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“Ending the De Novo Drought: Examining the Application Process for De Novo Financial Institutions”

Testimony before the House Subcommittee on Financial Institutions and Consumer Credit

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Good afternoon Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee. My name is Sarah Edelman, and I direct the housing finance team at the Center for American Progress, a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. Thank you for inviting me to testify on this important topic.

The number of new bank applications to the FDIC has declined substantially since the global financial crisis. This decline is largely the result of macroeconomic factors, including, historically low interest rates reducing the profitability of new banks, as well as investors being able to purchase failing banks at a discount following the financial crisis.

It is true that the financial crisis also severely damaged the FDIC insurance fund, which drove the FDIC to enact temporary measures, including greater oversight of new banks, to protect its insurance system. Additionally, the application process has occasionally been a challenge for *de novo* financial institutions. However, the FDIC has worked to improve the process significantly, and most of the obstacles facing new small bank entrants are not related to the FDIC application process or bank regulations. Thus, gutting FDIC oversight is not likely to address the shortage of new bank applications.

In this testimony, I will describe the challenges facing new bank entrants and what the FDIC has done to date to make the application process more transparent and easier to navigate. I will also provide an overview of the current health of the community banking sector and steps Congress and regulators can take to help level the playing field for the smallest community banks.

Shortage of new bank applications largely caused by macroeconomic factors

While some of the conversation about the shortage of new bank entrants has centered on increased compliance costs and a difficult application process, the research shows that other factors are far more significant. A 2014 Federal Reserve study showed that 75-80 percent of the decline in new banks can be explained by low interest rates and weak macroeconomic factors.[1]

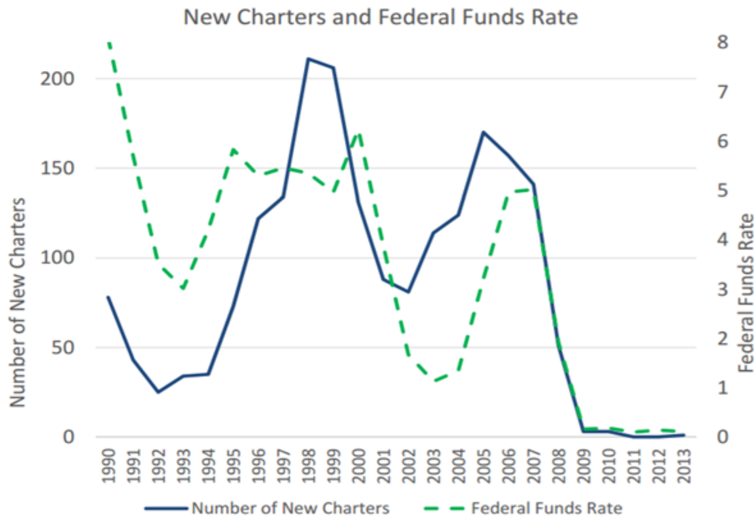
Moreover, the study found that the declining trend is not unique to new banks entrants – bank branches opened by existing banks have experienced a similar decline. The authors explain that "since both expansion and *de novo* entry have declined, regulations that affect only *de novo* banks are likely not the main cause of the entry void."[2]

Low interest rates are a significant factor discouraging new bank entrants. While low interest rates have helped to stimulate economic growth and demand for business and consumer loans, they reduce net interest margin for new banks.[3] Low interest rates make it less expensive for a consumer or business to take out a loan, which is good for the economy and housing market but a challenge to new bank profitability. While existing banks can earn profits on loans they originated when interest rates were higher, new banks cannot bolster earnings through existing loans.

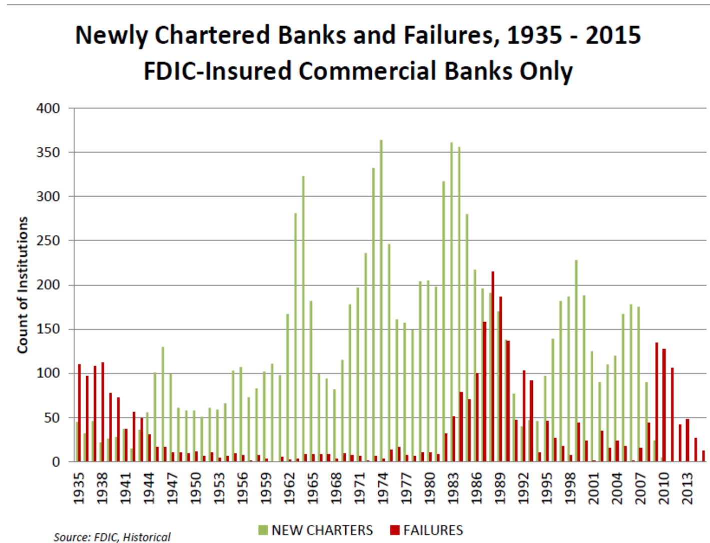
According to Federal Reserve research, new bank formation is closely correlated with interest rates. When rates are low, fewer new banks enter the market and when they are higher, more new banks are created.

New investment in the banking sector has also taken different forms in recent years. While few new banks have formed, between 2008 and 2012 four hundred and sixty-five failing banks had their assets purchased through the FDIC bank resolution process.[4] Purchasing a failing bank at a discount from the FDIC can be a less expensive way to start a bank.

[1] Robert Adams and Jacob Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation," (Washington: Federal Reserve Board, 2014), available at https://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.
[2] Ibid.
[3] Ibid, net interest margin refers to interest revenue minus interest costs divided by total assets.
[4] CAP calculations of data from FDIC "Annual Reports," available at https://www.fdic.gov/about/strategic/report/ (last accessed March, 2017).



Source: Robert Adams and Jacob Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation."



Source: FDIC[5]

[5] Martin Gruenberg, Statement of FDIC Chairman before the House Committee on Oversight and Government Reform, "*De Novo* Banks and Industrial Loan Companies," July 13, 2016, available at https://www.fdic.gov/news/news/speeches/spjul1316.html.

The FDIC is taking steps to improve the *de novo* bank application process

In 2009, when the nation was experiencing widespread bank failures and the FDIC insurance fund was approaching negative levels, the FDIC put additional safeguards in place to prevent more bank failures.[6]

FDIC research shows that during the crisis, newly-formed *de novo* banks failed at twice the rate of existing small community banks.[7] To lower the risk of more new bank failures, the FDIC lengthened its period of enhanced supervision for new banks from three to seven years.[8] This policy change made sense, especially during a time when economic conditions were deteriorating and new banks were failing in large numbers.

Research has found that new banks' higher failure rates are the result of them having less portfolio diversity, riskier investments, and greater reliance on irregular funding; making them significantly more susceptible to failure, especially when business cycle conditions deteriorate.[9] There are many examples from the crisis, including Haven Trust which was reported on as a case study of such failures in *The New York Times* – it was a small bank based in Georgia founded in 2000 that failed in 2008 because of its lax lending standards, poor risk controls and excessive portfolio of risky construction loans.[10] It simply did not have the diversification necessary to weather difficult economic conditions or offset its poor lending.[11]

In 2016, after the FDIC fund had recovered and bank failures had declined, the FDIC returned the enhanced supervision period to 3 years.[12] The FDIC has also taken steps to make the application process more transparent and efficient. For instance, the agency published a detailed question and answer document about FDIC's criteria for approving new banks to help applicants submit stronger proposals.[13] The agency also hosted a

[6] Ibid.
[7] Yan Lee and Chiwon Yom, "The Entry, Performance and Risk Profile of De Novo Banks," Working Paper 2016-03 (FDIC CFR, 2016), available at https://www.fdic.gov/bank/analytical/CFR/2016/WP_2016/WP2016_03.pdf.
[8] Martin Gruenberg, "De Novo Banks and Industrial Loan Companies."
[9] Yan Lee and Chiwon Yom, "The Entry, Performance and Risk Profile of De Novo Banks."
[10] Eric Dash, "Post-Mortems Reveal Obvious Risk at Banks," *The New York Times*, November 18, 2009, available at http://www.nytimes.com/2009/11/19/business/19risk.html.
[11] Federal Deposit Insurance Corporation, "Material Loss Review of Haven Trust Bank, Duluth, Georgia," Report No. AUD-09-017 (August, 2009), available at https://www.fdicig.gov/reports09/09-017-508.shtml.
[12] Federal Deposit Insurance Corporation, "De Novo Banks: Economic Trends and Supervisory Framework," *FDIC Supervisory Highlights*, 13(1)(Summer, 2016), available at https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum16/SI_Summer16.pdf.
[13] Ibid.

training about the application process for state and federal regulators to encourage more communication among the regulators who approve new bank charters and have hosted multiple *de novo* roundtables with stakeholders across different regions.[14] The FDIC also released a proposed handbook for *de novo* applicants for comment at the end of 2016 and is currently in the process of incorporating the feedback and finalizing the handbook.

While the FDIC should continue to improve the application process, it should not lower its standards for approving new banks for FDIC insurance. As economist Simon Johnson explained during his testimony before the House Committee on Oversight and Government Reform, bank failures that occur as a result of lower standards could force the FDIC to increase deposit insurance costs across the banking sector to keep the insurance fund healthy.[15] While some new bank failures are to be expected, the FDIC should not approve new banks that it does not believe can be profitable and serve the banking needs of their communities over the long term.

The U.S. community banking sector is strong, but a long-term decline in the number of small community banks persists

By most measures, the community banking sector is strong and profitable.
In terms of profitability, the core return on assets (ROA) for community banks has been relatively stable between 1985 and 2015. Core profitability rose sharply from a low in the late 1980s during the S&L crisis to a high in the early 1990s, then trended down slowly through the mid-2000s before falling sharply to a low during the financial crisis in 2008, and has now returned to pre-crisis levels. [16]

According to the FDIC, there are now more banks with assets between $100 million and $10 billion than in 1985. Specifically, they report that "[t]he number of banks with assets between $100 million and $1 billion increased by 7 percent between 1985 and 2013, while the number of banks with assets between $1 billion and $10 billion increased by 5

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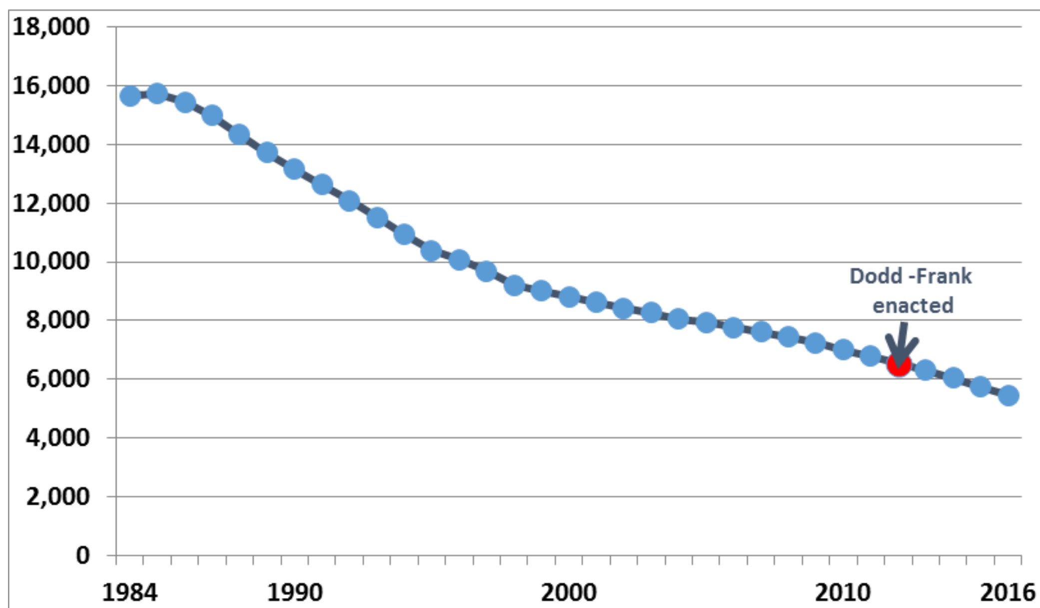
[14] Ibid; FDIC Community Banking Initiative, "De Novo Outreach Meetings,:" available at https://www.fdic.gov/news/conferences/communitybanking/2017/denovo/index.html (last accessed March 2017); https://www.fdic.gov/news/conferences/communitybanking/2017/denovo/index.html; https://www.fdic.gov/news/news/press/2016/pr16110.html; FDIC Press Release, "FDIC Seeking Comment on New Handbook for De Novo Organizers Applying for Deposit Insurance," (December, 2016), available at https://www.fdic.gov/news/news/press/2016/pr16110.html (last accessed March 2017).
[15] Simon Johnson, Testimony submitted to the House Committee on Oversight and Government Reform, "Oversight of the FDIC Application Process," July 13, 2016, available at https://oversight.house.gov/wp-content/uploads/2016/07/Johnson-Statement-Statement-FDIC-7-13.pdf.
[16] Division of Insurance and Research of the FDIC, *FDIC Quarterly*, 10(4) (2016), available at https://www.fdic.gov/bank/analytical/quarterly/2016_vol10_4/fdic_v10n4_3q16_quarterly.pdf.

percent."[17] Many of these banks are community banks, and the FDIC also reports that during the same period these institutions saw significant asset growth.[18] These banks also experienced growth in terms of total assets.

In spite of the relative stability in the community bank share of banking charters, the community bank shares of offices and assets have steadily declined since 1985. While some have blamed this decline on the recent costs of complying with the Dodd-Frank Act, the decline predated financial reform by decades. As a share of total banking offices, community
banks have declined from 53 percent in 1985 to 35 percent in 2013.[19]

Number of U.S. Community Banks



Source: Federal Deposit Insurance Corporation, Historical Community Banking Reference Data

It's the smallest banks that have experienced the most challenges. The number of small community banks, those with assets below $100 million, declined by 85 percent between

[17] Division of Insurance and Research of the FDIC, "Community Banks Remain Resilient Amid Industry Consolidation."
[18] Ibid.
[19] Ibid.

1985 and 2013, while the number of community banks with assets between $100 million and $10 billion increased during the same time period.[20]

Small community banks play an important role in communities across the country. They help businesses create jobs and help families pursue their dreams of buying a home or sending a child to college. Their decline is worrying to local and national policymakers alike. However, as is the case with respect to *de novo* charters, it does not appear that the Dodd-Frank Act is responsible for the decline in small banks.

The factors that have contributed to this decline in the number of small community banks are as follows: First, in the 1980s and 1990s, the banking industry lobbied for and achieved regulatory changes that paved the way for interstate banking.[21] Prior to these regulatory changes, banks could not open branches across state lines and, in some cases, not even across county lines.[22] These changes led to massive consolidation within the banking industry, which among other things, reduced the number of small community banks.[23]

Second, while many new banks start as small community banks with assets below $100 million, if they are successful and their assets grow over time, many become mid-sized community banks. According to an FDIC study, out of nearly 14,000 banks that in 1984 that had less than $100 million in assets, 2,774 or 20 percent of the total expanded to hold more than $250 million in assets by 2011. A number also grew dramatically, with 11 of them holding over $10 billion in assets in 2011. [24]

Third, the majority of small community banks consolidated or disappeared after the savings and loan crisis in the 1980s and the financial crisis in 2008.[25] This massive loss

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[20] Council of Economic Advisers, "The Performance of Community Banks Over Time," (August, 2016), available at https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160810_cea_community_banks.pdf.
[21] Division of Insurance and Research of the FDIC, "Community Banks Remain Resilient Amid Industry Consolidation."
[22] Erin Davis and Tara Rice, "The Branch Banking Boom in Illinois: A Byproduct of Restrictive Branching Laws," *Chicago Fed Letter*, No. 238, Federal Reserve Bank of Chicago, (May, 2007), available at https://www.chicagofed.org/publications/chicago-fed-letter/2007/may-238.
[23] Council of Economic Advisers" The Performance of Community Banks Over Time."
[24] Federal Deposit Insurance Corporation, "Community Banking Study Chapter 2: Structural Change Among Community and Noncommunity Banks," (2012), available at https://www.fdic.gov/regulations/resources/cbi/report/CBSI-2.pdf.
[25] *Division of Insurance and Research of the FDIC, "Community Banks Remain Resilient Amid Industry Consolidation."*

of community banks following turmoil in the financial system underscores the importance of a well-regulated financial sector.

Finally, larger banks benefit from economies of scale typically not available to small banks. For instance, as Adam Levitin explained during his testimony before the Committee on Financial Services, there are some consumer financial products like credit cards that are hugely profitable for larger banks and harder for small banks to offer because of the steep overhead costs.[26] Larger firms can also spread general operation costs across a larger number of bank branches. These difficulties are not unique to the banking sector. Small businesses across sectors in the U.S. economy are struggling to keep up with larger firms.

Leveling the playing field for small community banks

Congress and regulators have recognized the unique role that small community banks play in our communities and the unique challenges associated with their business model. As a result, they have taken steps to level the playing field for small community banks competing against larger banks and non-bank financial institutions.

When Congress passed the Dodd Frank Wall Street Reform and Consumer Protection Act in 2010 to help ensure that Wall Street could never again crash the financial system, Congress and regulators carved out small community banks from many of the new Dodd Frank bank compliance requirements. Some of these carve-outs and flexibilities are listed below:

- Underwriting flexibility: Small banks have greater underwriting flexibility when making Qualified Mortgage, or QM, loans—those that are eligible for the highest level of protection from legal challenges—because if small banks hold the loans on portfolio, they are not bound to the fixed debt-to-income ratio limit that applies to larger lenders.[27]Small institutions serving rural or underserved areas also can get QM protection for loans that require a balloon payment, although the general QM definition bans balloon loans.[28]

[26] Adam J. Levitin, Written Testimony before the House Committee on Financial Services, "Preserving Consumer Choice and Financial Independence," March 18, 2015, available at http://financialservices.house.gov/uploadedfiles/hhrg-114-ba00-wstate-alevitin-20150318.pdf.
[27] Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide" (2013), Section 4.3, available at http://files.consumerfinance.gov/f/201308_cfpb_atrqm-implementation-guide_final.pdf.
[28] Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide," Section 4.6.2.11

- Mortgage servicing flexibility: Small creditors are exempt from most mortgage-servicing rules.[29]
- Capital: Global Systemically Important Bank (G-SIBs) capital surcharge applies only to the 8 U.S. G-SIBs and the countercyclical capital buffer will only apply to banks above $250B[30]
- Liquidity: Liquidity coverage ratio applies only to banks above $250B
- Leverage: supplementary leverage ratio applies only to banks over $250B[31]
- Living wills: only applies to banks above $50B
- Stress testing: only applies to banks above $10B
- Enhanced risk management standards: applies only to banks above $50B
- Long term debt: TLAC/LTD requirements are for G-SIBS only
- Examinations: Banks and credit unions with less than $10B in net assets are examined by one single regulator. Large banks are examined by their prudential regulator and the CFPB [32]
- CFPB enforcement: CFPB enforcement only applies for financial institutions above $10B[33]

There are also various opportunities for small banks to weigh in with regulators about the regulatory process. The CFPB, the FDIC and the Federal Reserve have all formed community bank advisory councils since the financial crisis.[34] Moreover, the CFPB has to permit small businesses, including community banks, to weigh in on rulemaking efforts before proposed rules are released for public comment.[35] The voices of community banks are well represented and regulators continue to be responsive to their concerns.

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[29] Consumer Financial Protection Bureau, "2013 Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Final Rules: Small Entity Compliance Guide"(2013), Section 3, available at http://files.consumerfinance.gov/f/201306_cfpb_compliance-guide_2013-mortgage-servicing-rules.pdf.

[30] *Also includes banks with more than $10bn in on balance sheet foreign exposure

[31] *Also includes banks with more than $10bn in on balance sheet foreign exposure

[32] 12 U.S.C. § 5515 (Section 1025 of the Dodd-Frank Act).

[33] 12 U.S.C. § 5516 (Section 1026 of the Dodd-Frank Act).

[34] Consumer Financial Protection Bureau, "Advisory groups," available at http://www.consumerfinance.gov/advisory-groups/ (last accessed March 2017); Government Accountability Office, "Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings," GAO-12-881, Report to Congressional Requesters, September 2012, available at http://www.gao.gov/assets/650/648210.pdf.

[35] Consumer Financial Protection Bureau, "Fact Sheet: Small Business Review Panel Process," available at http://files.consumerfinance.gov/f/201503_cfpb_factsheet-small-business-review-panel-process.pdf (last accessed March 2017).

The FDIC also implemented Dodd Frank requirements that have shifted costs away from small banks and toward larger financial institutions. First, the FDIC changed the way it calculates a bank's assessment base for deposit insurance in a way that largely favors small banks. The FDIC estimated that this change reduced FDIC premiums charges for community banks by about one third.[36] The FDIC also raised the amount of deposit insurance it provides to $250,000 from $100,000, which allows small banks to be more competitive for consumer deposits.[37]

Finally, Congress now requires regulators to oversee non-bank financial institutions, which helps to level the playing field for community banks.[38] In the lead up to the crisis, some non-bank financial institutions offered profitable, but predatory, products that stripped wealth from communities.[39] It was often difficult for a small banks offering safe products to consumers to compete with these unregulated institutions. Federal supervision of nonbank institutions helps prevent non-bank financial institutions from leading a race to the bottom.

Instead of deregulating Wall Street, Congress and regulators should build on their work to level the playing field for small banks and to ensure that all markets are well served by banks.

Deregulating the financial sector, as proposed by the Financial CHOICE Act, would only put community banks at a greater economic disadvantage. Providing the big banks with carve outs and exemptions currently only available to community banks would do nothing to help community banks. Moreover, reducing the rules that constrain excessive risk taking by large banks can allows them to boost their short-term profits, as they did in

[36] Doreen R. Eberley, Testimony before the House Subcommittee on Financial Institutions and Consumer Credit, "Examining Regulatory Burdens," April 23, 2015, available at https://www.fdic.gov/news/news/speeches/archives/2015/spapril2315.html.
[37] Ibid.
[38] Edward V. Murphy, "Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets," Congressional Research Service (January, 30, 2015), available at https://fas.org/sgp/crs/misc/R43087.pdf.
[39] James H. Caar, "Wealth Stripping: Why It Costs So Much to Be Poor," *Democracy Journal* 26 (Fall, 2012), available at http://democracyjournal.org/magazine/26/wealth-stripping-why-it-costs-so-much-to-be-poor/; Charles L. Nier, III and Maureen R. St. Cyr, "A Racial Financial Crisis: Rethinking The Theory Of Reverse Redlining To Combat Predatory Lending Under The Fair Housing Act," *Temple Law Review* 83 (Summer 2011), available at https://www.templelawreview.org/lawreview/assets/uploads/2012/02/83.4_Nier_St.Cyr_.pdf; Debbie Bocian, Delvin Davis, Sonia Garrison and Bill Sermon, "The State of Lending in America & its Impact on U.S. Households," Center for Responsible Lending, (December 2012), available at http://staging.community-wealth.org/sites/clone.community-wealth.org/files/downloads/report-bocian-et-al.pdf.

the run up to the financial crisis. Ending the restraints on predatory finance can crowd out sound lending and safer financial products.

Moreover, the FCA is a huge step backward in the effort to limit financial instability which during the crisis was generated by the large banks and the shadow banking system. This instability put community banks at a heightened risk of failure and led to the Great Recession.

The FCA allows Wall Street megabanks to opt out of vital financial stability protections including stress testing, liquidity rules, and risk management standards in exchange for a modest increase in capital. Moreover, it eliminates the Orderly Liquidation Authority (OLA) a new tool established by Dodd-Frank that enables regulators to wind down a complex financial firm in an orderly manner. Without OLA, in a crisis regulators will be stuck with the two same terrible options they had in 2008: Lehman-style bankruptcies or AIG-style bailouts. If implemented, the Financial CHOICE Act would put us squarely back in the vicious cycle of unchecked financial sector risk, financial crises, and bailouts. Too many workers lost their jobs, too many people lost their homes, and too many families lost their wealth to make the same mistakes again.

If Congress is serious about leveling the playing field for community banks, it will provide small banks with more support and ensure strong oversight of too big to fail banks. Pressuring the FDIC to lower standards for new banks or taking steps to deregulate the financial sector is unlikely to address the core challenges facing new banks.