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Community Banks – Help is on the way… but capital investment and consolidation are still needed

We have noted before that community banks lack economies of scale and are increasingly facing a competitive disadvantage versus larger banks as they (1) shoulder the costs required to meet heightened regulatory requirements; (2) struggle to acquire the technology needed for products and services innovation; and, (3) ensure customer data security.

The plight of small banks has been receiving needed attention recently and help is on the way. We expect to see some regulatory relief and other developments, which should reduce the cost burden, promote organic growth, and ease the consolidation process in the banking industry.

However, there is a limit to the extent of the relief that can be provided. Infrastructure costs will continue to increase and negatively impact efficiency ratios. The only solution for is for small banks to grow, whether organically or through consolidation, to gain some scale to compete across a wider product range and improve return on equity. In many cases, capital injection may be required to provide the power to leverage the bank in its expanding geographical and demographic marketplace. .

Here are five recent developments that should aid community banks.

1. **Senate Testimony of Banking Regulators**

Senior officials of the Federal Reserve System (Fed), Federal Deposit Insurance Corporation (FDIC) and Office of the Controller of the Currency (OCC) testified before the Senate Committee on Banking, Housing and Urban Affairs in February. The subject of the hearing was “Regulatory Relief for Community Banks and Credit Unions.” The regulators described the importance of community banks to the financial system and the economy; and expressed their commitment to tailor their supervision and rule making to a bank’s size and complexity. They addressed a number of measures the agencies are taking, and proposing to take, to help ensure that their activities and policies do not place an undue burden on small banks, including establishing exam schedules tailored to the size and risk of the bank; proposing to move national banks and federal savings associations having up to $750 million in assets to the longer exam cycle which now applies only to banks with less than $500 million in assets (OCC); excluding small bank holding companies and small savings and loan holding companies that meet certain qualitative requirements from regulatory capital requirements (Fed); reducing reporting requirements on banks with under $1 billion in assets (Fed);

replacing complex quarterly reporting requirements for holding companies with less than $1 billion in assets with less complex reports to be made semiannually (Fed). The OCC has drafted a legislative proposal to exempt from the Volker Rule national banks and federal savings banks with less than $10 billion in assets. In testimony on April 23rd before the House Subcommittee on Financial Institutions and Consumer Credit, OCC Senior Deputy Comptroller Toney Bland explained that "as the vast majority of banks under $10 billion in asset size do not engage in the proprietary trading or covered funds activities that the statute sought to prohibit, we do not believe that they should have to commit compliance resources to determine of compliance obligations under the rule would apply."

2. Harvard Kennedy School Study

The Harvard Kennedy School Mossavar-Rahmani Center released a comprehensive report on the regulatory burdens facing community banks entitled "The State and Fate of Community Banking" authored by Marshall Lux and Robert Greene.

The Lux-Greene report highlights the important role community banks play in the economy, describes the extent to which they have been losing market share and, in the language of the report, concludes that their "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." The report offers solutions: (1) streamlining existing regulations with regard to the effects they have on community banks; (2) expanding regulatory exemptions for community banks – including exempting banks with less than $10 billion in assets from the Volker Rule; and (3) reforming the regulatory process, including requiring that regulators conduct cost benefit analyses of economically significant rules.

There seems to be concurrence in many respects between the regulators' testimony and the Lux-Greene report, such as (1) the recognition that regulations need to be tailored to community banks to avoid unnecessary burdens and (2) the identification of some of solutions that are needed. That is not to say that regulatory and legislative adjustments will satisfy all industry participants, but there is a recognition and commitment among regulators that should yield positive results.

3. An Innovative Proposal to Reduce Costs.

In January of this year the OCC released a thoughtful paper proposing ways in which community-focused national banks and federal savings association might reduce costs by becoming a "community of organizations" which undertake collaborative efforts to share resources, including jointly purchasing materials or services, sharing back-office or other services, sharing a specialized staff member or team and jointly providing or developing products and services. The paper points out that collaboration could allow small banks to acquire the technology to offer new products and services they otherwise could not afford and could permit management to refocus their limited resources on core functions. It also cautions that any collaborative activities must comply with antitrust laws and suggests that banks that do not directly compete may find it easier to collaborate, and that those banks that do compete

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may want to exclude activities, including marketing and advertising, that differentiate the banks.

4. A New Potential Avenue To Organic Growth.

The Lending Club, which describes itself as an online marketplace connecting borrowers and investors, in February of this year announced an alliance with a consortium of 200 community banks ranging in asset size from $200 million to $10 billion. As reported by the Wall Street Journal, the arrangement will permit the community banks to build a portfolio of unsecured consumer loans of up to $35,000 per loan. "Until now, small banks generally haven't been able to justify the cost of underwriting those loans…. Now, instead of analyzing loans on their own, the banks will rely on Lending Club's software, which uses a data-driven process to evaluate a borrower's ability to repay." The borrowers can be both the bank's customers and other individuals sourced by Lending Tree.

This could be a prudent, low cost way for small banks to diversify into a profitable consumer lending product that they heretofore avoided because of the underwriting and consumer credit compliance costs. We do not know the extent to which this arrangement has received regulatory approvals. Regulators generally require that banks make their own credit decisions and we would think that the arrangement can be structured consistent with that requirement.

5. Consolidation Made Easier

On April 9th of this year, the Federal Reserve issued a rule expanding the applicability of its Small Bank Holding Policy Statement, which eases the process for consolidation of small banks.

Generally the Fed believes that a high level of holding company debt impairs the ability of the holding company to be a source of strength to subsidiary banks; but the Fed recognizes that small bank consolidation often requires the use of acquisition debt. Accordingly, under the Policy Statement bank holding companies with assets of less than $500 million that met certain qualitative requirements were permitted to incur acquisition debt of up to 75% of the purchase price of the bank to be acquired. That comes with some restrictions: (1) all debt must be retired within 25 years of being incurred; (2) the Fed expects that the bank holding company reaches a debt to equity ratio of 0.30:1 or less within 12 years; and (3) dividends may not be paid until the debt to equity ratio declines to 1.0:1 or less.

By this action, the Fed raised the asset threshold of the Policy Statement from $500 million to $1 billion and also made it applicable to savings and loan holding companies.

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The measures outlined above and the growing impetus to alleviate the burdens on small banks will have a positive effect, but the problem of "too small to succeed" will persist. Compliance costs will increase – regulation is not going away and as existing products become more

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complex and new products are developed, the cost and complexity of complying will increase. Required anti-money laundering measures, in particular, will increase in scope with a corresponding need for more technology and more people. Cyber security is a new frontier and will need constant enhancement. Product innovation will continue and, although small banks will not likely bear the cost of development, once a new product appears, they will need to acquire the technology to offer it to remain competitive. The mobile banking app is one recent example. Banks become compelled to make the investment to offer it due to its popularity. And once the app becomes part of the product set, it will have to be upgraded - for example to offer more features such as deposit taking through check scanning – at more cost.

Many community banks will still need to achieve greater scale through organic growth or mergers and acquisitions. Boards of Directors and bank executive management will be constantly challenged to reach the scale that permits them to be competitive and gain access to capital in the public or private markets on reasonable terms by generating adequate returns on assets and equity.

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