Oral Statement of

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Chairman Moore and members of the Committee, thank you for the opportunity to testify at this timely hearing on the future of community banks.

Over the past 20 years, as the banking industry has consolidated into fewer and larger banks, a perennial question has been, "Is the community bank model viable?" The short answer is, yes. The longer answer is, yes, if they are not put at a competitive disadvantage by policies which favor and subsidize the largest financial institutions. I have worked closely with community bankers my entire career, through good and bad economic times. I know their business model works.

There are more than 6,700 banks in the country, and all but 83 would be considered community banks based on a commonly used cutoff of $10 billion in assets. In the Tenth Federal Reserve District, we have about 1,100 banks, and all but 3 would be considered a community bank. A lower threshold of $250 million, which focuses on a far more homogeneous group, includes about 4,600 institutions or about two-thirds, of all banks. My submitted materials and remarks now are directed toward this group of banks, which serve Main Street in communities across the country.

Community banks are essential to the prosperity of the local and regional economies across the country. The maps I provided show that community banks have the majority of offices and deposits in almost a third of all counties nationwide. However, their presence and market share are most substantial among Midwestern states, where their role is particularly crucial in rural areas and smaller cities. It is the economies in these states that would suffer most significantly without their presence. Why?

Community banks have maintained a strong presence despite industry consolidation because their business model focuses on strong relationships with their customers and local communities. Community banks serve all facets of their local economy including consumers, small businesses, farmers, real estate developers, and energy producers. They know their customers and local markets well; they know that their success depends on the success of these local firms; and they recognize that they have to be more than a gatherer of funds if they hope to prosper. These factors are a powerful incentive to target their underwriting to meet specific local credit needs. And it gives their customers an advantage of knowing with whom they will work in both good and difficult economic times. Larger banks are important to a firm as they grow and need more complicated financing, but in this region, most businesses are relatively small and their needs can be met by that local bank.

It is said that a community with a local bank can better control its destiny. Local deposits provide funds for local loans. Community banks are often locally owned and managed – through several generations of family ownership. This vested interest in the success of their local communities is a powerful incentive to support local initiatives. It is the very “skin in the game” incentive that regulators are trying to reintroduce into the largest banks. It’s the small community’s version of “risking your own funds” that worked so well in the original investment banking model, and kept partners from making risky mistakes that would result in personal bankruptcy back then, and government intervention more recently.

There is no better test of the viability of the community bank business model than the financial crisis, recession, and abnormally slow recovery that we’ve experienced over the past 2½ years. The community bank business model has held up well when compared with the megabank model that had to be propped up with taxpayer funding. Community bank earnings last year were lower than desired but on par with those of larger banks. However, community banks generally had higher capital ratios that put them in a better position to weather future problems and support lending.

This is an important point to note as the decline in overall bank lending, particularly to small businesses, is a major concern. Data show that community banks have done a better job serving their local loan needs over the past year. Community banks, as a whole, increased their total loans by about 2 percent as compared to a 6 percent decline for larger banks. In addition, community banks have had either stronger loan growth or smaller declines across major loan categories. Business lending in particular stands out, with community bank loans dropping only 3 percent as compared with a 21 percent decline for larger banks.

Of course, some community banks made poor lending and investment decisions during the housing and real estate boom of the mid 2000s. Unlike the largest banks, community banks that fail will be closed or sold. For community banks that survive, it will be a struggle to recover. Commercial real estate, particularly land development loans, will be a drag on earnings for some quarters yet. Nevertheless, for those that recover, a business model that continues to focus on customer relationships will be a source of strength for local economies.

Thus, community banks will survive the crisis and recession and will continue to play their role as the economy recovers. The more lasting threat to their survival, however, concerns whether this model will continue to be placed at a competitive disadvantage to larger banks. Because the market perceived the largest banks as being too big to fail, they have had the advantage of running their business with a much greater level of leverage and a consistently lower cost of capital and debt. The advantage of their too-big-to-fail status was highlighted during the crisis, when the FDIC allowed unlimited insurance on non-interest-bearing checking accounts out of concern that businesses would move their deposits from the smaller to the largest banks. As outrageous as it seems, in many cases it is <u>easier</u> for larger banks to expand through acquisitions into smaller communities. This occurs because smaller banks tend to focus on their local markets and therefore often face significant antitrust restrictions to in-market mergers. This policy ignores the fact that the largest 20 banking organizations in the United States now control just less than 80% of the industry's total assets.

Going forward, the community bank model will face challenges. Factors such as higher regulatory compliance costs and changing technology will encourage community bank consolidation. And despite the provisions of the Dodd-Frank Act to end too big to fail, community banks will continue to face higher costs of capital and deposits until investors are convinced it has ended. But community banks have always faced such challenges. They have survived and prospered. If allowed to compete on a fair and level playing field, the community bank model is a winner.