Kansas City Fed Community Banking Conference, September 2011

Scott E. Hein

Brown Chair in Finance and Director of the Texas Tech School of Banking

Community Banking Conference

- What are Community Banks?
  - Conventional wisdom; total asset size determines if a bank is a community bank ($500m, $1b, $5b, etc.)
- **Thesis I**: Community Banks have very different business models from large banks and therefore are not direct competitors with large banks.
  - Aside: It is better to look at business models than asset size to define a community bank
- **Thesis II**: Washington DC Policymakers focus on large banks and generally don't understand community banks, nor have they really helped community banks
- **Thesis III:** Community banks are a vital engine to promote economic growth in our economy.

Many Banks are Doing Quite Well Today

- Characteristics of Strong Community Banks
  - Fortress balance sheets
  - Diversified loan portfolios & strong core funding
  - Conservative credit culture
- Largest Banks are doing well and have an Implicit Government Guarantee (TBTF)
  - Access to capital and emergency liquidity facilities
  - Reduced borrowing costs
  - Diversified revenue streams (non-interest income)

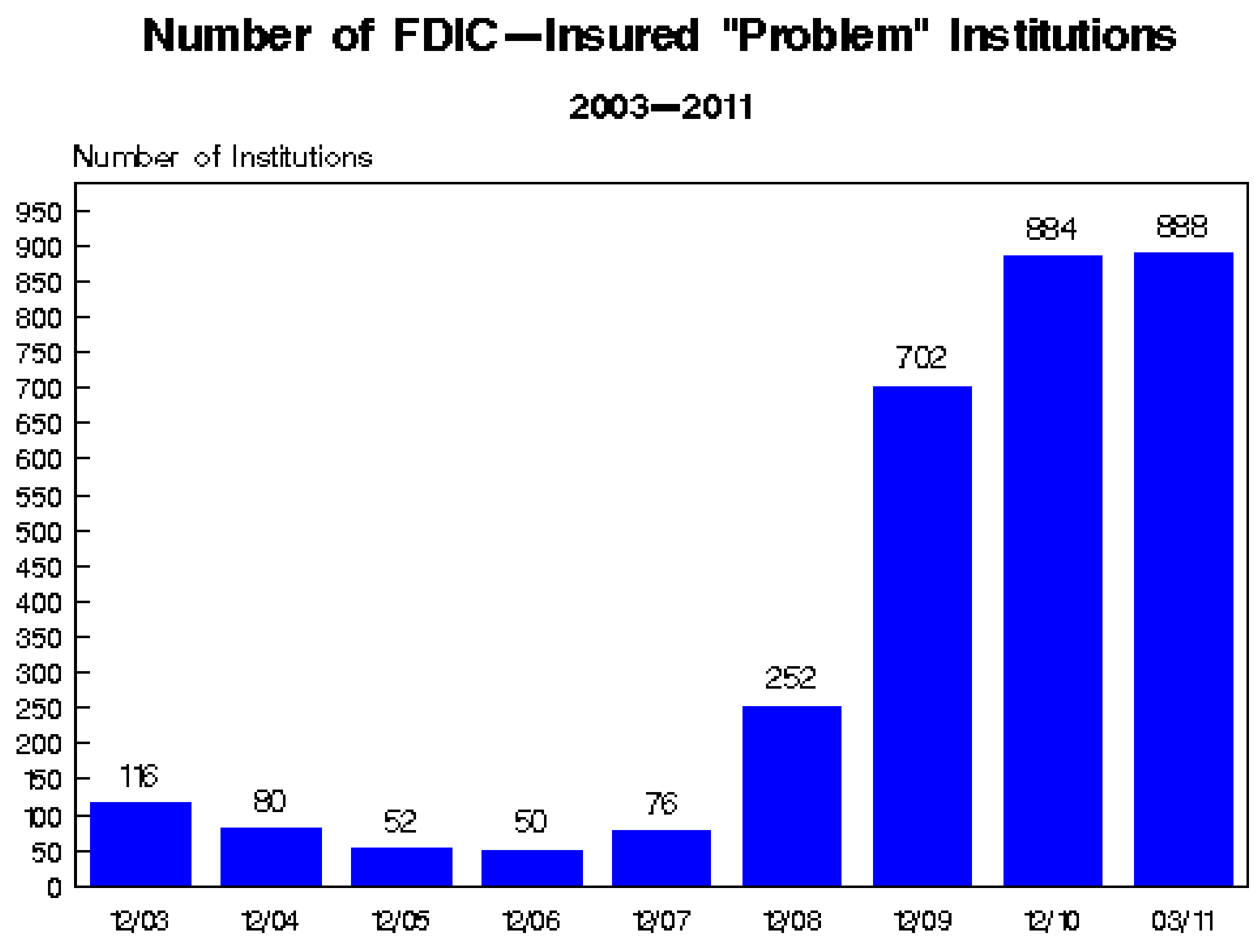
Only concern is big banks is European sovereign debt

Different Types of Community Banks

We have:

- High performers with fortress balance sheets
- 'Walking Wounded' who will muddle through with no or slow growth
- Dead (dreaming of an acquirer or capital injection)

Moreover, we have added to the numbers in the latter two camps



FDIC Quarterly Banking Profile, graph book, March 2011; *2nd Quarter 2011 update; 865 problem banks, 22 banks failed in the quarter.*

What is a Fortress Balance Sheet?

Assets

- **Reasonable loan/TA**
- **Diversified loan portfolio**
- **Low NPA & low charge-offs**
- **Meaningful amounts of unpledged liquid securities**

Liabilities

- **Ample stable, core deposits**
- **Limited non-core funding (brokered CDs, FHLB advances**
- **High levels of transaction accounts (direct deposits, remote capture, …)**

Capital

- **High levels of Common Equity**

What is the difference in "large bank" business models as opposed to "community bank" business models?

- **Relationship banking**
  - Community banks use soft information that is not easy to quantify, by getting to "know" their customers
    - Deposit-driven versus loan-driven community banks
  - Large banks try to minimize costs and see soft information as too expensive to warrant obtaining. They use hard information, easy to quantify.
    - Washington DC policymakers don't understand this difference and they only use "hard information" themselves.

Implication regarding soft information on Community banks and economic growth

- Because community banks are willing to use hard-to-come-by soft information, they are better equipped to identify the new successful entrepreneurs, and are willing to extend them credit that large banks don't even know about.
- As such, it is no small wonder that we have little macro-economic growth, as community banks struggle in this tough economic climate.

Large bank business models vs. Community bank business models

- **Decision making and authority**
  - Community banks have more localized decision making and authority
    - This again makes community banks better equipped to spot good new entrepreneurial credits.
  - Large banks centralize decision making a authority
- **Community focus**
  - Community banks give much more to their <u>local communities</u>
  - Big banks give much more to their <u>Washington DC lobbying efforts</u>
- **Funding sources**
  - Community banks rely on deposits, especially core deposits as funding source
    - Community banks have <u>limited access to capital markets</u>, especially as trust preferred markets dried up
  - Large banks borrow more funds and use <u>capital markets</u> much more
    - Note the <u>new FDIC deposit insurance pricing</u> based on total liabilities, not insured deposits, should raise the cost of deposit insurance for the big banks and lower them for the community banks

Contrasting Business Models

- **Ownership**
  - Community banks have more concentrated ownership, especially amongst management
  - Large banks have publicly traded stock that is diffusely held, in relatively small amounts of total ownership, especially management
- **Corporate Structure**
  - Many community banks are S corporations, paying no tax at the corporate level
    - Many don't understand what S corps are (witness TARP)
  - Large banks have too many shareholders to qualify for S corporation status and therefore are C corporations
- **Securitization**
  - Community banks did not do much, retaining loans on portfolio
  - Large banks did this and stumbled especially with mortgage related instruments

Bank Policymakers and Community Banks

- In the banking environment, policymakers focus on large banks.
  - As Willie Sutton said in a different context, "That's where the money is."
  - Top 10 sized banks control 77% of total banking assets.
  - The 2008-2009 financial crisis provided first hand evidence on this.
    - TARP
    - FDIC's debt guarantee program
- To a great extent, Washington DC bank policymakers don't understand community banks and their importance in our financial system as an engine of growth
- District Federal Reserve banks and State regulators better understand the uniqueness of community banks and the role of soft information.

Community banks and the financial crisis

- Policymakers did much to improve the financial health of our large banks in this country.
- Policymakers have done little to nothing to help community banks.
  - The small business lending facility was supposed to help community banks lend to small businesses. The program was so poorly designed that after 10 months the program has injected only $0.5 billion into community banks, compared with the program cap of $35 billion.

Too Big to Fail (TBTF) is all about large banks, by definition

- Dodd-Frank and TBTF
  - Diversity of opinion could not be wider on this issue
    - One camp: DF will end TBTF
    - Other camp: DF will legislate that we permanently have TBTF
      - I favor the latter opinion.
- As long as we have TBTF, we will not have a level playing field for all banks and community banks will be disadvantaged.
- The obvious and most effective way to end TBTF is to break up the big banks.

Dodd-Frank and Community Banks

- A real uncertainty hanging over community banks is how much added compliance expense will they be bearing to deal with the new regulations being put on the books.
  - It is disturbing that we have no better handle on this question one year after Dodd-Frank was past than a year ago.

Dodd-Frank and the FDIC Assessment Base –Good news for Community Banks

- Dodd-Frank requires the FDIC to change the assessment base from insured deposits to total liabilities.
- There is little difference for most community banks between insured deposits and total liabilities.
- Since large banks have substantial borrowings, large bank's total liabilities are larger than insured deposits.
- This should result in large banks paying more for deposit insurance and community banks paying less.

Summary

- Community banks operate differently than the large banks in this country.
- Community banks are relatively more important in promoting economic growth.
- Washington DC did much to help the large banks in the financial crisis and pretty much ignored community banks.
- Dodd-Frank has created added uncertainty for community banks and has not resolved TBTF to a level of widespread acceptance.
- The change in FDIC assessment base is a rare plus for community banks.