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The State and Fate of Community Banking

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Abstract

This working paper focuses on the plight of community banks in the United States. It begins by examining different definitions of what constitutes a community bank, and goes on to review what makes these institutions unique and distinguishes them from larger regional or national peers. Our assessment of Federal Deposit Insurance Corporation data finds that community banks service a disproportionately large amount of key segments of the U.S. commercial bank lending market – specifically, agricultural, residential mortgage, and small business loans. However, community banks' share of U.S. banking assets and lending markets has fallen from over 40 percent in 1994 to around 20 percent today. Interestingly, we find that community banks emerged from the financial crisis with a market share 6 percent lower, but since the second quarter of 2010 – around the time of the passage of the Dodd-Frank Act – their share of U.S. commercial banking assets has declined at a rate almost double that between the second quarters of 2006 and 2010. Particularly troubling is community banks' declining market share in several key lending markets, their decline in small business lending volume, and the disproportionate losses being realized by particularly small community banks. We review studies on the impact of regulation, consumer trends and other factors on community banks, and examine the consequences of consolidation on U.S. lending markets. We conclude with a discussion of policies that could promote a more competitive and robust banking sector.

JEL Codes: G21, G28, K23

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1. Introduction

The community bank is a characteristically American enterprise, existing in larger numbers than nearly anywhere else in the world, and, as Harvard Law School's Mark Roe has written, is a financial structure shaped by the tendencies of U.S. politics toward decentralization and local control.¹ But for over 40 years, these small, locally owned lenders to local businesses and consumers have shrunk in visibility, first through the culling of the savings and loan crisis in the 1980s; then through the removal of barriers to bank consolidation; then through economic breakdowns like the financial crisis of 2008.

In this study, we assessed the state of U.S. community banks in recent years using Federal Deposit Insurance Corporation (FDIC) data. We also surveyed and synthesized the research on community banks, and examined the effect of regulatory efforts like Dodd-Frank on these institutions. We tackled the question of defining a community bank, and characterized aspects of community banks that distinguish them from larger regional or national peers. We examined recent trends, particularly in regulation, and asked a series of questions: What is a community bank and why is it special? How far has consolidation gone, and what have been the effects for markets served primarily by community banks? What are the consequences of massive regulatory efforts like Dodd-Frank? And what policies need to be altered or developed to preserve vital services provided by community banks?

The full picture of community banking in the U.S. is quite complex. We found that although community banks' share of the U.S. bank-lending market and of U.S. banking assets has declined by about 50 percent in the last two decades, the sector continues to play a vital role in key lending segments. Community banks provide 77 percent of agricultural loans and over 50 percent of small business loans. Agricultural lending, in particular, is a specialty that requires a knowledge of farming, often very specific to the region, to the farm or to the farmer, and a longer-term perspective; agricultural cycles are fairly long. Community banks also play a major role in local real estate lending, particularly for housing, another business where knowledge of local conditions and borrowers is necessary. In 2013, the default rates for loans secured by one-to four-family residential properties ran at 3.47 percent for small community banks (banks with \$1 billion or less in assets) versus 10.42 percent for banks with more than \$1 billion in assets.²

Community banks generally are relationship banks; their competitive advantage is a knowledge and history of their customers and a willingness to be flexible.³ (This is sometimes a problem, particularly in a regulatory system that reflects big bank processes, which are transactional, quantitative and dependent on standardization and mark-to-market accounting practices.) Their financials are different than those of the bigger banks, with less leverage and less-robust returns, and they tend to use less technology. They are not as deeply involved in the capital and

¹ Mark Roe, *Strong Managers Weak Owners: The Political Roots of American Corporate Finance* (Princeton, New Jersey: Princeton University Press, 1994).

² Hester Peirce, Senior Research Fellow, The Mercatus Center at George Mason University, testimony on July 18, 2013, before the House Committee on Oversight and Government Reform, 113th Congress, 1st sess.

³ See Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System (speech at the Community Bankers Symposium, Chicago, Ill., November 7, 2014).

securitization markets as larger banks. Their earnings stream is also less diverse, making them more vulnerable to disruption.

Community banks (defined as banks with less than \$10 billion in assets) withstood the financial crisis of 2008-09 with sizeable but not major losses in market share – shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010, according to this working paper’s findings. But since the second quarter of 2010, around the time of the Dodd-Frank Wall Street Reform and Consumer Protection Act’s passage, we found community banks’ share of assets has shrunk drastically – over 12 percent.

We also assessed community banks’ role in key lending markets, and analyzed what factors are fueling changes in these markets and consolidation trends. Overall, community banks have lost market share in consumer, real estate, and commercial and industrial (C&I) lending markets. Since Q2 2010, the smallest community banks’ (\$1 billion or less in assets) share of U.S. banking assets has fallen 19 percent.

What is behind the decline of the community bank? Technology is obviously a factor. It may drive consolidation but ensure that some traditional banking services will be available if community banks’ role in the banking sector naturally diminishes. Yet many commentators, community bankers, and regulators have also expressed fear or produced research showing that Dodd-Frank has exacerbated the preexisting trend of banking consolidation by piling up regulatory costs on institutions that neither pose systemic risks nor have the diversified businesses to support such costs. As a small North Carolina lender told the *Wall Street Journal*, “When they created ‘too big to fail,’ they also created ‘too small to succeed.’”⁴

Our findings appear to validate concerns that an increasingly complex and uncoordinated regulatory system has created an uneven regulatory playing field that is accelerating consolidation for the wrong reasons. We offer several solutions to mitigate this troubling trend.

2. What is a community bank?

Intuitively, the definition of a community bank is straightforward: a relatively small, standalone bank typically focused on providing basic banking activities to a local community; a “Main Street bank.” But there is great variation within community banking. Some community banks are standalone institutions, but many are not. Community banks often have branches and automated teller machines, which extend their reach. Some community banks may have outlets in nearby towns or affiliations with other community banks. Community banks are often – but not always – locally owned and managed. Historically, local ownership, with its ties to the town or the region, to its industries and its consumers, defined the “community” aspect. Part of the rich ethos of community banking was the presence of a local board that directly approved loans based on their intimate knowledge of customers. But today, bank investors may not necessarily come from the local community, and bank boards may include outside professionals – lawyers, IT professionals, product specialists, accountants – with specialized skills. Even the range of assets in a community bank varies widely.

⁴ Michael Rapoport, “Small Banks Look to Sell as Rules Bite,” *Wall Street Journal*, April 2, 2014.

Moreover, what constitutes small, basic banking activities, or even a “local community,” is quite difficult to define. Many of these qualities are subjective and hard to measure.

Thus, as a number of commentators note, regulators cannot even agree on what constitutes a community bank.⁵ The three largest federal banking regulators – the Office of the Comptroller of the Currency (OCC), the FDIC, and the Federal Reserve Board – all use different definitions.⁶ The FDIC changed its definition in 2012 to take into account total loans-to-assets, exclude specialty lenders, use geographic reach as a proxy for a bank’s engagement in proxy lending, and incorporate several other non-asset-based criteria.⁷ Using this approach, 94 percent of U.S. banking organizations were community banks in 2011, the last time the FDIC completed a thorough community banking study.⁸ On the other hand, the OCC and the Federal Reserve Board define community banks by asset size (\$1 billion and \$10 billion, respectively).⁹

Throughout this paper, we cite varying studies about community banks – some by regulators and some by scholars and industry experts, many of whom use different definitions. Admittedly, we use the term loosely as we report the findings of existing literature.

3. Literature review: Why are community banks unique?

I. Lines of business

Community banks play a critical and unique role in the U.S. economy. According to the Consumer Financial Protection Bureau (CFPB), community banks “can be a lifeline to hard-working families paying for education, unexpected medical bills, and homes.”¹⁰ Business pressures over the past decade have increasingly meant that community banks have pulled back from consumer lending and grown dependent on lending to small and medium-sized companies.¹¹ Federal Reserve Board Governor Daniel Tarullo explained:

This state of affairs is not surprising when one considers that credit extension to smaller firms is an area in which the relationship-lending model of community banks retains a comparative advantage. It means that community banks are of special significance to local economies. It also means that, particularly in rural

⁵ See, for example, Tanya D. Marsh & Joseph W. Norman, “Reforming the Regulation of Community Banks After Dodd-Frank” (paper presented at the Community Banking in the 21st Century conference, Federal Reserve System & Conference of State Bank Supervisors, St. Louis, Mo., October 2-3, 2013); Hester Peirce, Ian Robinson & Thomas Stratmann, “How Are Small Banks Faring under Dodd-Frank?” (Working Paper 14-05, The Mercatus Center at George Mason University, February 2014).

⁶ Ibid.

⁷ Federal Deposit Insurance Corporation (FDIC), *FDIC Community Banking Study*, December 2012, 1–2.

⁸ Ibid., 1–3.

⁹ Board of Governors of the Federal Reserve System, *Supervisory Policy and Guidance Topics, Community Banking*, http://www.federalreserve.gov/bankinfo/topics/community_banking.htm (accessed January 10, 2015); The Office of the Comptroller of the Currency, *Community Bank Supervision, Comptroller’s Handbook*, EP-CBS, October 2014, 1.

¹⁰ Consumer Financial Protection Bureau, *Community Banks and Credit Unions*, <http://www.consumerfinance.gov/small-financial-services-providers/> (accessed January 10, 2015).

¹¹ See Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System (speech at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, Ill., May 8, 2014).

areas, the disappearance of community banks could augur a permanent falloff in this kind of credit, at least a portion of which may not be maintained in the more standardized approach to lending, characteristic of larger banks.¹²

Community banks distinguish themselves by relying heavily on personal relationships. In their analysis of several studies, researchers at the Federal Reserve Bank of St. Louis highlighted some of the distinguishing characteristics of “thriving” community banks: “conservative lending principles,” emphasis on interpersonal relationships, high involvement of shareholders in the banks’ operations, and well-designed credit administration and underwriting policies.¹³ A recent Mercatus Center at George Mason University study of “small banks” (under \$10 billion – our definition of community banks) found that their “ability to gather and consider ‘soft information’ enables them to lend to borrowers that might not be able to get loans from larger institutions that rely more on standardized lending criteria,” so-called “informationally opaque borrowers.”¹⁴

The Government Accountability Office (GAO), the Federal Reserve Board, and the FDIC echo similar arguments: community banks leverage interpersonal relationships in lieu of financial statements and data-driven models in making lending decisions, rendering them better able to serve small businesses.¹⁵ A 2012 study presented at the 2013 Community Banking in the 21st Century Conference co-hosted by the Federal Reserve System and the Conference of State Bank Supervisors reinforced the notion that interpersonal relationships are of high importance to community banks by finding that small business loans originated by rural community banks defaulted at significantly lower rates than loans originated by urban community banks.¹⁶ This is a key attribute that runs to the heart of what makes community banks unique and that justifies the sheer number of small bank units, which might not appear maximally efficient from an economic perspective. In certain lending markets, the technologies larger institutions can deploy have not yet proven to be effective substitutes for the skills, knowledge, and interpersonal competencies of many traditional community banks.

II. Financials

The financials of community banks differ from those of larger institutions. Community banks are generally much less leveraged than their larger peers. In 2014, Federal Reserve Bank of Kansas City President Esther George noted that community banks are very well capitalized: banks with less than \$1 billion in assets had a Tier 1 leverage ratio of 10.5 percent and had similarly high ratios long before Basel III.¹⁷ Returns differ as well, however, dampened by reduced leverage.

¹² Ibid.

¹³ R. Alton Gilbert, Andrew P. Meyer & James W. Fuchs, “The Future of Community Banks: Lessons from Banks That Thrived During the Recent Financial Crisis,” *Federal Reserve Bank of St. Louis Review* 95, no. 2 (March/April 2013): 115-43, 128-131.

¹⁴ Peirce et al., “How Are Small Banks Faring under Dodd-Frank?,” 12.

¹⁵ U.S. Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rulemakings*, GAO-12-881, September 2012, 17-18.

¹⁶ Robert DeYoung et al., “Small Business Lending and Social Capital: Are Rural Relationships Different?” (paper presented at the Community Banking in the 21st Century conference, Federal Reserve System & Conference of State Bank Supervisors, St. Louis, Mo., October 2-3, 2013).

¹⁷ Esther George, President, Federal Reserve Bank of Kansas City (speech at the Community Banking in the 21st Century conference, Federal Reserve System & Conference of State Bank Supervisors, St. Louis, Mo., September

The University of New Orleans' Kabir Hassan and University of La Verne's William Hippler reported in a 2014 study that the average community bank had a return on equity (ROE) of 12.1 percent, versus 14.7 percent for non-community banks in 2013.¹⁸ But over a 20-year period between 1993 and 2013, non-community banks saw net income grow by 395 percent, while community banks' increased by only 102 percent.¹⁹ According to Hassan and Hippler, return on assets (ROA) over that 20-year period eroded for community banks; early in that time frame community banks outpaced their larger brethren, but over the entire period they saw returns fall 15 percent while non-community banks' returns grew 18 percent.²⁰ Alternatively, the average net interest margin – turning interest-bearing deposits into interest-paying loans – for community banks is roughly on par with that of non-community banks: 3.66 percent and 3.7 percent, respectively, in 2013.²¹ This likely stems in part from the fact that the Federal Reserve has kept federal funds rates near zero in the post-crisis period.

Trends during the crisis reveal the benefits of community banks' lending patterns. From 2007 to 2009, community banks' ROA remained positive, while the ROA of large banks collapsed in 2007 to negative values in 2008 and 2009.²² A 2014 *Wall Street Journal* analysis of FDIC data found a significant gap between large and small banks' ROEs, ROAs, and overall performance during the crisis – with small banks performing quite well.²³

In April 2011, an OCC official testified that historically low net interest margins have played a major part in driving down community bank revenue.²⁴ “Because of their focus on traditional lending and deposit-gathering, community banks derive 80 percent of their revenue from net interest income compared with about two-thirds at non-community banks,” noted the FDIC in 2012.²⁵ “Consistent with a legacy concentration of real estate loans, community banks have experienced the highest ratios of OREO-to-assets on their books,” wrote Gary S. Corner and Daigo Gubo in a 2012 article published by the Federal Reserve Bank of St. Louis.²⁶ OREO refers to “other real estate owned,” meaning real assets that the bank has accumulated, usually through foreclosure, that are not earning and that require considerable costs to maintain and dispose of over time.

Community banks also manage their liabilities quite well. According to research presented at the Federal Reserve Bank of St. Louis, between 2003 and 2012, the portfolio default rates on

23, 2014), <http://www.kc.frb.org/publicat/speeches/2014-George-StLouis-CSBS-09-23.pdf> (accessed January 10, 2015), 7.

¹⁸ Kabir Hassan & William Hippler, “National and Regional Trends in Community Banking” (Working Paper, 2014), 7, accessed January 10, 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2493726.

¹⁹ Ibid., 6.

²⁰ Ibid.

²¹ Ibid., 9.

²² U.S. Government Accountability Office, 10.

²³ Michael Rapoport, “Small Banks Look to Sell as Rules Bite,” *Wall Street Journal*, April 2, 2014.

²⁴ Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, Office of the Comptroller of the Currency, statement on April 6, 2011, before the Senate Committee on Banking, Housing and Urban Affairs, 112th Congress, 1st sess. (cited by U.S. Government Accountability Office, 12).

²⁵ FDIC, *Community Banking Study*, III.

²⁶ Gary S. Corner & Daigo Gubo, “Trends in OREO: Community Banks Still Have a Long Way to Go,” *Central Banker*, Federal Reserve Bank of St. Louis (Winter 2012).

residential mortgages of community banks ran at 0.20 percent versus 1.64 percent overall.²⁷ The study finds that this trend has been even more apparent in recent years; between 2009 and 2013, the average default rate for community banks was 0.23 percent while overall it was 3.62 percent – 15.7 times higher than the default rate for community banks.²⁸ Furthermore, community banks' liability structure is relatively less risky than that of larger competition, leading to a lower risk of default.²⁹ As commentators have noted, community banks' lower default rates stem in part from this relationship-based lending.³⁰

III. Areas served

Community banks disproportionately serve rural American communities. In 2011, community banks held the majority of deposits in rural and “micropolitan” counties – areas surrounding an urban center between 10,000 and 50,000 people – according to the FDIC.³¹ The FDIC also found that community banks were four times more likely than non-community banks to locate their offices in rural areas.³² In 2011, the physical banking offices in about 20 percent of American counties – approximately 600 in all – were exclusively owned by community banks.³³

4. Our methodology

In this working paper, we aim to examine and assess trends in community banking and their current engagement in lending markets. However, as mentioned previously, there is no agreed-upon definition of a community bank. For purposes of our analyses, we choose to use an asset-based – and not a behavioral or qualitative – approach to defining community banks, in order to estimate the extent to which community banks are engaged in various lending sectors. Accordingly, we adopt a definition of community bank that mirrors the definition used by the Federal Reserve Board and the GAO: less than \$10 billion in total assets.³⁴ However, to highlight recent trends facing particularly small community banks, we also employ the OCC's \$1 billion threshold.

To assess banking sector trends in the U.S., we use the FDIC's Statistics on Depository Institutions quarterly dataset; the FDIC last updated files used in this report in August 2014.³⁵ This data includes quarterly lending activity and assets held by FDIC-insured depository institutions largely obtained from the Federal Financial Institution Examination Council Call

²⁷ Marsh & Norman, 29.

²⁸ Ibid.

²⁹ Jim Fuchs & Andrew P. Meyer, “Most Community Banks Will Pay Lower Premiums under FDIC Assessment Rules,” *Central Banker*, Federal Reserve Bank of St. Louis (Summer 2012); Lili Cai, “Default Probability: Smaller Banks Have a Historically Lower Default Rate Than Larger Banks,” *Bloomberg Briefs* (Financial Regulation, Special Edition, June 2014): 7.

³⁰ See Marsh & Norman; Peirce.

³¹ FDIC, *Community Banking Study*, 3–4.

³² Ibid.

³³ Ibid., I.

³⁴ See Board of Governors of the Federal Reserve System, *Supervisory Policy and Guidance Topics, Community Banking*; The Office of the Comptroller of the Currency, *Community Bank Supervision, Comptroller's Handbook*.

³⁵ FDIC, *Statistics on Depository Institutions, All SDI Data*, https://www2.fdic.gov/sdi/download_large_list_outside.asp (updated August, accessed October 2014).

Reports that these institutions submit.³⁶ Since this data comes at the institutional level, we aggregate it at the holding company level in order to better portray the total assets held by the largest financial institutions. We then use a \$10 billion “total assets” threshold to determine whether a bank is a community bank or not, and include a \$1 billion or lower threshold to identify particularly small community banks.³⁷ Clearly, our methodology causes smaller holding companies with two community banks marginally below \$1 billion in assets to be viewed as one institution above that threshold. Throughout our analysis, we refer to the “top five largest banks,” meaning the five largest each quarter using overall asset size.

We also obtained lending data from the FDIC’s Statistics on Depository Institutions dataset and, unless otherwise noted, strictly use the FDIC’s definitions for various lending statistics. We matched that lending data to banks using Federal Reserve ID and RSSDID numbers.³⁸ To calculate a particular lending market’s share of overall U.S. lending activity, we calculated loans outstanding as a percentage of total loans and leases.

5. What are recent trends in community banking?

I. Unique lending patterns

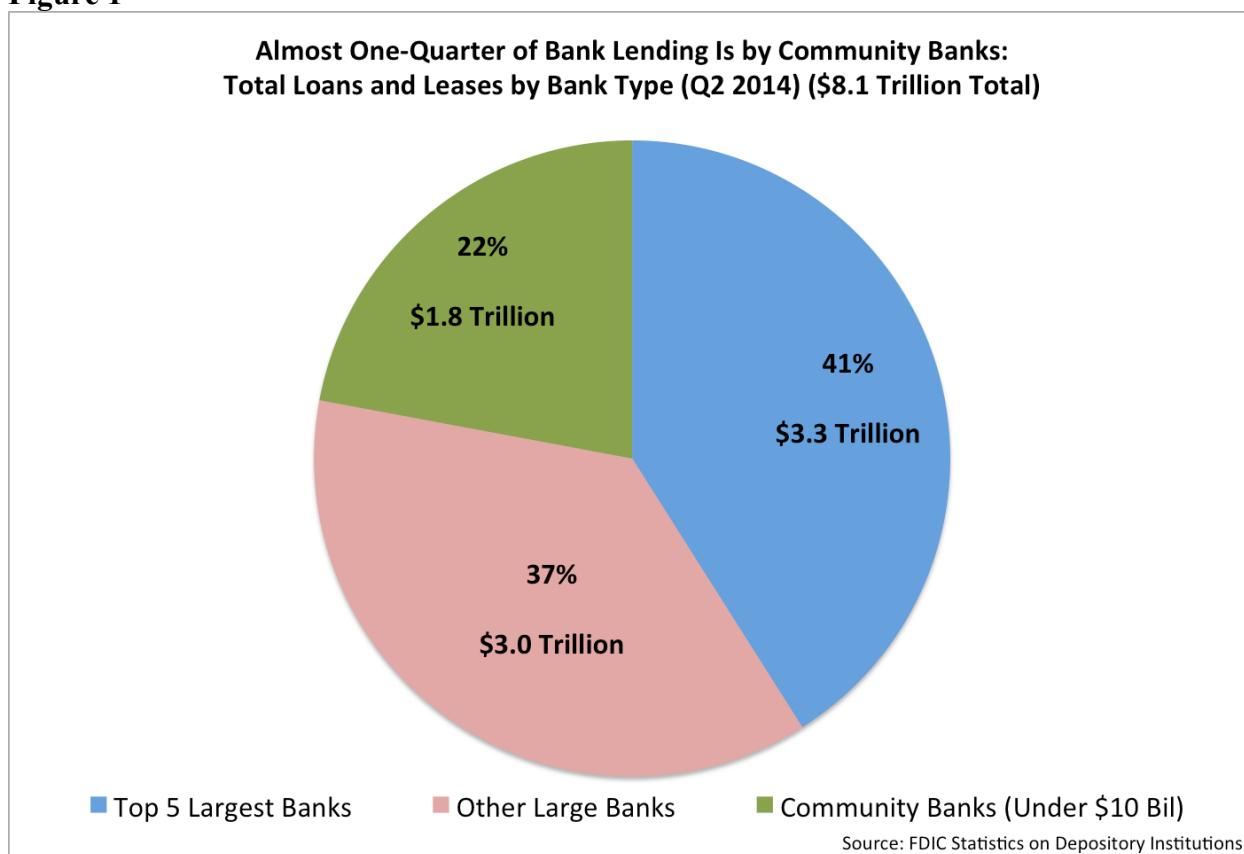
According to our calculations, community banks (banks with less than \$10 billion in assets) accounted for 22 percent of bank loans in 2014 (Figure 1).

³⁶ FDIC, *Statistics on Depository Institutions, Disclaimer and Notes*, <https://www2.fdic.gov/sdi/main.asp> (accessed January 10, 2015).

³⁷ FDIC, *Statistics on Depository Institutions, SDI Map & Definitions*, <https://www2.fdic.gov/sdi/main.asp> (accessed January 10, 2015). The FDIC defines total assets as: “The sum of all assets owned by the institution including cash, loans, securities, bank premises and other assets. This total does not include off-balance-sheet accounts.”

³⁸ See *ibid* for more information on these identification codes.

Figure 1



However, during Q2 2014, community banks (banks with less than \$10 billion in assets) constituted 98 percent of FDIC-insured depository institutions, consolidated at the bank holding company level.³⁹ Despite this relatively small share of the total U.S. lending market, the vast majority of agricultural loans⁴⁰ originated from community banks, as shown in Figures 2 and 3. There were \$150.3 billion in agricultural loans outstanding in mid-2014, accounting for 2 percent of the bank lending market.⁴¹ The volume of these loans has grown 19 percent since Q2 2010. Community banks provided 77 percent of agricultural loans in the U.S. in mid-2014, while the smallest community banks controlled 55 percent of the agricultural lending market.

³⁹ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors' calculations.

⁴⁰ We define agricultural loans as those "securitized by farm land" or that "finance agricultural production and other loans to farmers." Ibid; American Bankers Association, *Top 100 Farm Lenders Ranked by Dollar Volume* (accessed January 10, 2015), <https://www.aba.com/Tools/Research/Documents/Top100AgBanksbyDollarVolume.pdf>.

⁴¹ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors' calculations.

Figure 2

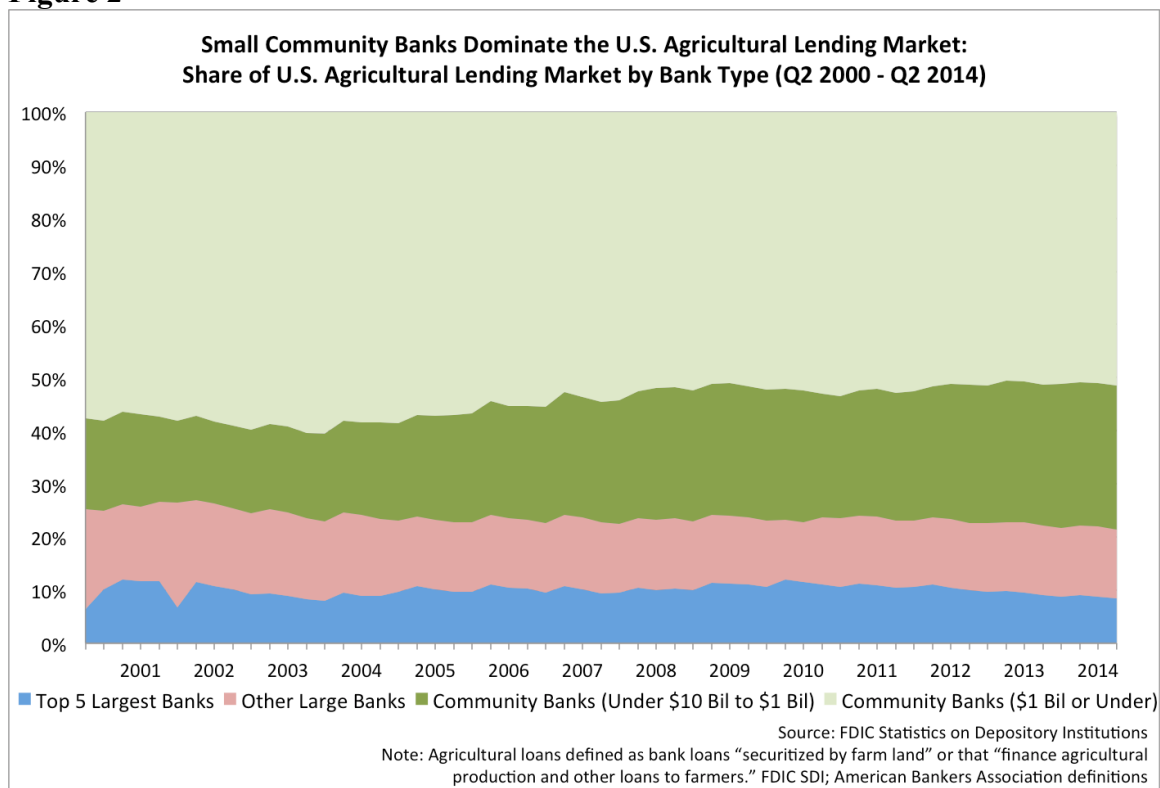
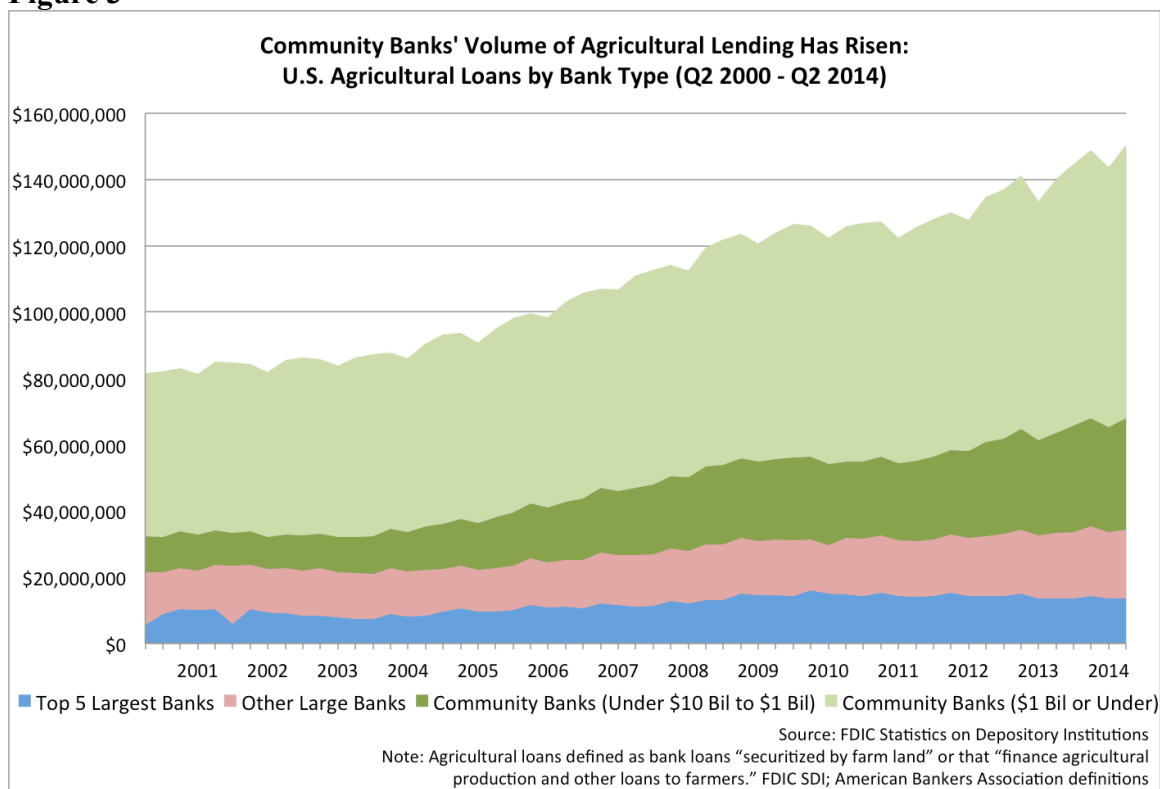
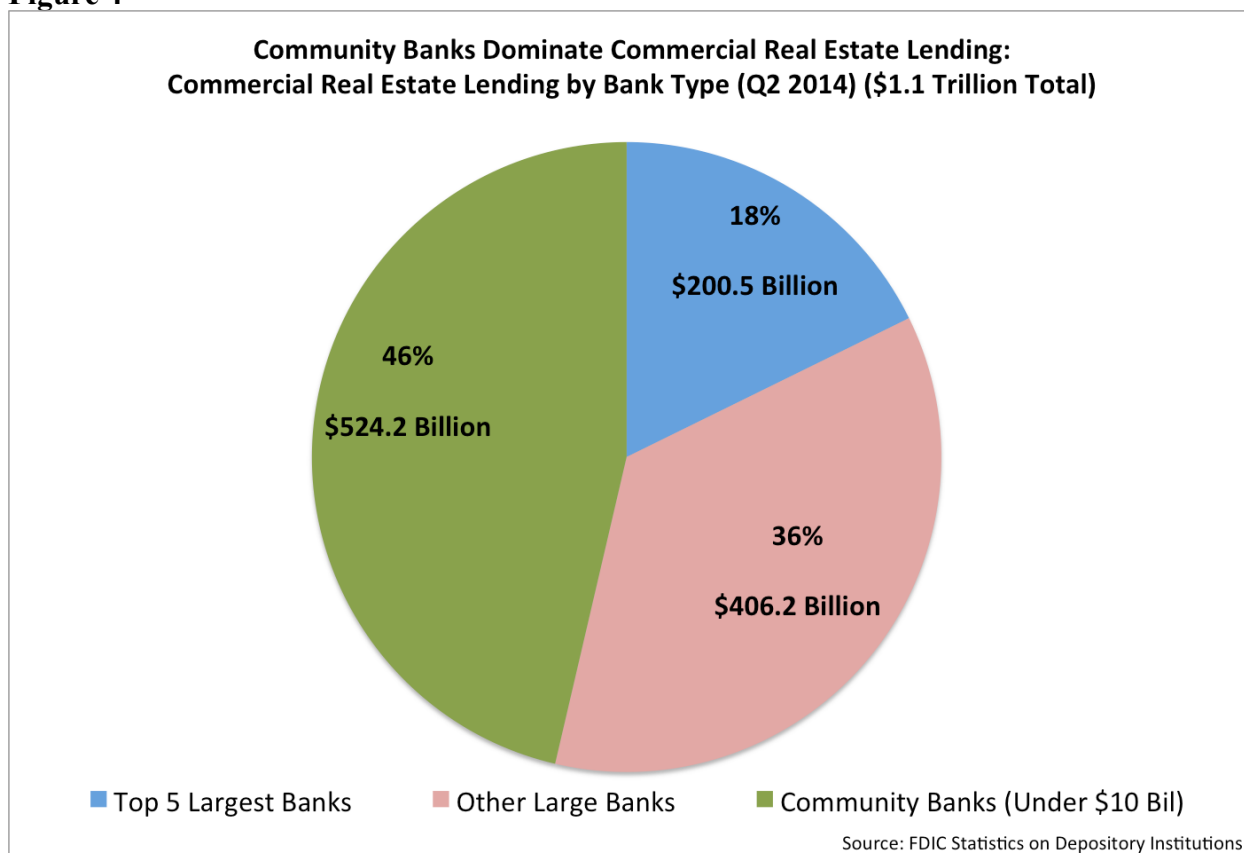


Figure 3



Overall, community banks also make up a disproportionately large share – 46 percent – of the commercial real estate lending market. These loans (some of which are small business loans) made up 14 percent of the market and were worth \$1.1 trillion in Q2 2014 (Figure 4).

Figure 4

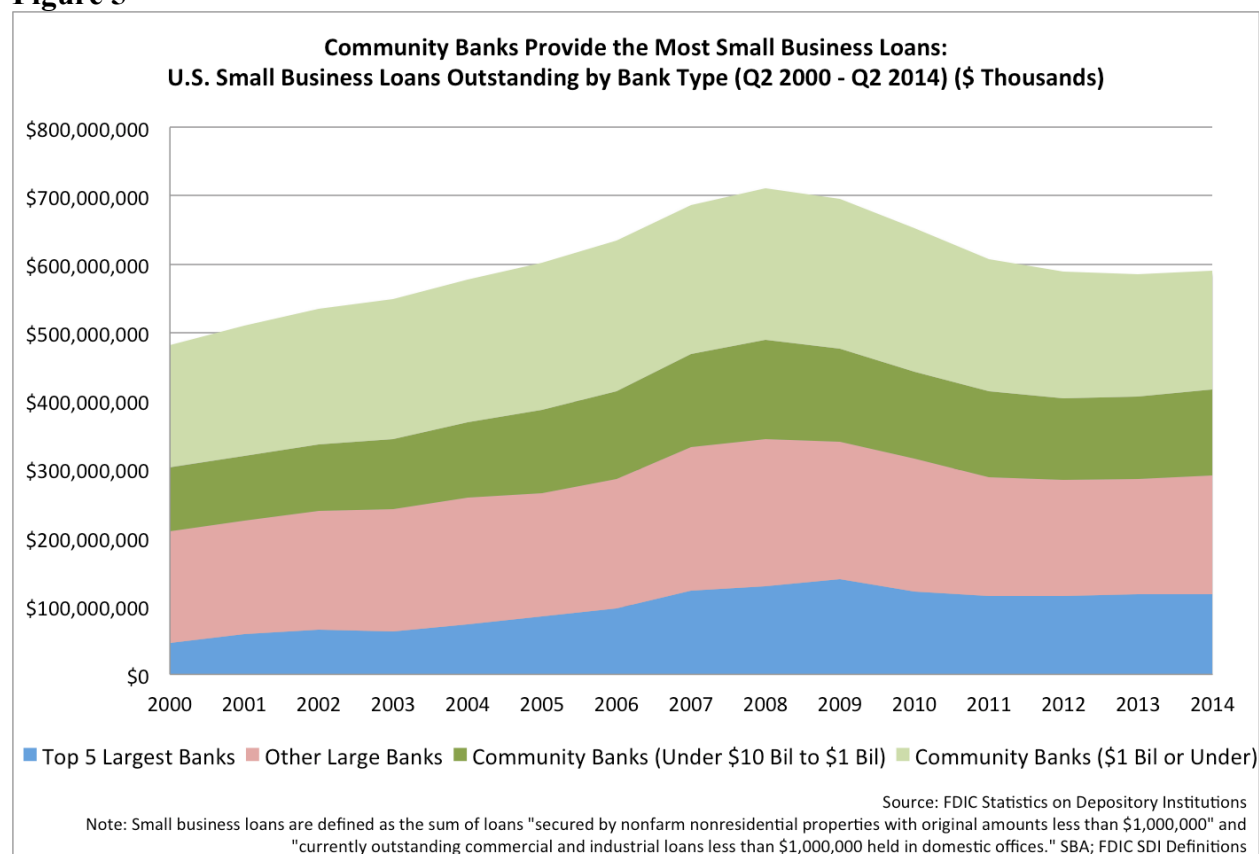


Most striking, as Figures 5 and 6 reveal, community banks provide 51 percent of small business loans.⁴² In the decade before the crisis (Q2 1998 to Q2 2008), community banks' lending to small businesses doubled in volume.⁴³ Small businesses create the majority of new jobs and account for the vast majority of employers, as we discuss later in greater depth. Alarming, however, community banks' overall volume of small business lending has declined significantly since Q2 2010 – down 11 percent. Overall, small business loans make up 7 percent of the bank lending market, and the top five largest banks' volume of loans in this market has declined about 3 percent since Q2 2010, while other large banks' volume has fallen 11 percent.

⁴² Defined as the sum of loans “secured by nonfarm nonresidential properties with original amounts less than \$1,000,000” and “currently outstanding commercial and industrial loans less than \$1,000,000 held in domestic offices.” See Small Business Administration, *Small Business Lending in the United States 2012*, accessed January 10, 2015, https://www.sba.gov/sites/default/files/files/sbl_12study.pdf; FDIC, *Statistics on Depository Institutions, SDI Map & Definitions*.

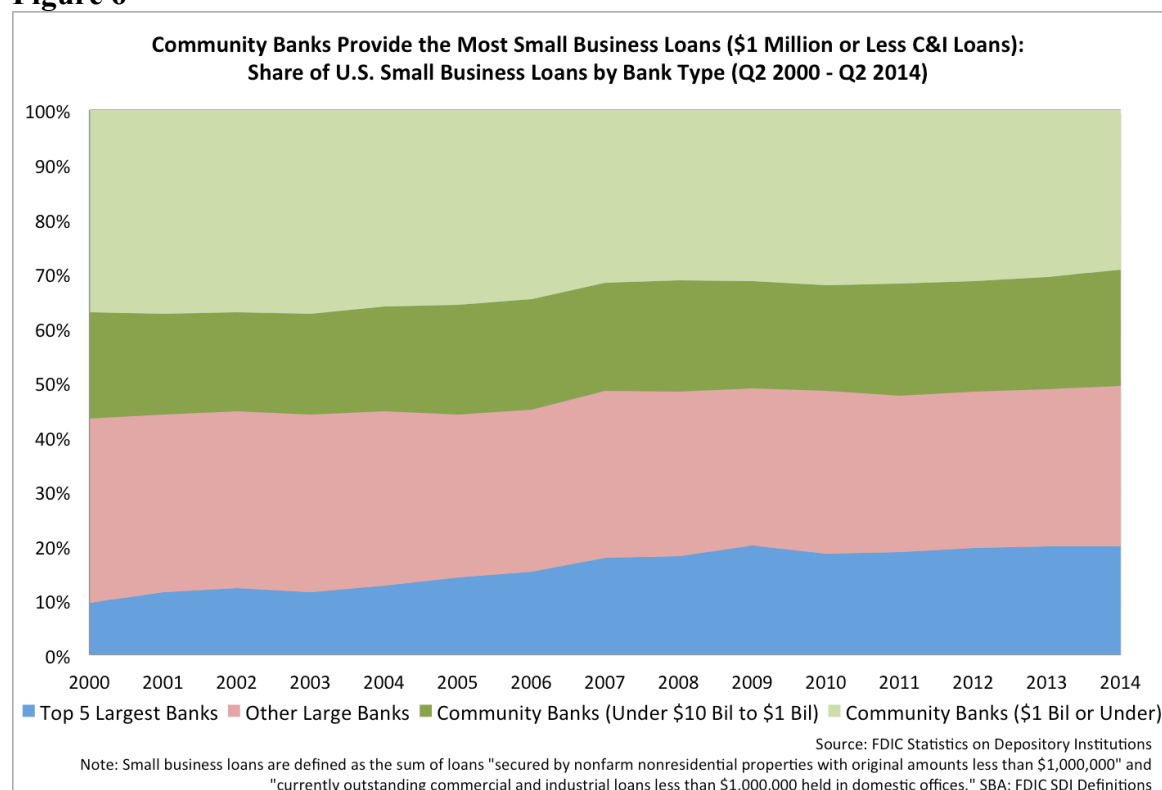
⁴³ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors' calculations.

Figure 5



Community banks' share of small business loans has declined at a rate slower than the decline in their volume of small business lending. As Figure 6 shows, in 2000, community banks were responsible for about 57 percent of small business lending; today, 51 percent of small business loans originate from community banks, and this is down 1.7 percent since Q2 2010. Small community banks' (\$1 billion or less in assets) share of the small business lending market has shrunk about 21 percent since 2000, when they provided 37 percent of small business loans, and 9 percent since 2010, to 29 percent today. Meanwhile, the top five largest banks' share of the lending market has grown from about 9 percent to 20 percent between 2000 and 2010, while other large banks' share of the small business lending market has decreased to 29 percent from 34 percent.

Figure 6



Community banks also play a disproportionately large role in the U.S. residential mortgage origination (first liens) market, which is worth \$1.8 trillion, accounts for one-fifth of the overall bank lending market and has grown 3 percent since Q2 2010, but is still down 10 percent since Q2 2006, before the financial crisis.⁴⁴

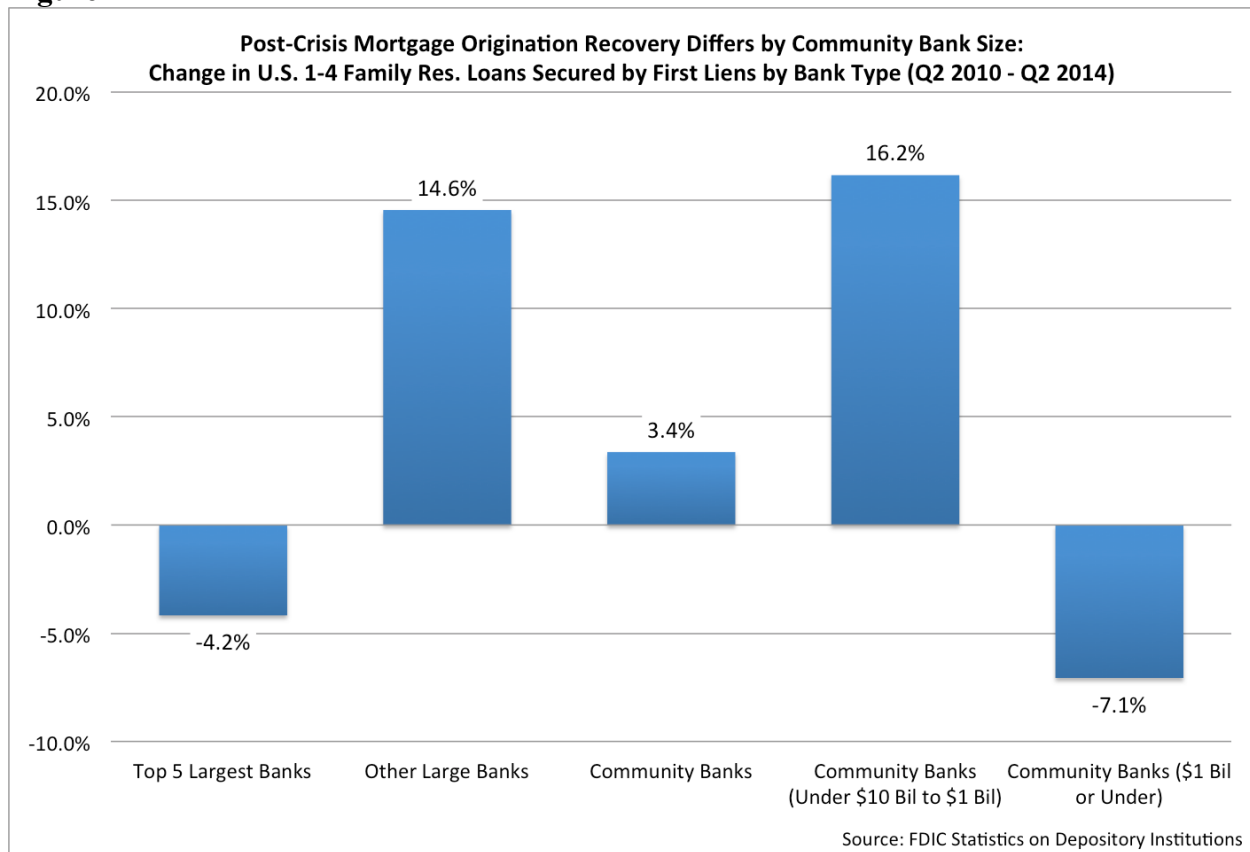
Today, community banks account for 25 percent of loans in this market, and that market share is split evenly between community banks with \$1 billion or less in assets and larger community banks.⁴⁵ However, unlike market share trends for community banks' share of lending in small business and agricultural markets, in the mortgage origination market – which makes up more than twice those markets combined – large community banks have gained market share since Q2 2010 (up to 12.6 percent from 11.2), while smaller community banks have lost market share (down to 12.4 percent from 13.7).⁴⁶ As we discuss later, the discrepancy in performance between large and small community banks in part stems from the disproportionate cost of regulation on smaller institutions. In terms of volume, small community banks hold 7 percent fewer one- to four-family residential mortgage originations today, in terms of dollar amount, than in mid-2010, whereas larger community banks hold 16 percent more (Figure 7).

⁴⁴ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors' calculations.

⁴⁵ Ibid.

⁴⁶ Ibid.

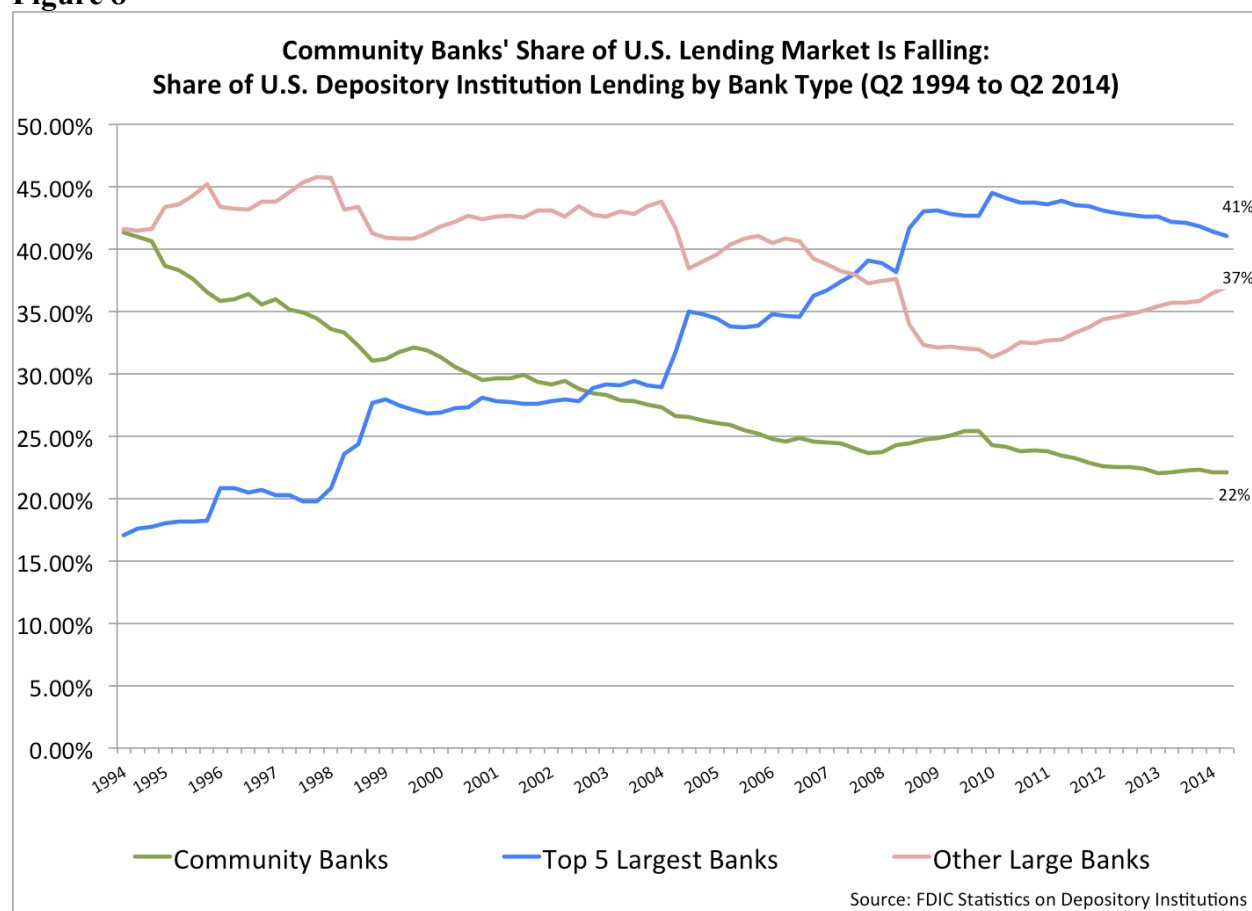
Figure 7



II. Consolidation and its drivers

Since 1994, community banks' share of the U.S. lending market has fallen by approximately half – from 41 percent to 22 percent – while the top five largest banks' share has more than doubled – from 17 percent to 41 percent – as Figure 8 illustrates.

Figure 8

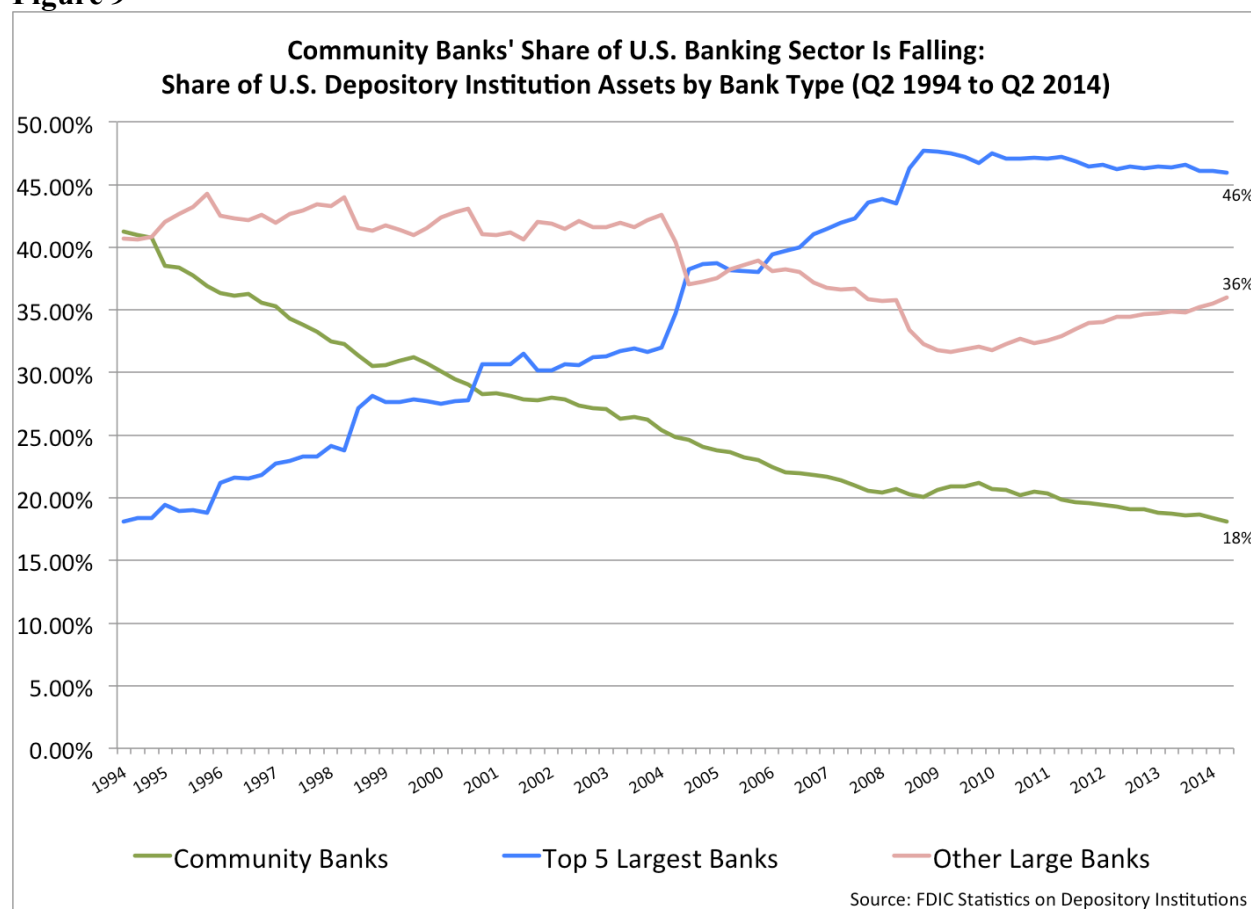


Lost lending market share reflects broader industry trends. The number of community banks (institutions with less than \$10 billion in assets, consolidated at the holding company level) has shrunk from 10,329 in Q2 1994 to 6,094 in Q2 2014.⁴⁷ Meanwhile, the number of large banks has increased from 73 to 100.⁴⁸ Despite the comparatively large number of community banks, their share of U.S. banking assets has decreased by more than half – from about 41 percent to 18 percent (Figure 9) since 1994. The five largest banks’ share of U.S. commercial banking assets has more than doubled – from roughly 18 percent to 46 percent. Other large banks’ share of assets declined slightly – from about 41 percent to 36 percent – during the decade.

⁴⁷ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors’ calculations.

⁴⁸ Ibid.

Figure 9



What drives consolidation? The GAO pointed out that the “Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 authorized interstate mergers between federal chartered banks starting in June 1997, regardless of whether the transaction would be prohibited by state law.”⁴⁹ In fact, Riegle-Neal only swung the door open wider on a process that had begun at state and regional levels several decades earlier. The federal government was catching up with the states, encouraging federal charters and attaching Community Reinvestment Act provisions as part of bank mergers and acquisitions. There was an element of regulatory competition at play here, which helped open up interstate banking. By the late 1990s, consolidation was accelerating, not only within commercial banking but also, after the repeal of Glass-Steagall, between the largest financial institutions.

The GAO also found that consolidation has been driven by economies of scale – in line with findings of other recent academic literature.⁵⁰ Specifically, St. Louis Fed Vice President and Deputy Director of Research David Wheelock and Clemson University economics professor Paul Wilson noted that as early as 2006, banks faced increasing returns to scale – an incentive to

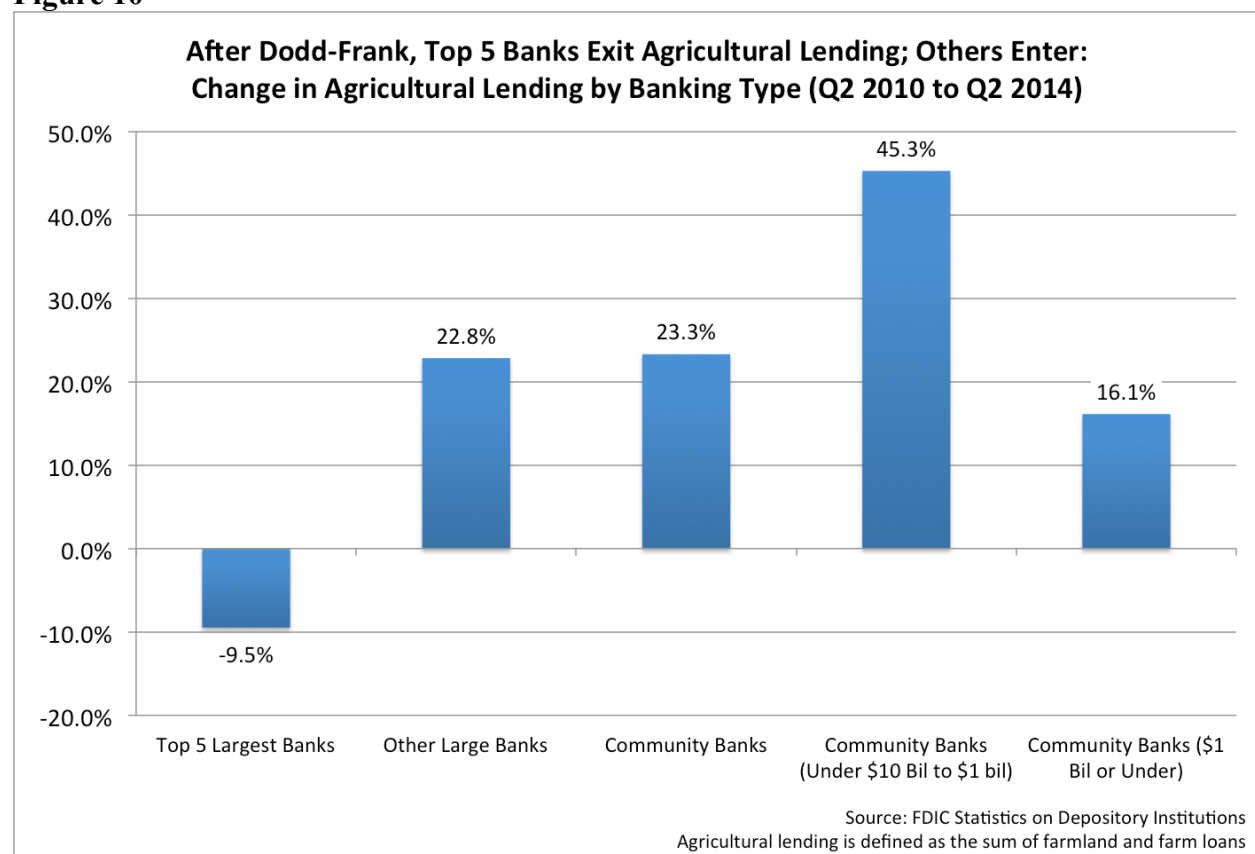
⁴⁹ U.S. Government Accountability Office, 8.

⁵⁰ Ibid., 9.

grow.⁵¹ The FDIC also found evidence of economies of scale in banking, particularly above the \$100 million threshold, but its pervasiveness is less evident in certain subsectors – particularly for banks engaged in agricultural lending and financing.⁵²

This finding reflects recent trends displayed in Figure 10. Despite losing market share to the five largest banks, community banks’ role in agricultural lending surged after the crisis. Between Q2 2010 and Q2 2014, community banks’ volume of agricultural loans increased 23.3 percent, and mid-size banks’ grew 22.8 percent. Meanwhile, the top five largest banks issued a smaller volume of loans to the agricultural sector, despite industry growth. Clearly, consolidation of the banking sector is not driving the largest financial institutions to engage in agricultural lending.

Figure 10



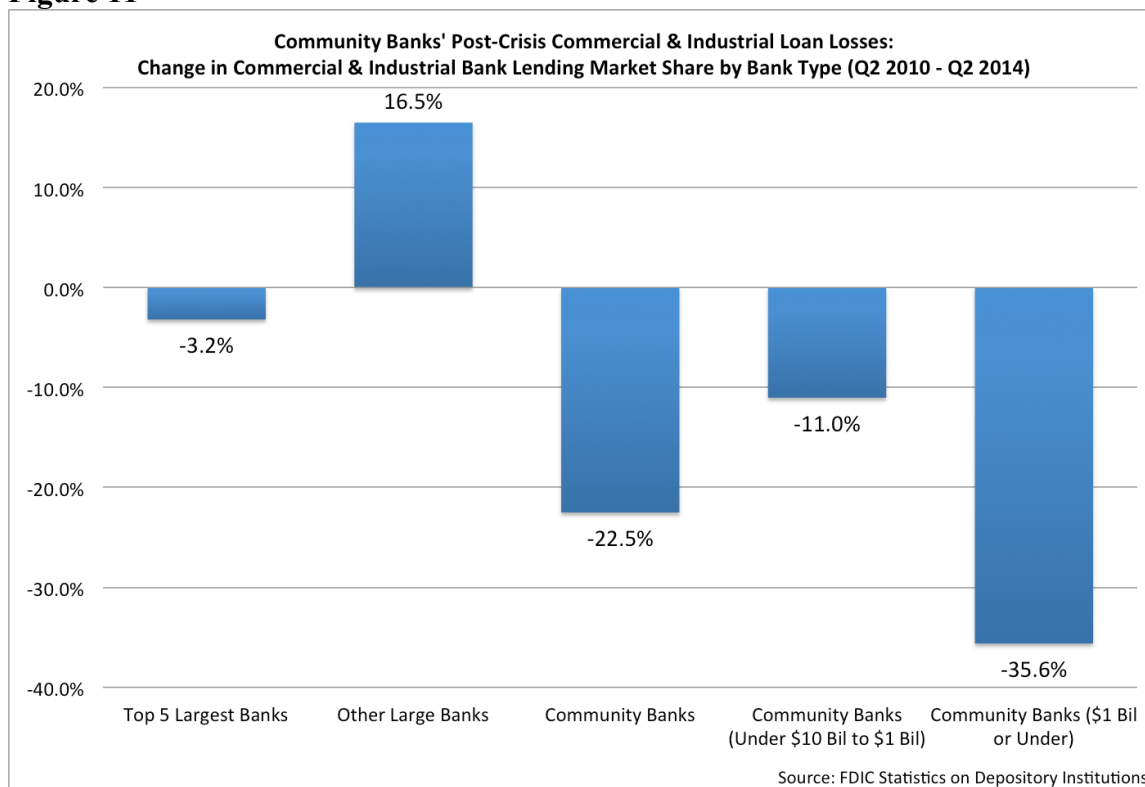
Most recently, one factor driving lending market share away from community banks overall (banks with less than \$10 billion in assets) is a decline in residential lending volume (explained above), but another is a 44 percent increase in C&I loans outstanding (which accounts for 21 percent, or \$1.7 trillion, of the overall lending market) since mid-2010, coupled with huge

⁵¹ “Do Large Banks Have Lower Costs? New Estimates of Returns to Scale for U.S. Banks,” *Journal of Money, Credit and Banking* 44, issue 1 (2012): 171-99.

⁵² FDIC, *Community Banking Study*, 5–22–5–24.

market share losses for community banks in this sector.⁵³ As Figure 11 shows, community banks' share of this lending market is down 22.5 percent since Q2 2010 (from 20.6 percent to 16.0 percent). More striking, the smallest community banks' market share is down 35.6 percent (from 9.6 percent to 6.2 percent) since Q2 2010, and despite overall lending growth in the sector, these banks realized a net decrease in volume of 7.5 percent.⁵⁴

Figure 11



Meanwhile, similar trends have occurred in individual lending markets, which account for 17 percent, or \$1.4 trillion, of the overall bank lending market, further driving consolidation.⁵⁵ The volume of community banks' loans to individuals is down 6.3 percent,⁵⁶ while its share of this lending market is down 7.9 percent since Q2 2010 (Figure 12). Meanwhile, mid-size competitors have realized significant increases in market share within this sector. Again, small community banks have realized particularly large market share losses.

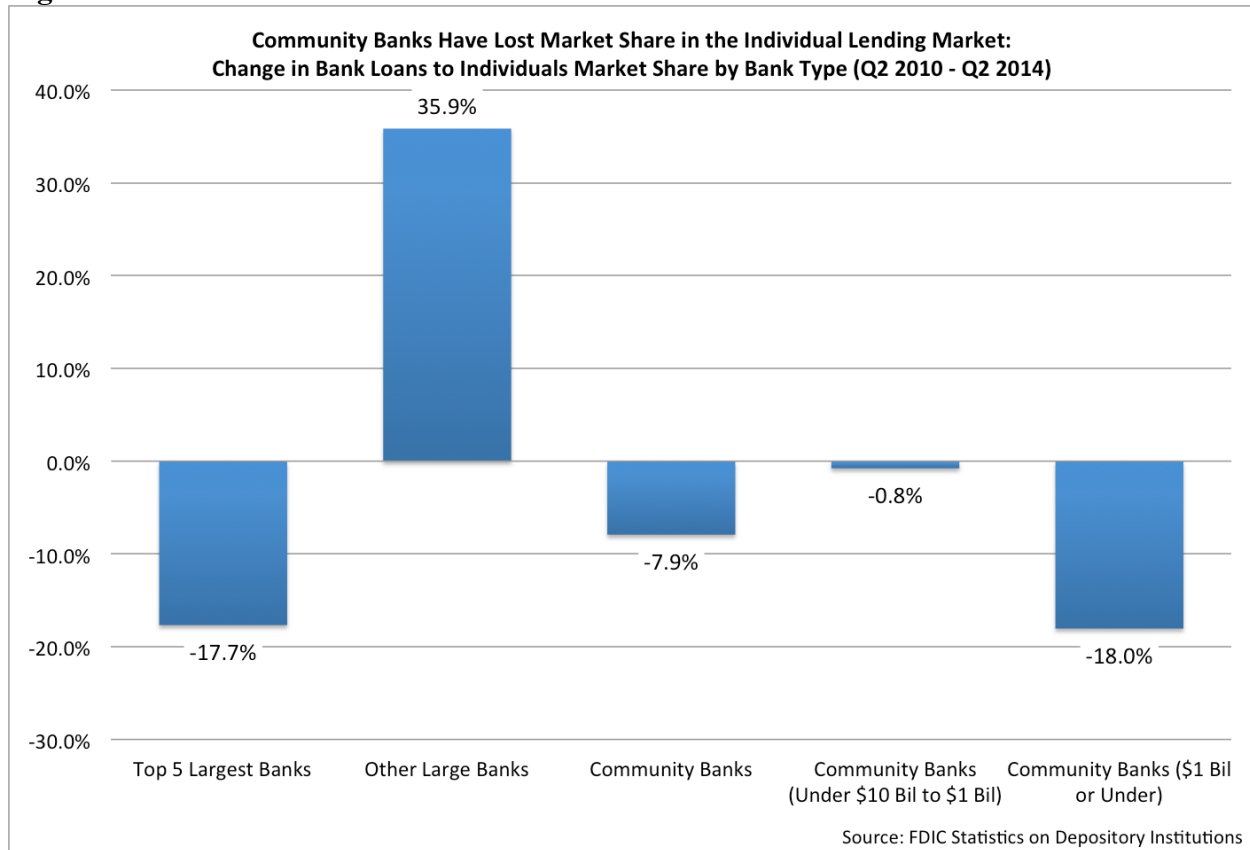
⁵³ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors' calculations.

⁵⁴ Ibid.

⁵⁵ Ibid.

⁵⁶ Ibid.

Figure 12



III. Discrepancy in crisis and post-crisis performance

What is most noticeable about many of the images in sections I and II above are the large losses in market share and lending volume that community banks – particularly small community banks – have faced between Q2 2010 and Q2 2014 (the post-crisis recovery period) in so many sectors. Even more striking is that, as Figures 13 and 14 show, community bank consolidation trends have almost doubled since the passage of Dodd-Frank, relative to the Q2 2006 and Q2 2010 time frame, which includes the crisis period.

Figure 13

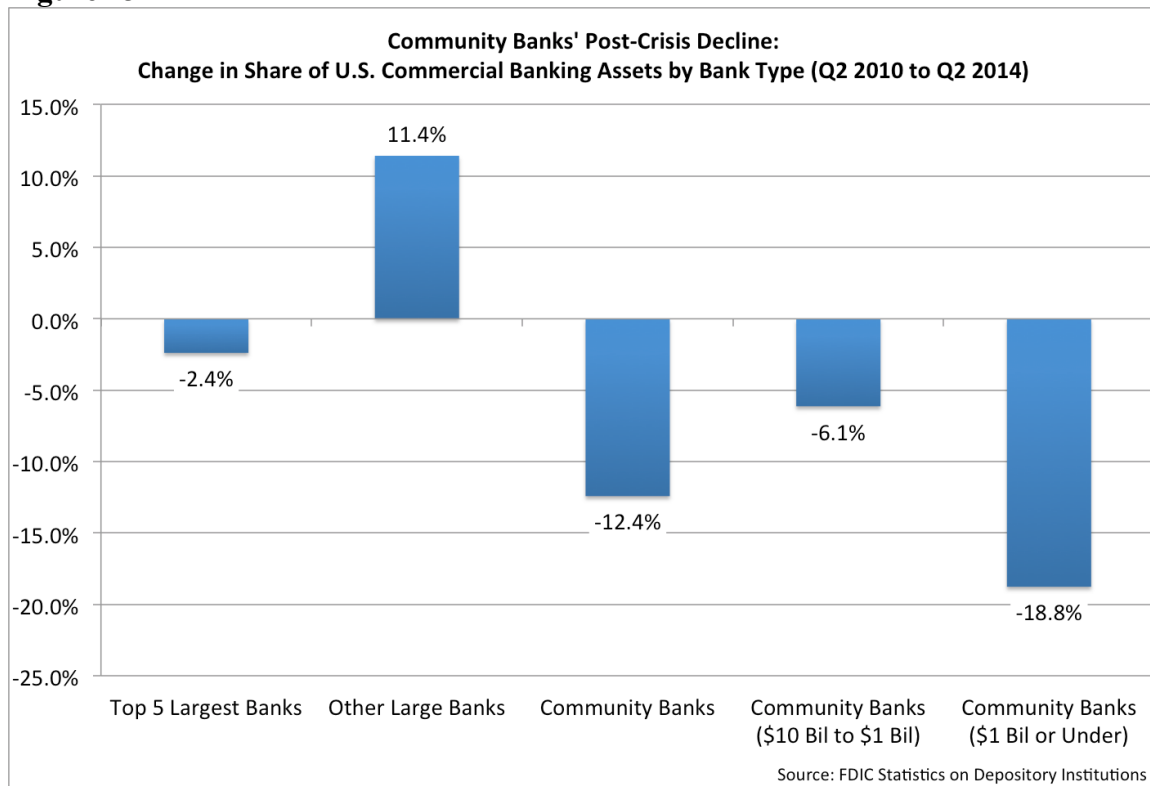
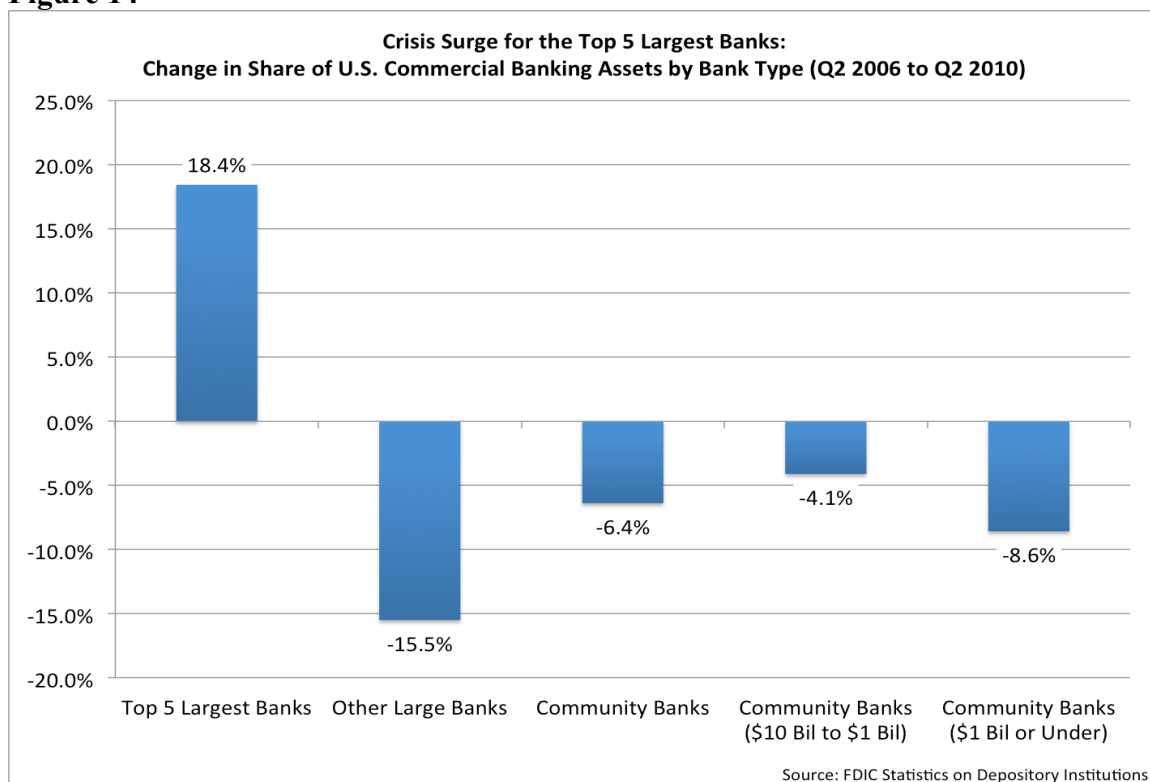


Figure 14



Yet, as community banks' share of U.S. banking assets declined substantially between Q2 2006 and Q2 2010, Figure 14 reveals that the five biggest institutions' share of banking assets skyrocketed 18.4 percent during this period at the expense of other large banks, some of which failed in the crisis. Interestingly, community banks' vitality has been challenged more in the years after Dodd-Frank than in the years during the crisis.

Clearly, as Figures 8, 9, and 13 reveal, Dodd-Frank did not mitigate concerns over banking sector concentration: The top five bank-holding companies control nearly the same share of U.S. banking assets as they did in the fiscal quarter before Dodd-Frank's passage. Meanwhile, community banks with \$1 billion or less in assets have seen a significant decline, while large community banks have also suffered losses, albeit at a less drastic pace. The rapid rate of consolidation away from community banks that has occurred since Dodd-Frank's passage is striking given that this regulatory overhaul was billed as an effort to end "too-big-to-fail."

6. How is regulation affecting consolidation?

In a 2014 study that examined bank consolidation, the FDIC argued that concerns over consolidation are overstated: "The disparity between the decline in very small [bank] charters and growth among charters between \$100 million and \$10 billion suggests that economies of scale offer only a limited explanation for consolidation, and that community banks have been much less affected by consolidation than is commonly thought to be the case."⁵⁷ (The FDIC considers almost all banks with less than \$10 billion in assets to be community banks.⁵⁸) The regulator saw the greatest effect on the smallest banks, whose numbers have declined by 85 percent between 1985 and 2013, the agency found, while banks over \$10 billion have tripled in number during that time.⁵⁹ The FDIC argues that "the rate of total attrition through failure or merger has been far lower among community banks than for non-community banks."⁶⁰ When they do fail, the agency points out, community banks are nearly always bought by other community banks.⁶¹

A serious drawback of this FDIC study is that it fails to assess the impact that regulatory burdens have had on consolidation of the community bank sector.⁶² As the GAO reports, regulators, industry participants, and Fed studies all find that consolidation is likely driven by regulatory economies of scale – larger banks are better suited to handle heightened regulatory burdens than are smaller banks, causing the average costs of community banks to be higher.⁶³

⁵⁷ FDIC, "Community Banks Remain Resilient Amid Industry Consolidation," *FDIC Quarterly* 8, vol. 2 (2014): 33-43, 43.

⁵⁸ FDIC, *Community Banking Study*, 1-3.

⁵⁹ FDIC, "Community Banks Remain Resilient Amid Industry Consolidation," 43.

⁶⁰ *Ibid.*

⁶¹ *Ibid.*

⁶² See Hester Peirce, "FDIC Community Bank Analysis Largely Ignores Impact of Regulatory Burden," *Point of Law*, The Manhattan Institute (April 2014).

⁶³ U.S. Government Accountability Office, 13-14.

Recent Minneapolis Fed research suggested that while banking consolidation trends will likely stay in line with historical levels in the near future, they could accelerate rapidly.⁶⁴ The authors reported that consolidation tends to increase in the five-year window after substantive banking regulation legislative changes (such as FIRREA, FDICIA and Dodd-Frank) pass.⁶⁵ While this suggests a causal relationship, the research emphasized the “difficulty in trying to confirm a link between changes in regulation/supervision and subsequent consolidation.”⁶⁶ Yet other findings reinforce concerns that banking consolidation is being driven by regulatory changes.

A 2014 Mercatus Center at George Mason University survey reported that over one-quarter of community banks (defined as those with less than \$10 billion in assets) would hire new compliance or legal personnel in the next 12 months, and that another quarter were unsure about whether they would do so.⁶⁷ It also found over one-third of banks had already hired new staff in order to meet new CFPB regulations.⁶⁸ Another 2014 Minneapolis Fed study highlighted the perilous consequences of regulation-driven hiring at the smallest community banks (those with less than \$50 million in assets), which, according to our calculations, in Q2 2014 accounted for 11 percent, or 682, of depository institutions (consolidating at the holding company level).⁶⁹ At these institutions, the study found that hiring two additional personnel reduces median profitability by 45 basis points, resulting in one-third of these banks becoming unprofitable.⁷⁰ As Fed Governor Tarullo has noted, “Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets.”⁷¹

In 2012 congressional testimony, William Grant, then chairman of the Community Bankers Council of the American Bankers Association, made a “very conservative” post-Dodd-Frank estimate of total industry compliance costs at \$50 billion annually, or 12 percent of operating cost.⁷² For community banks, he explained, “The cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks.”⁷³ And as Albert Kelly, chairman-elect of the American Bankers Association, explained before Congress the previous year: “Traditional banks tailor products to borrowers’ needs in local communities, and prescriptive rules inevitably translate into less access to credit and banking services.”⁷⁴

⁶⁴ Ron Feldman & Paul Schreck, “Assessing Community Bank Consolidation” (Economic Policy Paper 14-1, Federal Reserve Bank of Minneapolis, February 2014).

⁶⁵ Ibid., 4.

⁶⁶ Ibid.

⁶⁷ Peirce, Robinson & Stratmann, 36.

⁶⁸ Ibid., 48.

⁶⁹ FDIC, *Statistics on Depository Institutions, All SDI Data*. Authors’ calculations.

⁷⁰ Ron Feldman, Ken Heinecke & Jason Schmidt, “Quantifying the Costs of Additional Regulation on Community Banks” (Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis, May 2013), 4-5.

⁷¹ Tarullo (speech at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014).

⁷² William Grant, Chairman, Community Bankers Council, American Bankers Association, testimony on May 9, 2012, before the House Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, 112th Congress, 2nd sess., 5, accessed January 10, 2015, <http://financialservices.house.gov/uploadedfiles/hhrg-112-ba15-wstate-wgrant-20120509.pdf>.

⁷³ Ibid., 5.

⁷⁴ Albert C. Kelly, chairman-elect, American Bankers Association, testimony on March 11, 2011, before the House Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, 112th Congress, 1st sess., 4, accessed January 10, 2015,

The Federal Reserve System and Conference of State Bank Supervisors (CSBS) reported in early 2014 that many community banks found qualified-mortgage and ability-to-repay rules to be particularly burdensome.⁷⁵ In fact, according to a CSBS survey in this study, “15 percent of active mortgage lenders noted 80 percent or more of their one-to-four-family mortgage loans would not meet qualified mortgage (QM) requirements.”⁷⁶ As our data shows, residential lending activity is down significantly for the smallest community banks. However, the recent qualified residential mortgage (QRM) rule finalization may alleviate some of the community banks’ concerns regarding mortgage origination (while obviously also generating serious moral hazard concerns). Under the final QRM rule, most mortgages originated by banks will be QRMs, and because the rule removes the need for mortgage originators to have “skin in the game,” it will likely mitigate the banking industry’s concerns surrounding the QM rule and original QRM proposals that would have required that the QRMs entail substantial down payments.⁷⁷ However, as interest rates increase, refinancing opportunities will decline, and community banks could realize even more lost market share in this sector. In a late 2014 Independent Community Bankers Association (ICBA) survey of member community banks, 73 percent listed regulation as a factor holding back mortgage lending.⁷⁸

To better understand the regulatory burdens most troubling to community banks, we asked Continuity Control – a firm that handles regulatory compliance concerns from community banks – to provide us with a list of the regulatory arrangements that most frequently drive their community banking clients to contact them with compliance concerns. According to this list, which ranks regulatory categories by client requests for assistance, Continuity Control reports that the following regulatory arrangements are most burdensome to community banks:

- 1) Truth in Lending Act and Regulation Z rules governing open-end and closed-end changes stemming from the Dodd-Frank Act and the Credit CARD Act
- 2) Real Estate Settlement Procedures Act changes from Dodd-Frank that govern modifications to residential mortgages
- 3) Bank Secrecy Act and anti-money laundering rulemakings surrounding customer identification and due diligence
- 4) Fair Credit Reporting Act rules that require the establishment of the Identity Theft Red Flags Program and the development of risk-based pricing notices
- 5) Capital planning and stress testing regulations required by the Dodd-Frank Act⁷⁹

The precise effects of certain Dodd-Frank rulemakings are difficult to measure due to data limitations; for example, the Federal Reserve Bank of Boston found this to be the case in trying

<https://www.aba.com/Issues/Documents/119bf75cd076485f8aab3beba4dd2a02KellKellyDFAImpactonSmallBanksFINAL.pdf>.

⁷⁵ Federal Reserve System & Conference of State Bank Supervisors, *Community Banking in the 21st Century: Opportunities, Challenges and Perspective* (2014).

⁷⁶ *Ibid.*, 18.

⁷⁷ See Floyd Norris, “Banks Again Avoid Having Any Skin in the Game,” *The New York Times* (October 23, 2014).

⁷⁸ Independent Community Bankers Association, *2014 ICBA Community Bank Lending Survey*, October 2014 (scheduled to be released January 2015).

⁷⁹ Continuity Control. List of most burdensome rules, according to their clients, provided to authors via e-mail, November 2014.

to assess the effect on community banks of the Durbin Amendment to Dodd-Frank, which limits so-called swipe fees on credit cards.⁸⁰ But while hard to quantify, regulation has clearly affected the product mix. Federal Reserve Board Governor Jerome Powell explained in 2013 that “as auto, mortgage, and credit card loans have become increasingly standardized, community banks have had to focus to a greater extent on small business and commercial real estate lending – products where community banks’ advantages in forming relationships with local borrowers are still important.”⁸¹ Professor Scott Shane of Case Western Reserve University recently noted in *Bloomberg Businessweek* that a complex web of regulatory burdens is impeding the ability of banks to lend to small businesses.⁸² And a recent Harvard Business School working paper co-authored by former U.S. Small Business Administrator Karen Mills reported that regulatory burdens may be impeding community banks’ ability to participate in small business lending markets.⁸³ In the late 2014 ICBA survey, 26 percent listed “regulatory burden” as a factor hindering consumer lending.⁸⁴

In addition, regulation – as opposed to market forces – appears to be an increasingly powerful force driving the growth of bank mergers. A May 2014 *Wall Street Journal* analysis of SNL Financial data found that community bank mergers increased 30 percent between May 2013 and May 2014.⁸⁵ An October 2013 *Bloomberg Businessweek* story reported on banks engaging in “buying sprees” in response to regulatory pressures once they crossed the \$10 billion threshold.⁸⁶ A 2012 study found that community banks listed regulatory changes as the most common reason (38 percent) for M&A activity,⁸⁷ and a 2013 study concluded that the top factor (35 percent) for information technology spending on infrastructure or compliance by community banks is “leveraging data more effectively for regulatory requirements.”⁸⁸ In 2011, community banks reported to the FDIC that the problem was not any single regulation, but rather the web of regulations in their totality.⁸⁹ The result? The Mercatus Center survey reported that 83 percent of small banks believe compliance costs have increased at least 5 percent since the passage of Dodd-Frank.⁹⁰

Other anecdotes also highlight the impact of regulation on community bank mergers and consolidation. For example, in September 2012, one small bank in Missouri closed its doors

⁸⁰ Kaili Mauricio, “The Durbin Amendment and First District Banks” (Community Development Issue Brief 2, The Federal Reserve Bank of Boston, 2013).

⁸¹ Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System (speech at the Federal Reserve/Conference of State Bank Supervisors, Community Banking Research Conference, St. Louis, Mo., October 3, 2013).

⁸² Scott Shane, “Collateral Damage for Small Business Credit,” *Bloomberg Businessweek*, September 13, 2013.

⁸³ Karen Mills & Brayden McCarthy, “The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game” (General Management Unit Working Paper No. 15-004, Harvard Business School, July 2014).

⁸⁴ Independent Community Bankers Association, *2014 ICBA Community Bank Lending Survey*.

⁸⁵ Saabira Chaudhuri, “Accelerating Pace of Small-Bank Deals Driving Sector’s Merger Market,” *Wall Street Journal*, May 26, 2014.

⁸⁶ Leslie Picker & Matthew Monks, “Small Banks Feel the Urge to Merge,” *Bloomberg Businessweek*, October 3, 2013.

⁸⁷ KPMG, *Community banking outlook survey: Executives say regulatory requirements are stifling growth and driving M&A activity* (2012), 5.

⁸⁸ KPMG, *Community banking outlook survey: Encouraging outlook moves beyond regulation* (2013), 17.

⁸⁹ FDIC, *Community Banking Study*, B-3.

⁹⁰ Peirce, Robinson & Stratmann, 34.

because it expected Dodd-Frank to increase compliance costs by \$1 million per year.⁹¹ And in 2014, First State Bank of San Diego, Texas, CEO Dale Wilson testified on behalf of the Texas Bankers Association that in 2014 compliance costs were increasing 50 to 200 percent as a result of Dodd-Frank.⁹²

7. What if we do nothing?

According to the FDIC, “More than 1,200 U.S. counties (out of a total of 3,238), encompassing 16.3 million people, would have limited physical access to mainstream banking services without the presence of community banks.”⁹³ So what happens in those counties when the last bank leaves?

Consider Harding County, New Mexico, population 693, which lost its last remaining bank in October. Deposits held by customers in Community 1st Bank Las Vegas were transferred to the parent in Nevada.⁹⁴ Although the bank left two ATMs in Harding, the deposits reside in Las Vegas, some 11 hours away by car.⁹⁵

Certainly, technology offers the promise of reducing the need for physical banking branches. While many studies have found that small businesses prefer community banks,⁹⁶ some new research finds that this preference may be fading for small businesses engaged in certain circumstances.⁹⁷ If this finding is correct, alternative lenders may leverage technology to serve the needs of some small businesses, and this would accelerate consolidation while maintaining banking services. But the recent Harvard Business School working paper co-authored by former U.S. Small Business Administrator Katherine Hills suggests that community banks will still be a critical part of small business lending markets even if, or as, online alternatives accelerate.⁹⁸

Lending to small businesses and farms is more difficult to standardize and transfer to online platforms. So despite growth in agricultural lending markets, if interest rates rise, regulatory burdens continue to grow, and demand for agricultural loans declines while already-declining

⁹¹ Marsh & Norman, 5 (citing Francesco Guerrero, “Dodd-Frank, Seen from Missouri,” *Wall Street Journal*, January 21, 2013).

⁹² Dale Wilson, on behalf of Texas Bankers Association, testimony on July 23, 2014, before the House Committee on Financial Services, 113th Congress, 2nd sess., 3, accessed January 10, 2015, <http://www.aba.com/Advocacy/Testimonies/Documents/HFSC%20Testimony%20Texas%20Bankers%20Association%20Dale%20Wilson%20072314%20%282%29.pdf>.

⁹³ FDIC, *Community Banking Study*, 3–5.

⁹⁴ Dennis Domrzalski, “Harding County bank latest in slate of rural bank closures,” *Albuquerque Business First*, October 8, 2014.

⁹⁵ *Ibid.*

⁹⁶ *See, for example*, Jonathan A. Scott, “Small Business and the Value of Community Financial Institutions,” *Journal of Financial Services Research* 25, no. 2/3 (April/June 2004): 207-30; Rebel A. Cole, Lawrence G. Goldberg & Lawrence J. White, “Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks,” *Journal of Financial and Quantitative Analysis* 39, no. 2 (June 2014): 227-51; Allen N. Berger et al., “Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks,” *Journal of Financial Economics* 76 (2005): 237-69.

⁹⁷ Allen N. Berger, William Goulding & Tara Rice, “Do Small Businesses Still Prefer Community Banks?” (International Finance Discussion Paper No. 1096, Board of Governors of the Federal Reserve System, December 31, 2013).

⁹⁸ Mills & McCarthy, Figure 28.

small business bank loan demand accelerates more rapidly, then the lending market gaps left may be so wide that technology cannot adequately fill them in, even though it may be able to service individual lending markets quite easily. While agricultural and small business loans are not a large part of the overall U.S. bank-lending market, these markets drive critical components of the U.S. economy. Small businesses are also responsible for the majority of new jobs created – approximately half in November 2014.⁹⁹

Yet as we reported in Figure 6, community banks' share of small business lending has declined steadily since the crisis ended. Meanwhile, non-regulated nonbanks are entering small business lending aggressively – there is clearly unmet demand for loans from small businesses.¹⁰⁰ The recent Harvard Business School working paper by Mills and McCarthy reported that great uncertainty surrounds how alternative online lenders would perform in an economic downturn, and noted the strategic advantage they currently possess as largely unregulated entities.¹⁰¹ Given the small market share of these alternatives, the seeming inevitability that their regulatory competitiveness will dwindle after another downturn occurs, and an increasingly concentrated banking sector with fewer community banks, what will be the consequences for small business?

As Professor Arthur Wilmarth of George Washington University Law School explained in a recent paper, the nature of small-and-medium-enterprise (SME) lending in the U.K. and Canada is illustrative. He notes that in the U.K., a highly centralized banking system results in less competition, and consequently, government research finds that customers in SME lending receive lower-quality service than they otherwise would have in a more competitive market.¹⁰² Wilmarth also points out that Canadian Federation of Independent Businesses research has suggested that the lack of community banks in Canada's highly concentrated banking system has resulted in poor service provision to SMEs, which have turned to credit unions instead.¹⁰³ And over the years, according to the study, Canadians have reported the largest banks' service to be systemically inadequate when compared to credit unions.¹⁰⁴ But it is not realistic to think credit unions – which in large part proliferated because of their tax-exempt status – will fill in the gap in the U.S.

Consolidation could transform the U.S. banking system to resemble more closely those systems deemed by the World Economic Forum to be the world's "soundest."¹⁰⁵ However, evidence suggests the merits of high consolidation are mixed. A 2014 Bank of Finland study finds that SME lending is less extensive in countries where the banking sector is dominated by major

⁹⁹ ADP Research Institute, *ADP Small Business Report* (November 2014), <http://www.adpemploymentreport.com/2014/November/SBS/SBS-NER-November-2014.aspx> (accessed January 10, 2015).

¹⁰⁰ Mills & McCarthy.

¹⁰¹ *Ibid.*, 53.

¹⁰² Arthur E. Wilmarth, "A Two-Tiered System of Regulation Is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks" (GWU Law School Public Law Research Paper No. 2014-53, George Washington University Law School, October 2014), 46-7.

¹⁰³ *Ibid.*, 48-9 (citing Canadian Federation of Independent Businesses, "Research: Battle of the Banks: How SMEs Rate Their Banks" [May 2013]).

¹⁰⁴ *Ibid.*, 48 (citing Canadian Federation of Independent Businesses).

¹⁰⁵ See Louise Bennetts, "Thanks to Dodd-Frank, Community Banks Are Too Small to Survive," *American Banker*, November 8, 2012.

financial institutions.¹⁰⁶ In 2004, a *Journal of Financial Research* study found that developing nations with larger community banking sectors enjoyed higher GDP and employment by SMEs.¹⁰⁷ The apparent acceleration of banking sector consolidation by poorly designed and coordinated regulations – and the economy-wide consequences that could result – should be of immense concern to policymakers, and serve as an impetus to act.

8. What should we do?

Community banks had little role in the financial crisis, yet play a major role in critical U.S. lending markets. However, as our analysis of lending market data reveals, community banks are losing market share and volume in individual, small business, and residential mortgage lending markets. Smaller community banks have fared particularly poorly the last four years. What can policymakers do to mitigate these trends and avert negative consequences in U.S. lending markets?

As we noted earlier, one of the most significant problems community banks face is the sheer volume of banking regulations and the seeming lack of coordination. In fact, according to one estimate, Dodd-Frank will increase total U.S. financial regulatory restrictions 32 percent relative to 2010 levels once all of its rulemakings are complete.¹⁰⁸ The legal costs for community banks associated with more regulations are inherently a larger portion of overall revenue than for larger institutions, making any form of compliance more difficult.¹⁰⁹ Thus, policymakers should strive to create a more reasonable and streamlined regulatory system that is consequently less burdensome to these unique institutions. We propose three broad policy objectives and several accompanying proposals for them to do so.

I. Reform the regulatory process to mitigate unintended consequences

To ensure better-designed regulation in the future and avert unintended consequences that jeopardize lending market vitality in the U.S., more robust economic analyses of financial regulatory rulemakings are needed. Currently, most financial regulators are “independent regulatory agencies,” meaning their regulations are not subject to Executive Order requirements necessitating cost-benefit analyses and the review of these analyses by the Office of Information

¹⁰⁶ Iftekhar Hasan et al., “Bank Ownership Structure, SME Lending and Local Credit Markets” (Bank of Finland Research Discussion Paper No. 22/2014, Bank of Finland, August 2014).

¹⁰⁷ Allen N. Berger, Iftekhar Hasan & Leora F. Klapper, *Journal of Financial Services Research* 25, no. 2 & 3 (2004): 169-202.

¹⁰⁸ 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, February 2014).

¹⁰⁹ See Peirce; Tarullo (speech at the Federal Reserve Bank of Chicago Bank Structure Conference, May 8, 2014).

and Regulatory Affairs (OIRA).¹¹⁰ Research finds that OIRA review is associated with higher-quality analyses.¹¹¹

While some federal financial regulators are subject to limited statutory requirements to conduct cost-benefit analysis, others are not, and the Committee for Capital Markets Regulation found in a 2012 review of 192 Dodd-Frank rulemakings that 57 contained no cost-benefit analysis, and 85 had non-quantitative analyses.¹¹² In 2011 the GAO found that federal financial regulators' efforts to conduct economic analysis for Dodd-Frank rulemakings "fall short of what could be done to determine the potential costs and benefits of the new rules."¹¹³

To mitigate the unintended consequences of financial regulations on community banks, all federal financial regulators should be required to conduct cost-benefit analyses for economically significant proposed rulemakings, and these analyses should be subject to non-binding review by OIRA, as legislation introduced in 2013 by Senators Rob Portman (R-OH), Susan Collins (R-ME), and Mark Warner (D-VA) would have accomplished.¹¹⁴ This proposal, supported by the Committee on Capital Markets Regulation, would enable the President to expand executive orders mandating cost-benefit analyses to independent regulatory agencies (most financial regulators), while maintaining agency independence. Congress should reintroduce and pass this legislation.¹¹⁵ Additionally, Congress could pass statutory requirements that financial regulators conduct cost-benefit analyses for economically significant proposed and final rules.¹¹⁶

While implementing more stringent cost-benefit analysis standards would help ensure that regulations achieve their intended outcomes without resulting in unnecessary harm for community banks, more structural reforms are likely necessary for the CFPB, which already is subject to some statutory cost-benefit requirements.¹¹⁷ The Federal Reserve System and Conference of State Bank Supervisors reported in 2014 that community banks in many states are very concerned about recent regulatory actions by the CFPB and its lack of accountability.¹¹⁸ As former FDIC chair Sheila Bair pointed out in 2012, the CFPB's rules are "too long and complex."¹¹⁹ Consequently, "smaller banks have basically gotten out of consumer finance because it's just too hard."¹²⁰

¹¹⁰ See Committee on Capital Markets Regulation, *A Balanced Approach to Cost-Benefit Analysis Reform* (2013); Curtis W. Copeland, "Economic Analysis and Independent Regulatory Agencies" (report prepared for the Administrative Conference of the United States, April 30, 2013) (both providing a more thorough explanation of "independent regulatory agencies," OIRA review, and Executive Order Requirements).

¹¹¹ Patrick McLaughlin & Jerry Ellig, "Does OIRA Review Improve the Quality of Regulatory Impact Analysis? Evidence from the Final Year of the Bush II Administration," *Administrative Law Review* 63, Special Edition (2011): 179-202.

¹¹² Committee on Capital Markets Regulation, letter to Chairman Tim Johnson, Ranking Member Richard Shelby, Chairman Spencer Bacchus & Ranking Member Barney Frank, March 7, 2012.

¹¹³ U.S. Government Accountability Office, *Dodd-Frank Act Regulations, Implementation Could Benefit from Additional Analyses and Coordination*, GAO-12-151, November 2011, 37.

¹¹⁴ S. 1173, Independent Agency Regulatory Analysis Act of 2013, 113th Congress, 1st sess., June 18, 2013.

¹¹⁵ See Committee on Capital Markets Regulation, *A Balanced Approach to Cost-Benefit Analysis Reform*, 18; McLaughlin & Greene.

¹¹⁶ See Committee on Capital Markets Regulation, *A Balanced Approach to Cost-Benefit Analysis Reform*, 18.

¹¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, § 1022(b)(2)(A).

¹¹⁸ Federal Reserve System & Conference of State Bank Supervisors.

¹¹⁹ Megan Barnett, "Sheila Bair on Ben Bernanke, banking, and what's next," *Fortune*, October 2, 2012.

¹²⁰ *Ibid.*

To improve the effectiveness of its rulemakings, the CFPB should be reorganized into a multi-member commission structure. Doing so will increase the likelihood that concerns of community banks will be heard internally and result in a more deliberative rulemaking process that better weighs the costs and benefits of proposed rules. In fact, the U.S. Department of the Treasury proposed in 2009 that a new consumer financial regulator be established as a multi-member board so that it would “represent a diverse set of viewpoints and experiences.”¹²¹ The CFPB is unique in that it operates with few institutional restraints and is led by just one director – instead of a commission structure. Changing it into a commission, along with OIRA review of its cost-benefit analyses, would alleviate some of the pressure community banks currently feel by improving the CFPB’s rulemaking process.

II. Improve existing regulations

A bipartisan commission should be established to identify opportunities to merge, streamline and simplify banking and consumer financial regulations, particularly with regard to the effects they have on community banks. Such a commission structure – modeled after the Base Realignment and Closure Commission – has been proposed for all federal regulations,¹²² but it could be more feasible and effective to apply such an idea specifically within the realm of banking and consumer finance regulation.

This commission could weigh the costs and benefits created not just by individual TILA, Regulation Z, RESPA, and Bank Secrecy Act rulemakings (all identified by Continuity Control as some of the most burdensome regulations for community banks), but also the unintended costs generated by regulatory accumulation, which studies have found can be substantial.¹²³ These costs, along with individual rules’ compliance costs, would then be weighed against specific rules’ social benefits and inform a proposal to amend or remove regulations. Congress would then vote on that proposal. Such a commission would force policymakers to prioritize the objectives of financial regulations and understand how these social goals can be achieved at a lower cost.

Additionally, the Dodd-Frank-mandated interagency Financial Stability Oversight Council (FSOC) is required to “facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions.”¹²⁴ The FSOC is also tasked to serve as a “forum” for the “discussion and analysis of emerging

¹²¹ U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation* (2009), 58.

¹²² See Michael Mandel & Diana G. Carew, “Regulatory Improvement Commission: A Politically Viable Approach to U.S. Regulatory Reform” (Policy Memo, Progressive Policy Institute, May 2013); Patrick McLaughlin & Richard Williams, “Regulatory Accumulation and a Proposed Solution” (Working Paper 14-03, The Mercatus Center at George Mason University, February 2014).

¹²³ See, for example, John W. Dawson & John J. Seater, “Federal Regulation and Aggregate Economic Growth,” *Journal of Economic Growth* 18 (2013): 137-77; Norman V. Loayza et al., “The Impact of Regulation on Growth and Informality: Cross-Country Evidence” (World Bank Policy Research Working Paper No. 3623, The World Bank, 2005).

¹²⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, § 112(a)(2)(E).

market developments and financial regulatory issues.”¹²⁵ However, in recent years, the FSOC has largely focused on addressing systemic risks posed by large financial institutions. This perspective should change. The FSOC should utilize its unique institutional advantage as a council of regulators to identify what regulatory conflicts are unnecessarily harming community banks, to ensure better coordination and to reduce unintended consequences stemming from conflicting regulatory objectives.

III. Expand community banks’ regulatory exemptions

Complex risk-weighted capital requirements may be appropriate for large financial institutions, but they are not for community banks. In a recent speech, the Kansas City Fed’s George noted, “Community banks continue to hold higher levels of capital than the largest banks.”¹²⁶ She continued: “Even so, community banks must adopt the more complicated capital rules with finer degrees of risk weights and capital buffers. The risk-weighted asset schedule of the call report has 57 rows and 89 pages of instructions, yet no additional capital was required for the majority of community banks.”¹²⁷ Continuity Control data suggests that capital requirement and reporting regulations are a major burden to community banks.¹²⁸

Because community banks are often better capitalized than their larger peers, banking regulators should consider setting a non-risk-weighted capital-ratio threshold that, if met, would exempt community banks from risk-weighted standards. Doing so would entail lower compliance costs and help level the regulatory playing field for community banks. A simpler capital ratio approach is more effective than risk-based ratios at predicting default, according to a 2014 Bank of England research paper, a 2013 study by the OECD, a 2013 George Mason University working paper and a 2010 IMF working paper.¹²⁹ In the fall of 2014, a speech by the Kansas City Fed’s George suggested that she supports “simpler capital rules.”¹³⁰

Granted, simpler capital ratios for community banks can facilitate regulatory arbitrage by treating high-risk and low-risk assets equally. However, this is unlikely to emerge, because the smallest community banks rarely hold the type of high-risk assets often associated with this behavior. Such a tiered arrangement, however, could create opportunities for regulatory arbitrage by favoring certain institutions over large institutions. Accordingly, policymakers could consider shifting more generally toward the overall use of simple capital ratios in banking. As the Bank of England’s Andrew Haldane and Vasileios Madouros noted in 2012, simple, predictable policy

¹²⁵ Ibid., (a)(2)(M).

¹²⁶ George (speech at the Community Banking in the 21st Century conference, September 23, 2014), 7.

¹²⁷ Ibid.

¹²⁸ Continuity Control.

¹²⁹ Andrew Haldane, “Constraining discretion in bank regulation” (paper presented at Federal Reserve Bank of Atlanta Conference on ‘Maintaining Financial Stability: Holding a Tiger by the Tail(s),’ Federal Reserve Bank of Atlanta, Atlanta, Ga., April 9, 2013); Adrian Blundell-Wignall, Paul Atkinson & Caroline Roulet, “Bank Business Models and the Basel System: Complexity and Interconnectedness,” *OECD Journal: Financial Market Trends*, vol. 2013, issue 2 (2014): 43-68; Thomas L. Hogan, Neil R. Meredith & Xuhao (Harry) Pan, “Evaluating Risk-Based Capital Regulation” (Working Paper No. 13-02, The Mercatus Center at George Mason University, January 2013); Asli Demirgüç-Kunt, Enrica Detragiache & Ouarda Merrouche, “Bank Capital: Lessons from the Financial Crisis” (IMF Working Paper No. 10/286, International Monetary Fund, December 2010).

¹³⁰ George (speech at the Community Banking in the 21st Century conference, September 23, 2014), 6-7.

prescriptions are often best at mitigating complex risk.¹³¹ However, a discussion of the consequences of expanding simple capital ratios more broadly is outside the scope of this paper.

To further minimize compliance burdens, regulators should consider exempting banks with less than \$10 billion in assets from rules like the Volcker Rule, and Dodd-Frank's Section 956 compensation requirements should not be applicable to community banks. In November 2014, Tarullo expressed his support for community bank exemptions to these rules,¹³² which, while likely not affecting most community banks, create compliance concerns that will distract industry participants from growing businesses, and perhaps expend vital resources on unnecessary legal fees. Some community banks have sold assets simply due to uncertainty over the Volcker Rule.¹³³ A pure exemption would settle confusion once and for all. Additionally, policymakers should consider exempting community banks from data collection requirements, and expanding the CFPB's mortgage servicing "small servicer" exemption from 5,000 loans to a larger amount such as 10,000 or 20,000.¹³⁴

9. Conclusion

Our research suggests that community banks continue to play a uniquely important role in U.S. agricultural, residential and small business lending markets. We find that while community banks weathered the crisis with greater resilience than many mid-size counterparts, since the passage of the Dodd-Frank Act the pace at which community banks have lost market share is nearly double what it was during the crisis.

Consolidation is not inherently a bad trend, but policymakers should be concerned that a critical component of the U.S. banking sector may be withering for the wrong reasons – inappropriately designed regulation and inadequate regulatory coordination. Improving federal regulators' cost-benefit analysis through non-binding OIRA review would enable regulators to achieve intended goals more efficiently and at lower costs to community banks. Congress should act to improve existing regulatory processes by introducing OIRA review to financial regulations and to establish a bipartisan commission aimed at streamlining existing financial regulations. Furthermore, the FSOC and the CFPB must improve structurally and culturally in order to more adequately monitor the effect of rulemakings on community banks. Policymakers should also examine simpler capital rules and various rule exemptions for community banks.

¹³¹ Andrew G Haldane, Chief Economist and Executive Director, Monetary Analysis & Statistics, Bank of England & Vasileios Madouros, Economist, Bank of England (speech at Federal Reserve Bank of Kansas City's 366th Economic Policy Symposium, 'The changing policy landscape,' Jackson Hole, Wyo., August 31, 2012), <http://www.bis.org/review/r120905a.pdf> (accessed January 10, 2015).

¹³² Tarullo (speech at the Community Bankers Symposium, November 7, 2014).

¹³³ See Abha Bhattarai & Catherine Ho, "Four years into Dodd-Frank, local banks say this is the year they'll feel the most impact," *The Washington Post*, February 7, 2014.

¹³⁴ Independent Community Bankers Association, *Plan for Prosperity: A Regulatory Relief Agenda to Empower Local Communities* (February 2013), 4; Independent Community Bankers Association, *ICBA Policy Resolutions for 2014* (2014), <http://www.icba.org/advocacy/index.cfm?ItemNumber=31887> (accessed January 10, 2015).