

THE STATE AND FATE OF COMMUNITY BANKING

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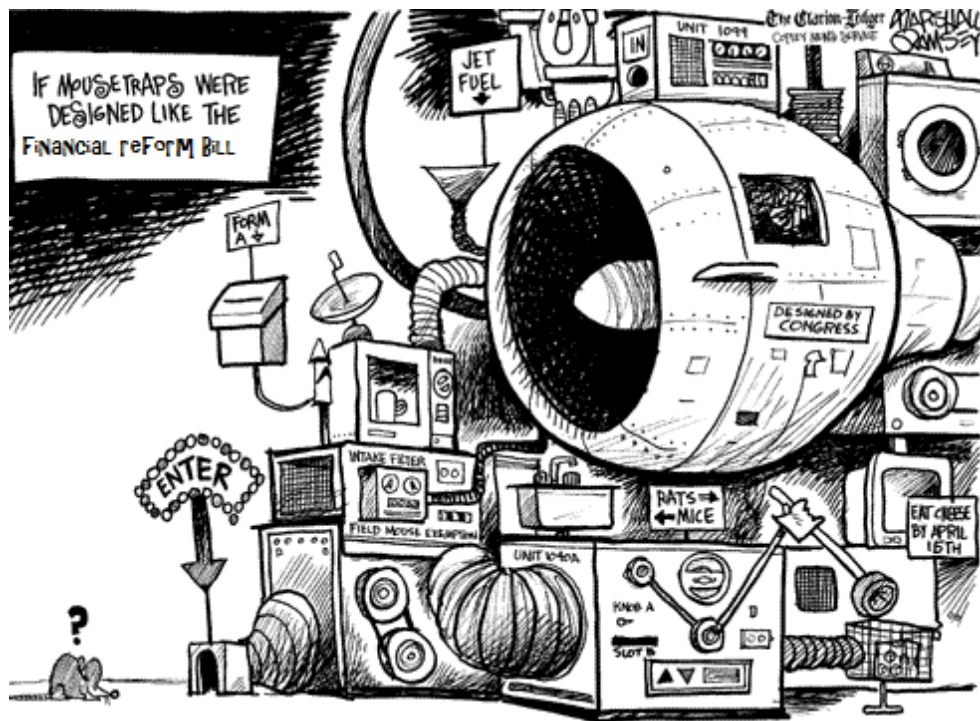
OVERVIEW

- **Motivation & Methodology**
- **Our findings**
- **What factors are driving consolidation?**
- **What if we do nothing?**
- **What should we do?**

MOTIVATION & METHODOLOGY

- **Motivation**

- Anecdotal evidence of **Dodd-Frank & Basel III** regulatory pressures on community banks
- Wanted to understand and quantify the role community banks play in our economy and how that role has changed in recent years

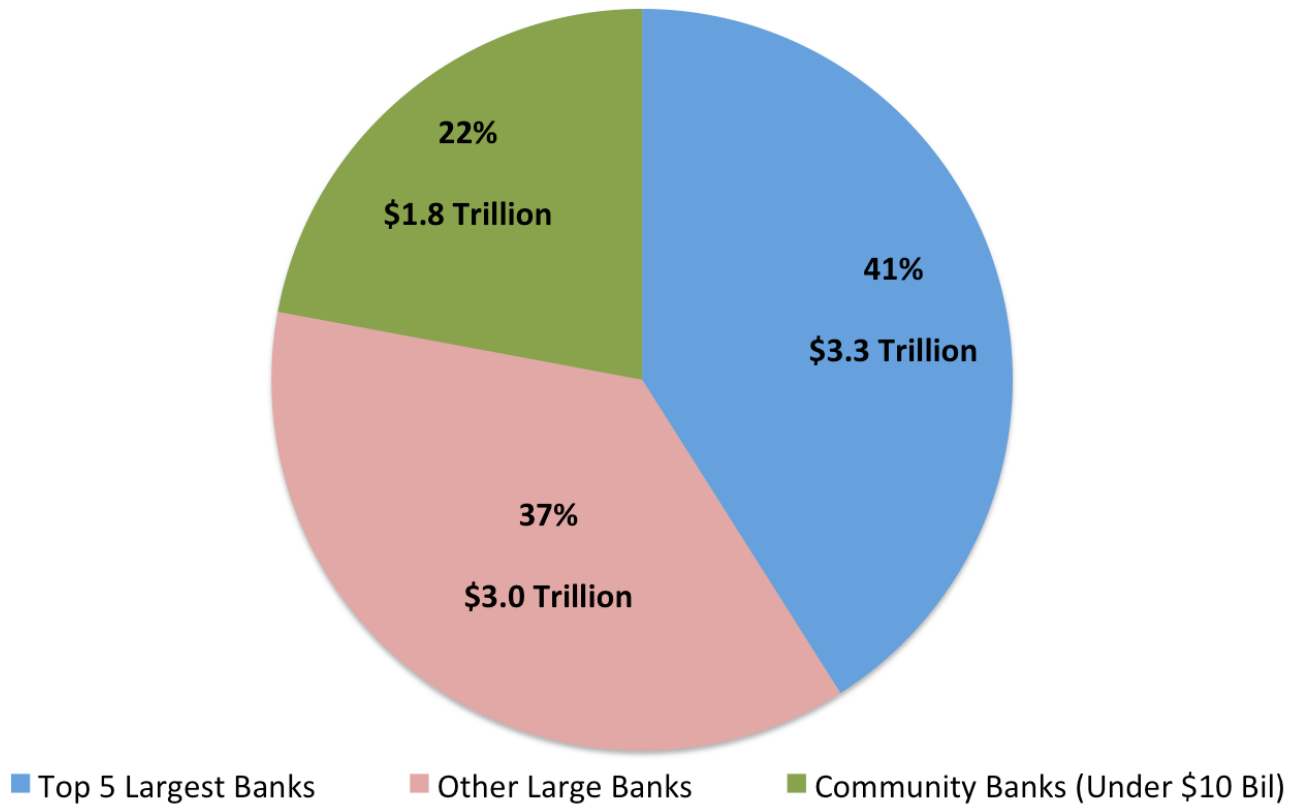


MOTIVATION & METHODOLOGY

- **Methodology**
 - Used FDIC call report data
 - Defined community banks as \$10 billion or less in assets
 - Aggregated assets at the holding company level
 - Results in 98 percent of banks being community banks
 - Conducted thorough literature review

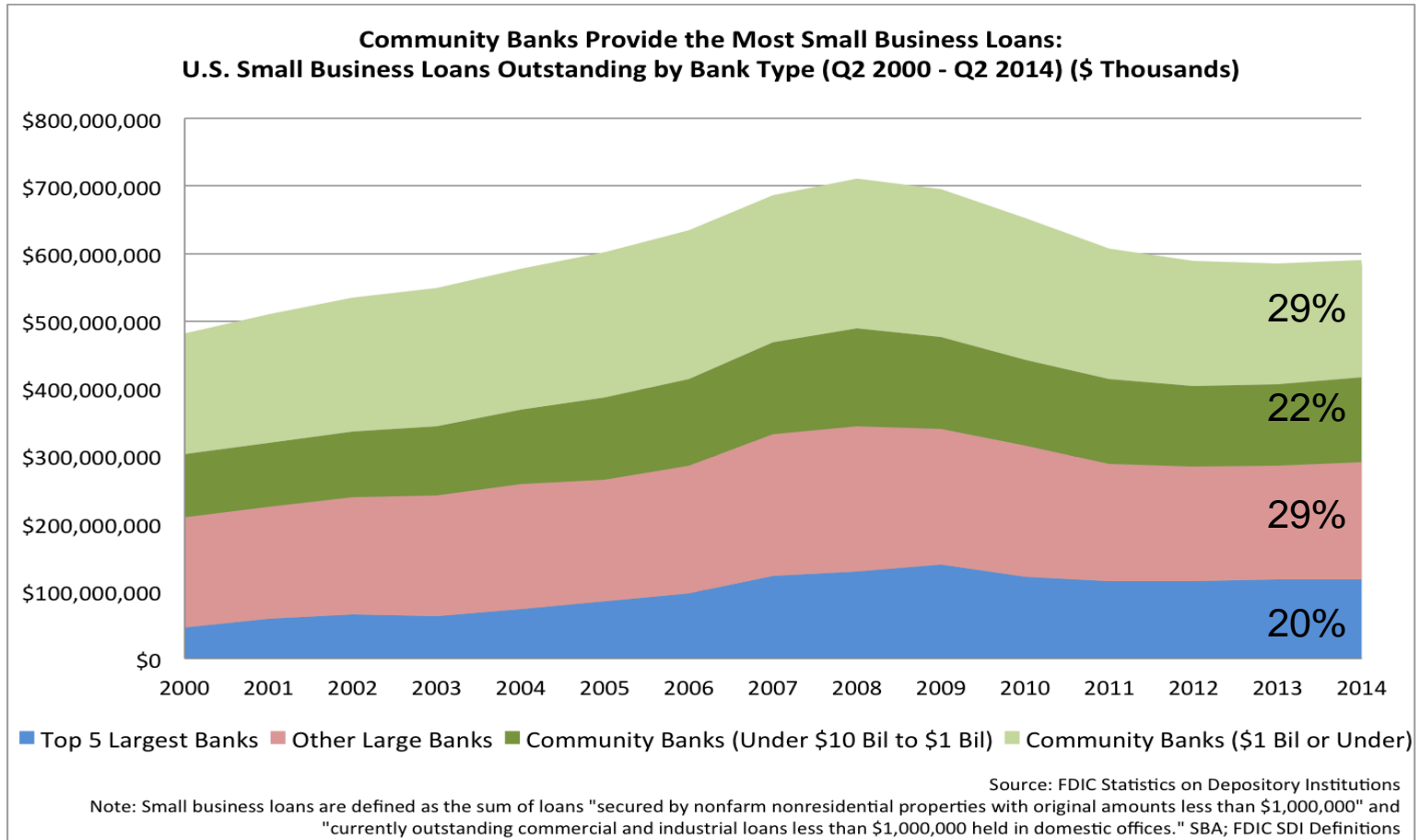
OUR FINDINGS

**Almost One-Quarter of Bank Lending Is by Community Banks:
Total Loans and Leases by Bank Type (Q2 2014) (\$8.1 Trillion Total)**



Source: FDIC Statistics on Depository Institutions

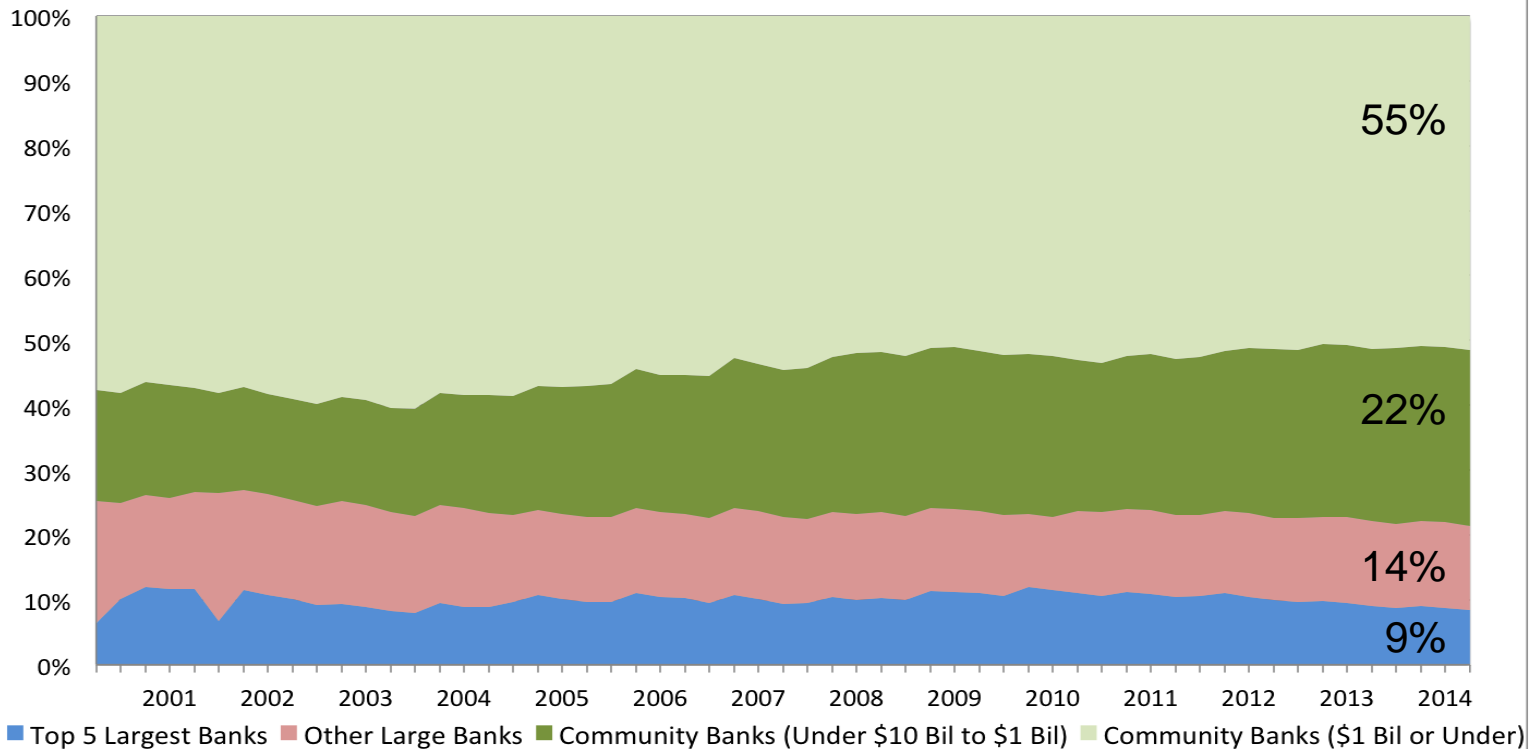
OUR FINDINGS



- Takeaways:**
- Comm. banks hold 51% of bank small bus. loans, down from 55% in Q2 2010
 - 10% decline in bank small business loans since mid-2010; 17% decline at small comm. banks while near-constant at larger comm. banks
 - Mid-2003 to mid-2007: 25% growth in small bus. loans; +15% at comm. banks

OUR FINDINGS

**Small Community Banks Dominate the U.S. Agricultural Lending Market:
 Share of U.S. Agricultural Lending Market by Bank Type (Q2 2000 - Q2 2014)**



Source: FDIC Statistics on Depository Institutions
 Note: Agricultural loans defined as bank loans “securitized by farm land” or that “finance agricultural production and other loans to farmers.” FDIC SDI; American Bankers Association definitions

- Takeaways:**
- Comm. banks make up 77% of bank ag. loans; was 75% in mid-2010
 - Comm. bank ag. loans up 23% since mid-2010; down 9.5% at large banks
 - Ag. loans (\$150.3 billion) are 2% of overall bank loans

OUR FINDINGS

Number of Banks		
	Community Banks	Large Banks
Q2 1994	10167	73
Q2 2002	7956	86
Q2 2006	7499	106
Q2 2010	6937	95
Q2 2014	6094	100

Q2 1994- Q2 2014

bank number change

Community banks: **-40%**

Large banks: **+37%**

Q2 2010- Q2 2014

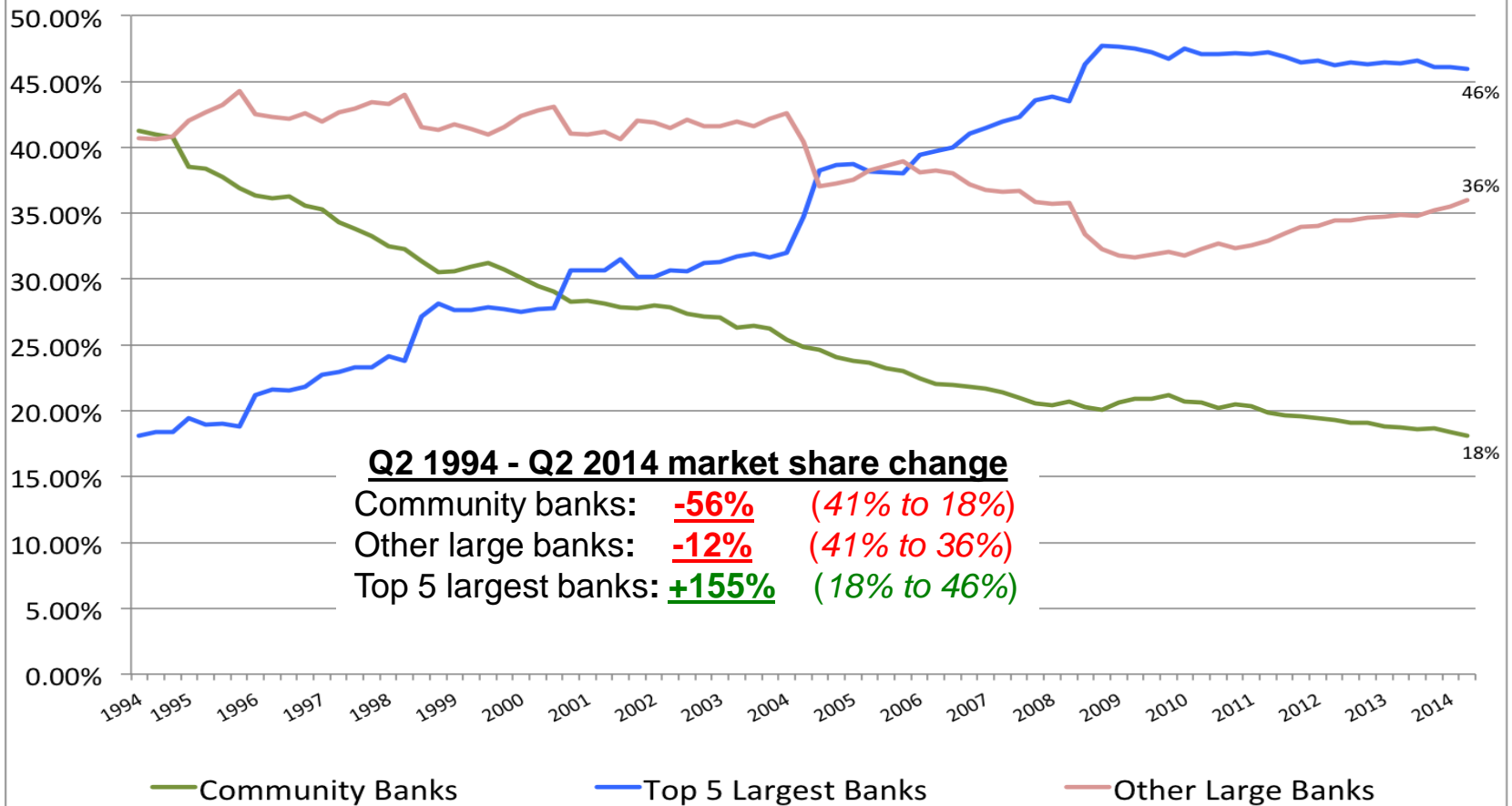
bank number change

Community banks: **-12%**

Large banks: **+5%**

OUR FINDINGS

**Community Banks' Share of U.S. Banking Sector Is Falling:
 Share of U.S. Depository Institution Assets by Bank Type (Q2 1994 to Q2 2014)**



Source: FDIC Statistics on Depository Institutions

WHAT IS DRIVING CONSOLIDATION?

- **Technology**
- **Changing demographics**
- **Customer demands**
- **Economies-of-scale**
- **Mergers**
- ***REGULATION***
 - Dodd-Frank is estimated to increase regulatory restrictions 32 percent
 - GAO and numerous government officials have expressed worry about unintended impacts of growing regulatory complexity

HOW REGULATION DRIVES CONSOLIDATION

FIGURE 3: REGULATORY RESTRICTIONS GROWTH FOR CFR TITLES 12 & 17: PRE-DODD-FRANK (1997–2010) VS. DODD-FRANK (CURRENT AND PROJECTED)



Source: Code of Federal Regulations, Government Printing Office.

Data note: Restrictions computed using the RegData methodology. RegData is only able to calculate regulatory restrictions for 1997 and subsequent years because electronic copies of the complete, annual CFR are publicly available from the Government Printing Office for only that time period. Produced by Patrick A. McLaughlin, Robert Greene, and Rizqi Rachmat, Mercatus Center at George Mason University.

Source: Patrick McLaughlin & Robert Greene, “Dodd-Frank’s Regulatory Surge: Quantifying Its Regulatory Restrictions and Improving Its Economic Analyses” (Mercatus on Policy, The Mercatus Center at George Mason University, Feb. 2014)

HOW REGULATION DRIVES CONSOLIDATION

- Disproportionately high compliance costs
 - Intuitively a higher as a percentage of asset base
 - Personnel strains:
 - 25% of community banks say they plan to hire new compliance personnel (Peirce et al., Mercatus Center)
 - Two additional personnel reduces the smallest community banks' median profitability by 45 basis points, resulting in 1/3 of these banks becoming unprofitable (Feldman & Schreck, Minneapolis Fed)
- It impacts mergers and product lines
- Banking scholars: “new entries are more likely when there are fewer regulatory restrictions” (McCord et al., Richmond Fed)

WHAT IF WE DO NOTHING?

- Technology & non-banks will fill in some of the gaps (Mills & McCarthy, Harvard Business School)
- Rural communities and small businesses will likely be disproportionately impacted (FDIC, 2011)
- Concentrated banking systems don't necessarily serve small and medium enterprises well (Wilmarth; Hasan et al.)
- Community banks – a source of banking system stability (GAO) – could wither for the wrong reasons

SOLUTIONS

- **Reform the regulatory process to mitigate unintended consequences**
 - Cost-benefit analysis
 - OIRA-review
- **Heightened regulatory coordination**
 - Bipartisan commission to streamline regulations
 - FSOC should leverage its position as a multi-regulator council to improve regulatory coordination
- **Exemptions**
 - From: Volcker rule, certain capital requirements, compensation requirements, & some quarterly call reports
 - But be careful: exemptions often fail to exempt

CONCLUSION

- Our research shows:
 1. Consolidation is a long-term trend, but has accelerated once again since the passage of Dodd-Frank
 2. Community banks play a vital and unique role in specific US bank lending markets
- Multiple factors impact consolidation, but intuitively and empirically regulation is a factor
- Regulation is the factor that policy-makers have the most flexibility to adjust (as opposed to consumer preferences)
- We have outlined several bipartisan solutions for them to do just that

SOURCES

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