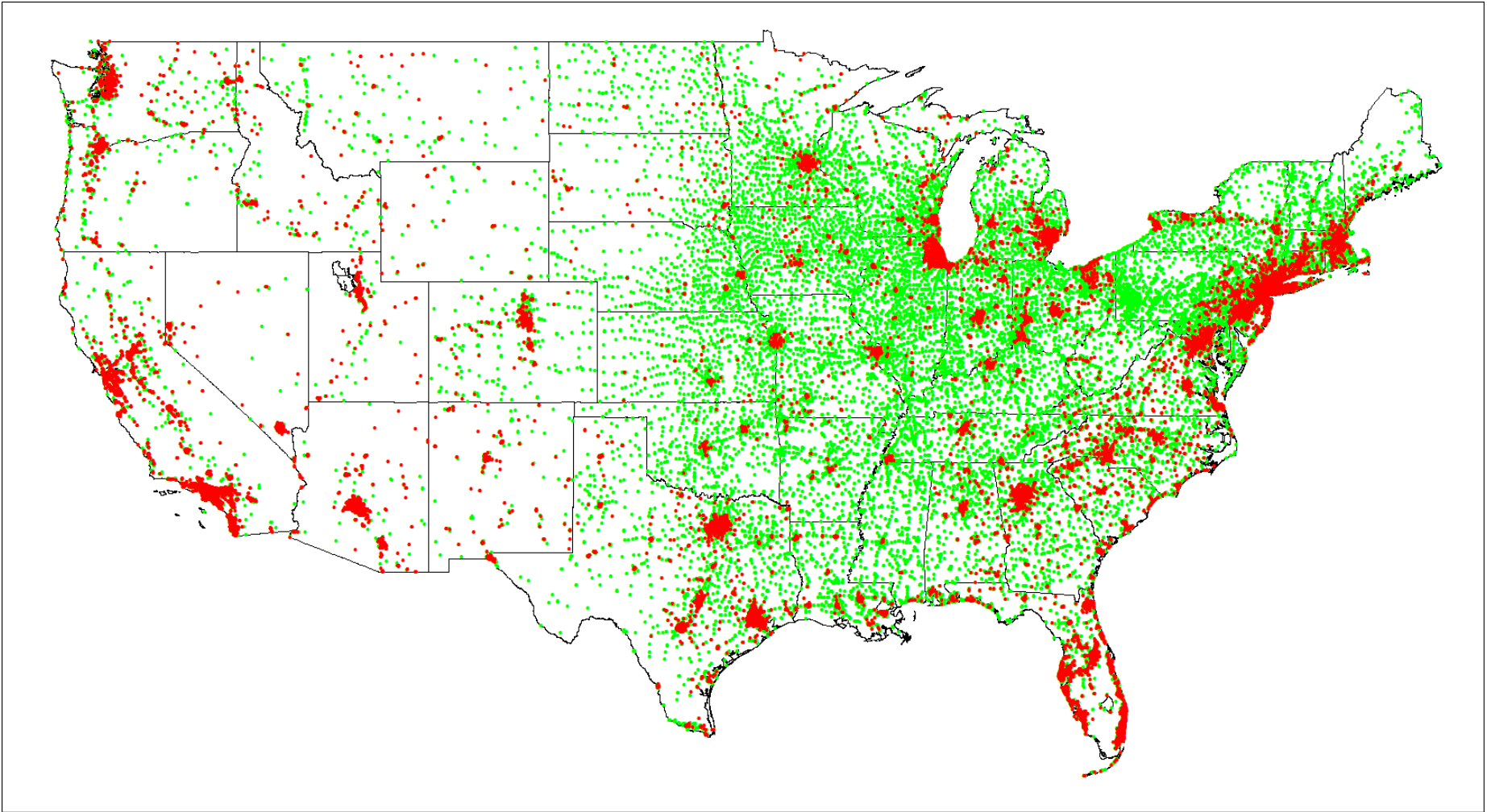
As I mentioned at the beginning of my testimony, addressing the challenges facing community banks now is very important and a meaningful exercise. However, as important as understanding the current condition of community banking is, an awareness that decisions made and actions taken today will have a long-term impact on the viability of the community banking model is critical. After the nation recovers from the recession and the provisions of the Dodd-Frank Act are implemented, what will our banking industry look like? We must ensure industry diversity and full access to credit across the country by creating an environment which benefits all institutions, but particularly the community banks which are so vital to providing stability, access to credit, and support for the small business sector.

CSBS stands ready to work with Members of Congress and our federal counterparts to create a regulatory regime which encourages industry diversity, creates a level playing field for all institutions, and will ultimately strengthen the local economies and the U.S. economy.

Thank you for the opportunity to testify today, and I look forward to answering any questions you may have.



# Branch locations of Top 7 (red) overlaid on all others (green) as of October 19, 2009







February 22, 2011

Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW.  
Washington, D.C. 20551  
Docket No. R-1404  
RIN No. 7100-AD63

Dear Ms. Johnson,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Reserve Board's Notice of Proposed Rulemaking (NPR) regarding Debit Card Interchange Fees and Routing. We are concerned that the NPR's response may disproportionately disfavor community banks engaged in debit card issuance, thus raising safety and soundness concerns and potentially driving further consolidation in the banking industry. Accordingly, CSBS recommends extending the rulemaking process to allow time for further study of the implications of the interchange fee alternatives and the small debit card issuer exemption.

Considering the magnitude of this regulation, we do not believe the full impact on the industry is understood. If economic pressures force small debit card issuers to operate at a 12 cent interchange fee, it is possible that many banks will stop issuing cards because their costs do not utilize the same economies of scale as larger financial institutions. This scenario raises safety and soundness concerns as a large revenue stream will be ceased, and will also incentivize further consolidation between debit card issuers and potentially drive customers to alternative products outside of the banking system. Due to these uncertainties, CSBS believes it would be prudent to fully understand the economic consequences across the dual banking system and determine the benefit, if any, to the consumer. We appreciate the opportunity to comment, and would be glad to coordinate any efforts to include state chartered banks in the interchange cost study process.

Sincerely,

A handwritten signature in black ink, appearing to read "Neil Milner". The signature is written in a cursive, flowing style.

Neil Milner  
President & CEO