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Too Small to Succeed?—Community Banks in a New Regulatory Environment

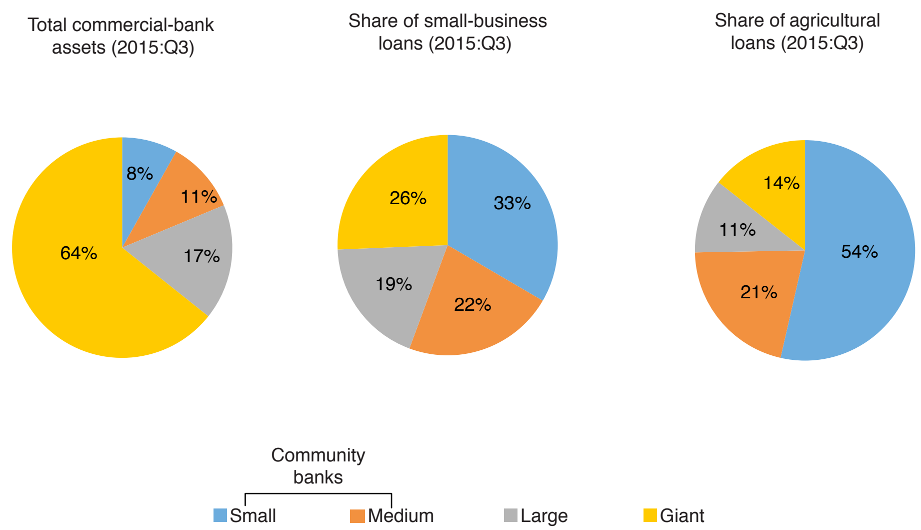
by Preston Ash, Christoffer Koch and Thomas F. Siems

Much has been discussed and written regarding what to do about the so-called "too-big-to-fail" banks and their role in the 2008–09 Great Recession. But now, more than five years after passage of legislation designed to create a new regulatory framework to promote financial stability and protect American consumers, smaller community banks are finding it increasingly tough to survive, due in part to the compliance costs needed to deal with the new regulations. This article focuses on the importance of community banks, examines the trends in banks exiting and entering the financial industry and highlights the apparent rising regulatory burden confronting banks today.

Community Banks Are Big Lenders to Small Businesses and Ag Sector

Community banks have long prided themselves on a unique model of banking that uses knowledge of, and relationships with, local communities' individuals and businesses. As a percentage of total U.S. banking assets, small and medium-sized banks—small banks being $1 billion and below in assets and medium-sized banks being between $1 billion and $10 billion in assets—have seen their market share decrease considerably over the last two decades.[1] In 1992, community banks accounted for 64 percent of $4.6 trillion in total banking assets.[2] By 2015, their market share had dropped to 19 percent of $15.9 trillion in total assets (*Chart 1*). Despite this decrease, community banks still account for the largest share of small-business loans. Currently, small- and medium-sized banks hold 55 percent of small-business loans and 75 percent of agricultural loans.

Chart 1 Community Banks: Low Market Share, But Important Small-Business and Agricultural Lenders



NOTE: Small banks are categorized as having total assets equal to, or below, $1 billion, medium-sized banks, between $1 billion and $10 billion in total assets, large banks, between $10 billion and $100 billion in total assets, giant banks, $100 billion and above in total assets.

SOURCE: Federal Deposit Insurance Corporation, Statistics on Depository Institutions.

DALLAS FED RESOURCES

Economic Updates

Regional—"Regional Economic Outlook Remains Mixed Going into 2016"

National—"We Have Liftoff"

International—"Deflation Remains Concern, Stock Markets Mostly Improve"

Publications

Community Banking Connections—3rd Quarter

Dallas Beige Book
Dec. 2, 2015, Summary

Economic Letter
"Cheaper Crude Oil Affects Consumer Prices Unevenly"

Southwest Economy
"Texas Health Coverage Lags as Medicaid Expands in U.S."

Surveys & Indicators

Agricultural Survey

Texas Business Outlook Surveys—Manufacturing, Service Sector, Retail

Texas Economic Indicators

Find other resources on the Dallas Fed website at www.dallasfed.org.

CALENDAR OF EVENTS

Jan. 12
Southeast Texas Economic Development Foundation
Beaumont, Texas

Jan. 28
Southlake Chamber of Commerce
Southlake, Texas

Feb. 12
Federal Reserve Bank of Dallas Real Estate Conference
Dallas, Texas

Feb. 18
Texas A&M University Texarkana
Texarkana, Texas

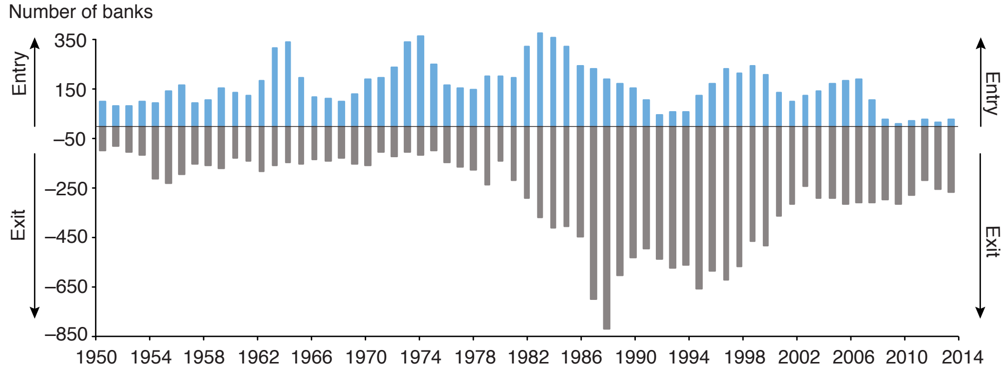
March 29
Shreveport Rotary Club
Shreveport, Louisiana

For more information about these events, email FIRM at Dallas_Fed_Firm@dal.frb.org.

A Bird-in-Hand Bank Is Worth…

Notwithstanding the benefits community banks bring to the economy, practically no new banks have entered the market since 2008. In fact, since 2010, the U.S. has had only one de novo bank charter—an Amish-backed bank in Pennsylvania called Bank of Bird-in-Hand.[3] The other banks entering the market were thrift conversions connected to the dissolution of the Office of Thrift Supervision in 2011 (*Chart 2*). While the number of banks exiting the market has exceeded entrants since 1983 as the industry consolidates, the lack of new charters in recent years is alarming. What forces are behind this recent trend?

Chart 2 After the Great Recession, Dramatic Declines in Bank Entrants



SOURCE: Federal Deposit Insurance Corporation, Statistics on Depository Institutions.

Are Regulatory Burdens on Community Banks Rising?

As we visit with community bankers around the Eleventh District, regulatory factors remains the top concern for financial institution leaders as they contemplate their institution's future and the future of their industry. And their concerns are echoed in other surveys and reports. In 2014, the Centre for the Study of Financial Innovation indicated regulatory worries were the greatest concern of financial leaders both globally and nationally.[4] Recently, KPMG published results in which a majority of community bankers voiced that regulatory and legislative pressures represent the most significant growth barrier over the next 12 months for their institution.[5] Are their concerns justified?

U.S. bank regulators require financial institutions to report financial information in quarterly Call Reports. In the 1950s, these reports (excluding instructions) were four-page filings. As shown in Chart 3, the reports for the smallest institutions grew to about 30 pages in the 1980s, about 40 pages in the 1990s and about 50 pages in the 2000s. Now, the Call Report is 84 pages. Moreover, the number of items within these Call Reports has also increased. At the end of 1970, Call Reports contained 53 items that banks filled out; this past quarter's filing included 2,379 items, with recent additions of more off-balance sheet and memoranda items.

While the costs incurred to banks to complete the added pages and items of Call Reports has not increased as dramatically, the burden to report more aspects about each institution has clearly risen. Indeed, the increase in the page numbers and items per filing in Call Reports might be a meaningful proxy for the hard-to-measure, latent requirements that regulators have placed on smaller banks.

To capture the complexity of regulations, we examine the number of new banking legislations and the length of these acts. The Federal Deposit Insurance Corporation (FDIC) has produced a list of banking legislation that has significantly impacted the financial sector.[6] Looking back roughly 100 years, the first item on the list is the 30-page Federal Reserve Act of 1913, which established the Federal Reserve System. The last item on the list is the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 and contains 849 pages. Indeed, from 2001–10, 10 major banking acts became law, totaling 1,858 pages (*Chart 4*).

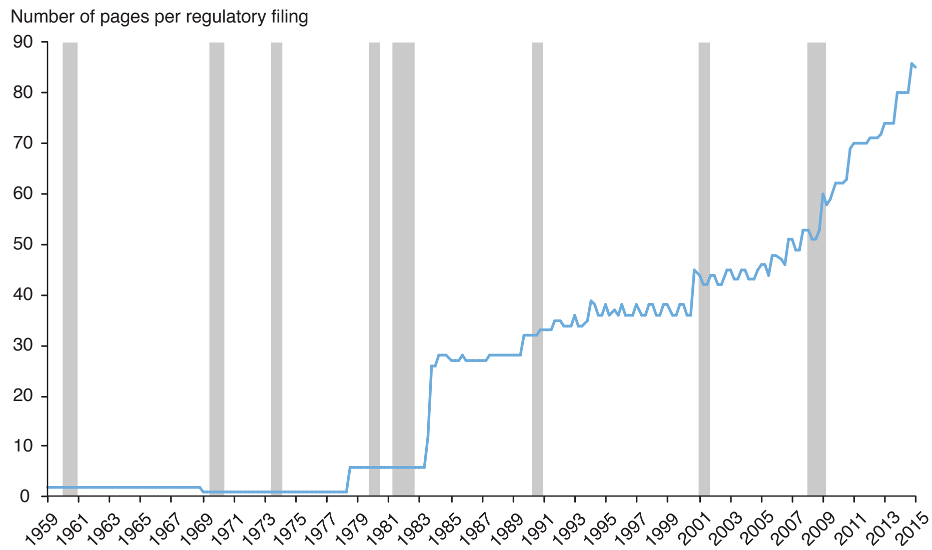
ABOUT *FINANCIAL INSIGHTS* AND FIRM

Financial Insights is published periodically by FIRM—Financial Institution Relationship Management—to share timely economic topics of interest to financial institutions. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

FIRM was organized in 2007 by the Federal Reserve Bank of Dallas as an outreach function to maintain mutually beneficial relationships with all financial institutions throughout the Eleventh Federal Reserve District. FIRM's primary purpose is to improve information sharing with district financial institutions so that the Dallas Fed is better able to accomplish its mission. FIRM also maintains the Dallas Fed's institutional knowledge of payments, engaging with the industry to understand market dynamics and advances in payment processing.

FIRM outreach includes hosting economic roundtable briefings, moderating CEO forums hosted by Dallas Fed senior management, leading the Dallas Fed's Community Depository Institutions Advisory Council and Corporate Payments Council, as well as creating relevant webcast presentations and this publication. In addition, the group supports its constituents by remaining active with financial trade associations and through individual meetings with financial institutions.

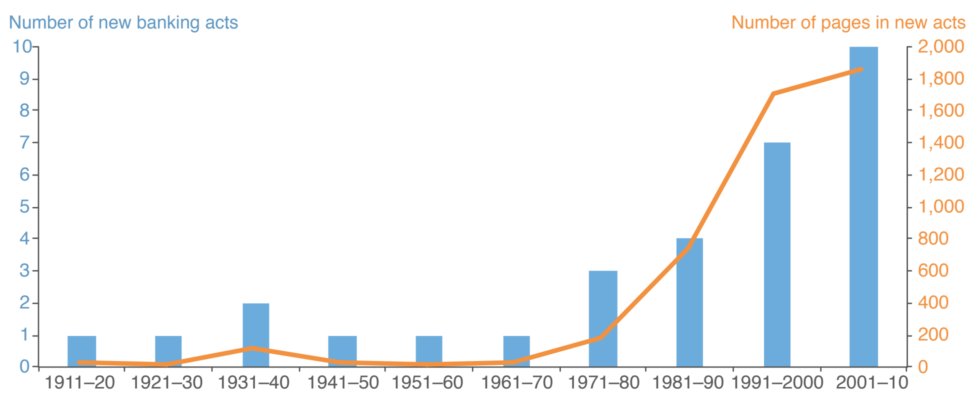
Chart 3 After Great Recession, Pages in Bank Regulatory Filings Upsurge



NOTES: Gray bars indicate recessions. Maximum number of report pages for domestic banks only.
1959:Q4–1983:Q4 Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
1984:Q1–2000:Q4: Forms FFIEC 032, FFIEC 033 and FFIEC 034.
2001:Q1–present: FFIEC 041.

SOURCE: Federal Financial Institutions Examination Council, Call Report.

Chart 4 Over the Past Century, Legislative Complexity Soared



SOURCE: Federal Deposit Insurance Corporation, Important Banking Legislations.

Banks of all sizes and complexities have to hire compliance personnel to properly align their institutions with these new regulations. But for smaller institutions, the compliance burden is likely greater. Feldman, Schmidt and Heinecke (2013) at the Federal Reserve Bank of Minneapolis find that the median reduction in profitability (return on assets) for the smallest banks—those banks with assets less than $50 million—is 14 basis points if they have to increase staff by one-half of a person and 45 basis points if they increase staff by two people.[7]

Community Banks Are Unique and Important

Community banks continue to play a unique and vital role in the U.S. economy. Although the number of community banks and their share of banking assets has declined, community banks are important lenders in small-business and agricultural markets. Community banks are relationship lenders. Their comparative advantage is to know their customer, understand their markets and needs and provide flexible services. Yet, in a regulatory environment that increasingly addresses big bank processes and tends to be "one size fits all," smaller community banks appear to have a valid concern that their compliance burden is rising and the playing field is becoming more uneven. Regulatory oversight should match the level of risk an institution poses to the financial system and economy at large. Otherwise, more banks may become too small to succeed.

Ash is an economic outreach specialist in FIRM, Koch is a research economist in the Research Department and Siems is an assistant vice president and senior economist in FIRM.

NOTES
[1] These percentages are computed at the bank level. Moreover, the small- and medium-sized bank thresholds are dominated by one-bank holding companies and stand-alone commercial banks.
[2] Size thresholds are not inflation adjusted.
[3] See "Historical Statistics on Banking," by the Federal Deposit Insurance Corporation, www5.fdic.gov/hsob/HSOBRpt.asp. Data only available through end of 2014.
[4] See "Banking Banana Skins 2014: Inching Towards Recovery," by the Centre for the Study of Financial Innovation, in association with PricewaterhouseCoopers, May 2014.
[5] See "Community Banking Survey: Seeking Strategic Advantage," by KPMG LLP, 2014.
[6] See "Important Banking Laws," by the Federal Deposit Insurance Corporation, fdic.gov/regulations/laws/important/index.html.
[7] See "Quantifying the Costs of Additional Regulation on Community Banks," by Ron J. Feldman, Jason Schmidt and Ken Heinecke, Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis, May 30, 2013.

Noteworthy Items

Vice Chairman of the Board of Governors Stanley Fischer gives a speech entitled "Central Bank Independence" at the 2015 Herbert Stein Memorial Lecture for the National Economists Club (Nov. 4, 2015)
Fischer presents information from current and past research on why it is essential for a nation's central bank to be politically independent. He also suggests areas that the Federal Reserve System could improve upon such as the role of the Fed in financial stability in the future.

Dallas Fed President Rob Kaplan delivers remarks before the University of Houston entitled "A Discussion of Economic Conditions and Federal Reserve Policy" (Nov. 18, 2015)
Kaplan suggests that given the economic data, it is appropriate that monetary policy remain accommodative for some time. A lower-than-usual federal funds rate might be needed to achieve this accommodation. He further indicates that the return to "normal" interest rates will be gradual.

Vice Chairman of the Board of Governors Stanley Fischer gives a speech entitled "Financial Stability and Shadow Banks: What We Don't Know Could Hurt Us" at the 2015 Financial Stability Conference in Washington, D.C. (Dec. 3, 2015)
Fischer talks about the vulnerabilities that he sees in the financial system and also outlines areas where regulators and researchers can help better monitor financial sector conditions. Fischer particularly notes the need for more theory and better data to help explain the current roles of shadow banking and to highlight how bank and nonbank interactions are driven by economic incentives.

Federal Reserve releases FOMC statement (Dec. 16, 2015)

Did You Know?

The Federal Reserve does not print paper currency. Federal Reserve notes are printed by the Bureau of Engraving and Printing, an arm of the U.S. Treasury Department.

MEMBERS OF FIRM

Tom Siems
Assistant Vice President and Senior Economist
Tom.Siems@dal.frb.org

Matt Davies
Assistant Vice President
Matt.Davies@dal.frb.org

Steven Boryk
Relationship Management Director
Steven.Boryk@dal.frb.org

Donna Raedeke
Payments Outreach Analyst
Donna.Raedeke@dal.frb.org

Preston Ash
Economic Outreach Specialist
Preston.Ash@dal.frb.org

Contact us at Dallas_Fed_FIRM@dal.frb.org.