2014 Fed/CSBS Community Banking Research and Policy Conference

Research Paper Abstracts

Session 1- Community Bank Formation, Behavior and Performance

Title: *The Entry, Performance, and Viability of De Novo Banks*

Authors: Yan Lee and Chiwon Yom

Abstract: De novos are of interest as they represent the beginning of a community bank's life cycle. From 2000 to 2008, 1,042 new banks were chartered, mostly in large, rapidly growing regions, with incumbent banks focused on construction and development (C&D) lending. Compared to small established banks, de novos failed at higher rates and were acquired at lower rates during the recent financial crisis. De novo banks that failed tend to have lower equity, lower earnings, higher non-performing loans, higher reliance on noncore funds, and higher concentration in C&D loans.

Title: *Where Are All The New Banks? The Role of Regulatory Burden in New Charter Creation*

Authors: Robert M. Adams and Jacob Gramlich

Abstract: The number of new bank charters in the United States has declined dramatically in recent years. From 1990 to 2008, 1,850 new banks were formed, a rate of nearly 100 per year. From 2010 to 2012, only 5 new banks were formed, a rate of fewer than 2 per year. The cause of the decline is not immediately obvious, but two leading theories—with rather different policy implications—have been put forward. Some have suggested that the decline is due to increased regulatory burden on banks—including new FDIC regulations and the 2010 Dodd Frank Act. Others have suggested that the weak economy—with its associated weak demand for banking services and low interest rate environment—are depressing bank profits. The former case may be of more concern to policymakers than the latter. This paper assesses the causes of the drop in new charter creation. We model firms' new charter decisions at the county level with an ordered probit using U.S. data from 1995 to 2012. The results suggest that a substantial portion (perhaps up to 90 percent) of the decline in new bank formation is attributable to the low interest rate environment and weak demand for banking services. This suggests a rather small role for the effects of increased regulatory burden on banks. It is less clear whether regulation will play a role when the economy returns to more robust state.

Title: *Rivalry, Market Structure and Innovation: The Case of Mobile Banking*

Author: Zhaozhao He

Abstract: This paper focuses on a novel phenomenon—mobile banking diffusion—to analyze innovative behavior in the U.S. modern banking era. Using a unique, hand-collected dataset of mobile banking app adoption for 2008-2012, this study shows strong evidence that rivalry adoptions spur technological innovation. This effect increases monotonically with the degree of market concentration, and is the strongest in most concentrated markets, where banks compete on non-price attributes. These results are robust to the application of instrumental variables that address the possibility that adoptions are merely simultaneous reactions to the same common forces. Finally, the impact of mobile app adoption on bank performance is also examined.

Title: *What Explains Low Net Interest Income at Community Banks?*

Authors: Charles S. Morris and Kristen Regehr

Abstract: Community bank performance has improved significantly since the financial crisis but is still below pre-crisis levels. One key concern is net interest income, which rose early in the recovery but now is near a 40-year low. Net interest income is important to the long-term viability of community banks because it is their core source of revenue. Given community banks' significance to local households and businesses, policymakers, bankers, and other stakeholders would like to know whether low net interest income is the "new normal" or if it will reverse when the economy improves.

This article examines the historical behavior of net interest income for community banks, focusing on how it compares in the current recovery to four previous recoveries starting in the mid-1970s. The data show low interest rates, a flat yield curve, and a decline in lending are important reasons why net interest income still has not recovered. In fact, compared to the recoveries from the relatively severe 1973-75 and 1981-82 recessions, net interest income is somewhat stronger this far into the recovery. Thus, as monetary policy normalizes and the economy recovers, community bank net interest income should be expected to rise toward pre-recession levels.

Session 2- The Effect of Government Policy on Bank Lending and Risk-taking

Title: *Assessing Targeted Macroprudential Financial Regulation: The Case of the 2006 Commercial Real Estate Guidance for Banks*

Authors: William F. Bassett and W. Blake Marsh

Abstract: In the mid-2000s, federal bank regulatory agencies became alarmed by steadily increasing concentrations of commercial real estate (CRE) loans at many banks, particularly loans used to finance construction and land development (CLD). In January 2006, they issued guidance that required banks with specific high concentrations in those asset classes to tighten managerial controls. This paper shows that banks with concentrations in excess of the thresholds set in the guidance subsequently experienced slower growth in their CRE and CLD portfolios than can be explained by changes in the health of their balance sheets and economic conditions. Moreover, banks that were above the CRE thresholds also tended to have slower growth in C&I loans but faster growth in loans to households after the guidance was issued. The results highlight the potential for this type of macroprudential regulation to have a significant and broad influence on bank behavior.

Title: *The Impact of the Small Business Lending Fund on Community Bank Lending to Small Businesses*

Authors: Dean Amel and Traci Mach

Abstract: Following the financial crisis, total outstanding loans to businesses by commercial banks dropped off substantially. Large loans outstanding began to rebound by the third quarter of 2010 and essentially returned to their previous growth trajectory while small loans outstanding continued to decline. Furthermore, much of the drop in small business loans outstanding was evident at community banks. To address this perceived lack of supply of credit to small businesses, the Small Business Lending Fund (SBLF) was created as part of the 2010 Small Business Jobs Act. The fund was intended to provide community banks with low-cost funding that they could then lend to their small business customers. As of December 31, 2013, the U.S. Department of the Treasury reports that SBLF participants had increased their small business lending by $12.5 billion over their baseline numbers. The current paper uses Call Report data from community banks and thrift institutions to look at the impact of receiving funds from SBLF on their small business lending. The analysis controls for economic and demographic conditions, market structure and competition. Simple regression estimates indicate that participants in the SBLF program increased their small business lending by about 10 percent more than their non-participating counterparts, in line with numbers reported by Treasury. However, estimates

that control for the ongoing growth path in small business lending indicate no significant impact of SBLF participation on small business lending.

Title: *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations*

Author: Julie Andersen Hill

Abstract: Banks and credit unions sometimes complain that the examination process regulators use to police banking practices is oppressive. These financial institutions complain that regulators reach unduly negative examination conclusions known as "material supervisory determinations." Institutions are wary because negative determinations can subject an institution to further regulatory scrutiny or enforcement actions.

To guard against erroneous determinations, Congress, in 1994, en-acted a statute requiring federal financial institution regulators to provide an appeals process. Each of the four regulators (the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve, and the National Credit Union Administration) adopted unique material supervisory determination appeals processes.

Using data (some collected through Freedom of Information Act requests) about material supervisory decision appeals since 1994 and interviews with top regulators, this Article provides the first in-depth analysis of the appeals process. It shows that the appeals process is sometimes dysfunctional and seldom used.

To improve the appeals process, the Article recommends three changes. First, once a regulator issues a material supervisory determination, financial institutions should have direct access to a dedicated appellate authority outside of the examination function. Second, the appellate authority should engage in a robust review process; it should consider a broad scope of appealable matters and employ a clear and rigorous standard of review. Third, regulators should release detailed information about each decision reached by the appellate authority.

Session 3: The Effect of Government Policy on Community Bank Viability

Title: *How Are Small Banks Faring Under Dodd-Frank?*

Authors: Hester Peirce, Ian Robinson, and Thomas Stratmann

Abstract: This paper presents the results of the Mercatus Center's Small Bank Survey, which include responses from approximately 200 banks across 41 states with less than $10 billion in assets each, serving mostly rural and small metropolitan markets. The initial analysis suggests that Dodd- Frank significantly affects small banks and their customers. A large majority of respondents viewed Dodd-Frank as more burdensome than the Bank Secrecy Act, and the participating banks reported substantially increased compliance costs in the wake of new regulations. These costs include hiring new compliance personnel, increased reliance on outside compliance experts, additional resources allocated to compliance, and more time spent by noncompliance employees on compliance. The increased regulatory burdens have led small banks to reconsider their product and service offerings, including considering whether to stop providing residential mortgages. Many small bank customers, who will have difficulty locating convenient alternatives, will feel the indirect effects of Dodd-Frank.

Title: *Did the JOBS Act Benefit Community Banks? A Regression Discontinuity Study*

Author: Joshua Mitts

Abstract: This study examines the effect of section 601(a)(2) of the Jumpstart Our Small Business (JOBS) Act of 2012, which modified the threshold for unlisted banks and bank holding companies (BHCs) to deregister under the Securities Exchange Act of 1934 from 300 to 1,200 shareholders of record. This change in the

cutoff permits utilizing the quasi-experimental technique of regression discontinuity to identify the causal effect of Exchange Act deregistration on the performance of banks and BHCs that took advantage of the statutory change. Using an original dataset consisting of 187 community banks and a novel application of comparative interrupted time series analysis to regression discontinuity, I estimate the local average treatment effect of deregistration on compliers. Consistent with theory and qualitative evidence that the JOBS Act was beneficial for smaller banks, deregistration caused $1.27 higher net income and $3.38 lower pretax expenses per $1 of average assets, and $1.24 million greater assets per employee. However, deregistered banks also had $2.35 lower pretax income and $1.95 lower equity capital per $1 of assets.

Title: *A Tiered System of Regulation Is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks*

Author: Arthur E. Wilmarth Jr.

Abstract: The financial crisis of 2007-2009 and its aftermath have accelerated a consolidation trend that has transformed the U.S. banking system during the past three decades. During that period, the number of community banks and their share of the banking industry's assets have fallen by more than half, while the largest banks have captured much of the industry's assets. In responding to the financial crisis, the federal government encouraged further consolidation by adopting extraordinary assistance programs and forbearance measures designed to ensure the survival of the biggest institutions. In contrast, federal officials gave little help to community banks and subjected them to strict supervision and enforcement policies. Federal regulators allowed only one large depository institution (Washington Mutual) to fail, but they stood by while more than 450 community banks failed between 2008 and 2012. Similarly, the Federal Reserve's monetary policy since the outbreak of the crisis has benefited megabanks while suppressing the earnings of community banks.

In addition to the fact that community banks received very limited assistance during the financial crisis, they must now comply with costly new regulatory requirements imposed by the Dodd-Frank Act and Basel III. Many of the new regulatory burdens are not justified, since community banks did not play any substantial role in causing the financial crisis. The foregoing developments threaten the viability of community banks, which provide essential services to small businesses and local economies. At the same time, Dodd-Frank does not provide an adequate response to the growing risks posed by megabanks to our national and global economies. Dodd-Frank has not ended "too big to fail" (TBTF) treatment for megabanks, and big banks and their supporters have already succeeded in weakening the implementation of even the relatively mild remedies called for by Dodd-Frank.

new tiered system of regulation is urgently needed to correct the perverse effects of our current regulatory regime. My proposal for tiered regulation would reduce regulatory burdens on community banks and would encourage them to maintain their traditional business model of relationship-based intermediation. My proposal would also seek to remove TBTF subsidies from megabanks and other systemically important financial institutions (SIFIs). SIFIs would be required to conduct their deposit-taking activities within "narrow banks" that would be barred from transferring their safety net subsidies to nonbank affiliates. SIFIs would also be required to pay risk-based premiums to pre-fund the Orderly Liquidation Fund in order to shield taxpayers from the future costs of resolving failed SIFIs. By removing TBTF subsidies, my proposal would enable financial markets and regulators to exercise much more effective discipline over our largest financial institutions. In addition, SIFIs would be obliged to structure compensation packages for their executives and key employees so that at least half of their total compensation is paid in the form of long-term contingent convertible bonds (CoCos). CoCos would help to align the personal incentives of executives and other key employees of SIFIs with the interests of creditors, the FDIC and taxpayers.

My proposed tiered system of regulation would help to restore a more balanced, diverse and resilient banking industry. Community banks have compiled a superior record of meeting the needs of their customers while maintaining a more stable business model that serves the longer-term interests of their stakeholders and communities. In contrast, megabanks have shown a strong and persistent tendency to pursue short-term, high-risk business strategies that produce boom-and-bust cycles and impose tremendous costs on our economy and taxpayers. If the TBTF subsidies for megabanks were removed, those banks would have strong incentives to spin off risky activities and adopt more conservative and transparent business policies.

Title: *Federal Policy, Market Distortions, and the Challenge for Community Banks*

Author: Tanya D. Marsh

Abstract: Community banks are an important part of the American financial services sector. They provide essential services to a significant number of Americans, particularly in rural areas. They pose less of a threat to the safety and stability of the American financial system than large banks because of their relatively uncomplicated and transparent activities, and their size limits the potential impact of any single bank failure. Because they are tied so closely to particular communities, they have natural disincentives for predatory lending and similar consumer protection abuses.

Community banks are under stress. Their raw numbers and share of banking industry assets have dropped significantly in the past thirty years. They are less attractive to investors because they are less profitable than other financial services firms. They are not accused of having contributed to the financial crisis in any meaningful way, yet are required to shoulder increased regulatory burdens as a result. Some argue that the inability of community banks to effectively compete is a natural phenomenon, and that they will eventually be replaced by more efficient and profitable firms. Others argue that the recent increase in industry consolidation is linked to the financial crisis and will soon subside.

This paper argues that the stress on community banks is not natural and it will not subside without major policy changes. The stress has been created by market distortions as a result of federal policies that: (1) award competitive advantages to certain categories of financial intermediaries; and (2) encourage Americans to invest in capital markets rather than in depository accounts. The explicit goals of federal policy regarding the financial system are to ensure safety and soundness, consumer protection, and access to credit. There are few that would argue that a financial system where a handful of firms control the lion's share of assets, and where household assets are largely invested in the potentially turbulent capital markets, achieves any of these goals. The goal of this paper is to take a step back from the current granularity of the discussion surrounding the future of community banks and take a broader view of federal policies which impact the financial system. Recognizing that many of the challenges facing community banks are not natural alters the policy discussion, which is essential if we are serious about protecting the millions of Americans who depend upon community banks for financial services.