Economic Outlook and Revenue Assessment
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1. What percentage of the Gross State Product does your industry contribute?

Source: Bureau of Economic Analysis (provided by the Idaho Department of Labor)

	2010	2011	2012
Industry: Finance and Insurance	4.90%	4.73%	5.10%
Sub-sector: Federal Reserve banks, credit intermediation and related services (sub-sector not yet available for 2012)	3.00%	2.80%	----

2. What is your forecast for growth in your industry for the current state fiscal year?

Projected growth for the current fiscal year is tepid. While the industry does continue to recover from the financial downturn, continued economic uncertainty is suppressing growth rates. Using asset growth as an indicator, the numbers indicate low single digit growth. At June 30, 2013, commercial banks and savings institutions headquartered in Idaho posted 3.12 percent asset growth over the same period prior year. This compares favorably to the national growth rate of 2.70 percent for the same period. For the same period, loan growth also appears to be improving as banks are slowly moving excess liquidity into loan volume.

3. What is your forecast for growth in your industry for the upcoming state fiscal year?

Growth forecast for industry growth beyond the current fiscal year is difficult to obtain. Much of the potential growth depends on continued stabilization of the industry and future Federal Reserve monetary policy. It is likely that low growth rates will continue for the next few years.

4. What is the current state of your industry? How do sales compare to one year ago?

Positive trends in key banking performance ratios indicate that the industry continues to recover from the financial downturn. At June 30, 2012, the average return on assets (ROA) for state chartered institutions was 0.46 percent with ten of fourteen institutions reporting profits. At June 30, 2013, the average return on average assets improved to 0.66 percent, with twelve of fourteen institutions reporting profits. All commercial banks and savings institutions headquartered in

Idaho reported an improvement in ROA from 0.51 percent to 0.68 percent for the same period. Similarly, asset quality measures for both groups are showing continued improvement. Much of the earnings improvement is the result of sharply reduced loan loss provisions, gains on sales of bank owned property, and reduced expenses related to asset quality. State chartered institutions report a decline in noncurrent loans to total loans from 3.79 percent at 6/30/12, to 2.35 percent at 6/30/13.

Capital ratios have seen a slight decline, primarily due to growth in the balance sheet and an increase in loan volume. State chartered institutions reported a slight decrease in Tier 1 Leverage Ratio from 12.07 percent at 6/30/2012 to 12.00 percent at 6/30/2013. Commercial banks and savings institutions headquartered in Idaho reported a decrease from 12.03 percent to 11.95 percent. The ratios for both groups compare favorably to the national average of 9.34 percent.

5. How many people are employed by your industry?

Source: Idaho Department of Labor

Finance & Insurance	2012	20,563 jobs
	2011	20,567 jobs
Idaho Headquarter Banks	9/30/2013	1,945 FTEs
	9/30/2012	1,959 FTEs

How does payroll compare to a year ago?

Source: Idaho Department of Labor

	2012	$502,047,961
Credit Intermediate & Related Activity	2011	$457,146,720

6. How much of the state's sales tax and income tax is due to your industry?

Sales tax *(source: Idaho State Tax Commission):*

Industry 600 (Banking)	2012	.07%
	2011	.06%

Income tax *(source: Idaho State Tax Commission)*:

According to the Idaho State Tax Commission, this information is not tracked.

7. **How does your industry impact other Idaho businesses?**

I am a firm believer that the banking industry in whole is a key to economic viability across our state. I have attached to my report the executive summary produced by the FDIC on the importance of community banking in the United States and many of the changes that we have seen over the past twenty years. A few of the highlights from the report support my belief in the importance of the banking system. The number of community banks has diminished dramatically since the mid 1980's as have the percent of assets held by those banks. Despite those changes in assets held, as of 2011, community banks made up 92% of FDIC insured and 95% of U.S. banking organizations. Community banks hold the majority of banking deposits in the U.S. rural and micropolitan counties, and there are more than 600 counties - or almost one out of every five - in the United States that have no other physical banking offices except those held by community banks.

The consolidation in the industry is a multi decade trend that reduced the number of federally insured banks from 17,901in 1980 to 7,357 in 2011. Over this time period, the number of banks with assets under $25 million declined by 96%. Banks under $100 million accounted for the total number of charter reductions. Meanwhile, those banks with assets over $10 billion grew eleven fold in size raising their share of industry assets from 27% in 1984 to 80% in 2011. Despite these dramatic changes, the study demonstrates "that community banks continue to play a unique and important role in our economy. Further, community banks have always been inextricably connected to entrepreneurship. As of 2011, they held 14% of the banking industry assets but 46% of the industry's small loans to farms and businesses."

To understand the impact of a community bank in a small market, we have the experience of the Blaine County business owners when the local bank was closed. The loan portfolios were moved to the FDIC or under the assuming bank's process but the disruption to the local market was significant and happened at a time of economic stress. Community banking is relationship based and those relationships come from a commitment to act as a catalyst across all sectors, including support of the not for profit sector in each market.

8. Do you know of any companies that are planning on moving operations into or out of Idaho in the next 18 months?

My company is a member of the Boise Metro Chamber and the affiliated Boise Valley Economic Partnership. We are fortunate to have excellent leadership at both of the entities and both work closely with other economic development groups in the Valley and with the Department of Commerce. Current BVEP activity reported continues to be encouraging with growing interest in the Treasure Valley from companies seeking to relocate or expand. Anything the State can do to support those efforts will pay dividends. The financial commitment to the Idaho Opportunity Fund, Idaho Tech Council, Governor's Education Task Force, and other important elements to attracting and growing business is meaningful.

I am not aware of any specific new companies moving operations into Idaho on a de novo basis. We will see a new regional banking competitor as Umpqua acquired the Sterling Bank Group. I also would say that the new Zion's tower at 8th and Main signals a large commitment to the Idaho market. My own company has announced the acquisition of Nampa based Home Federal Bank. I also think it is significant that Bank of America chose to sell many of their Oregon, Washington, and Idaho offices including rural offices which were acquired by Washington Federal. I understand that Washington Federal is bringing a commercial lending team to our market to fill the void left by Bank of America.

In discussion with several technology-related companies who are faced with the challenge of finding highly skilled engineers, programmers and other specialists that are mission critical state that they could be forced to move for those human resources. The other often heard issue is the availability of venture capital funding and a well established network in the Treasure Valley.

9. Do you see any consolidation in your industry in the future and if so, do you anticipate impacts on the local economy?

I referred to the consolidation seen in the banking industry over the past 20 years in previous comments. Over 17,000 banks in the 1980's reduced to near 7,000 today. The recent economic crisis led to the failure of over 800 banks across the country, and there are still banks finding it very difficult to make an adequate return on the investment of their owners or shareholders. Margins are very tight in the industry with some help in sight from a potential return to a more normal yield curve, improved loan quality, improved economy and potentially fewer competitors.

I believe future consolidation is inevitable across the banking industry. There will always be a place for the type of relationship and entrepreneur oriented service levels that a community bank can provide. As noted, many rural markets are served exclusively by a community bank and that is true in Idaho. Banks are very important to the local economies they serve. The very large banks tend not be as focused in smaller markets and that fact may result in acquisitions or mergers of the smaller banks by companies that may have a culture and scale that allows them to grow modestly and profitably in those markets.

Of the 7,000 banks remaining, over 2,000 are less than $100 million in assets. Estimates are available on the minimum asset size required to cover the heightened level of regulatory and compliance related oversight. I am going to take a conservative view and say that a traditional community bank can reach or exceed a 1% return on assets that is necessary to provide dividends, build reserves and serve the community. Banks with assets less than $250 million that are not in a unique niche business will be under pressure to merge or acquire other banks. Increased size can provide efficient operational levels including the new level of risk assessment.

Consolidation is coming and likely at an even more accelerated pace than we experienced in 2013. The trend to banking assets moving away from the community banks to the larger regional and national banking organizations will continue. In the rural markets, I have concerns that the loss of a community engaged bank is not a positive outcome. Idaho data indicates that 77% of the jobs in Idaho are attributable to employers with less than 250 employees. That percentage suggests that a banking industry that recognizes and supports small business and job creation is very important.

10. How will the Idaho economy perform in the remainder of FY 2013 (January 2013 to June 2013) and FY 2014 (July 2013 to June 2014), and what impact will this likely have on state tax revenue?

The packet presented to the Economic Outlook and Revenue Assessment Committee was excellent. The State will continue the modest growth trend through the end of the fiscal year. An improved unemployment base will likely add to the individual income tax collection, and the increased valuation of real estate across most of our major markets will have the same effect. The budget monitor says the year will end near $48.8 million above budget projections are Sine Die 2013. I tend to think from what we are seeing in the economy today that could be a low estimate.

11. How will the national economy perform in the remainder of FY 2013 (January 2013 to June 2013) and FY 2014 (July 2013 to June 2014), and how will this affect Idaho?

I had the privilege of representing Idaho for six years on the Federal Reserve Branch Board in Salt Lake City. I gained a high regard for the FRB's economic forecasting that is coupled with feedback from the local markets. From the San Francisco FedView Report of Research Advisor Daniel Wilson on December 12th, I will paraphrase his outlook. Recent data suggests the recovery is gaining traction. Indicators of consumer and business spending show signs of strength and suggest solid economic growth in 2014. In addition to the consumer strength, Wilson expects ongoing housing market recovery, increases in stock market wealth, declines in energy prices and a rebound in state and local government spending. It is also his expectation that federal fiscal policy restraints may ease.

The labor market news is particularly encouraging with employers adding just over 200,000 jobs in November bringing the last three months average gain to 193,000 new jobs. The unemployment rate fell to 7.0% nationally.

Inflation continued below the Federal Open Market Committee long run goal of 2%. Lower costs for energy and medical services contribute to this outcome as well as ongoing economic slack in the system. Full employment in the Federal Reserve view would be in a range around

5%. The best estimate is that inflation will drift up toward the 2% target over the next two years. The Federal Fiscal Policy data is attached for your review.

The same factors outlined by Mr. Wilson are expected by my company to affect Idaho over the next year. Your packet clearly outlines an improving job market, tied to a general recovery in Idaho. Gross State Product will grow and that growth will likely come from many of the sectors we have seen over the past few years and are well outlined in the EORAC information packet.

12. What areas of the economy will be strong over the next 18 months? Which areas will be weak?

Idaho is fortunate to have a diversified economy, and we will continue to benefit from that mix in 2014. Healthcare will continue to be an important element in our economy. One example of the growth in this sector is a community owned hospital system which is the largest private employer in the State. Idaho is fortunate to have a great healthcare network provided by hospitals, clinics, and independent physicians across Idaho. That industry will see dramatic change as the Affordable Care Act focus places emphasis on community wellness, pay for outcomes, and individual accountability.

With the return of the consumer, I would expect the retailers in Idaho to see continued improvement in their revenues. One specific group would be the automobile dealers. The average age of cars on the road across the country suggests a great deal of pent up demand. The new Meridian Market Place development is a good indication of what many national brands think of the opportunity in the Treasure Valley. This $300 million development includes office, retail, entertainment, a skating rink, and a park all in the new lifestyle center.

Our agriculture industry has experienced multi positive years, and 2014 will be no exception. The dairy industry that has been developed in the Magic Valley has given rise to Chobani and Glanbia Foods plants and, in the Treasure Valley, Sorrento Lactalis continues to expand. The livestock industry also continues to thrive as cattle numbers continue at a level to support good returns for growers. The diversity in crops including seed where Idaho is in the top ten in production in the United States assure future viability. Idaho will continue to benefit where we can add value to those products we raise in the State before we ship them to the end user.

The banks hold a significant amount of liquidity that they are anxious to turn into more productive earning assets than Fed Funds or Treasuries. As the economy improves, I believe the banks are ready and willing to fund good businesses and projects.

Technology holds great opportunity for our State. Companies like Micron form a solid base for Idaho creativity and invention. We have leadership in that industry - White Cloud Analytics, Keynetics, Cradle Point, Innovus Solar, and Clearwater Analytics to name a few are examples of companies that will lead the way in new job generation for Idaho.

Finally, the housing and construction sector will continue to grow in importance to the State's employment numbers. We have seen solid improvement in the valuations in this sector and good demand for new homes as excess and shadow inventories have been removed in Idaho. There is also solid demand for multi-family housing with many projects completed and under way in the urban markets.

I do not see any areas that would expect any significant slow down as we look to a positive economic environment in Idaho and the nation in 2014.

13. At what rate do you expect the population of Idaho to grow or decline over the next 18 months?

Population growth will return to above the national averages that Idaho experienced up until the economic downturn. Idaho is attracting retirees, new business, and those fleeing states with high tax burdens.

14. What are the impacts of the U.S. trade and budget deficits on the U.S. and Idaho economies?

The U.S. trade and budget deficits are a drag on the national and local economy. Idaho has earned a reputation for fiscal responsibility that is reflected in our very positive bond rating. Idaho paper is in demand because the market understands that we can repay any debt obligation on schedule.

The Federal budget deficit is a historically normal part of our government taking action to reduce the impact of an economic recession or slow down. As the economic issue passes and the economy grows back toward full employment and utilization, the deficits will be reduced or theoretically turn to surplus. The recent concerns revolve around the non-variable portion of the budget that is committed to Social Security, Medicare, transfer payments, national defense and other social programs. There remains a concern that we continue to "kick the can" down the road and not take necessary steps to assure the sustainability of the programs in place and balance the budget. Ultimately, as the U.S. dollar is the world's currency, we need to protect that status by exhibiting fiscal and monetary leadership.

Trade deficits represent an imbalance in what the U.S. buys from our trading partners and is able to sell to them. As the deficit widens, we are exporting jobs to our trading partners which also depresses the value of our currency. I have seen some data that would suggest that the U.S. manufacturing sector may rebound as worldwide costs of production are moving toward our costs and transportation and other costs make it possible for highly efficient American companies to bring production back on shore.

15. How is Idaho faring compared to other states?

My company does business primarily in Idaho and Oregon. Idaho's and Oregon's economic climate are both positive. I understand that Utah weathered the economic storm better than Idaho. Utah has also been very innovative with their public private support for technology and new business.

16. What role do the capital markets have in predicting the state's economic vitality?

Idaho does have access to capital markets as a State - we have a sterling credit rating. My company was re-capitalized by three large private investment companies. In no small measure those groups saw Idaho with a focus on the Treasure Valley as a good place to invest. We have seen activity with funding for tech companies, Albertson's, Boise Corp and others that are more industry specific. Idaho would benefit from a higher profile in the capital markets - a direct result could be expansion of current business and attraction of new companies.

17. What effect will federal austerity (fiscal cliff) measures have on Idaho's economy?

I mentioned that Dr. Wilson from the Federal Reserve saw easing in U.S. Government fiscal restraint as being additive to the economic growth forecast. Federal spending is a portion of the equation. That spending would be more positive if it were not funded by additional government borrowing. The fiscal cliff threats are a negative to the U.S. image and leadership in the world financial markets. One example of the political impacts of that sort of gamesmanship was the downgrade of our debt obligations. The markets appreciate and respond well when our country is predictable and dependable in its fiscal direction. Difficult choices must be made for our future and Idaho's economy as well as the nation's is damaged when we cannot provide clarity.

18. Is there any potential federal legislation that you are aware of that could impact the Idaho economy? If so, what is the likely impact?

I would suggest the Dodd Frank legislation if fully implemented as originally envisioned is a threat to the community banking sector. I am not aware of any other looming legislation that would impact Idaho more than other States.

Thank you for the opportunity to meet with this group, and I appreciate all that each of you do for the State of Idaho.

FDIC Community Banking Study

Federal Deposit Insurance Corporation
FDIC

December 2012

Executive Summary

The FDIC Community Banking Study is a data-driven effort to identify and explore issues and questions about community banks. The first chapter develops a research definition for the community bank that is used throughout the study. Subsequent chapters address, in turn, structural change, the geography of community banking, comparative financial performance, community bank balance sheet strategies, and capital formation at community banks. This study is intended to be foundational, providing a platform for future research and analysis by the FDIC and other interested parties.

Defining the Community Bank

To study community banks, it is necessary to define them. In the past, most analysts have used a maximum asset size, often $1 billion. However, using only a size cutoff does not account for industry growth, and the attributes associated with community banks are not exclusively tied to size. To overcome these problems, the study develops a new research definition of a community bank around criteria related to traditional lending and deposit gathering activities and limited geographic scope. Based on this definition, there were 7,658 FDIC-insured community banks operating within 6,914 separate banking organizations (or 94 percent of all banking organizations) as of year-end 2010. Importantly, the new definition captures 330 larger banking organizations that might have been excluded if asset size were the only criterion used.

Community Banks Retain a Unique Identity

Far-reaching changes in the U.S. financial sector in recent decades have made community banks a smaller part of our financial system. Of the U.S. credit market debt held by domestic financial intermediaries, the share held by U.S. chartered banks declined by almost half between 1984 and 2011, from 49 percent to 25 percent.[1] Over the same period, the share of U.S. banking assets held by community banks declined by more than half, from 38 percent to 14 percent.

Despite these changes, this study demonstrates that community banks continue to play a unique and important role in our economy. As of 2011, community banks made up 92 percent of FDIC-insured banks and 95 percent of U.S. banking organizations. The study shows that community banks hold the majority of banking deposits in U.S. rural and micropolitan counties, and that there are more than 600 counties—or almost one out of every five U.S. counties—that have no other physical banking offices except those operated by community banks.

The value of community banks has always been associated with the unique combination of services they provide to their customers, as well as the manner in which they do business. Community banks tend to be relationship lenders, characterized by local ownership, local control, and local decision making. By carrying out the traditional banking functions of lending and deposit gathering on a local scale, community banks foster economic growth and help to ensure that the financial resources of the local community are put to work on its behalf. Community banks have always been inextricably connected to entrepreneurship. As of 2011, they held 14 percent of banking industry assets, but 46 percent of the industry's small loans to farms and businesses.

The Implications of Banking Industry Consolidation

Consolidation in the U.S. banking industry is a multidecade trend that reduced the number of federally insured banks from 17,901 in 1984 to 7,357 in 2011. Over this period, the number of banks with assets less than $25 million declined by 96 percent. The decline in the number of banks with assets less than $100 million was large enough to account for all of the net decline in total banking charters over this period. Meanwhile, the largest banks—those with assets greater than $10 billion—grew elevenfold in size over this period, raising their share of industry assets from 27 percent in 1984 to 80 percent in 2011.

These trends took place in the context of powerful historical forces that were highly conducive to consolidation, particularly in the first half of the study period. One of these forces has been bank failures. Altogether, some 2,555 banks and thrifts failed during the study period, mostly as a result of the banking crisis of the late 1980s and early 1990s and the financial crisis that began in 2007. From this experience, it is clear that the future pace of industry consolidation depends in large part on whether the coming years are marked by a period of financial stability

[1] Source: Federal Reserve, *Flow of Funds*, Table L.1.

or another wave of bank failures. The stronger the risk management practices of community banks, and the more effective the supervisory policies put in place by regulators, the less consolidation will take place as a result of failures.

Most of the consolidation that took place during the study period came about through mergers of banks belonging to different organizations and consolidation of banks within organizations. In all, some 7,583 banks exited the industry through merger during the study period, while another 4,929 exited through consolidation. In order to evaluate the implications of these trends, it is useful to consider why they occurred. One of the most important factors driving voluntary consolidation during this period was the relaxation of restrictions on intrastate branching and interstate banking that took place in the 1980s and early 1990s. Based largely in state law, these long-standing restrictions had the effect of artificially inflating the number of banking charters, and their removal was bound to result in consolidation. In the former unit banking states, for example, banking organizations that were prohibited from operating branches could instead operate separate charters within their organization. The same was true for banking organizations that crossed state lines, where interstate banking and branching were frequently restricted prior to the mid-1980s.

With the relaxation of restrictions on branching and interstate banking in the late 1980s and early 1990s, the pace of mergers and consolidations gathered steam. Between 1995 and 1998, the period immediately following the passage of the Riegle-Neal Act, an average of 5.7 percent of banks merged or consolidated each year. However, a slowing pace of mergers and consolidations suggests that the effects of these regulatory changes are beginning to wane. In the pre-crisis period between 2004 and 2007, this yearly average of mergers and consolidations fell to 3.7 percent.

It is possible that such forces as financial innovation, technology and regulatory developments could lead to additional consolidation. However, it is not clear that these forces would operate on the same scale as the past waves of consolidation that have resulted from the relaxation of branching and geographic restrictions or from failures.

The Implications of Geography

Although most banking offices operated by both community and noncommunity banks are located in metro counties, this study describes how community banks have a particular relevance in nonmetro counties—the small towns and rural areas that make up most of the country by area. Community banks are almost three times more likely than noncommunity banks to operate a banking office outside a metro area, and they hold the majority of banking deposits in both micropolitan and rural counties.

While the prevalence of community banks in nonmetro areas remains part of their unique identity, it may come at the cost of size and growth. Nonmetro areas accounted for just 16 percent of U.S. population in 2011, and just over 12 percent of U.S. economic output. Moreover, they experienced consistently slower rates of growth in population and economic output during the study period. Fifty percent of rural counties lost population between 1980 and 2010, continuing a long-term trend that has accelerated since the 2000 census.

These disparities in population and growth have not necessarily hurt the financial performance of community banks that operate in nonmetro areas. Both community and noncommunity banks headquartered in nonmetro areas outperformed their counterparts headquartered in metro areas on the basis of pretax return on assets (ROA) for the study period as a whole and for each five-year interval for which the comparison was made. Even the 1,091 community banks headquartered in depopulating rural counties in 2011 outperformed their counterparts headquartered in metro areas over the past decade. Instead, the disparities between metro and nonmetro counties are reflected in the growth rates of the institutions headquartered there. Banks headquartered in metro areas in 2011 that also operated in 1984 grew more than twice as fast over that interval as similar banks headquartered in nonmetro areas.

One of the reasons that noncommunity banks were able to accumulate an 86 percent share of industry assets during the study period was their ability to shift their activities to (and accumulate market share in) fast-growing metro areas. In the 21 fastest-growing U.S. metro areas with population of more than one million in 2011, 237 noncommunity banks were able to accumulate a 90 percent deposit share in part by directly or indirectly acquiring nearly 8,700 banks during the study period. Moreover, as described in Chapters 2 and 5, asset growth at noncommunity banks was led by mortgage and consumer lending during a period when these loan types were expanding rapidly. Between 1984 and 2011, total U.S. mortgage debt grew 7.7 times while total consumer debt grew fivefold.[2]

[2] Source: Federal Reserve, *Flow of Funds,* Tables L.218 and L.222.

Most of this growth, however, predated the financial crisis that began in 2007. The crisis marked a sudden interruption of a long-term cycle of rising home prices, rising mortgage and consumer debt, and expanding residential construction activity that not only fueled balance sheet expansion at noncommunity banks, but also provided much of the impetus for economic growth in metro areas and for the U.S. as a whole. Whether metro-area growth continues to fuel the expansion of mortgage and consumer loan portfolios at noncommunity banks in the years ahead depends in no small part on the extent to which the pre-crisis pattern of growth reasserts itself in coming years.

Some signs suggest that the future pattern of U.S. economic growth may not be a replay of the past 25 years. The composition of U.S. economic output has undergone something of a shift away from some of the sectors that boomed before the financial crisis. Between 2006 and 2011, the share of U.S. economic output derived from construction, retail trade, and finance, insurance and real estate declined by 2.3 percentage points, while the share derived from mining, utilities and agriculture, forestry, and fishing expanded by 0.7 percentage points.[3] To the extent that this shift in the pattern of growth persists, it could help to mitigate the disparity in growth rates between metro and nonmetro areas that has limited the growth potential of community banks.

The Implications of Performance Gaps Between Community and Noncommunity Banks

The study identifies some long-term gaps in profitability and efficiency between community and noncommunity banks. Between 1993 and 2006, noncommunity banks reported a pretax ROA that averaged 35 basis points higher than for community banks. This was a period characterized by high consumer spending and borrowing, as well as significant banking industry consolidation through which noncommunity banks increased their market share through acquisitions.

While it is true that community banks have earned a lower average pretax ROA than noncommunity banks over the past 15 years, most community banks in most periods have been profitable. Moreover, there are readily identifiable segments of the community banking sector that have posted earnings that are relatively high and stable. One such group is community banks that operated continuously from 1984 through 2011. Their weighted average pretax ROA over the study period was one basis point higher than that of continuously operating noncommunity banks.

One element of the performance gap has been a narrowing of the traditional advantage that community banks have had in generating net interest income in recent years as the net interest margin (the spread between asset yields and funding costs) has narrowed. Because of their focus on traditional lending and deposit gathering, community banks derive 80 percent of their revenue from net interest income compared with about two-thirds at noncommunity banks. Accordingly, the narrowing of net interest margins places a significant drag on the earnings of community banks.

The historically low level of interest rates in recent years has been an important factor pushing down net interest margins at community banks. The heavy reliance of community banks on deposit funding—typically an advantage during periods of higher interest rates—has been more problematic in recent years as community banks have found it difficult to pass along ultra-low interest rates to their deposit customers.

Another factor contributing to the earnings gap between community and noncommunity banks has been the ability of noncommunity banks to generate noninterest income from a wider variety of sources. These include trading, venture capital and investment banking activities that are not typically part of the community banking model. Noninterest income averaged 2.05 percent of assets at noncommunity banks over the study period compared with only 0.8 percent at community banks.

While the disparity in performance between community banks and noncommunity banks has been driven by revenue, the study also explores community bank credit losses and overhead expenses. Community banks have almost always incurred lower credit losses than noncommunity banks. This difference has been most notable in economic downturns, and is likely a result of the relationship lending approach favored by most community banks. Community banks also have traditionally incurred lower noninterest expenses than noncommunity banks, and their ratio of noninterest expenses to assets remained fairly steady over the study period. Noncommunity banks were able to lower their noninterest expenses as a percent of assets in the pre-crisis years by reducing average expenses associated with employees and premises.

[3] FDIC calculations based on data from the Bureau of Economic Analysis. Each percentage point equals approximately $150 billion in 2011 U.S. economic output.

One question the study tried to address was how regulatory costs have changed for community banks over time. Unfortunately, the data available through Call Reports and other regulatory filings do not provide a breakdown of regulatory versus other types of noninterest expenses. As part of this study, the FDIC conducted interviews with nine community bankers to better understand what drives the cost of regulatory compliance at their bank (see Appendix B). Most interview participants stated that while no one regulation or practice had a significant effect on their institution, the cumulative effects of regulatory requirements led them to increase staff over the past ten years. Moreover, the interviews indicated that it would be costly in itself to collect more detailed information about regulatory costs. As a result, measuring the effect of regulation remains an important question that presents substantial challenges.

The performance gap between community and noncommunity banks can also be expressed in terms of the efficiency ratio (the ratio of noninterest expense to net operating revenue). An "efficiency gap" in favor of noncommunity banks grew from 1.3 percent in 1998 to 9.7 percent in 2011. By 2011, noncommunity banks on average generated a dollar in net operating revenue for every 60 cents in noninterest expenses incurred, while community banks generated a dollar of revenue for every 70 cents in noninterest expenses. While the efficiency ratio of noncommunity banks declined (improved) through much of the study period because of lower noninterest expenses, those gains largely dissipated after the onset of the crisis that began in 2007. Instead, the efficiency gap that emerged between 1998 and 2011 was almost entirely attributable to a cumulative 8 percentage point increase (deterioration) in the efficiency ratio of community banks.

Why did community banks become so much less efficient in generating revenue after 1998? A relatively small portion (20 percent) of the net deterioration in efficiency at community banks was attributable to higher noninterest expenses, all of which came about after 2008. A much larger portion (72 percent) of the net deterioration in efficiency at community banks is attributable to a decline in net interest income (discussed above), most of which occurred in the last five years of the study period.

Whether the performance gaps of recent years might persist into the future appears to depend on three factors. One is the extent to which new community bank charters enter the industry in coming years. *De novo* institutions typically require some time to become profitable, and can also be vulnerable to problems during economic downturns. If the number of new community bank charters in the next decade were to approach the 997 de novo community banks established in the 2000s, the likely result would be to push down the aggregate financial performance of community banks over that period.

The second factor that will determine the existence and size of any performance gaps going forward is the timing, speed and magnitude of the eventual increase in interest rates to levels more in line with historical norms. The longer this normalization in rates is delayed, the longer community banks will experience a squeeze on their net interest margin and the longer the current efficiency gap is likely to persist. At the same time, a large and abrupt increase in interest rates also carries risks to institutions that have increased their holdings of long-term assets in the current low-interest-rate environment.

The third factor that appears likely to shape the competitive playing field in coming years is the ability of large noncommunity banks to generate noninterest income and cut noninterest expenses. In the years immediately preceding the crisis, the largest noncommunity banks were able to generate significant amounts of noninterest income through a variety of sources, including securitization and other capital markets activities, mortgage origination and servicing, and service charges on deposit accounts. There is reason to question whether some elements of this revenue model will regain their former importance in the wake of the financial crisis. For example, the volume of private mortgage securitization remains more than 95 percent below its pre-crisis peak, and the market share of the top five mortgage originators fell by 6 percentage points in the first half of 2012 compared with the prior year.[4]

Similarly, the large reductions in the noninterest expense ratio of noncommunity banks that took place in the pre-crisis years may not be sustainable in the post-crisis period. In the aftermath of the crisis, large noncommunity banks have incurred billions of dollars in expenses associated with problems such as process deficiencies in mortgage underwriting and servicing, insufficient controls on trading activity, and misleading disclosures to investors in capital markets instruments. Through 2011, the ratio of noninterest expenses to average assets at noncommunity banks had already risen by more than 11 percent from its 2008 low for the study period. Deficiencies that have been identified in mortgage servicing, trading, and other income-generating activities may necessitate even higher

[4] Source: *Inside Mortgage Finance*.

expenditures on the part of noncommunity banks in the years ahead. These developments raise the possibility that much of the large decline in noninterest expenses at noncommunity banks that occurred before the crisis will be reversed as these deficiencies are fully addressed.

Finally, the large-scale consolidation that took place during the study period naturally leads to the question of whether it is related to economies of scale among community banks that might put smaller institutions at a competitive disadvantage. As part of this study, the FDIC conducted research designed to detect the presence of economies of scale among community banks that could prompt them to try to lower their average costs through growth.[5] These results show that most of the benefit from economies of scale is realized once community banks reach $100 million to $300 million in total assets, depending on the lending specialty. These results comport well with the experience of consolidation during the study period, during which the number of banks with assets less than $25 million declined by 96 percent, but the number of banks with assets between $100 million and $10 billion increased by 19 percent. This is where 65 percent of community banks operated in 2011. In short, there does not appear to be much evidence to suggest that economies of scale are an important source of competitive disadvantage for most community banks or that they will compel significant additional consolidation in the years ahead.

The Implications of Community Bank Lending Strategies

While many community banks hold relatively diversified asset portfolios, the study categorizes community banks into seven lending specialty groups to further explore the relationship between business model and long-term performance. As of 2011, about 57 percent of community banks were categorized as mortgage specialists, consumer specialists, commercial real estate (CRE) specialists, commercial and industrial (C&I) specialists, and agricultural specialists, while the rest were categorized into a group with multiple lending specialties or a group with no lending specialty. The no specialty group was the largest group in nearly every period, and is made up of banks that are diversified lenders or that tend to have more securities and fewer loans.

[5] Paul Kupiec and Stefan Jacewitz, Community Bank Efficiency and Economies of Scale, FDIC, December 2012, http://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf. This study of efficiency and economies of scale was limited to the universe of community banks, and does not provide comparisons of cost with noncommunity banks, which are frequently much larger in size.

Community banks in the mortgage, agricultural and no specialty groups were generally the strongest and steadiest performers over the study period, reporting lower provision expenses to assets and a lower incidence of failure than each of the other four lending specialty groups. In addition, agricultural specialists and the no specialty group reported higher average pretax ROA than any of the other five groups across the study period. At the other end of the spectrum, CRE lending specialists turned out to be the lowest-performing lending specialty group by a variety of measures. They trailed the average ROA of all community banks by one-third, and failed more than twice as often as the average community bank.

While noncommunity banks shifted their loan portfolios away from commercial lending and toward retail lending during the study period, community banks shifted their portfolios toward loans secured by commercial real estate. Among the seven lending specialty groups identified in this study, CRE specialists became the largest specialty group between 2005 and 2009, peaking at just under 30 percent of all community banks. Still, the CRE category includes a variety of loan types that performed differently in the real estate downturn of the late 2000s. More than one-third of all CRE loans held by community banks in 2011 were secured by owner-occupied nonfarm nonresidential properties, meaning that they were essentially collateralized commercial loans. This type of lending increased among community banks in every specialty group over the study period. During the recent crisis, the performance of loans secured by nonfarm nonresidential properties was roughly comparable to that of C&I loans, with both loan types performing much better than the construction and development (C&D) loans that made up 16 percent of community bank CRE portfolios in 2011.

Despite the relatively strong long-term operating results obtained by community banks in the baseline mortgage, agricultural and no specialty groups, hundreds of community banks shifted out of these groups and into other lending specialties between 2000 and 2005, mostly by accumulating larger balances of C&D and other CRE loans. The community banks most likely to undertake such a shift in lending strategy after 2000 were those organized as C corporations, those chartered since 1980, those headquartered in a metro county or in a state where home prices were rising rapidly, and those with trust preferred securities (TruPS) outstanding at the holding company level.

While these alternative strategies initially provided a small performance advantage for community banks that shifted into them after 2000, they proved to be highly problematic during the crisis period that followed. Community banks that shifted to a C&D strategy failed almost five times more frequently than the average community bank between 2006 and 2011, while more than half of those that survived after 2008 were rated 3, 4 or 5 by bank supervisors. While the results were somewhat better for community banks that shifted to a more diversified CRE strategy, they, too, failed at almost twice the rate of all community banks after 2006, and after 2008 they were rated 3, 4 or 5 more than twice as often as banks that remained in one of the baseline specialty groups.

One of the factors that appears to have contributed to the shift from the baseline groups to the C&D and CRE strategies is the search for growth. Of community banks that belonged to one of the three baseline specialty groups in 2000, those that switched to a C&D strategy grew more than 90 percent faster on average between 2000 and 2005 than those that did not, while those that switched to a CRE strategy grew more than 80 percent faster. Community banks with a growth imperative in the first half of the 2000s were able to grow faster by raising their concentrations in C&D and CRE loans than by maintaining a specialty in mortgage or agricultural loans or by holding a diversified portfolio.

Targeted research further explores the role of bank management decisions in determining the pretax ROA of community banks by estimating a model that accounts for factors such as underwriting standards, loan growth, capital base, funding mix, lending specializations, and staffing in addition to local economic conditions. The results underscore the importance of a management approach that sticks to the basics, avoiding such practices as out-of-area lending and reliance on noncore funding, and emphasizing portfolio diversification and strong practices in loan underwriting and administration. These results also suggest a trade-off between growth and financial performance that appears to define the opportunity set facing many community banks.

The high credit losses and elevated failure rates experienced by CRE and C&D lenders during the two banking crises covered by the study period point to an important policy issue for future research. This study documents the considerable costs associated with credit losses and bank failures among the CRE specialist group. Clearly, concentrations in these loan types—particularly in the C&D category—can represent a significant risk during real estate market downturns. What this study does not document are the social benefits that arise from commercial real estate financing by community banks. In many respects, CRE lending exemplifies the type of local knowledge and local decision-making at which community banks excel. Not only is construction activity essential to economic activity and the quality of life in local communities, but community banks are very important providers of credit to the construction industry. Future research should further explore the appropriate policy balance between the social benefits and social costs of CRE lending by community banks.

The Implications of Community Bank Capital Strategies

The ability of any bank to consistently meet the credit needs of its borrowers over time depends on maintaining a solid base of equity capital. By standard measures, community banks reported higher capital ratios than noncommunity banks across the study period, and they mostly maintained this level of capitalization through internally generated sources of capital. Community banks reporting positive earnings set aside 57 percent of their net income as retained earnings during the study period. Retained earnings accounted for 48 percent of all additions to equity capital from internal and external sources—percentages that were in both cases substantially higher than for noncommunity banks. Retained earnings for community banks were at their highest as a percent of prior-period equity between the early 1990s and the mid-2000s—precisely the periods when their pretax ROA was also at its highest levels. In periods where earnings have faltered, retained earnings have declined sharply or become negative, requiring more community banks to raise capital from external sources.

Relatively few community banks were found to raise capital frequently from external sources during the study period. Of community banks operating in 2011, 42 percent had never raised external capital after their first year of operation, 40 percent had done so occasionally, and 19 percent had done so frequently, or more than once in five years on average.[6] The overall frequency of external capital raising by community banks rose after 2000, as TruPS became, for a time, more common on the balance sheets of bank holding companies. With the financial crisis that began in 2007, both community and noncommunity banks

[6] Based on the lifetime frequency of community banks not in their first year of operation raising capital from external sources between 1984 and 2011. The reported figures add up to 101 percent due to rounding.

initially experienced large financial losses that temporarily reduced their capital ratios and diminished their ability to generate new capital through retained earnings. As a result, both groups of institutions expanded the frequency and volume of their capital raising from external sources. However, in every year of the study period, noncommunity banks raised external capital more frequently than community banks, and also made use of TruPS and the Troubled Asset Relief Program more frequently than community banks. By 2011, however, as earnings and capital ratios recovered from the crisis, both community and noncommunity banks began to return to a more normal mix of additions to capital through internal and external sources.

While community banks were found to rely less on external capital and more on retained earnings than noncommunity banks, the study showed that many community banks were able to access external sources of capital when needed. In many cases, they did so in response to financial difficulties or a desire to grow. One-third of the capital raises carried out by community banks during the study period were undertaken by "troubled" institutions, or those that had been rated 3, 4 or 5 within the past two years. During non-crisis periods, up to half of all capital raises undertaken by community banks were found to immediately precede an acquisition or a period of significant growth.

Taken together, these trends suggest a community banking sector that can generate most of the capital it needs through retained earnings. However, two important caveats to this conclusion are in order. First, the ability to generate capital internally depends on a healthy level of earnings. In periods where earnings have faltered, retained earnings have declined sharply or become negative, requiring more community banks to raise capital from external sources. Second, retained earnings can only be a sufficient source of capital if the asset base of the institution is not growing more rapidly than its earnings. Chapter 5 demonstrates how hundreds of community banks in relatively stable, high-performing lending specialties in 2000 pursued growth-oriented strategies centered on C&D and CRE lending that ultimately underperformed for many of them. Community banks with TruPS at the holding company level were almost twice as likely to undertake such a shift in strategy as those that did not use TruPS. The experience of community banks during the study period appears to indicate that maintaining a stable balance between growth and earnings has been the surest path to long-term viability.

Topics for Future Research

The detailed analysis of banking industry data in this study provides a basis for further research of community banking issues. The study points to the considerable costs associated with credit losses and bank failures among CRE specialists. Clearly, concentrations in CRE, and especially C&D lending, can represent significant risk during real estate market downturns. However, construction activity is essential to the economic activity in local communities. Further research should explore the appropriate policy balance between the social benefits and the social costs of CRE lending by community banks. The study tried to examine how regulatory costs for community banks have changed. Measuring the effect of regulation remains an important question that presents substantial challenges. The competitive effects of chartering policies, and the benefits and risks of chartering activity during boom periods, also warrant further study. Finally, as new technology continues to transform the financial sector, more research will be needed on the future implications for the community banking sector.

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Past issues

Daniel Wilson, research advisor at the Federal Reserve Bank of San Francisco, provides his views on current economic developments and the outlook.

- Recent data suggest the recovery is gaining traction. Top-line GDP growth is likely to dip a bit in the fourth quarter, largely reflecting reduced accumulation of inventories by firms after a sizable increase in the third quarter. Importantly, indicators of consumer and business spending show signs of strength, and suggest solid economic growth in 2014.

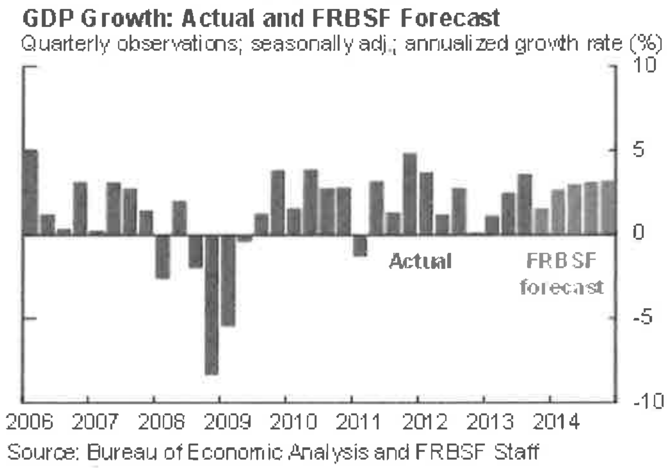
- In addition to these indicators, our expectations for stronger growth in 2014 are based on ongoing housing market recovery, increases in stock market wealth, declines in energy prices, and a rebound in state and local government spending. We also expect some restraints, particularly federal fiscal policy, to ease.

- Recent news on the labor market has been particularly encouraging, with employers adding just over 200,000 jobs in November, bringing the average monthly gain over the past three months to 193,000. In addition, the unemployment rate in November fell three-tenths of a percentage point to 7.0%. Though some of that decline reflected federal workers returning to work following the October government shutdown, it also reflected the labor market's general ongoing recovery. Nevertheless, there remains a substantial amount of slack, as shown by the unemployment gap, which is the difference between the unemployment rate and our estimate of the natural or equilibrium rate of unemployment. We expect slack to improve gradually over the next couple of years.
- Inflation over the past year has fallen further below the Federal Open Market Committee's longer-run goal of 2%. This is due in part to lower inflation for energy and medical services, which we expect to be temporary, as well as ongoing economic slack. As the temporary factors dissipate and slack narrows, we expect inflation to gradually rise toward the 2% objective over the next two years.
- As mentioned earlier, one factor behind the persistent economic slack and relatively modest growth during the current recovery is federal fiscal policy. Here we take a more in-depth look, assessing how contractionary recent policy has been compared with its typical pattern in recoveries and what we might expect over the next couple of years.

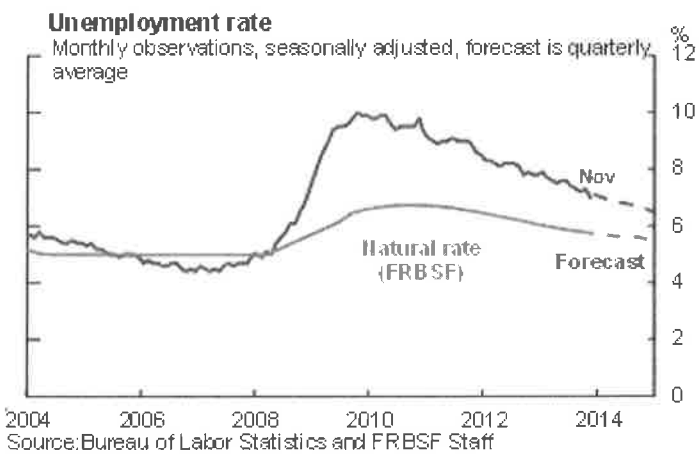
- We start with a broad overview of the typical historical pattern of federal government spending and revenue over the course of the business cycle. Generally speaking, federal spending is countercyclical, meaning it tends to rise in bad times and fall in good times. This pattern reflects two phenomena. First, spending on safety net programs automatically rises when economic conditions weaken, as more people become eligible for benefits. Second, Congress and the President frequently enact short-term stimulus spending measures during downturns to help boost the economy.
- Tax revenue, on the other hand, tends to be procyclical, falling in bad times and rising in good times. As with spending, there is both a passive, automatic element to this pattern and an active policy element. During downturns, as individual and corporate incomes fall, the tax base declines, as does tax revenue. As the economy picks back up and incomes rise again, tax revenue rises. On top of that, legislation, including temporary tax relief and tax incentives, often are enacted during recessions. Both of these factors contribute to the typical procyclical nature of federal revenue.

- In an economic downturn, increased federal spending and falling revenue combine, resulting in a larger budget deficit. Deficits are therefore countercyclical. By considering the historical relationship between economic conditions and the budget deficit, we can measure how much the deficit would normally rise during a downturn. Here, we measure economic conditions using the output gap as estimated by the Congressional Budget Office (CBO). The output gap is the percentage difference between actual and potential (or full-employment) GDP. However, our results would be similar if we used the unemployment gap. We relate the output gap to the primary deficit, which excludes net interest payments on debt. We find that between 1960 and the middle of 2013, a 1 percentage point drop in the output gap is associated with a 0.5 percentage point increase in the deficit-to-GDP ratio on average. For example, in the 1981–82 recession, the output gap fell by roughly 6 percentage points, while the deficit as a share of GDP rose by roughly 3 percentage points.
- Turning to the most recent recession and the recovery to date, we see that the deficit rose much more rapidly during the recession—from the fourth quarter of 2007 through the second quarter of 2009—than we would expect if fiscal policy were following the historical pattern. This atypical response was primarily due to the 2009 economic stimulus package, which included both substantial temporary increases in spending and tax reductions. After 2010, however, the stimulus spending began to fade and the deficit began to fall. As the recovery proceeded, new cuts in spending were implemented, temporary tax reductions expired, and the decline in the deficit accelerated. Overall, during the past three years the deficit contracted more rapidly than we would expect if policy had followed the typical historical pattern given the weak pace of the recovery.
- Over the next couple of years, based on CBO projections of the deficit and the output gap, the deficit's pace of decline is expected to slow, and it should line up more with the historical pattern as economic conditions improve.

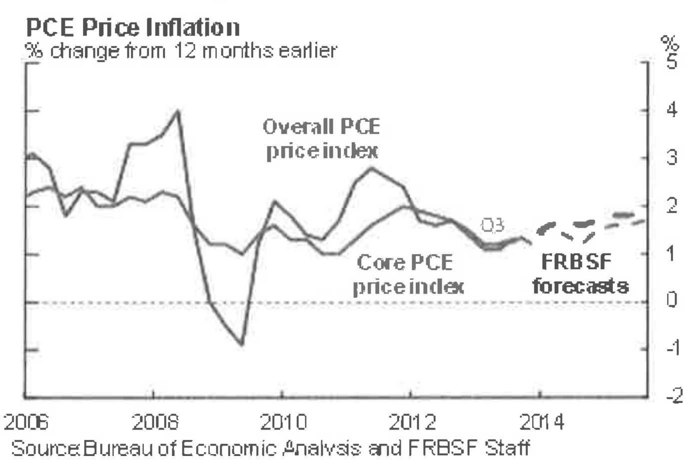
Recovery gaining traction



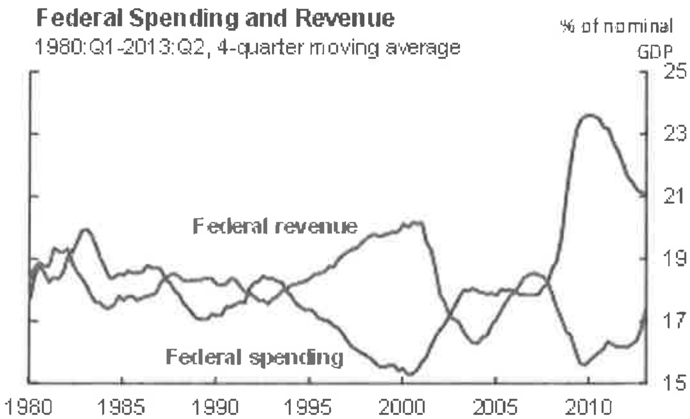
Gradual decline in unemployment rate



Inflation expected to remain below 2%

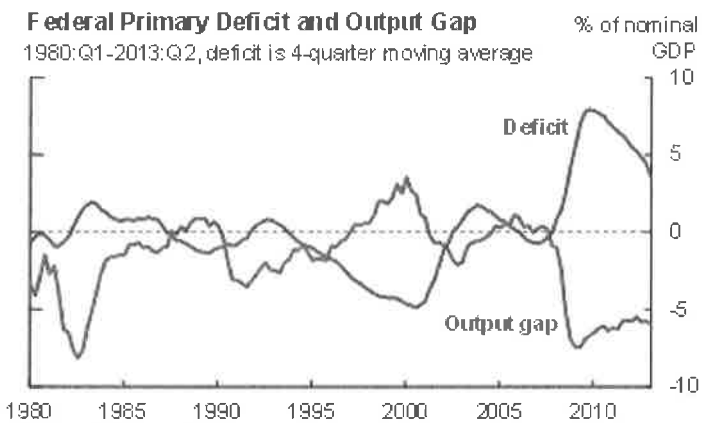


Government spending and revenue



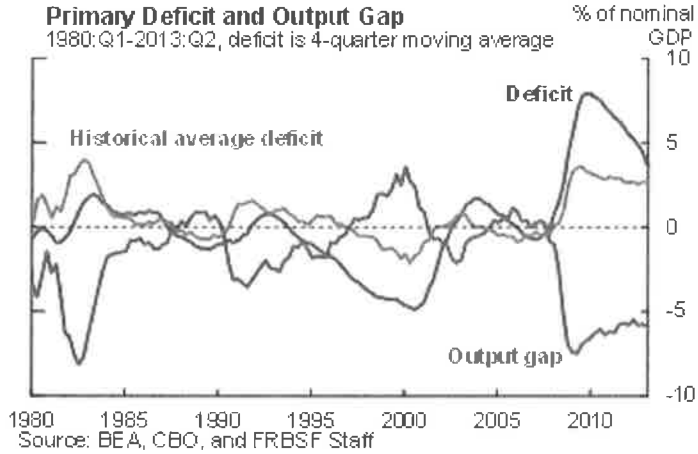
Source: BEA. Note: Spending excludes interest on the debt

Deficit rises in bad times, falls in good

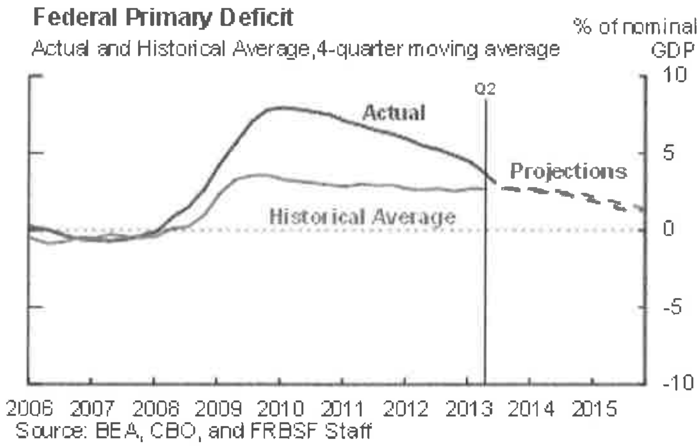


Source: BEA and CBO

Deficit's average historical pattern



From expansion to contraction to neutral



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