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LESSONS LEARNED FROM THE FINANCIAL CRISIS REGARDING COMMUNITY BANKS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE MAJOR TRENDS AFFECTING COMMUNITY BANKS AND LESSONS LEARNED FROM COMMUNITY BANK FAILURES DURING THE FINANCIAL CRISIS

JUNE 13, 2013

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C O N T E N T S

THURSDAY, JUNE 13, 2013

LESSONS LEARNED FROM THE FINANCIAL CRISIS REGARDING COMMUNITY BANKS

THURSDAY, JUNE 13, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:27 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I apologize for being a bit late, but the vote was called. Good morning. I call this hearing to order.

Today we will discuss three recent studies on community banks: the GAO's study, "Causes and Consequences of Recent Bank Failures"; the FDIC Inspector General's "Comprehensive Study on the Impact of the Failure of Insured Depository Institutions"; and the "FDIC Community Banking Study".

Between January 2008 and December 2011, 414 insured U.S. banks failed. Of these, 353 were depository institutions with less than $1 billion in assets. Despite these failures, over 7,000 small financial institutions survived. We know that community banks did not cause the financial crisis, but many were casualties of the Great Recession that followed.

Community banks entered the crisis with strong capital and, despite weakening earnings, most of them remained well capitalized through the crisis. However, some banks saw an increase in nonperforming loans and a decrease in income that strained their capital levels.

I look forward to today's witness testimony. The FDIC, the GAO, and FDIC IG have taken important steps to analyze the impact of the financial crisis on community banks, and specifically the GAO and IG studies looked at the factors that contributed to the bank failures during this period. All three studies have provided lessons learned from the crisis regarding community banks and have made recommendations that would strengthen the community bank model and improve regulation and supervision.

Since community banks play such a vital role in so many cities and towns of all sizes, including many in my home State of South Dakota, it is important for this Committee to explore major trends affecting community banks and lessons learned from the financial crisis. It is my hope that this Committee can find consensus and ways to strengthen community banks and the communities they serve without undermining safety and soundness regulation or consumer protection.

Ranking Member Crapo, do you have an opening statement?

OPENING STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Yes, Mr. Chairman, and thank you.

Today the Committee will hear about the lessons we have learned from the financial crisis regarding community banks. I want to thank the FDIC and the GAO for coming to testify pursuant to a statutory requirement to brief us on bank failures and their causes.

This is a critical issue since small banks represent the lifeblood of many communities across America, and especially rural communities, in Idaho and elsewhere. In fact, the FDIC's Community Banking Study, commissioned by Chairman Marty Gruenberg, shows that community banks hold the majority of banking deposits in rural counties, with one in five U.S. counties having no other banking presence.

Banking used to be a community-based enterprise, relying on local knowledge and expertise to extend credit based on creditworthiness of the bank's depositors. Many community banks continue to operate that way even today.

Despite the many benefits of such relationship-based banking, the industry has become increasingly concentrated since the 1980s. The number of banking organizations has shrunk by nearly one-third from 1990 to 2006, and most of this contraction has involved small community banks whose numbers have now fallen by more than 3,000 during that time.

The financial crisis of 2008 only exacerbated the consolidation trend. Between January 2008 and December 2011, 414 U.S. banks failed, according to the GAO. Of those, 85 percent, or 353 banks, had less than $1 billion in assets. Those banks often specialized in small business lending, so their failure has had a disproportionately large impact on small business lending and local employment.

We must carefully examine what led to such a large number of small banks closing and the residual effect on local communities.

We also need to be able to put this most recent crisis in perspective and examine how it compares to past community bank crises. While this hearing is focused on lessons learned from the most recent financial crisis, much can be learned from the postcrisis response as well. The regulatory framework that emerged out of Dodd-Frank has made it increasingly difficult for community banks to maintain and operate their business presence in many communities. Community banks are disproportionately affected by increased regulation because they are less able to absorb the additional cost.

The majority of community banks today have $250 million or less in assets, according to the GAO, which often translates into a one- or two-person compliance department. Small institutions simply do not have the resources necessary to review and parse through thousands of pages of new rules. As a result, many community and small banks have identified Dodd-Frank as imposing overwhelming regulatory burdens on them or serving as barriers to entry.

As Federal Reserve Governor Duke outlined in a November 2012 speech, "If the effect of a regulation is to make a traditional banking service so complicated or expensive that significant numbers of community banks believe they can no longer offer that service, it should raise red flags and spur policy makers to reassess whether the potential benefits of the regulation outweigh the potential loss of the community bank's participation in that part of the market."

I believe we have reached that point, and I look forward to the testimony from our witnesses today.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. Thank you all.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit. Now I will introduce our witnesses.

Mr. Richard Brown is Chief Economist at the FDIC.

The Honorable Jon T. Rymer is Inspector General of the FDIC.

Mr. Lawrance L. Evans, Jr., is Director for Financial Markets and Community Investment at the GAO.

I thank all of you for being here today. I would like to ask the witnesses to please keep their remarks to 5 minutes. Your full written statements will be included in the hearing record.

Mr. Brown, you may begin your testimony.

STATEMENT OF RICHARD A. BROWN, CHIEF ECONOMIST, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. BROWN. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I appreciate the opportunity to testify on behalf of the FDIC regarding the FDIC Community Banking Study. This research effort was initiated in late 2011 to better understand the changes that have taken place among community banks over the past quarter century. This effort was motivated by our sense of the importance of community banks to small businesses and local economies in every part of the country and by our understanding that community banks have faced a number of challenges in the postcrisis financial environment.

Our research confirms the crucial role that community banks play in our financial system. As defined by the study, community banks represent 95 percent of all U.S. banking organizations. They account for just 14 percent of U.S. banking assets but hold 46 percent of the industry's small loans to farms and businesses.

While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and other nonmetropolitan counties. Without community banks, many rural areas, small towns, and urban neighborhoods would have little or no physical access to mainstream banking services. The study identified 629 counties where the only banking offices are those operated by community banks.

Our study examined the long-term trend of banking industry consolidation that has reduced the number of banks and thrifts by more than half since 1984. But the results cast doubt on the notion that future consolidation will continue at this same pace or that the community banking model is in any way obsolete.

Since 1984, more than 2,500 institutions have failed, with the vast majority failing in two crisis periods. To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future consolidation. About 80 percent of the consolidation that has taken place resulted from eliminating charters within bank holding companies or from voluntary mergers, and both of those trends were facilitated by the relaxation of geographic restrictions on banking that took place in the 1980s and the early 1990s.

But the pace of voluntary consolidation has slowed over the past 15 years as the effects of these one-time changes were realized.

The study also showed that community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies exhibited relatively strong and stable performance over time, including during the recent crisis. By comparison, institutions that pursued more aggressive growth strategies underperformed.

The strongest performing lending groups across the entire study period were community banks specializing in agricultural lending, diversified banks with no single specialty, and consumer lending specialists. Agricultural specialists and diversified nonspecialists also failed at rates well below other community banks during the study period. Other types of institutions that pursued higher-growth strategies—frequently through commercial real estate or construction and development lending—encountered severe problems during real estate downturns and generally underperformed over the long run.

Now, with regard to measuring the costs of regulatory compliance, the study noted that the financial data collected by regulators does not identify regulatory costs as a distinct category of noninterest expenses. As part of our study, the FDIC conducted interviews with a group of community banks to try to learn more about regulatory costs. Most participants stated that no single regulation or practice had a significant effect on their institution. Instead, most said that the strain on their organization came from the cumulative effects of a number of regulatory requirements that have built up over time. Several of those interviewed indicated that they have increased staff over the past 10 years to support their responsibilities in the area of regulatory compliance. Still, none of the interview participants said that they actively track the various costs associated with compliance, citing the difficulties associated with breaking out those costs separately.

In summary, despite the challenges of the current operating environment, the study concluded that the community banking sector will remain a viable and vital component of the overall U.S. financial system for the foreseeable future.

Thank you for the opportunity to testify, and I look forward to your questions.

Chairman JOHNSON. Thank you, Mr. Brown.

Mr. Rymer, please proceed.

STATEMENT OF JON T. RYMER, INSPECTOR GENERAL, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. RYMER. Thank you, Chairman Johnson, Ranking Member Crapo, Senator Warren. Thank you for the opportunity to testify today on the lessons learned from the financial crisis. As you requested, I will focus my remarks on the study my office conducted on the impact of the failure of insured financial institutions. I will summarize the study's overarching conclusions and general observations. In addition, I will highlight some of the work my office has completed over the last 5 years that could contribute to the Committee's "lessons learned" discussion.

The events leading to the financial crisis, and the subsequent efforts to resolve it, involved the dynamic interplay of laws, regulations, agency policies and practices with the real estate and financial markets. Banks expanded lending, fueling rapid growth in construction and real estate development. Many of the banks that failed did so because management relaxed underwriting standards and did not implement adequate oversight and control.

For their part, many borrowers did not always have the capacity to repay loans and, in some cases, pursued many projects without considering all the risks involved.

As for the regulators, while they generally fulfilled their responsibilities, most of the material loss reviews conducted by the three bank regulatory IGs found that the regulators could have provided earlier and greater supervisory attention to troubled banks and thrifts.

Four general observations emerged from our study, and they are as follows:

First, the FDIC's resolution methods—including the shared loss agreements—were market driven. Often, failing banks had poor asset quality and little or no franchise value, and as a result did not attract sufficient interest from qualified bidders for the FDIC to sell the banks without a loss-share guarantee. The FDIC used these agreements to leave failed bank assets in the financial services industry, thereby supporting asset values and reducing losses to the Deposit Insurance Fund, or the DIF.

Second, most community bank failures were the result of aggressive growth, asset concentrations, poor underwriting, deficient credit administration, and declining real estate values.

Third, we found that examiners generally followed and implemented longstanding policies. However, they did not always document all of the examination steps they performed.

And, fourth, the FDIC has investment-related policies in place to protect the DIF and to ensure the character and fitness of potential investors.

In my remaining time, I would like to highlight some of the other work my office has completed related to the financial crisis.

My office has conducted over 270 reviews of failed banks to determine the reason for the failure and, in many cases, to assess the FDIC's supervisory performance as the primary Federal regulator of these banks.

In addition to these reviews, we separately summarized the major causes, trends, and common characteristics of bank failures. In a December 2010 report, we examined the FDIC's supervisory actions taken up to that point in the crisis and offered recommendations geared to further enhance the FDIC's supervisory program.

Although our focus was primarily on failed banks, we have also looked to gain an understanding of why similarly situated banks did not fail. Our findings from an October 2012 report were not surprising as essentially they confirmed that planning, risk management, and strong leadership at both the bank management and board levels are the key ingredients to a successful bank.

Finally, my office, along with the other two bank regulatory IGs, looked at the use and impact of prompt regulatory actions established in the FDI Act. In a September 2011 report, we found that prompt corrective actions occurred too late to rescue most troubled institutions. And while critically undercapitalized institutions were closed promptly, the losses to the DIF were still significant.

In closing, the main lessons that should be learned from the work we did during the crisis is for the FDIC to remain vigilant in its supervisory activities in both good economic times and in bad. Focusing examination attention on key processes and risk management before an institution experiences financial and capital decline is the supervisory key to maintaining healthy banks.

FDIC management must ensure that the lessons learned from the crisis become ingrained in its day-to-day operations in order to avoid a repeat of the last 5 years. We must all realize that these lessons will become more difficult to apply, or sustain, as the economy improves and banks return to profitability.

This concludes my prepared statement. Thank you for the opportunity to be here today and join in this discussion. I look forward to answering your questions.

Chairman JOHNSON. Thank you, Mr. Rymer.

Mr. Evans, please proceed.

STATEMENT OF LAWRANCE L. EVANS, JR., DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. EVANS. Chairman Johnson, Ranking Member Crapo, and Senator Warren, I am pleased to be here this morning to discuss our January 2013 report on bank failures.

Between 2008 and 2011, 414 insured U.S. banks failed. Since then, there have been 67 additional failures. Examining failed institutions, especially in contrast to their nonfailing peers, provides an opportunity to glean lessons learned that may be useful for regulators and policy makers going forward. Whereas my written statement covers a number of issues, my oral remarks today will focus on the causes of community banks failures.

As we detailed in our report, 72 percent of the failures were concentrated in 10 States—in the West, Midwest, and Southeast. Almost all the failures involved small and medium-size banks. As mentioned, 85 percent of the banks had less than $1 billion in assets at the time of failure. Our analysis of these failures revealed four key issues.

First, the failures were associated with high concentrations in commercial real estate, particularly acquisition, development, and construction loans. These loans grew rapidly and exceeded the regulatory thresholds for heightened scrutiny by a significant margin. ADC concentrations at failed banks grew from roughly 100 percent of total risk-based capital to nearly 260 percent in 2008. At the onset of the financial crisis, ADC loans made up 30 percent of the total loans at failed banks, roughly 20 percentage points higher than at their open peers.

Second, ADC and CRE concentrations were often associated with aggressive growth, poor risk management, weak credit administration, and risky funding sources. In some cases, IG reviews noted that failed banks engaged in lending outside of their normal geographical trade areas where they had no experience. We found that 28 percent of the failed banks had been chartered for less than 10 years at the time of their failure. According to regulators, many of these were formed to take advantage of the commercial real estate boom but lacked the experience necessary to manage the risks associated with heavy concentrations.

FDIC staff noted that in many cases these young failed banks departed sharply from the approved business plan originally filed with the FDIC. Our econometric analysis found that banks with higher ADC concentrations and greater use of broker deposits were more likely to fail, while banks with better asset quality and greater capital adequacy were less likely to fail over the 2008–11 period.

Our model found that high concentrations of CRE loans unrelated to acquisition, development, and construction did not increase the likelihood of failure, of course, abstracting from extreme concentrations.

Third, the majority of the assets held by failing banks were not subject to fair value accounting. In fact, less than 1 percent of the assets held by failed banks were subject to fair value accounting on a recurring basis. We found that the biggest contributors to credit losses at failed institutions were nonperforming loans recorded at historical costs.

Significant declines in real estate values contributed to these losses because, as collateral-dependent loans suffered impairment, accounting rules required that they be written down to the value of the collateral.

Last, loan loss reserves were not adequate to absorb credit losses, in part because the accounting model for estimating credit losses is based on historical loss rates or incurred losses. As a result, estimated losses were based on economic conditions that understated default risk. As the level of nonperforming loans began to rise during the crisis, banks were forced to increase loan loss allowances and raise capital when they were least able to do so.

To address this issue, accounting standard setters have proposed a more forward-looking approach that focuses on expected losses and would, therefore, incorporate a broader range of credit information. If operationalized, an expected loss model could potentially reduce the cycle of losses and failures that emerged in the recent crisis and could also encourage prudent risk management practices.

Federal Reserve staff noted that if management at failed banks were forced to recognize loan losses earlier, it may provided an incentive to limit concentrations and the types of loans that later resulted in significant losses.

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, this concludes my opening statement. I will be happy to answer any questions you have.

Chairman JOHNSON. Thank you, Mr. Evans, and thank you very much for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Mr. Evans and Mr. Rymer, with the vast majority of community banks that survived the financial crisis, what characteristics based on your research helped them survive? What lessons should community banks and regulators learn from those that failed? Mr. Rymer, let us begin with you.

Mr. RYMER. Yes, sir, thank you. I think that is a great question to start with. We did do a study on that particular question a couple of years ago. We looked at banks that did have—I think all three of us have noted that concentrations in ADC—acquisition, development, and construction lending in commercial real estate—such concentrations, which had been a problem at many of the failures. We identified over 400 banks during the period of 2007 to 2011 that had concentrations of 300 percent or more of capital in ADC loans.

We looked at a particular group of those banks, 18 banks in that group that were high-performing or well-performing banks, either CAMELS—rated 1 or 2, and what we found in those banks was that the common characteristics were strong and engaged board leadership, strong management, a focus on local markets, strong core funding or local funding, and a focus on risk management and planning.

So, in net, it is all the things that you would expect a well-run bank or a well-run business to do. I think the key is, in those community banks that are actively engaged in ADC lending, to recognize the risks associated with that business line and invest in the controls and management to manage that risk.

Chairman JOHNSON. Mr. Evans.

Mr. EVANS. So I will speak on net here because our findings were quite similar. We found that it was unhealthy concentrations in acquisition, development, and construction loans that were very important. And I think that underlies the core issues, which were poor risk management and aggressive growth. So I think, in this case—and we saw this across all banks, even the large institutions—we saw poor risk management, aggressive growth strategies, and weak credit administration practices. It just materialized a bit different for the small banks as opposed to their larger peers, and their larger peers were, of course, concentrated in nontraditional residential mortgage loans. And, of course, with the community banks, it was large and unhealthy concentrations in acquisition, development, and construction loans.

Now, to build on the October 2012 report that the IG referred to, we also have some findings that are consistent with those findings. We found through our rigorous econometric analysis that CRE concentrations themselves, once you control for capital adequacy and asset quality, did not lead to an increased likelihood of failure. Of course, these were non-ADC portions of commercial real estate, so your strip malls and your gas stations and the like. That abstracts again from very large and significant concentrations of, say, 600 percent, something well beyond the regulatory thresholds that would trigger additional scrutiny.

Chairman JOHNSON. Mr. Brown, have community banks fully recovered from the financial crisis? And how have community banks strengthened their balance sheets since the crisis?

Mr. BROWN. Chairman Johnson, community banks have made significant progress in overcoming the challenges they faced in the crisis. They still have some way to go. As a group, as we have defined them in our study, they earned a pretax return on assets of 1.06 percent in 2012. That is an update to our study. That is 3 times more than their profitability in 2010, so that gives you a sense of the progress that they have made.

But as our study documented, half of the loan portfolios of these institutions are real estate secured, and real estate is still in a difficult situation in many parts of the country. Problem loan levels remain elevated, and that is one of the reasons that loan growth remains slow.

Now, the community banks were steady providers of credit during the depths of the crisis. I think the noncommunity banks showed much larger contractions in the credit that they provided. But community bank loans have grown slowly recently, largely because of the loans secured by nonfarm, nonresidential properties, in many cases where real estate serves as collateral for what otherwise is a commercial loans. So there are still some challenges that they face.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Evans, in December 2012, the FDIC issued a comprehensive report on community banks, and some of the findings of that report suggest that bank consolidation has very real consequences for the economy because community banks and small banks play such a vital role in the local source of credit. Yet some industry observers are estimating that nearly 2,000 banks will need to be acquired or to sell their assets in the aftermath of the crisis. Others speculate that 90 percent or more of small banks with less than $1 billion in assets are not likely to survive.

First of all, did you agree with this assessment that the smaller banks still face a very serious potential of not surviving in large numbers? And what can the FDIC do given the causes that you have just identified and discussed with us of so much of the failure, what can the FDIC do to ensure that community banks, especially in rural areas, do survive?

Mr. EVANS. Very important question, especially given the importance of community banks for local communities.

I would say our work here is fairly limited that would allow me to answer this question. But I will note that as of the end of the first quarter of 2013, there were 612 banks on the problem bank list. So that indicates that there are still issues that need to be worked through.

I think some of the issues with respect to community banks, where the examiners can play a more significant role, is determining what it really means when concentration thresholds are exceeded, and they say it requires additional scrutiny or heightened scrutiny. What does that mean? Because it is really those significant concentrations that contributed to the problems that we saw across the board.

And, again, just regulators in general, there are a number of issues we should be thinking about in terms of regulatory burden and right-sizing regulations.

Senator CRAPO. I know you have studied the regulatory burden that our community banks or smaller banks have faced. Could you give us any—just comment on what your conclusions are with regard to whether we have too excessive a burden right now or whether we need to fine-tune the approach that we have taken?

Mr. EVANS. Right. So, I mean, and this is an important issue. It is important to frame it appropriately, and I think there is a minimization problem that we are trying to solve, so we are trying to minimize regulatory burden on institutions, especially when some of the regulations were designed to impact the largest, most complex and internationally active institutions.

So, clearly, there is a minimization problem that needs to be solved here, but there is a constraint, and that constraint is safety and soundness. So framing the debate in that way suggests that it is important for regulators to use their flexibility as granted by Dodd-Frank to offer exemptions and tier these regulations appropriately.

Again, that having been said, safety and soundness is an important concern. Certain regulations are certainly appropriate for banks of all sizes. And so starting to have that dialog I think will be appropriate in determining where we can tier and right-size some of these regulations.

Senator CRAPO. Thank you.

Mr. Rymer, in the time I have got left, I would like to talk with you about the examination process just briefly. The FDIC has reviewed its examination rulemaking and guidance processes during 2012, and as a result of that review, the FDIC has implemented a number of enhancements to its supervisory and rulemaking processes.

What feedback, if any, have you received from your revisions from the institutions that are being supervised? How is this working?

Mr. RYMER. Well, very little direct feedback from the industry. Those changes to the FDIC's supervisory processes are very recent, but many of those changes I believe were responsive to some of the work we did in our 2009 and 2010 reports.

The FDIC, in general, is focused on community bank examination, and I know this Committee is very interested in that issue. I know we received a letter from Chairman Johnson, I believe early last year, on that very topic. We have looked at examination frequency and examination consistency. It is my view that the FDIC is taking more of a risk-based approach to spending more examination time, frankly, on banks that may deserve it. There is an awareness in the agency that banks are in the business of banking, not in the business of complying with regulation, although regulation, as it has been noted, is critical to the business.

Banking is a highly regulated industry. It does receive support in the sense of insured deposits from the FDIC, so the FDIC does have a duty to protect those deposit insurance funds. But I think there is an acknowledgment within the FDIC through the more risk-focused examination process and its attention to the community banking industry through some of the work that Rich and his staff has done and then Chairman Gruenberg's recently forming of a community bank advisory council. There seems to me to be a focus within the institutions, the FDIC, and the industry as a whole about the critical importance of the examination process.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, thank you, Ranking Member Crapo, for holding this hearing, and thank you all for being here.

I believe we need banks of all sizes, including community banks. Community banks are important because they increase consumer choice, they promote competition, they counteract the concentration that we have with too-big-to-fail banks.

But one of the principal benefits that community banks bring us is lending to small businesses, and I think the data show that disproportionately it is our community banks that are out there making these loans to small businesses.

The smallest banks, those with $250 million or less in assets, account for only 4 percent of the assets in the banking industry. And yet they constitute 13.7 percent of all the business loans out there. So small businesses really count on these community banks.

When I was working on the Congressional Oversight Panel during the crisis, we warned about the concentration in the banking industry and about the impact it would have on small business lending. And here we are 5 years out now, still worrying about concentration in the industry.

So what I would like to do is just give you a chance here, Mr. Evans, if you could talk for just a minute about the GAO's findings in your report about the impact that concentration in banking has on small business lending.

Mr. EVANS. OK. So in this particular report, when we looked at concentration what we were trying to get at is whether the bank failures created the types of concentration concerns that would trigger potential anticompetitive effects. And so in this particular report, when we looked at it, we saw that the acquiring banks generally stepped in and limited concentration levels from going above that point where we would be concerned about anticompetitive effects.

Senator WARREN. Well, let me push back, though, just a little bit on that, Mr. Evans, because part of the concern I have is not simply whether there is physically a bank outlet operated somewhere, but that community banks do more small business lending, and once they are swallowed up by big banks, whether they are swallowed up because they were failing or whether they were just bought up, whether they were gobbled up by the big banks, that what we see is that small businesses have much more trouble getting access to capital.

Mr. EVANS. Right, and that is one of the things we really could not get at in the study, but we do point it out. We point out that the patterns of lending could change because of some of these acquisitions. And those institutions and borrowers likely to be most hurt would be those that rely on their local community banks for small business loans.

Senator WARREN. Good. Then let me just follow up on a question that Senator Crapo had put out on the table about how we maintain a strong environment for our community banks, because they are so important to the rest of our economy.

You know, after the crisis, there was just nearly a panic about people who could not get access to credit. One of the responses, of course, was Dodd-Frank, but one of the concerns that I have is that in Dodd-Frank we now have a regulatory system that, while Dodd-Frank made some distinctions between large and small banks, small banks are still subject to many regulations that were written for the larger financial institutions.

And so what I am concerned about is that we now have a regulatory system for which many parts of it are neutral on its face, but the impact on smaller financial institutions that cannot afford to hire an army of lawyers to go and interpret these rules turns out to be crushing.

So the question I want to ask, and I hope we have time that I can ask it of all of you, is whether or not we are reaching a point where we should really think about a two-tiered regulatory system.

Mr. Rymer, would you like to address that?

Mr. RYMER. Yes, ma'am, to the extent I can. We have not, again, done a lot of work in that area in terms of post- Dodd-Frank. Our focus on Dodd-Frank will be—as we have some work planned—related to the effect of Dodd-Frank. We are planning work later this fall to look at whether examination efforts are coordinated between the CFPB and the primary Federal regulators as it relates to regulatory burden, and there are clear dividing lines between CFPB responsibilities in a bank and the primary Federal regulator.

But I think the broader question that you are asking is what can the regulators do and potentially the Congress do to encourage or improve the health and sustainability of the community bank model. Frankly, I think whatever we can do to encourage profitability and encourage the types of positive behaviors in a community bank that make it successful. The key to community banking, frankly, is profitability. The majority of banks that have evaporated from the community bank landscape have done so through merger and acquisition, and that is because the folks that owned those banks chose to sell those banks, and perhaps in many cases those banks were not as profitable as they could have been. So I think enhanced profitability ultimately has got to be the focus.

Senator WARREN. Although I am not sure we regulate that directly here in Washington. If I can just have a few more seconds, if that is all right, Mr. Chairman, I would really like to hear Mr. Brown's comments on this since they are doing this at the FDIC. Have we reached a point where it is time to think about a two-tier regulatory system for our small banks?

Mr. BROWN. Well, Senator, the issue that you bring up is a very important one, and I think it is addressed in the supervisory process by a risk-focused supervisory system that tries to scale the nature of the supervisory process to the risk and the complexity of institutions. And it is something where it is sort of hard to write rules in advance and create thresholds that work for all cases. I think supervisors at the FDIC try very hard to make sure that the process is scaled to the risk and complexity of those institutions.

I would just add that in the precrisis years there definitely was a performance gap between the larger noncommunity banks and community banks. The noncommunity banks grew much faster. They earned much more money. And, of course, they did so through——

Senator WARREN. I am sorry. Can we also add to that the noncommunity banks were the ones that took on all the risk and crashed the economy?

Mr. BROWN. Yes, I was headed in that direction.

Senator WARREN. Which sort of suggests that maybe they did not have proper oversight.

Mr. BROWN. And I think the reforms in Title I and Title II of Dodd-Frank, ending too big to fail, is a very important element to leveling the playing field and making sure that the community banking sector stays vibrant in the years ahead.

Senator WARREN. Thank you very much.

Thank you for your indulgence, Mr. Chairman.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Chairman, thank you. I appreciate the opportunity to visit with individuals from the FDIC.

Most of my time in the Senate, which is short, certainly in the Banking Committee we have raised the topic of regulations of community banks, and I have raised that not just with the FDIC but other regulators. There is a pretty standard response to those questions about how we understand the value of community banks. We treat them differently. We have an advisory committee that we get input from. And yet the statistics and trends continue with additional consolidation. I see it in the numbers in Kansas. The number of banks is less than it was a year ago. And I heard it anecdotally, the continual conversation, and it makes sense to me that the increasing cost of regulation means that a bank has to be larger in order to cover the costs of those regulations. Fixed costs matter.

I remember a banker telling me that an examiner was in the bank and suggested that they hire two more people in the bank to comply with rules and regulations. The bank employs eight people. Two people is a significant increase in the number of people working there. Increasing employment would be a good thing, but not if you cannot afford to do that.

And so our bankers' options, particularly as the economy becomes more difficult, their options generally are find some other bank interested in buying them. And I think there is a significant consequence to rural America in the absence of community financial institutions, the ability to—the relationship banking remains important to my farmers, ranchers, small business men and women. And my concern or complaint is that—I do not want to be pejorative and say we continue to provide lip service to this issue, but I cannot ever find any evidence that we are really doing anything differently in regard to the regulatory environment that community financial institutions face.

Maybe you could satisfy me with the suggestion that we have a different examining standard, we have different criteria when our examiners are in the bank, we have a different set—we have eliminated—give me an example of regulations that we have eliminated or modified because of the size and scope of the bank. And, again, I would portray this, at least in my view, that all of this is in the context of financial institutions that are not too big to fail and that have little consequence—significant consequence in a community or to shareholders, but little consequence systemically to the economy.

Can you assure me that the conversations that I have had with individuals who regulate banks and are responsible for those regulations over the last 2½ years have done more than tell me they understand my problem and have done something about it?

Mr. BROWN. Senator, your question on consolidation is a very good one, and I do want to put it in perspective, that after——

Senator MORAN. My other questions are not?

[Laughter.]

Mr. BROWN. They are all very useful.

After two-and-a-half decades of consolidation that we followed in our study, 95 percent of banking organizations in 2011 were community banks, and we saw the biggest decline among very small community banks. The number under $25 million actually declined by 96 percent, much less consolidation at slightly larger size groups.

In fact, the number of charters with assets between $100 million and $1 billion increased by 19 percent over the study period, and that is where 65 percent of community banks currently operate.

We did studies of economies of scale. How much do average costs fall as asset size increases? For some lines of business, like commercial real estate lending, there were some economies of scale, but most of them are realized at an asset size of $100 to $300 million. So, you know, the idea that you have to be a $2 or $3 billion bank to do business, I am not sure that the numbers square up with that.

That said, we also understand that the overhead expenses of community banks are very sensitive to regulatory costs and staffing for regulatory purposes. The FDIC has undertaken a number of steps—you described them—to try to mitigate those costs, provide services that are valuable to the banks in terms of meeting those regulatory requirements.

Senator MORAN. That answer is different than the other answers I have received over the last 2½ years. What are the specific examples of modifications that the FDIC has made to accommodate—and I guess let me further indicate to you that I understand—if this was a matter of bank consolidation because of normal free market economic principles about size of scale economies, that to me is a different issue for us than one that is driven by the regulatory environment and the fixed costs or the costs associated with meeting those requirements.

I do not know whether your study demonstrates what—is there an explanation for why those costs increase and the economies of scale—I guess to further indicate that a $25 million bank is important to me and to a community in Kansas, and when you assure me that things get better at $100 million and above, I mean, I am pleased to know that, but there are a lot of banks in Kansas that fall between that $25 million and that $100 million that are very important certainly to the people who work there, who own that bank, but more importantly, to the community that they serve.

Mr. BROWN. Well, understood, and I think those economies of scale that I referred to, the decline in average cost includes both regulatory and nonregulatory costs. The fact is we do not have the data to break down overhead expenses between those two categories, so we can only look at overall overhead costs. But for the community banking sector the last 3 years, those overhead costs as a percent of assets have been stable at 2.9 percent of average assets. And so we are not seeing large increases in overall overhead expenses.

We do understand, though, the need on the part of the FDIC to provide technical assistance. We have created a Web-based pre-exam tool to make sure that information requests are synchronized and very clear with the bank being examined. We have created a regulatory calendar that reminds institutions of when the comment periods and what the compliance periods are. And we have created a series of videos on our Directors Resource Center that provide very detailed technical information about how to comply with the various standards coming down the pike so consultants are not needed to explain that. So we think those can be helpful in terms of helping to navigate.

Senator MORAN. Thank you very much. My time has expired. I would only point out that what the FDIC does is critical in this arena. You are at least one of the few, if not the one regulator that the bank cannot escape. As we have seen in our State and elsewhere in the country, as banks have rechartered to become State institutions to alter this regulatory environment, they are never going to get away from you. And what you do matters to the success not just of my banks, but the communities that they serve.

Thank you.

Chairman JOHNSON. Senator Heitkamp.

Senator HEITKAMP. You are going to hear a recurring theme here. Thank you, Mr. Chairman, and thank you for this hearing. You are going to hear a recurring theme in all of this. We are deeply concerned in a very nonpartisan way with the viability and the continuing operation of small community banks. And our overall concern is that we are now in an era where we create an atmosphere too big to fail and what the net result is too small to succeed.

And I would suggest, Mr. Evans—and without having any dialog behind this—that, in fact, when you say you look at overall overhead costs and they have not increased, I would suggest to you that is because banks are doing things that—are not doing things that they have done in the past because they do not want to get in trouble. And one of those issues that is very critical in North Dakota is housing. Our small community banks have always been a huge part of financing residential development, and we are seeing a huge retraction from that responsibility to the community, not as a matter of choice but as a matter of—we do not know that we can comply. We do not know that we have the capacity to comply with what is coming at us.

And so where I listened to the discussion that you had today about, you know, we are listening, we are moving, I had a conversation with the Chairman and suggested that he needs to listen directly to the small community banks. And I am grateful to report that he, in fact, will be coming out to North Dakota to do roundtables with our small community banks in North Dakota to address these issues.

But I want to take this in a little different direction. You know, there is postcrisis research regarding community banks showing that public benefits provided in the crisis and in the recovery stages after the crisis actually minimized the direct effect. Having a good relationship with your bank gave you the ability to continue to get the capital that you needed, the operating loans that you needed.

You know, their central role—and, you know, I know you guys deal with numbers, but a lot of this in little towns in North Dakota, in Hankinson, North Dakota, it is about relationships. They have a generation-generation-generation relationship with their depositors. They have done operating loans for years, and now they are terrified to do them. And, you know, that may be drive, in fact, by reality or it may be driven by just the fear of what is coming down.

And so I cannot impress upon this panel enough that we are deeply concerned about consolidation. We think it is being driven by regulation—I do think it is being driven by regulation. And we want to know whether this will reach the top runs in terms of evaluating what we can do to stop consolidation on the lower level and continue the viability of small community banks. I will start with you, Mr. Evans.

Mr. EVANS. So the re-occurring theme here I think is important because it speaks to the need to minimize, where appropriate, burdens on community banks. And so I would take this time to plug some of the work we have done on Dodd-Frank where we have made recommendations to the regulators to strengthen their prospective analysis before they write these rules, as well as the retrospective analysis, because we have heard from community bankers that it is the cumulative burden of these regulations—"death by a thousand cuts," as it is often referred to—that raises the most significant concern. And so retrospective analysis there would be extremely important because this will allow us to really assess the impact of various regulations.

And we have also asked the regulators to start to plan and think about the data they need to collect in order to do this assessment, because we do need to understand the impact of regulations and exemptions on stability, efficiency, and competitiveness.

Mr. BROWN. I think one thing to keep in mind is that the forces of consolidation include, potentially, regulation going forward, but in the past they also have included bank failures. We had more than 2,500 bank failures during the study period that led to consolidation. And I think that the safety and soundness of the industry is one of the important factors, obviously, in determining the future pace of consolidation.

I think one of the other things that we have observed is that the banks that came through the crisis in pretty good shape are generally pretty conservatively run. They generally have high supervisory ratings. They have the types of governance qualities that

Mr. Rymer described in his statement and generally comply with the regulatory requirements as they are.

And so I know that the cost of the change in regulation is disconcerting for many. We are trying to help them work through that. We think that communication is absolutely critical to making sure there are no surprises and making sure that there is an agreement between supervisors and banks as to how the regulations are going to work going forward.

Senator HEITKAMP. Mr. Chairman, if I could just take—just make one more point, which is enforcement versus regulation. There is not a kid that you grew up with who does not like being lumped in when their older siblings do something wrong and they all get punished, right? And so, you know, we are in an atmosphere—in North Dakota, no bank failures, but yet my banks are suffering the consequences of what happened. And I would suggest to you that the lack of enforcement of existing regulations before Dodd-Frank is a critical component to bank failures, and the reaction has been to regulate, and some would argue excessively, in response to that, which is one-size-fits-all, we are going to punish you all equally regardless of your appropriate conservative management of your financial institution.

And so be very careful, because I am going to judge things very carefully on regulatory versus enforcement, and what I would suggest to you may have failed is enforcement, but what we got was regulation.

Chairman JOHNSON. Senator Crapo will make a statement.

Senator CRAPO. Thank you, Mr. Chairman. Before we wrap up, I just wanted to make a very brief summary statement, and to the panel, again, thank you for coming and for the work you are doing on this critical issue. I think every Senator who has been at the hearing here today has raised the same issue set with you. We are concerned about whether we have it right in law and in regulation and implementation in terms of the regulatory system that we are applying to our smaller and community banks, whether it is a question of whether we need to move to a two-tier system or whether we need to do other reforms at the congressional level, at the policy level, or whether we need to be more aggressive at making the appropriate distinctions in the regulatory, implementation, and the examination process, or what have you.

I would just encourage you to help us answer this question correctly, to do the kind of analysis and studies that gets to the answers to some of the questions that we do not have answers to yet, and to work with us to help identify the proper structure and system that we need to have in place to create the best safety and soundness and the best profitability for our strong community bank system.

Thank you.

Chairman JOHNSON. I want to thank our witnesses for their testimony today as well as their continued focus on efforts to strengthen the community bank system.

This hearing is adjourned.

[Whereupon, at 11:24 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF RICHARD A. BROWN

CHIEF ECONOMIST, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 13, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, we appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the state of community banking and to describe the findings of the *FDIC Community Banking Study* (the Study), a comprehensive review based on 27 years of data on community banks. [1]

As the Committee is well aware, the recent financial crisis has proved challenging for all financial institutions. The FDIC's problem bank list peaked at 888 institutions in 2011. Since January 2008, 481 insured depository institutions have failed, with banks under $1 billion making up 419 of those failures. Fortunately, the pace of failures has declined significantly since 2010, a trend we expect to continue.

Given the challenges that community banks, in particular, have faced in recent years, the FDIC launched a "Community Banking Initiative" (Initiative) last year to refocus our efforts to communicate with community banks and to better understand their concerns. The knowledge gathered through this Initiative will help to ensure that our supervisory actions are grounded in the recognition of the important role that community banks play in our economy. A key product of the Initiative was our *FDIC Community Banking Study,* published last December, which is discussed in more detail below.

In my testimony, I describe some key lessons from the failures of certain community banks during the recent crisis identified by the *FDIC Community Banking Study.* Consistent with the studies performed under P.L. 112-88 by the FDIC Office of Inspector General (OIG) and Government Accountability Office (GAO), the Study found three primary factors that contributed to bank failures in the recent crisis, namely: (1) rapid growth; (2) excessive concentrations in commercial real estate lending (especially acquisition and development lending); and (3) funding through highly volatile deposits. By contrast, community banks that followed a traditional, conservative business plan of prudent growth, careful underwriting, and stable deposit funding overwhelmingly were able to survive the recent crisis.

FDIC Community Banking Study

In December 2012, the FDIC released the *FDIC Community Banking Study,* a comprehensive review of the U.S. community banking sector covering 27 years of data. The Study set out to explore some of the important trends that have shaped the operating environment for community banks over this period, including: long-term industry consolidation; the geographic footprint of community banks; their comparative financial performance overall and by lending specialty group; efficiency and economies of scale; and access to capital. This research was based on a new definition of community bank that goes beyond the asset size of institutions to also account for the types of lending and deposit gathering activities and the limited geographic scope that are characteristic of community banks.

Specifically, where most previous studies have defined community banks strictly in terms of asset size (typically including banks with assets less than $1 billion), our study introduced a definition that takes into account a focus on lending, reliance on core deposit funding, and a limited geographic scope of operations. Applying these criteria for the baseline year of 2010 had the effect of excluding 92 banking organizations with assets less than $1 billion while including 330 banking organizations with assets greater than $1 billion. Importantly, the 330 community banks over $1 billion in size held $623 billion in total assets—approximately one-third of the community bank total. While these institutions would have been excluded under many size-based definitions, we found that they operated in a similar fashion to smaller community banks. It is important to note that the purpose of this definition is research and analysis; it is not intended to substitute for size-based thresholds that are currently embedded in statute, regulation, and supervisory practice.

Our research confirms the crucial role that community banks play in the American financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions accounted for just 14 percent of the U.S. banking assets in our Nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the

[1] *FDIC Community Banking Study,* December 2012, *http://www.fdic.gov/regulations/resources/cbi/study.html.*

majority of bank deposits in rural and micropolitan counties.[2] The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns and urban neighborhoods would have little or no physical access to mainstream banking services.

Our Study took an in-depth look at the long-term trend of banking industry consolidation that has reduced the number of federally insured banks and thrifts from 17,901 in 1984 to 7,357 in 2011. All of this net consolidation can be accounted for by an even larger decline in the number of institutions with assets less than $100 million. But a closer look casts significant doubt on the notion that future consolidation will continue at this same pace, or that the community banking model is in any way obsolete.

More than 2,500 institutions have failed since 1984, with the vast majority failing in the crisis periods of the 1980s, early 1990s, and the period since 2007. To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future consolidation. In addition, about one third of the consolidation that has taken place since 1984 is the result of charter consolidation within bank holding companies, while just under half is the result of voluntary mergers. But both of these trends were greatly facilitated by the gradual relaxation of restrictions on intrastate branching at the State level in the 1980s and early 1990s, as well as the rising trend of interstate branching that followed enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The pace of voluntary consolidation has indeed slowed over the past 15 years as the effects of these one-time changes were realized. Finally, the Study questions whether the rapid precrisis growth of some of the Nation's largest banks, which occurred largely as a result of mergers and acquisitions and growth in retail lending, can continue at the same pace going forward. Some of the precrisis cost savings realized by large banks have proven to be unsustainable in the postcrisis period, and a return to precrisis rates of growth in consumer and mortgage lending appears, for now anyway, to be a questionable assumption.

The Study finds that community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies during the Study period exhibited relatively strong and stable performance over time. The strongest performing lending groups across the entire Study period were community banks specializing in agricultural lending, diversified banks with no single specialty, and consumer lending specialists, although the latter group had shrunk to fewer than one percent of community banks by 2011. Agricultural specialists and diversified nonspecialists also failed at rates well below other community banks during the Study period. Other types of institutions that pursued higher-growth strategies—frequently through commercial real estate or construction and development lending—encountered severe problems during real estate downturns and generally underperformed over the long run.

Moreover, the Study finds that economies of scale play a limited role in the viability of community banks. While average costs are found to be higher for very small community banks, most economies of scale are largely realized by the time an institution reaches $100 million to $300 million in size, depending on the lending specialty. These results comport well with the experience of banking industry consolidation during our Study period (1984–2011), in which the number of bank and thrift charters with assets less than $25 million declined by 96 percent, while the number of charters with assets between $100 million and $1 billion grew by 19 percent.

With regard to measuring the costs associated with regulatory compliance, the Study noted that the financial data collected by regulators does not identify regulatory costs as a distinct category of expenses. In light of the limitations of the data and the importance of this topic in our discussions with community bankers, as part of our Study the FDIC conducted interviews with a group of community banks to try to learn more about regulatory costs. As described in Appendix B of the Study, most interview participants stated that no single regulation or practice had a significant effect on their institution. Instead, most stated that the strain on their organization came from the cumulative effects of all the regulatory requirements that have built up over time. Many of the interview participants indicated that they have increased staff over the past 10 years to support the enhanced responsibility associated with regulatory compliance. Still, none of the interview participants indicated that they actively track the various costs associated with regulatory compliance, be-

[2] The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with population between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

cause it is too time-consuming, too costly, and so interwoven into their operations that it would be difficult to break out these specific costs. These responses point to the challenges of achieving a greater degree of quantification in studying this important topic.

In summary, the Study finds that, despite the challenges of the current operating environment, the community banking sector remains a viable and vital component of the overall U.S. financial system. It identifies a number of issues for future research, including the role of commercial real estate lending at community banks, their use of new technologies, and how additional information might be obtained on regulatory compliance costs.

Examination and Rulemaking Review

In addition to the comprehensive study on community banks, the FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent, while maintaining safe and sound banking practices. This review was informed by a February 2012 FDIC conference on the challenges and opportunities facing community banks, a series of six roundtable discussions with community bankers around the Nation, and by ongoing discussions with the FDIC's Advisory Committee on Community Banking.

Based on concerns raised in these discussions, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has restructured the pre-exam process to better scope examinations, define expectations, and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision. Using Web-based tools, the FDIC created a regulatory calendar that alerts stakeholders to critical information as well as comment and compliance deadlines relating to new or amended Federal banking laws, regulations, and supervisory guidance. The calendar includes notices of proposed, interim, and final rulemakings, and provides information about banker teleconferences and other important events related to changes in laws, regulations, and supervisory guidance. The FDIC also is actively taking steps to provide bankers with additional insights on proposed or changing rules, regulations, and guidance through regional meetings and outreach. Further, we clarify and communicate whether specific rules, regulations, and guidance apply to the operations of community banks through the use of statements of applicability in our Financial Institution Letters.

Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers. In April, the FDIC issued six videos designed to provide new bank directors with information to prepare them for their fiduciary role in overseeing the bank. A second installment, to be released very soon, is a virtual version of the FDIC's Directors' College Program that regional offices deliver throughout the year. A third installment, expected to be released by year-end will provide more in-depth coverage of important supervisory topics and focus on management's responsibilities. The FDIC plans to continue its review of examination and rulemaking processes, and continues to explore new initiatives to provide technical assistance to community banks.

Conclusion

The recent financial crisis has proved challenging for financial institutions in general and for community banks in particular. Analyses of bank failures during the crisis by the FDIC, the FDIC OIG, and the GAO point to some common risk factors for institutions that failed during the recent crisis, including rapid growth, concentrations in high-risk loans, and funding through volatile deposits. In contrast, community banks that followed traditional, conservative business models overwhelmingly survived the recent crisis. The FDIC's extensive study of community banking over a 27-year period shows that while these institutions face a number of challenges, they will remain a viable and vital component of the overall U.S. financial system in the years ahead.

PREPARED STATEMENT OF JON T. RYMER

INSPECTOR GENERAL, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 13, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee: Thank you for the opportunity to testify in today's hearing on the lessons learned from the financial crisis related to community banks. As you requested, I will focus on the broad and comprehensive study, required by Public Law 112-88, that the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) conducted on the impact of the failure of insured depository institutions during the recent financial crisis. Specifically, I will summarize the study's general observations, findings, conclusions, and recommendations contained in the report, *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (Report No. EVAL-13-002, dated January 3, 2013). In addition, I will highlight some of the work my office has completed over the last 5 years that could contribute to the Committee's "lessons learned" discussion.

The OIG is an independent office within the FDIC, established to conduct audits, investigations, and other reviews to prevent and detect waste, fraud, and abuse relating to the programs and operations of the FDIC, and to improve the efficiency and effectiveness of those programs and operations. I was appointed as the Inspector General of the FDIC by President Bush, and confirmed by the Senate in June 2006.

Through its audits, evaluations, and other reviews, my office provides oversight of FDIC programs and operations. Our work is either required by law or self-initiated based on our assessment of various risks confronting the FDIC. Our audits, evaluations, and other reviews assess such areas as program effectiveness, adequacy of internal controls, and compliance with statutory requirements and corporate policies and procedures. We perform our work using internally available resources, supplemented by contracts with independent public accounting firms when expertise in a particular area is needed or when internal resources are not available. Our work, as well as that of our contractors, is performed in accordance with standards applicable to Federal audit, evaluation, and investigative entities.

Before I discuss the study's high-level observations and resulting recommendations, and to provide helpful context, I will briefly describe the regulatory framework and the individual regulator responsibilities for overseeing insured depository institutions and resolving those institutions when they fail.

Regulatory Framework and Regulator Responsibilities

In the wake of the savings and loan and banking crisis of the 1980s, the Congress passed two laws that drove the closure and resolution decisions we witnessed in this most recent crisis. These laws were the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the FDIC Improvement Act of 1991. Taken together, these laws amended the Federal Deposit Insurance (FDI) Act to require, among other things, that (1) institutions maintain minimum capital levels and the chartering regulator promptly close critically undercapitalized institutions through prompt corrective action provisions, (2) the FDIC resolve banks in the least costly manner, and (3) the FDIC maximize recoveries from failed institutions. The FDI Act also placed requirements on how the regulators examine institutions, including establishing minimum examination frequency requirements, requiring the agencies to establish standards for safety and soundness, and requiring the agencies to establish appraisal standards. In response, the FDIC and the other regulators issued implementing regulations and policy statements pertaining to many of the topics discussed in our report.

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the FDIC oversee the Nation's insured depository institutions to ensure they operate in a safe and sound manner. The OCC supervises national banks, the FRB supervises State-chartered banks that are members of the Federal Reserve System and bank holding companies, and the FDIC supervises State-chartered banks that are not members of the Federal Reserve System (State nonmember banks). The FDIC has additional responsibilities for insuring deposits, effectively resolving failed institutions, and maximizing the recovery of receivership assets.

In examining insured depository institutions, the regulators assess the condition of institutions through off-site monitoring and on-site examinations, and have longstanding policies for reviewing an institution's lending and loan review functions, assessing capital adequacy, and recommending improvements, if needed. When regulators determine that an institution's condition is less than satisfactory, they may take a variety of supervisory actions, including informal and formal enforcement actions, to address identified deficiencies. Each regulator has somewhat different approaches to enforcement actions.

Should an institution's condition decline to a point that it becomes Critically Undercapitalized, the chartering regulator (a State banking authority or the OCC) is generally required by law to promptly close institutions that cannot be recapitalized. The FDIC is required by law to resolve failing institutions in the least costly manner.

Study Results—Observations, Findings, and Conclusions

The financial crisis had devastating impacts on the banking industry, businesses, communities, and consumers. At the time of our review, over 400 institutions had failed and some of the country's largest institutions had required Government intervention to remain solvent. Commercial real estate (CRE) collateral values had fallen by more than 42 percent. Construction starts remained partially complete and continued to detract from the quality of neighborhoods and home values. Trillions of dollars of household wealth had vanished, and almost 18 million loans had faced foreclosure since 2007. Unemployment peaked at 10 percent in October 2009 and remained stubbornly high at the time of our study.

Events leading to the financial crisis and subsequent efforts to resolve it involved the dynamic interrelationship of laws passed by the Congress, regulatory rules, and agency-specific policies and practices with the real estate and financial markets in ways that are continuing to play out. In that regard, our study indicated the following:

- The markets drove behaviors that were not always prudent. Banks expanded lending to keep pace with rapid growth in construction and real estate development, rising mortgage demands, and increased competition. Many of the banks that failed did so because management relaxed underwriting standards and did not implement adequate oversight and controls. For their part, many borrowers who engaged in commercial or residential lending arrangements did not always have the capacity to repay loans and pursued many construction projects without properly considering the risks involved. Ultimately, these loans created significant losses for the institutions involved and often left the FDIC with the challenge of managing and disposing of troubled assets.
- In response to unprecedented circumstances, the regulators generally fulfilled their supervisory and resolution responsibilities as defined by statutes, regulations, accounting standards, and interagency guidance in place at the time. In addition, the regulators reacted to a rapidly changing economic and financial landscape by establishing and revising supervisory policies and procedures to address key risks facing the industry. While not a focus of this study, our report does acknowledge, however, material loss review findings that showed the FRB, OCC, and FDIC could have provided earlier and greater supervisory attention to troubled institutions that ultimately failed. For its part, among other initiatives associated with resolutions, the FDIC reinstituted the use of shared loss agreements (SLA) with acquiring institutions and took steps to promote private capital investments in failing institutions.

In our report, we provided a detailed presentation of our findings and conclusions for each of the topics under the law's eight matters. These matters include (1) SLAs, (2) significance of losses at institutions that failed, (3) examiner implementation of appraisal guidelines, (4) examiner assessment of capital adequacy and private capital investment in failing institutions, (5) examiner implementation of loan workout guidance, (6) application and impact of formal enforcement orders, (7) impact of FDIC policies on investments in institutions, and (8) the FDIC's handling of private equity company investments in institutions. In addressing these matters, we also made the following observations:

- The FDIC's resolution methods—including the SLAs that we studied—were market driven. Often, failing banks with little or no franchise value and poor asset quality did not attract sufficient interest from viable bidders to enable the FDIC to sell the banks without a loss-share guarantee. The FDIC used SLAs to keep failed bank assets in the banking sector, support failed bank asset values, and preserve the solvency of the Deposit Insurance Fund (DIF). The FDIC has established controls over its SLA monitoring program, which help protect the FDIC's interests, promote loan modifications, and require equal treatment of SLA and legacy loans. We did find, however, that the FDIC should place additional emphasis on monitoring commercial loan extension decisions to ensure that acquiring institutions do not inappropriately reject loan modification requests as SLAs approach termination. In addition, we concluded that the FDIC needed to formulate a better strategy for mitigating the impact of impending portfolio sales and SLA terminations on the DIF so that the FDIC will be prepared to address the potentially significant volume of asset sale requests.

- The majority of community banks failed as a result of aggressive growth, asset concentrations, poor underwriting, and deficient credit administration coupled with declining real estate values. These factors led to write-downs and charge-offs on delinquent and nonperforming real estate loans as opposed to examiner-required write-downs or fair value accounting losses.
- The regulators have longstanding policies for classifying problem assets, monitoring appraisal programs, assessing capital adequacy, evaluating CRE loan workouts, and administering enforcement actions, when warranted. The regulators also have processes and controls, training programs, and job aids to help ensure examiner compliance and consistency. We found that examiners generally followed relevant policies and implemented them appropriately. For example, examiners usually did not classify as loss loans that the institution claimed were paying as agreed without justification, nor did they question or reduce the appraised values of assets securing such loans. However, examiners did not always document the procedures and steps that they performed to assess institutions' appraisal and workout programs. We also noted that the regulators had different approaches to enforcement actions, particularly related to nonproblem banks.
- The FDIC has investment-related policies in place to protect the DIF and to ensure the character and fitness of potential investors. These policies are largely based in statute. By their nature, such policies are going to have an impact on investments in institutions. The FDIC approved most change-in-control and merger applications, although approval rates were lower for States such as California, Florida, and Nevada that were heavily impacted by the financial crisis. The FDIC has policies and procedures for certain aspects of the review of private capital investors, and the FDIC generally followed those policies. Purchases of failed institutions by private capital investors accounted for 10 percent of total failed bank assets acquired. Finally, we identified instances where the FDIC did not accept proposed open bank investments and instead closed an institution. However, in each case, we found that the FDIC identified concerns with the proposed investment related to safety and soundness issues, proposed management, or proposed business plans, or determined that the proposed transaction would not present the least loss option to the DIF.

Recommendations

While the regulators generally implemented their policies appropriately, our study identified certain areas for improvement and issues warranting management attention. In the interest of strengthening the effectiveness of certain supervisory activities and helping ensure the success of the FDIC's ongoing resolution efforts, we made seven recommendations. Five were addressed specifically to the FDIC and two were directed to the three regulators. These recommendations, which the regulators concurred with and proposed actions that adequately addressed the recommendations' intent, involved the following areas:

- *SLA Program.* We made recommendations related to developing additional controls for monitoring acquiring institutions' commercial loan modification efforts and developing a more formal strategy for mitigating the impact of impending portfolio sales and SLA terminations on the DIF.
- *Appraisals and Workouts.* We made several recommendations related to clarifying how examiners should review institutions' appraisal programs and strengthening examiner documentation requirements to more clearly define examination methodologies and procedures performed to assess institutions' appraisal and workout programs. These recommendations should help to assure agency management that examiners are consistently applying relevant guidance.
- *Enforcement Orders.* We recommended that the regulators study differences between the types of enforcement actions that are used by the regulators and the timing of such actions to determine whether there are certain approaches that have proven to be more effective in mitigating risk and correcting deficiencies that should be implemented by all three regulators.

Study Approach

Signed into law on January 3, 2012, Public Law 112-88 required my office to conduct this study and submit a report to the Congress not later than 1 year after the date of enactment. The legislation required my office to conduct work at the FDIC, OCC, and FRB, and as required, our scope included open and failed State member, State nonmember, and national banks. Our scope did not include institutions formerly regulated by the Office of Thrift Supervision. Our review time frames generally covered a 4-year period (i.e., 2008 through 2011).

My office performed work at three FDIC regions, three OCC regions, eight reserve bank districts, and selected State banking agencies. In conducting our work, we

- Interviewed agency officials and bank examiners, representatives at open banks, investment bankers, and compliance contractors;
- Reviewed relevant policies and guidance;
- Reviewed examination reports, working papers, material loss review reports, and documentation supporting loan workouts and enforcements orders;
- Analyzed institution financial data and agency enforcement action statistics; and
- Surveyed borrowers of failed institutions.

We conducted our work from January 2012 through October 2012, in accordance with the Council of the Inspectors General on Integrity and Efficiency's Quality Standards for Inspection and Evaluation. KPMG LLP assisted us with several areas of review. We also coordinated with the U.S. Government Accountability Office as that office conducted its work pursuant to Public Law 112-88.

Other OIG Work

As the Committee continues the discussion of the financial crisis and possible "lessons learned," I wanted to highlight some of the other work my office has completed. Over the last 5 years, my office was heavily involved in the efforts to explain what happened during the financial crisis. The following is a brief snapshot of this work.

During the financial crisis, my audit and evaluation staff was dedicated to conducting reviews of the FDIC-supervised banks that failed, and providing feedback to the FDIC to assist the Corporation in improving its bank supervision program. As required by section 38(k) of the FDI Act, and amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), my office, along with our fellow financial regulatory OIGs, was required, at some level, to review the 484 institutions that failed during the crisis. To date, we have issued 107 reports that take a comprehensive look at why the failed bank caused a material loss to the DIF and provide an assessment of the FDIC's supervision of that bank. Since the Dodd-Frank Act amended the FDI Act, my office has also performed 166 failed bank reviews, where the failure was below a certain loss threshold and no unusual circumstances existed to warrant a more in-depth review of the loss.

In a separate report, *Follow-Up Audit of FDIC Supervision Program Enhancements* (Report No. MLR-11-010), issued in December 2010, we examined the supervisory actions the FDIC had taken in response to an internal memorandum we issued in May 2009, which outlined major causes, trends, and common characteristics of the eight bank failures we had reviewed to date, and identified new trends and issues that emerged from our reviews of subsequent failures. Our January 2013 study further supported the existence of these trends and issues, which included concentrated assets in the CRE and acquisition, development, and construction (ADC) loan portfolios, inadequate risk management practices for loan underwriting and credit administration, and reliance on volatile funding sources to support growth.

In October 2012, my office issued a report, *Acquisition, Development, and Construction Loan Concentration Study* (Report No. EVAL-13-001), detailing our evaluation of FDIC-supervised institutions with significant ADC loan concentrations that did not fail during the economic downturn. We studied the characteristics and supervisory approaches for these institutions and identified the factors that helped them mitigate the risks associated with ADC concentrations during periods of economic stress. Our findings were not surprising, in that they confirmed what regulators have been saying are the ingredients for a strong bank—a well-informed Board, strong management, controlled growth, sound credit administration and underwriting, and adequate capital. We also observed that surviving banks were responsive to supervisory actions and guidance and maintained or secured capital needed to absorb losses in response to regulatory demands.

My office also teamed up with the other bank regulatory OIGs and evaluated prompt regulatory action, as described in sections 38 and 39 of the FDI Act. The OIGs from the FDIC, FRB, and Department of the Treasury issued a comprehensive joint report in September 2011, *Evaluation of Prompt Regulatory Action Implementation* (Report No. EVAL-11-006), which discussed the use and impact of prompt corrective action (PCA) and the safety and soundness standards during the crisis. We found that PCA occurred too late to rehabilitate most troubled institutions and while critically undercapitalize institutions were closed promptly, failure losses were still significant. We recommended the regulators consider several options for strengthening the prompt regulatory action provisions.

The reports noted above are available on our Web site, *www.fdicig.gov*.

This concludes my prepared statement. Thank you for the opportunity to discuss the work of the FDIC OIG. I will be pleased to answer any questions that you may have.

PREPARED STATEMENT OF LAWRANCE L. EVANS, JR.

DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

JUNE 13, 2013

United States Government Accountability Office

GAO

Testimony

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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FINANCIAL INSTITUTIONS

Causes and Consequences of Recent Community Bank Failures

Statement of Lawrance L. Evans, Jr., Director
Financial Markets and Community Investment

GAO-13-704T

GAO Highlights

Highlights of GAO-13-704T, a testimony before the Committee on Banking, Housing and Urban Affairs, U.S. Senate

June 13, 2013

FINANCIAL INSTITUTIONS

Causes and Consequences of Recent Community Bank Failures

Why GAO Did This Study

Between January 2008 and December 2011—a period of economic downturn in the United States—414 insured U.S. banks failed. Of these, 85 percent (353) were small institutions with less than $1 billion in assets. Small banks often specialize in small business lending and are associated with local community development and philanthropy. The failures of these banks have raised questions about contributing factors. Further, the failures have raised concerns about the accounting and regulatory requirements needed to maintain reserves large enough to absorb expected loan losses (loan loss allowances)—for example, when borrowers are unable to repay a loan (credit losses).

This statement is based on findings from GAO's 2013 report on recent bank failures (GAO-13-71) required by Pub. L. No 112-88. This testimony discusses (1) the factors that contributed to the bank failures in states with the most failed institutions between 2008 and 2011; (2) the use of shared loss agreements in resolving troubled banks; and (3) the effect of recent bank failures on local communities. To do this work, GAO relied on issued report GAO-13-71 and updated data as appropriate.

View GAO-13-704T. For more information, contact Lawrence Evans, Jr. at (202) 512-4802 or evansl@gao.gov.

What GAO Found

Ten states concentrated in the western, midwestern, and southeastern United States—areas where the housing market had experienced strong growth in the prior decade—each experienced 10 or more commercial bank or thrift (bank) failures between 2008 and 2011. The failures of small banks (those with less than $1 billion in assets) in these states were largely driven by credit losses on commercial real estate (CRE) loans, particularly loans secured by real estate to finance land development and construction. Many of the failed banks had often pursued aggressive growth strategies using nontraditional, riskier funding sources and exhibited weak underwriting and credit administration practices. The Department of the Treasury and the Financial Stability Forum's Working Group on Loss Provisioning observed that earlier recognition of credit losses could have potentially lessened the impact of the crisis. The accounting model used for estimating credit losses is based on historical loss rates, which were low in the prefinancial crisis years. In part due to these accounting rules, loan loss allowances were not adequate to absorb the wave of credit losses that occurred once the financial crisis began. Banks had to recognize these losses through a sudden series of increases (provisions) to the loan loss allowance that reduced earnings and regulatory capital. In December 2012, the Financial Accounting Standards Board issued a proposal for public comment for a loan loss provisioning model that is more forward looking and would incorporate a broader range of credit information. This would result in banks establishing earlier recognition of loan losses for the loans they underwrite and could incentivize prudent risk management practices. It should also help address the cycle of losses and failures that emerged in the recent crisis as banks were forced to increase loan loss allowances and raise capital when they were least able to do so.

The Federal Deposit Insurance Corporation (FDIC) used shared loss agreements to help resolve 281 of the 414 bank failures during the recent financial crisis to minimize the impact on the Deposit Insurance Fund (DIF). Under a shared loss agreement, FDIC absorbs a portion of the loss on specified assets of a failed bank that are purchased by an acquiring bank. FDIC officials, state bank regulators, community banking associations, and acquiring banks of failed institutions GAO interviewed said that shared loss agreements helped to attract potential bidders for failed banks during the financial crisis. FDIC compared the estimated cost of the shared loss agreements to the estimated cost of directly liquidating the failed banks' assets and estimated that the use of shared loss agreements saved the DIF over $40 billion.

GAO analysis of metropolitan and rural areas where bank failures occurred and econometric analysis of bank income and condition data suggested that the acquisitions of failed banks by healthy banks mitigated the potentially negative effects of failures on communities. However, the focus of local lending and philanthropy may have shifted. Also, bank officials whom GAO interviewed noted that in the wake of the bank failures, underwriting standards had tightened. As a result, credit was generally most available for small business owners with good credit histories and strong financials. Further, the effects of bank failures could potentially be significant for communities that had been serviced by only one bank or where only a few banks remain.

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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Chairman Johnson, Ranking Member Crapo, and Members of the Committee:

I am pleased to be here today as you examine lessons learned from recent community bank failures. Between January 2008 and December 2011, 414 insured U.S. commercial banks and thrifts (banks) failed. Of these, 85 percent (353) were small banks with less than $1 billion in assets. Banks of this size tend to be community banks with a relatively limited geographic scope of operations and often specialize in providing credit to local small businesses. Typically these banks are also associated with local community development, leadership, and philanthropy. The failures of these community banks, which were largely concentrated in certain parts of the country, occurred against the backdrop of the worst financial crisis since the Great Depression and raised a number of questions. Among these are the role played by local market conditions and related economic factors; the application of fair value accounting under generally accepted accounting principles (GAAP); and the potential effect on the communities where the banks were located, particularly in terms of credit availability, income and employment, and philanthropic activity.[1] In addition, these failures raise questions about the impact of the Federal Deposit Insurance Corporation's (FDIC) methods for resolving failed banks on the Deposit Insurance Fund (DIF).

My remarks today are based on our January 2013 report on the impact of bank failures.[2] My statement will address (1) the factors that contributed to the failure of banks in states with 10 or more failures between 2008 and 2011, including the extent to which losses related to fair value accounting treatment affected the regulatory capital positions of failed banks; (2) market factors that affected FDIC's choice of resolution method and the costs that the DIF incurred as a result of these methods; and

[1]Fair value accounting is a financial reporting approach that requires or permits financial institutions to measure and report on an ongoing basis certain financial assets and liabilities at the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

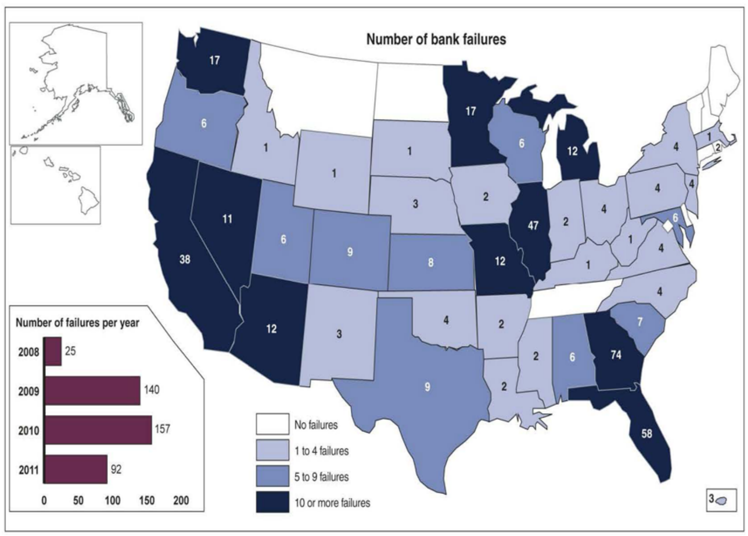
[2]GAO, *Financial Institutions: Causes and Consequences of Recent Bank Failures*, GAO-13-71 (Washington, D.C.: Jan. 3, 2013). This report was mandated by Pub. L. No. 112-88, § 3, 125 Stat. 1899, 1902 (2012). As part of this act, the FDIC Inspector General (IG) was also required to conduct a separate study on the impact of bank failures.

(3) the effect of recent small bank failures on local communities. To address these issues, we analyzed bank income and condition data (call report data); reviewed inspectors general (IG) reports of individual bank failures; conducted econometric modeling; and interviewed officials from federal and state banking regulators, banking associations, banks, and market experts. We also coordinated with the FDIC Inspector General on its study. We conducted this performance audit from February 2012 to December 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Ten states concentrated in the western, midwestern, and southeastern United States—all areas where the housing market had experienced strong growth in the prior decade—experienced 10 or more bank failures between 2008 and 2011 (see fig.1). Together, failures in these 10 states accounted for 72 percent (298), of the 414 bank failures across all states during this time period.

Figure 1: Number of Bank Failures by State, 2008-2011



Source: GAO analysis of FDIC data; Map Resources (map).

Within these 10 states, 86 percent (257) of the failed banks were small institutions with assets of less than $1 billion at the time of failure, and 52 percent (155) had assets of less than $250 million. Twelve percent (36) were medium-size banks with more than $1 billion but less than $10 billion in assets, and 2 percent (5) were large banks with assets of more than $10 billion at the time of failure.

Bank Failures Were Largely Related to Nonperforming Real Estate Loans, but Also Highlighted the Impact of Impairment Accounting and Loan Loss Provisioning

In the 10 states with 10 or more failures between 2008 and 2011, failures of small and medium-size banks were largely associated with high concentrations of commercial real estate (CRE) loans, in particular the subset of acquisition, development, and construction (ADC) loans, and with inadequate management of the risks associated with these high concentrations.[3] Our analysis of call report data found that CRE (including ADC) lending increased significantly in the years prior to the housing market downturn at the 258 small banks that failed between 2008 and 2011. This rapid growth of failed banks' CRE portfolios resulted in concentrations—that is, the ratio of total CRE loans to total risk-based capital—that exceeded regulatory thresholds for heightened scrutiny established in 2006 and increased the banks' exposure to the sustained downturn that began in 2007.[4] Specifically, we found that CRE concentrations grew from 333 percent in December 2001 to 535 percent in June 2008. At the same time, ADC concentrations grew from 104 percent to 259 percent. The trends for the 36 failed medium-size banks were similar over this time period. In contrast, small and medium-sized banks that did not fail exhibited substantially lower levels and markedly slower growth rates of CRE loans and as a result had significantly lower concentrations of them, reducing the banks' exposure.

With the onset of the financial crisis, the level of nonperforming loans began to rise, as did the level of subsequent net charge-offs, leading to a

[3] Regulators define CRE loans to include ADC loans that are secured by real estate to finance land development and construction, including new construction, upgrades, and rehabilitation. CRE loans also include unsecured loans to finance commercial real estate, loans secured by multifamily properties, and loans secured by nonfarm nonresidential property. ADC loans generally are considered to be the riskiest class of CRE loans because of their long development times and because they can include properties (such as housing developments or retail space in a shopping mall) that are built without firm commitments from buyers or lessees. By the time the construction phase is completed, market demand may have fallen, putting downward pressure on sales prices or rents, making ADC loans more volatile.

[4] Guidelines issued by federal banking regulators in 2006 described characteristics that would subject banks to greater regulatory scrutiny. These included an ADC concentration of more than 100 percent or a CRE concentration of more than 300 percent when there is an increase in the outstanding balance of the CRE portfolio of 50 percent or more during the prior 36 months. *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* 71 Fed. Reg. 74,580 (Dec. 12, 2006).

decline in net interest income and regulatory capital.[5] The rising level of nonperforming loans, particularly ADC loans, appears to have been the key factor in the failures of small and medium-size banks in the 10 states between 2008 and 2011. For example, in December 2001, 2 percent of ADC loans at the small failed banks were classified as nonperforming. With the onset of the financial crisis, the level of nonperforming ADC loans increased quickly to 11 percent by June 2008 and 46 percent by June 2011.[6] As banks began to designate nonperforming loans or portions of these loans as uncollectible, the level of net charge-offs also began to rise. In December 2001, net charge-offs of ADC loans at small failed banks were less than 1 percent. By June 2008, they had risen to 2 percent and by June 2011 to 12 percent.

CRE and especially ADC concentrations in small and medium-size failed banks in the 10 states were often correlated with poor risk management and risky funding sources. Our analysis showed that small failed banks in the 10 states had often pursued aggressive growth strategies using nontraditional and riskier funding sources such as brokered deposits.[7]

The IG reviews noted that in the majority of failures, management exercised poor oversight of the risks associated with high CRE and ADC concentrations and engaged in weak underwriting and credit administration practices. Further, 28 percent (84) of the failed banks had been chartered for less than 10 years at the time of failure and appeared

[5]Net charge-offs are the total amount of loans that are removed from the balance sheet because they are uncollectible, less amounts recovered on loans previously charged off. Net interest income is the difference between the interest income recognized on earning assets and the interest expense on deposits and other borrowed funds. Increases in the loan loss allowance for credit losses on nonperforming loans are charged to the bank's expenses on the income statement, thus reducing its net interest income. Reductions in a bank's income are reflected in its earnings, which are included in retained earnings, a component of regulatory capital.

[6]Nonperforming loans are defined as loans that are 90 days or more past due and loans on which the bank is no longer accruing interest. Institutions must estimate the credit losses on nonperforming loans and increase the loan loss allowance accordingly.

[7]A "brokered deposit" is defined as a deposit obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker. The broker pools large-denomination deposits from many small investors and markets the pooled deposits to financial institutions, usually in blocks nearing $100,000, and negotiates a higher rate for the pooled certificates of deposit. In contrast, core deposits are largely derived from a bank's regular customer base, and are typically the most stable and least costly source of funding with the lowest interest rates.

in many cases to have deviated from their approved business plans, according to FDIC. Large bank failures in the 10 states were associated with some of the same factors as small bank failures—high-risk growth strategies, weak underwriting and risk controls, and excessive concentrations that increased these banks' exposure to the real estate market downturn. The primary difference was that the large banks' strategies generally relied on risky nontraditional residential mortgage products as opposed to commercial real estate.

To further investigate factors associated with bank failures across the United States, we analyzed data on FDIC-insured commercial banks and state-chartered savings banks from 2006 to 2011. Our econometric analysis suggests that across the country, riskier lending and funding sources were associated with an increased likelihood of bank failures. Specifically, we found that banks with high concentrations of ADC loans and an increased use of brokered deposits were more likely to fail from 2008 to 2011, while banks with better asset quality and greater capital adequacy were less likely to fail.[8] An FDIC IG study issued in October 2012 found that some banks with high ADC concentrations were able to weather the recent financial crisis without experiencing a corresponding decline in their overall financial condition. Among other things, the IG found that these banks exhibited strong management, sound credit administration and underwriting practices, and adequate capital.[9]

[8]We excluded savings associations and insured branches of foreign banks from our analysis, because these institutions did not report data on key variables for the time period we analyzed. We collected data on characteristics that described a bank's capital adequacy; asset quality; earnings; liquidity; ADC lending; multifamily real estate lending; nonfarm, nonresidential real estate lending; commercial real estate lending not secured by real estate; brokered deposits funding; and size. We then estimated the likelihood of failure as a function of these characteristics, controlling for factors that affected the likelihood of failure of all banks, such as the market for the banks' products and services and overall economic conditions.

[9]FDIC Office of the Inspector General, Office of Audits and Evaluations, *Acquisition Development, and Construction Loan Concentration Study*, no. EVAL-13-001 (October 2012).

Credit Losses and Charge-offs from Nonperforming Loans Contributed Significantly to Bank Failures Nationwide, but Losses Due to Fair Value Accounting Did Not

We found that losses related to bank assets and liabilities that were subject to fair value accounting contributed little to bank failures overall, largely because most banks' assets and liabilities were not recorded at fair value. Based on our analysis, fair value losses related to certain types of mortgage-related investment securities contributed to some bank failures. But in general fair value-related losses contributed little to the decline in net interest income and regulatory capital that failed banks experienced overall once the financial crisis began.

We analyzed the assets and liabilities on the balance sheets of failed banks nationwide that were subject to fair value accounting between 2007 and 2011. We found that generally more than two-thirds of the assets of all failed commercial banks (small, medium-size, and large) were classified as held-for-investment (HFI) loans, which were not subject to fair value accounting.[10] For example, small failed commercial banks held an average of 77 percent of their assets as HFI loans in 2008. At the same time, small commercial banks that remained open held an average of 69 percent in such loans. Failed and open small thrifts, as well as medium-size and large commercial banks, had similar percentages.

Investment securities classified as available for sale (AFS) represented the second-largest percentage of assets for all failed and open banks over the 5-year period we reviewed. For example, in 2008, small failed commercial banks held an average of 10 percent of their assets as AFS securities, while small open banks averaged 16 percent. Generally, AFS securities are recorded at fair value, but the changes in fair value impact earnings or regulatory capital only under certain circumstances.[11] While several other asset and liability categories are recorded at fair value and

[10] Generally, HFI loans are recorded at amortized cost, net of an impairment allowance for estimated credit losses. Essentially, amortized cost is outstanding principal adjusted for any charge offs, deferred fees or costs, and unamortized discounts or premiums.

[11] Some assets and liabilities, such as securities designated for trading, are measured at fair value on a recurring basis (at each reporting period), where unrealized gains or losses flow through the bank's earnings in the income statement and affect regulatory capital. However, for certain other assets and liabilities that are measured at fair value on a recurring basis, such as AFS securities, unrealized fair value gains and losses generally do not impact earnings and thus generally are not included in regulatory capital calculations. Instead, these gains or losses are recorded through other comprehensive income, unless the institution determines that a decline in fair value below amortized cost constitutes an other-than-temporary impairment, in which case the instrument is written down to its fair value, with credit losses reflected in earnings.

impact regulatory capital, together these categories did not account for a significant percentage of total assets at either failed or open commercial banks or thrifts. For example, in 2008, trading assets, nontrading assets such as nontrading derivative contracts, and trading liabilities at small failed banks ranged from 0.00 to 0.03 percent of total assets.

As discussed earlier, declines in regulatory capital at failed banks were driven by rising levels of credit losses related to nonperforming loans and charge-offs of these loans. For failed commercial banks and thrifts of all sizes nationwide, credit losses, which resulted from nonperforming HFI loans, were the largest contributors to the institutions' overall losses when compared to any other asset class. These losses had a greater negative impact on institutions' earnings and regulatory capital levels than those recorded at fair value.

During the course of our work, several state regulators and community banking association officials told us that at some small failed banks, declining collateral values of impaired collateral-dependent loans—particularly CRE and ADC loans in those areas where real estate assets prices declined severely—drove both credit losses and charge-offs and resulted in reductions to regulatory capital. A loan is considered "collateral dependent" when the repayment of the debt will be provided solely by the sale or operation of the underlying collateral, and there are no other available and reliable sources of repayment. Data are not publicly available to analyze the extent to which declines in the collateral values of impaired collateral-dependent CRE or ADC loans drove credit losses or charge-offs at the failed banks. However, state banking associations said that the magnitude of the losses was exacerbated by federal bank examiners' classification of collateral-dependent loans and evaluations of the appraisals banks used to support the impairment analyses of these loans. Federal banking regulators noted that regulatory guidance in 2009 directed examiners not to require banks to write down loans to an amount less than the loan balance solely because the value of the underlying collateral had declined. The regulators added that examiners were generally not expected to challenge the appraisals obtained by banks unless they found that any underlying facts or assumptions about the appraisal were inappropriate or could support alternative assumptions.[12] The guidance also stated that in making decisions to write down loans, bank examiners were to first focus on the adequacy of cash flows to service the debt. If the sources of cash flows did not exist and the only likely repayment source was the sale of the collateral, then examiners were to direct the bank to write down the loan balances to the fair value of the collateral, less estimated costs to sell in certain circumstances. For example, one Federal Reserve official told us that some failed banks were extending ADC loans on an interest-only basis with no evidence that the borrower would be able to repay the principal and with underlying collateral whose value had declined by a very significant amount. In those cases, examiners questioned whether the banks would ever be repaid the principal owed. Under these circumstances, absent any evidence that the borrowers could pay through other means, the examiners would require a write-down.

[12]FDIC, Federal Reserve, OCC, OTS, the National Credit Union Administration (NCUA), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee, *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (Oct. 30, 2009) (see for example, Federal Reserve SR 09–07 and FDIC FIL-61-2009). We reported in 2011 that interviews with officials from 43 banks in different parts of the country had identified multiple concerns with examiner treatment of CRE loans and related issues. GAO, *Banking Regulation: Enhanced Guidance on Commercial Real Estate Risks Needed*, GAO-11-489 (Washington, D.C.: May 19, 2011).

Current Accounting Practices for Loss Provisioning May Have Delayed Reporting of Credit Losses during the Recent Crisis

A loan loss provision is the money a bank sets aside to cover potential credit losses on loans.[13] The Department of the Treasury (Treasury) and the Financial Stability Forum's Working Group on Loss Provisioning (Working Group) have observed that the current accounting model for estimating credit losses is based on historical loss rates, which were low in the years before the financial crisis. Under GAAP, the accounting model for estimating credit losses is commonly referred to as an "incurred loss model" because the timing and measurement of losses are based on estimates of losses incurred as of the balance sheet date. In a 2009 speech, the Comptroller of the Currency, who was a co-chair of the Working Group, noted that in a long period of benign economic conditions, such as the years prior to the most recent downturn, historical loan loss rates would typically be low. As a result, justifying significant loan loss provisioning to increase the loan loss allowance can be difficult under the incurred loss model.

Treasury and the Working Group noted that earlier recognition of loan losses could have reduced the need for banks to recognize increases in their incurred credit losses through a sudden series of loan loss provisions that reduced earnings and regulatory capital. Federal banking regulators have also noted that requiring management at the failed banks to recognize loan losses earlier could have helped stem losses. Specifically, such a requirement might have provided an incentive not to concentrate so heavily in the loans that later resulted in significant losses. To address this issue, the Financial Accounting Standards Board has issued a proposal for public comment for a loan loss provisioning model that is more forward-looking and focuses on expected losses. This proposal would allow banks to establish a means of recognizing potential losses earlier on the loans they underwrite and could incentivize prudent risk management practices. Moreover, the proposal is designed to help address the cycle of losses and failures that emerged in the recent crisis

[13]GAAP requires financial institutions to maintain an allowance for loan losses (loan loss allowance) at a level that is appropriate to cover estimated credit losses incurred as of the balance sheet date for their entire portfolio of HFI loans. Under GAAP, institutions must recognize impairment on HFI loans when credit losses are determined to be probable and reasonably estimable. That is, when, based on current information and events, it is probable that an institution will be unable to collect all amounts due (i.e., both principal and interest) according to the contractual terms of the original loan agreement. An increase in the loan loss allowance results in a charge to expenses, termed a provision for loan losses (loan loss provision), except in the case where there are recoveries of amounts previously charged off. Loan loss provisions reduce the net interest income earned as part of a bank's earnings, and regulatory capital declines.

as banks were forced to increase loan loss allowances and raise capital when they were least able to do so (procyclicality). We plan to continue to monitor the progress of the ongoing activities of the standard setters to address concerns with the loan loss provisioning model.

FDIC Used Shared Loss Agreements to Attract Bidders at Least Cost to the Deposit Insurance Fund

FDIC is required to resolve a bank failure in a manner that results in the least cost to the Deposit Insurance Fund (DIF). FDIC's preferred resolution method is to sell the failed bank to another, healthier, bank. During the most recent financial crisis, FDIC facilitated these sales by including a loss share agreement, under which FDIC absorbed a portion of the loss on specified assets purchased by the acquiring bank. From January 2008 through December 31, 2011, FDIC was appointed as receiver for the 414 failed banks, with $662 billion in book value of failed bank assets. FDIC used purchase and assumption agreements (the direct sale of a failed bank to another, healthier bank) to resolve 394 failed institutions with approximately $652 billion in assets. As such, during the period 2008 through 2011, FDIC sold 98 percent of failed bank assets using purchase and assumption agreements. However, FDIC only was able to resolve so many of these banks with purchase and assumption agreements because it offered to share in the losses incurred by the acquiring institution. FDIC officials said that at the height of the financial crisis in 2008, FDIC sought bids for whole bank purchase and assumption agreements (in which the acquiring bank assumes essentially all of the failed bank's assets and liabilities) with little success. Potential acquiring banks we interviewed told us that they did not have sufficient capital to take on the additional risks that the failed institutions' assets represented. Acquiring bank officials that we spoke to said that they would not have purchased the failed banks without FDIC's shared loss agreements because of uncertainties in the market and the value of the assets. Because shared loss agreements had worked well during the savings and loan crisis of the 1980s and early 1990s, FDIC decided to offer the option of having such agreements as part of the purchase and assumption of the failed bank.

Shared loss agreements provide potential buyers with some protection on the purchase of failed bank assets, reduce immediate cash needs, keep assets in the private sector, and minimize disruptions to banking customers. Under the agreements, FDIC generally agrees to pay 80 percent for covered losses, and the acquiring bank covers the remaining 20 percent. From 2008 to the end of 2011, FDIC resolved 281of the 414 failures (68 percent) by providing a shared loss agreement as part of the purchase and assumption. The need to offer shared loss agreements diminished as the market improved. For example, in 2012 FDIC was able to resolve more than half of all failed institutions without having to offer to share in the losses. Specifically, between January and September 30, 2012, FDIC had agreed to share losses on 18 of 43 bank failures (42 percent). Additionally, some potential bidders were willing to accept shared loss agreements with lower than 80-percent coverage. As of December 31, 2011, DIF receiverships had made shared loss payments totaling $16.2 billion. In addition, future payments under DIF receiverships are estimated at an additional $26.6 billion over the duration of the shared loss agreements, resulting in total estimated lifetime losses of $42.8 billion (see fig. 2).[14]

Figure 2: Shared Loss Agreements Entered into by Year, 2008-2011

Year	Number of shared loss agreements	Estimated lifetime losses (dollars in billions)
2008	3	$3.29
2009	90	19.92
2010	130	15.98
2011	58	3.65
	Total **281**	**Total** **$42.84**

Source: GAO analysis of FDIC data.

By comparing the estimated cost of the shared loss agreements with the estimated cost of directly liquidating the failed banks' assets, FDIC has estimated that using shared loss agreements has saved the DIF over $40 billion. However, while the total estimated lifetime losses of the shared loss agreements may not change, the timing of the losses may, and payments from shared loss agreements may increase as the terms of the agreements mature. FDIC officials stated that the acquiring banks were being monitored for compliance with the terms and conditions of the shared loss agreements. FDIC is in the process of issuing guidance to the

[14]FDIC reported that, as of December 31, 2012, DIF receiverships made shared-loss payments totaling $23.3 billion and are estimated to pay an additional $18.1 billion over the duration of the shared loss agreements, resulting in total lifetime losses of $41.4 billion. These data included shared-loss agreements associated with both the bank failures that occurred between 2008 and 2011 as well as the additional banks that failed in 2012.

acquiring banks reminding them of these terms to prevent increased shared loss payments as these agreements approach maturity.

The Impact of Bank Failures on Local Communities Was Mixed

The acquisitions of failed banks by healthy banks appear to have mitigated the potentially negative effects of bank failures on communities, although the focus of local lending and philanthropy may have shifted. First, bank failures and failed bank acquisitions can have an impact on market concentration—an indicator of the extent to which banks in the market can exercise market power, by, for example, raising prices or reducing the availability of some products and services. But, we found that a limited number of metropolitan areas and rural counties were likely to have become significantly more concentrated.

We analyzed the impact of bank failures and failed bank acquisitions on local credit markets using data for the period from June 2007 to June 2012. We calculated the Herfindahl-Hirschman Index (HHI), a key statistical measure used to assess market concentration and the potential for firms to exercise their ability to influence market prices. The HHI is measured on a scale of 0 to 10,000, with values over 1,500 considered indicative of concentration.[15] Our results suggest that a small number of the markets affected by bank failures and failed bank acquisitions were likely to have become significantly more concentrated. For example, 8 of the 188 metropolitan areas affected by bank failures and failed bank acquisitions between June 30, 2009, and June 29, 2010, met the criteria that indicate significant competitive concerns. Similarly, 5 of the 68 rural counties affected by bank failures during the same time period met the criteria. The relatively limited number of areas where concentration increased was generally the result of acquisitions by institutions that were not already established in the locales that the failed banks served. However, the effects could be potentially significant for those limited areas that had been serviced by one bank or where only a few banks remain.

[15]The HHI reflects the number of firms in the industry and each firm's market share. It is calculated by summing the squares of the market shares of each firm competing in the market. The HHI also reflects the distribution of market shares of the top firms and the composition of the market outside the top firms. According to the Department of justice and the Federal Trade Commission, markets in which the value of the HHI is between 1,500 and 2,500 points are considered to be moderately concentrated, and those in which the value of the HHI is in excess of 2,500 points are considered to be highly concentrated, although other factors also play a role.

Second, our econometric analysis of call report data from 2006 through 2011 found that failing small banks extended progressively less net credit as they approached failure, but that acquiring banks generally increased net credit after the acquisition, albeit more slowly.[16] Officials from acquiring and peer banks we interviewed in Georgia, Michigan, and Nevada agreed.[17] However, general credit conditions were generally tighter in the period following the financial crisis. For example, several bank officials noted that in the wake of the bank failures, underwriting standards had tightened, making it harder for some borrowers who might have been able to obtain loans prior to the bank failures to obtain them afterward. Several banks officials we interviewed also said that new lending for certain types of loans could be restricted in certain areas. For example, they noted that the CRE market, and in particular the ADC market, had contracted and that new lending in this area had declined significantly.

Officials from regulators, banking associations, and banks we spoke with also said that involvement in local philanthropy had declined as small banks approached failure but generally increased after acquisition. State banking regulators and national and state community banking associations we interviewed told us that community banks tended to be highly involved in local philanthropic activities before the recession—for example, by designating portions of their earnings for community development or other charitable activities. However, these philanthropic activities decreased as the banks approached failure and struggled to conserve capital. Acquiring bank officials we interviewed told us that they had generally increased philanthropic activities compared with the failed

[16]We used an econometric model to estimate net credit extended by banks during a quarter as a function of the capital adequacy; asset quality; earnings; liquidity; ADC lending; nonfarm, nonresidential real estate lending; multifamily real estate lending; commercial real estate lending not secured by real estate; brokered deposits; size; and other factors. We also included indicators for each quarter to control for factors affecting net credit extension that are common to all banks at the same time, such as the regulatory environment, the state of the market for bank products and services, and the condition of the overall economy. We then used the results of our model to predict net credit extended by failing banks in the quarters leading up to their failure and by acquiring banks in the quarters following acquisition of a failed bank.

[17]We chose to focus on these three states because they reflect the three major areas where the bank failures were concentrated—the southeast, southwest, and midwest. They reflect states with either highest numbers of bank failures or highest failure rates. They also reflect the economic conditions that contributed to the bank failures—high unemployment rates, and for two states, high declines in house prices.

community banks during the economic downturn and in the months before failure. However, acquiring banks may or may not focus on the same philanthropic activities as the failed banks. For example, one large acquiring bank official told us that the acquiring bank made major charitable contributions to large national or statewide philanthropic organizations and causes and focused less on the local community charities to which the failed bank had contributed.

Finally, we econometrically analyzed the relationships among bank failures, income, unemployment, and real estate prices for all states and the District of Columbia (states) for 1994 through 2011. Our analysis showed that bank failures in a state were more likely to affect its real estate sector than its labor market or broader economy. In particular, this analysis did not suggest that bank failures in a state—as measured by failed banks' share of deposits—were associated with a decline in personal income in that state. To the extent that there is a relationship between the unemployment rate and bank failures, the unemployment rate appears to have more bearing on failed banks' share of deposits than vice versa. In contrast, our analysis found that failed banks' share of deposits and the house price index in a state appear to be significantly related to each other. Altogether, these results suggest that the impact of bank failures on a state's economy is most likely to appear in the real estate sector and less likely to appear in the overall labor market or in the broader economy.[18] However, we note that these results could be different at the city or county level.

[18]We measured bank failures in a state as the fraction of deposits in a state that were in banks that failed during the past year. This measure captures both the size of the failing banks and their share of the deposits (a proxy for their weight in a state), whereas the absolute number of failures or the simple failure rate does not. We measured income in a state using state personal income, adjusted for inflation. We measured unemployment in a state using the unemployment rate. We measured real estate prices using house price indices for single-family detached properties with conventional conforming mortgages. For each variable, we estimated the relationship between the variable, its past values, and past values of the other three variables. We used a technique that controlled for time-invariant characteristics of states and features of the national economy that affected all states at the same time and that allowed for the possibility that all four variables were jointly determined and affected by each other. We then used Granger causality tests to estimate the likelihood that the past values of each variable helped explain the current values of the other variables.

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, this concludes my prepared statement. I would be happy to answer any questions that you may have at this time.

Contacts and Acknowledgments

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RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM RICHARD A. BROWN

Q.1. Academic researchers estimate that when Dodd-Frank is fully implemented, there will be more than 13,000 new regulatory restrictions in the Code of Federal Regulations. Over 10,000 pages of regulations have already been proposed, requiring more than 24 million compliance hours each year. As FDIC's Chief Economist, how are you trying to track the total compliance costs for community banks? Please share specific details.

A.1. *Quantifying Costs*—The costs of regulatory compliance and their effect on profitability and competitiveness are frequent topics of discussion among community bankers. While our ability to quantify the costs of regulatory compliance is somewhat limited, the FDIC has undertaken a number of initiatives designed to make those costs as small as possible.

This topic was repeatedly addressed in the six Roundtable discussions hosted by the FDIC in 2012 as part of the Community Banking Initiative, and also has been a frequent topic of discussion in meetings of the FDIC's Community Bank Advisory Committee.

Notwithstanding the high degree in interest in this topic by all concerned parties, regulatory data reported through the quarterly Call Reports provide only a limited picture of bank overhead expenses. While all FDIC-insured institutions report total noninterest expenses each quarter, these expenses are not broken down into regulatory and nonregulatory components. Expressed as a percent of total assets, noninterest expenses for community banks have been flat for three consecutive years (2010–12) at 3.0 percent.

In view of the data limitations, FDIC researchers conducted interviews with nine community bankers as part of our 2012 Community Banking Study to try to better understand what drives the cost of regulatory compliance and, where possible, obtain actual financial data to better understand how regulation and supervision affects bank performance.

Most participants stated that no single regulation or practice had a significant effect on their institution. Instead, most cited the cumulative strain imposed by a number of regulatory requirements over time. Several indicated that they have increased staff over the past 10 years to support regulatory compliance. Yet none indicated that they actively track compliance costs, citing the difficulties of breaking out these costs separately.

These responses from community bankers speak to the careful balance regulators must achieve when trying to measure regulatory costs. While community bankers themselves are certainly in the best position to understand their cost structure, requiring that they report more detailed data about the nature of those costs would itself impose a new regulatory burden.

Supervisory Approach—As the primary Federal regulator for the majority of smaller, community institutions (those with less than $1 billion in total assets), the FDIC is keenly aware of the challenges facing community banks and we already tailor our supervisory approach to consider the size, complexity, and risk profile of the institutions we oversee.

In addition, the FDIC has implemented a number of initiatives to mitigate the compliance costs associated with new regulations, based on feedback we received from community banks during our Examination and Rulemaking Review undertaken in 2012. This effort was informed by a national conference to examine the unique role of community banks in our Nation's economy and the challenges and opportunities they face and a series of roundtable discussions conducted in each of the FDIC's six supervisory regions that focused on the financial and operational challenges and opportunities facing community banks, and the regulatory interaction process.

First, as a result of comments we received, we developed a Web-based tool (e-Prep) that generates a preexamination document and information request list tailored to a specific institution's operations and business lines.

Second, we instituted a new Regulatory Calendar that alerts stakeholders to critical information as well as comment and compliance deadlines relating to changes in Federal banking laws and regulations.

Third, to enhance the ability of community banks to comply with regulatory requirements without the need for outside consultants, the FDIC recently made available new online resources. A new Director's Resource Center provides links to more than a dozen new instructional videos, including a new Virtual Director's College, designed to provide valuable information and advice to bank managers and directors. (In an effort to help reduce banks' compliance training costs, we have been conducting director and banker colleges in each region for some time now.) In addition to these efforts, the FDIC includes in all Financial Institution Letters a Statement of Applicability that clarifies whether the specific rules, regulations, and guidance will apply to community banks.

The FDIC continues to conduct outreach sessions, training workshops, and symposia to provide technical training and opportunities for discussion on subjects of interest to community bankers.

Q.2. Do you agree with Federal Reserve Chairman Bernanke's statement at a recent hearing that the burden of Dodd-Frank regulations falls disproportionately on small and community banks? If so, what can be done to reduce that burden?

A.2. As demonstrated in the crisis of 2008, the economic costs of financial instability are enormous. Prudential regulation and supervision of depository institutions have been instituted under the Federal Deposit Insurance Act and other statutory mandates to promote financial stability and to reduce the frequency and severity of such crises.

The costs of complying with these regulatory requirements on the part of FDIC-insured institutions are not insignificant. Moreover, these costs include some that vary a great deal with the size and complexity of the institution, and some that are relatively fixed. With regard to the latter category of fixed regulatory costs, it is true to say that they fall disproportionately on smaller institutions, which employ fewer people and have fewer financial resources that can be devoted to complying with regulatory requirements.

At the same time, there are many examples of regulatory costs and requirements that have been designed to vary with the size and complexity of the institution, and therefore, do not necessarily impose a higher cost on smaller institutions. Among these are the premiums charged by the FDIC for deposit insurance, which are based on both the size and the risk of each institution. It is worth noting that an important requirement of the Dodd-Frank Act was to broaden the assessment base for deposit insurance premiums from domestic deposits to total liabilities minus net worth. This shift, implemented by the FDIC in 2010, served to reduce the annual premiums paid by small banks (with assets under $1 billion) by about 30 percent. In addition, accommodations were made for smaller institutions when the Dodd-Frank mortgage rules were implemented. Special exemptions reduced the regulatory requirements and lowered compliance costs for smaller institutions. These exemptions were included in several key regulations, including those related to servicing, the ability-to-repay, and qualified mortgage regulations.

Nonetheless, the FDIC continues to pursue initiatives that will help to further reduce the costs of regulatory compliance on community banks, as described in the response to Question 1. These efforts recognize the potential for regulatory compliance costs to fall disproportionately on smaller institutions and include specific steps designed to help smaller institutions to minimizethose costs.

Q.3. In light of FDIC's thorough report on community banks and their failures, is there a single element that we should monitor in the event of future crises?

A.3. The *FDIC Community Banking Study* and the Material Loss Reviews conducted by the FDIC Office of Inspector General (OIG) both identified a collection of business strategies that proved to be especially problematic in the recent crisis and are now subject to close supervisory attention by the FDIC.

The *Community Banking Study* showed that institutions pursuing high-growth strategies—frequently through commercial real estate or construction and development lending—encountered severe problems during real estate downturns and generally underperformed over the long run. In contrast, community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies during the study period exhibited relatively strong and stable performance over time.

According to Material Loss Reviews conducted by the OIG in the aftermath of bank failures, losses at community banks during the crisis were most often caused by management strategies of aggressive growth and concentrations in commercial real estate loans, including notably, concentrations in acquisition, development and construction loans, coupled with inadequate risk management practices in an environment of falling real estate values that led to impairment losses on delinquent and nonperforming loans. Another common characteristic of failed banks was reliance on volatile brokered deposits as a funding source.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JON T. RYMER

Q.1. Public Law 112-88 requires that the FDIC OIG conduct a study on the impact of the failure of insured depository institutions during the recent financial crisis. One of the findings in your study is that the FRB, OCC, and FDIC could have provided earlier and greater supervisory attention to troubled institutions that ultimately failed. In your view, what have the regulators done to address such deficiencies? What else should they do?

A.1. While not a focus of the review called for in Public Law 112-88, we noted in our report that material loss reviews (MLR) performed by our office and the Inspectors General (IG) of the Board of Governors of the Federal Reserve System (FRB) and Department of the Treasury showed that the FRB, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) could have provided earlier and greater supervisory attention to troubled institutions that failed. As noted in our report, the regulators generally fulfilled their supervisory responsibilities as defined by statutes, regulations, accounting standards, and interagency guidance in place at the time. Our report also pointed out that the regulators reacted to a rapidly changing economic and financial landscape by establishing and revising supervisory policies and procedures to address key risks facing the industry.

The three reports summarized below describe the efforts the FDIC has made to strengthen its supervision program in light of the issues we identified in the nearly 100 MLR reports our office issued and other related work our office performed since the crisis began in 2008. Although one of the reports also comments on the efforts the FRB and OCC have made to strengthen their supervision programs, we are not the IG for the OCC or FRB and, accordingly, have not assessed the efforts or progress they may have made to strengthen their respective supervision programs.

Follow-up Audit of FDIC Supervision Program Enhancements (Report Number MLR-11-010, December 2010). In this audit, we discussed the efforts that the FDIC had taken to strengthen its supervision program in response to the financial crisis. We noted that the FDIC had implemented a comprehensive review and analysis of its approach to supervision and had implemented or planned actions that substantially addressed our reported MLR trends and issues. In particular, we reported that the FDIC had:

- emphasized a forward-looking supervisory approach, consisting of a comprehensive training program and various financial institution and examiner guidance, including guidance related to de novo banks;
- implemented other cross-cutting initiatives, such as establishing relevant Corporate Performance Goals in 2009 and 2010 related to some MLR issues;
- implemented a post-MLR assessment process to identify lessons learned from the bank failures and conclusions included in our MLR final reports and solicited input from its examination staff regarding suggested changes to policies and procedures. This process also resulted in the identification of potential best practices related to the FDIC's examinations;
- enhanced offsite monitoring activities;
- enhanced coordination between its risk management and compliance examination functions;
- improved interagency coordination for charter conversions; and

- worked with the other Federal regulatory agencies to implement a new agreement associated with the FDIC's backup examination authority.

Evaluation of Prompt Regulatory Action Implementation (Report Number EVAL-11-006, September 2011). In this evaluation, conducted jointly with the FRB and Department of the Treasury Offices of Inspector General (OIG), we reported that the regulators had begun to incorporate a number of lessons learned from the financial crisis into their regulatory processes, including those resulting from their respective IGs' MLR reports. We reported that the regulators had recognized the need to re-emphasize a supervisory approach that encompassed consideration of an institution's risk profile in all facets of the examination process. As it relates to the FDIC, we noted that the purpose of its supervisory enhancement initiative was to build upon the strengths of the supervision program, emphasize balanced and timely response to weak management practices and identified risks, and emphasize a more proactive approach to examination analysis and ratings based upon the lessons learned from recent failures. Importantly, we reported that although the new emphasis was a step in the right direction, sustaining long-term improvement depended on not forgetting the lessons learned once the economy and banking industry improve.

Acquisition, Development, and Construction Loan Concentration Study (Report Number EVAL-13-001, October 2012). In this evaluation, we looked more specifically at a particular area of concern contributing to the crisis—the excessive concentration of acquisition, development, and construction lending on the balance sheets of many financial institutions. In our report, we noted that the FDIC, in response to MLR findings and other issues, had issued specific examiner and financial institution guidance and taken actions, including:

- Recognizing factors that are indicative of elevated risk associated with management, which included high-risk appetite and degree of responsiveness to examiner recommendations;
- Issuing additional guidance regarding the inappropriate use of interest reserves;
- Emphasizing to examiners the risks that the use of noncore funding can present to a financial institution;
- Issuing guidance regarding consideration of brokered deposits in the deposit insurance risk assessment process, use of such funding sources for institutions that are in a weakened condition, processing requests for brokered deposit waivers, and interest rate restrictions for banks that are less than Well Capitalized; and
- Issuing guidance to emphasize the importance of monitoring institutions subject to enforcement actions, including the need to clarify expectations for quarterly progress reports, meet with an institution's Board at the beginning of a corrective program, and conduct on-site supervisory activities between examinations.

With regard to the question as to what else can be done, we believe, as we note in each of the reports described above, that sustaining long-term improvement will depend on the regulators remaining vigilant in their supervisory activities and not forgetting the lessons learned once the economy and banking industry begin to improve. In particular, early regulatory intervention (i.e., before an institution experiences financial and capital decline) is key to maintaining healthy banks. When examiners identify practices, conditions, or violations of law that could result in losses to a financial institution, they must aggressively address them and ensure that management takes prompt and effective corrective action. We acknowledge that these lessons may become more difficult to apply, or sustain, as the banks return to profitability. We also believe that the regulators should pursue interagency efforts to jointly address some of the more systemic MLR trends, such as capital definitions, capital levels, and liquidity.

Q.2. Your study also found that examiners did not always document the procedures and steps that they performed to assess institutions' appraisal and workout programs, and that the regulators had different approaches to enforcement actions, particularly related to nonproblem banks. How much progress have the regulators made to address such deficiencies? What else should the regulators do?

A.2. Provided below is how each of the three agencies responded to the findings detailed in our study related to documentation concerns.

- The OCC responded that while the agency believed its supervisory examination strategy and core assessment processes satisfied this recommendation, the OCC had plans to improve its guidance by including a section specific to appraisals in the commercial real estate and mortgage handbooks that are currently being revised.
- The FRB responded that it is continually looking for ways to improve its examination processes, including ways to improve documentation procedures.
- The FDIC agreed to coordinate with the FRB and OCC to review the interagency Appraisal and Evaluation Guidelines and determine the most appropriate way to strengthen examination documentation requirements.

As we do not oversee the OCC or FRB, we have not made an assessment of the internal progress that these regulators may have made to respond to our recommendations. As for the FDIC, we have been provided information through our audit follow-up process regarding the Corporation's efforts. Specifically, FDIC officials indicated that the FDIC, OCC, and FRB staff consulted in January and February 2013, and these officials continue to discuss with the OCC and FRB whether documentation requirements need to be strengthened going forward. At a February 2013 Federal Financial Institutions Examination Council (FFIEC) Task Force on Supervision meeting, the FDIC also discussed its plans to strengthen documentation, which include reiterating the FDIC's existing working paper documentation guidance to examiners and monitoring examiner compliance as part of the FDIC's internal control function. Finally, in February 2013, the FDIC clarified how examiners should approach and document their review of appraisal and workout programs during a policy conference call with regional FDIC representatives. The FDIC OIG will continue to monitor progress of these efforts until such time the FDIC takes sufficient action to close the recommendation.

Regarding the question as to what else regulators should do, our office believes that the FDIC should continue to identify efficient ways to document procedures that were performed during an examination.

The second part of the question related to the different approaches that regulators employ regarding enforcement actions and the progress that has been made to address such deficiencies. We do not view the regulators having different approaches to enforcement actions to be a deficiency on any regulator's part. In our report, we pointed out the differences and recommended that the regulators study them to determine whether there are common approaches that should be implemented by all three agencies. All three regulators concurred on this recommendation. At the abovementioned February 19, 2013, FFIEC meeting, representatives of the FDIC, FRB, and OCC agreed to research this recommendation as part of a joint Task Force on Supervision project.

As previously noted, as we do not oversee the OCC or FRB, we have not made an assessment of any internal initiatives these regulators may be pursuing. As noted in the comments on our study's report, the FDIC agreed to conduct an internal study in 2013 on its approach for using informal and formal enforcement actions to determine whether an alternative approach to mitigate risk and correct deficiencies may be more effective. We understand that the FDIC has begun an internal review of the scope and effectiveness of enforcement actions and will complete the study in 2013.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM LAWRENCE L. EVANS, JR.

Q.1. As Director for Financial Markets at the GAO, you have to analyze historical data. How does the most recent financial crisis compare to past crises with regard to community banks?

A.1. While we did not review the failure of community banks in past crises as part of our recent bank failures study, prior GAO work has addressed failures that occurred during the banking crisis of the 1980s and early 1990s. Between 1990 and 1994, more than 1,600 banks insured by FDIC were closed or received FDIC financial assistance. In our May 1989 report, "Bank Failures: Independent Audits Needed To Strengthen Internal Control and Bank Management" (GAO/AFMD-89-25), we reviewed the 184 bank failures that occurred during 1987. The vast majority of these failed banks were small institutions. [1] Common to the failures we studied in both crises were internal weaknesses in bank management and board oversight that led to weak underwriting, aggressive growth strategies fueled by riskier funding sources, and high loan concentrations.

[1] Ninety-two percent (172) of the banks that failed in 1987 had assets under $100 million. At that time, banks were considered community banks if they had assets under $250 million.

Q.2. Did you recognize any of the underlying causes of past crises in this crisis that caused community banks to fail? If so, please describe such shared causes.

A.2. As indicated above, we found several similarities in the underlying causes of the bank failures we studied in the banking crisis of the 1980s and early 1990s and the most recent crisis, in particular internal weaknesses in bank management and board oversight that led to weak underwriting, aggressive growth strategies fueled by riskier funding sources, and high loan concentrations.

The objectives of the 1989 review were in part to summarize data on internal weaknesses that Federal banking examiners cited in examinations of these banks prior to their failure. Of the internal control weaknesses Federal banking regulators identified, those that contributed most significantly to the 184 bank failures were lack of general lending policies (79 percent), inadequate supervision by the bank's board of directors (49 percent), weak loan administration (42 percent), and poor loan documentation and inadequate credit analysis (41 percent). Other internal weaknesses regulators cited related to an overreliance on volatile funding sources such as brokered deposits (32 percent), unwarranted loan concentrations (24 percent), excessive out-of-area lending (16 percent), excessively growth-oriented policies (26 percent), and a failure to establish adequate loan loss allowances (29 percent). We found that Federal regulators cited neither a single weakness nor a specific combination of weaknesses as the sole contributing factor to a bank's failure. Rather, each bank demonstrated a unique combination of weaknesses.

As we noted in our recent report, inadequate management of risks associated with high concentrations of CRE loans, and in particular, ADC loans were a primary cause of failure in small banks. Other internal control weaknesses we reported included weak underwriting and credit administration practices. In addition, these failed banks had often pursued aggressive growth strategies using nontraditional, riskier funding sources—particularly brokered deposits. Similar to the past crisis, failed banks often did not maintain an adequate loan loss allowance and some had engaged in out-of-territory lending through loan participations.

Q.3. If you had to single out one dominant cause for banks' failure in this past crisis, what would that be?

A.3. As our econometric analysis showed, banks with high concentrations of ADC loans and a greater use of brokered deposits were more likely to fail between 2008 and 2011. However, the build-up of such high concentrations of risky loans via a reliance on nontraditional funding sources is ultimately a reflection of aggressive growth strategies and poor risk management at these banks.