Testimony submitted to the House Committee on Oversight and Government Reform, hearing on "Oversight of the FDIC Application Process," Wednesday, July 13, 10am (embargoed until the hearing begins).

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A. Overview

1) The Federal Deposit Insurance Corporation's Application Process is an important part of how new banks obtain (or do not obtain) charters.[2] Some commentators have expressed concern that the current Process for obtaining federal deposit insurance inappropriately limits the amount of entry into the community banking sector.[3]
2) In April 2016, the FDIC rescinded Financial Institution Letter (FIL) 50-2009, *Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions.* This rule change reduced the "de novo period" for examinations, capital maintenance, and other requirements from seven years to three years.[4] Informal guidance is also reported to have changed, consistent with the goal of encouraging de novo banks to be created.[5]
3) This policy change was welcomed by the Independent Community Bankers of America (ICBA) and the American Bankers' Association (ABA).[6]
4) Community banks play an important role in the U.S. economy and encouraging de novo bank applications is a sensible policy goal. However, under current circumstances and based on

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[1] Also a member of the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Financial Research Advisory Committee, and the independent Systemic Risk Council (created by Sheila Bair and now chaired by Paul Tucker). All the views expressed here are mine alone. Underlined text indicates links to sources and supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com. For important disclosures, see http://baselinescenario.com/about/.

[2] The Process is summarized on the FDIC's website, https://www.fdic.gov/regulations/laws/rules/5000-3000.html. Section 6 of the Federal Deposit Insurance Act specifies the seven criteria that the FDIC must take into account in its evaluation. The FDIC does not charter banks – this is done by The Office of the Comptroller of the Currency (OCC) and state authorities.

[3] The FDIC has a broadly sensible and robust definition of community banking and I use that throughout this testimony. See Chapter 1 in the recent (2012) FDIC Community Banking Study, https://www.fdic.gov/regulations/resources/cbi/report/CBSI-1.pdf. Most of these banks are, as the name suggests, deeply rooted in local communities.

[4] In 2009, the de novo period was increased to seven years; it has now been returned to three years. This should be seen in the overall context of stronger FDIC forward-looking supervision. See the press release, https://www.fdic.gov/news/news/press/2016/pr16027.html; also the Supplemental Guidance, https://www.fdic.gov/news/news/financial/2016/fil16024.html and https://www.fdic.gov/news/news/financial/2016/fil16024a.pdf.

[5] This is the publicly expressed view of two law firms active in this area: Bracewell (http://www.bracewelllaw.com/news-publications/updates/fdic-action-encourages-de-novo-bank-charter-applications), and Kennedy Sutherland (http://kslawllp.com/category/financial-institutions/community-banks/de-novo/).

[6] See the ICBA press release, http://www.prweb.com/releases/2016/04/prweb13322093.htm, and the ABA announcement, http://bankingjournal.aba.com/2016/04/fdic-announces-effort-to-encourage-de-novo-applications/.

available data, the case for further changing the FDIC rules regarding the Application Process for de novo banks is not compelling.

5) The broad facts regarding community banks are not in dispute. The total number of commercial banks with FDIC-insured deposits fluctuated around 13,000-14,000 in the decades leading up to 1980. Since that time there has been a steady decline to just over 5,000 (from the latest available data, as of March 2016).[7]
6) Seen over a period of decades, the major policy change that led to the decline in the number of community banks was the phasing out of restrictions on inter-state banking.[8] A large part of the process of consolidation was driven by mergers and acquisitions, i.e., smaller banks had a positive market value on a forward looking basis and were bought by other banks.
7) In addition, the economies of scale in banking likely changed over a long period of time, in part due to the rising importance of information technology in this sector – and this made it harder for the smallest banks to survive as stand-alone entities. Recent evidence on average costs as a function of asset size suggest that these decline from around 9 percent to around 6 percent as assets rise to $100m.[9]
8) When executives at community banks make bad decisions (or are unlucky), the bank goes out of business – typically through an FDIC-managed resolution event. There are no "too big to fail"-type subsidies available from the government; deposit insurance ultimately protects depositors but not shareholders or executives. The failure of community banks is very much related to the overall business and credit cycle, particularly as it affects specific communities.
9) Looking back at the number of failures over the past three decades, the aberration or abnormal period seems to have been the long boom between 1994 and 2007, when very few banks failed. In 1986-1993, the annual rate of failure (as a percent of charters reporting at previous year-end) was 1.6 percent; in 2008-2013, the annual rate of failure was 1.0 percent; in 1994-2007, the annual rate of failure was only 0.05 percent.[10]
10) It seems reasonable to compare the latest credit cycle (with a peak in 2007, driven by residential real estate) with the previous cycle (peak in the late 1980s, driven by commercial

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[7] See Table 1 in the FDIC's latest Quarterly report, https://www.fdic.gov/bank/analytical/quarterly/2016_vol10_2/fdic_v10n2_1q16_quarterly.pdf. This gives the total number of "FDIC-insured institutions" as 6,122; excluding insured U.S. branches of foreign banks. Of the 6,122 institutions, 5,289 are Commercial Banks and 833 are Savings Institutions; see also FDIC Historical Trends, Statistics at a Glance, https://www.fdic.gov/bank/statistical/stats/2016mar/fdic.pdf. The FDIC's detailed Quarterly Banking Profile provides more detail and is available here: https://www.fdic.gov/bank/analytical/qbp/. The longest time series on FDIC-insured banks is available from the FDIC's data page, https://www5.fdic.gov/hsob/HSOBRpt.asp (and select the Commercial Banks option).

[8] See "Community Banks Remain Resilient Amid Industry Consolidation", FDIC Quarterly, 2014, Volume 8, No. 2; https://www.fdic.gov/bank/analytical/quarterly/2014_vol8_2/article.pdf.

[9] Stefan Jacewitz and Paul Kupiec, "Community Bank Efficiency and Economies of Scale", FDIC, December 2012, https://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf. The price level has more than doubled since the early 1980s and this should be taken into account when considering nominal thresholds for bank size over time. At year-end 2013, 68 percent of community bank charters had assets between $100 million and $10 billion (p.37 in "Community Banks Remain Resilient").

[10] See Chart 3 on p.35 of "Community Banks Remain Resilient".

real estate). In both instances some banks went out of business and the number of new charters quickly fell to a very low level.[11]

11) However, compared with the previous cycle, the number of applications for new charters has subsequently stayed very low since 2008.
12) The business model of community banks is primarily to take deposits (from households and small firms) and to make loans. A very low interest rate environment does not make things easy for this model.
13) Researchers at the Federal Reserve have looked carefully at this issue and found a strong correlation between interest rates and new entry into banking over a long period of time. With regard to recent experience, they concluded: "Our results suggest that even without any regulatory changes following the financial crisis, the weak economy and low interest rate environment would have caused 75-80% of the current decline in new charters."[12]
14) This view is consistent with the assessment of James Chessen, chief economist at the American Bankers Association, who wrote recently, "Great investment options don't exist in today's abnormally low-rate environment. But even with more normal rates and a steeper yield curve, can a new bank grow fast enough to cover investor expectations?"[13]
15) Mr. Chessen adds this important point: "Every bank knows the competition is tough among banks but even harder against tax-favored competitors like credit unions and the Farm Credit System, or new online marketplace lenders."
16) In addition, Trust Preferred Securities (TruPS) were an important way that community banks raised capital between 2000 and 2007 – these are a debt-like instrument that the Federal Reserve ruled (in 1996) could be counted as Tier 1 capital. Small TruPS were securitized into collateralized debt obligations (CDOs). These securities did not on the whole perform well during the crisis.[14] Smaller banks will likely find it hard to raise capital in this way.
17) More broadly, there has been dramatic concentration in the provision of credit in the United States since the 1980s – reflecting the advantages and implicit subsidies received by very large "too big to fail" financial institutions. Most of the growth in total assets over the past 30 years has been concentrated in banks with assets over $10 billion. There has been slight growth in the $100m-$10bn segments, and actually a decline in the total assets of banks with less than $100m.[15]

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[11] Chart 4 on p.36 of "Community Banks Remain Resilient". According to the FDIC's Statistics At A Glance, there were no "new reporters" in 2014, only one (a commercial bank) in 2015, and none in the year to date in 2016.

[12] Robert M. Adams and Jacob P. Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation," Finance and Economics Discussion Series 2014-113, Division of Research & Statistics and Monetary Affairs, Federal Reserve Board of Governors, Washington DC, http://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf

[13] James Chessen, "The Welcome Sign Is Up for De Novos – But Is It Enough?" ABA Banking Journal, June 24, 2016, http://bankingjournal.aba.com/2016/06/the-welcome-sign-is-up-for-de-novos-but-is-it-enough/.

[14] "By October 2010, about one-third of the dollar volume of TruPS used to collateralize CDOs had either defaulted or deferred dividend payments", FDIC, Community Banking Study, December 2012, p.6-10.

[15] A vivid graphic to illustrate this point has been prepared by Thomas Hoenig, vice-chairman of the FDIC: https://www.fdic.gov/about/learn/board/hoenig/creditchannels.pdf. Mr. Hoenig's summary assessment is, "[I]n 1984 the distribution of assets among community, regional, and money center banks was nearly proportional, with more than 15,000 commercial banks serving a variety of borrowers, from consumers and small businesses to global conglomerates. Today, the 20 largest banks by assets control

18) The bigger issues going forward are not the details of how the FDIC treats de novo banks but rather whether legislation and regulation has done enough to create a sufficiently level playing field within banking. The lack of effective living wills for systemically important financial institutions should in this context be seen as a major concern.
19) Section B below discusses the FDIC and de novo banks in more detail. Section C reviews evidence on whether "compliance costs" are deterring entry into finance more broadly.

B. The FDIC And De Novo Banks

De novo banks have a higher failure rate than do established small banks. In a recent FDIC study, staff members conclude, "Consistent with a life-cycle theory of de novos, compared with small established banks, these de novos were financially fragile and took many years to reach maturity, relying more on non-core funding, and failed at higher rates during the recent financial crisis".[16]

Specifically, the authors found that 12.8 percent of banks chartered between 2000 and 2008 subsequently failed. This should be contrasted with a failure rate of established small banks that was only 4.9 percent.[17]

As James Chessen (ABA chief economist) puts it, "Sure, de novos are risky. They have failed at twice the rate of other banks historically. They create losses for the FDIC (which banks fund)." The deposit insurance provided through the FDIC is funded privately (through quarterly assessments on insured banks), but it is a program set up by the government and has a backup line of credit from the U.S. Treasury.

Weak financial regulation was an important contributing factor in the crisis of 2008.[18] While the FDIC did much better than the Office of Thrift Supervision or the Federal Reserve, a significant number of FDIC-insured banks failed and the deposit insurance fund suffered losses. According to the FDIC's statistics, the deposit fund suffered significant losses in 2008 and 2009 – falling from a balance of $52.4 billion in 2007 to $17.3 billion in 2008 to negative $20.9 billion in 2009. The fund has since recovered and now stands at $75.1 billion. In 2008, 25 insured institutions failed – a significant increase relative to experience in previous 15 years. The number of failures rose to 140 in 2009 and peaked at 157 in 2010.

However, helped by the long (if slow) economic recovery, the FDIC now seems to have brought the situation under control – only 8 insured institutions failed in 2015, and the number of "problem institutions" is down to 165 (from a peak of 884 in 2010).

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more than 80 percent of industry assets, and the number of banking firms has declined to less than 6,200. The group of community banks with less than $1 billion of assets, which in 1984 controlled nearly a third of banking assets, today controls less than 10 percent of industry assets." https://www.fdic.gov/news/news/speeches/spapr0616b.html#_ftn1.

[16] See p.2 of "the Entry, Performance, and Risk Profile of Do Novo Banks," by Yan Lee and Chiwom Yom, April 7, 2016, FDIC CFR WP 2016-03 (working paper), https://www.fdic.gov/bank/analytical/CFR/2016/WP_2016/WP2016_03.pdf.

[17] Lee and Yom, 2016.

[18] See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, Pantheon, 2010, particularly Chapters 5 and 6.

The FDIC and all regulators face significant pressures to relax standards during relatively good years. But when another downturn arrives, as it surely will, both the macroeconomy and local communities will be stronger if the FDIC has been able to maintain stronger supervisory standards over the cycle.

The costs of the previous crisis were enormous – at least one year's worth of GDP in aggregate, and disproportionately borne by lower income Americans.[19] The FDIC is entirely right to seek a balance between encouraging new entry and ensuring the safety and soundness of banks with federally-insured deposits.

C. Compliance Costs

Is there a broader issue with "compliance costs" in the U.S. financial sector, in the sense that regulation is somehow limiting the availability of credit or other financial sector services?

The FDIC has looked directly at this question for community banks. Its conclusion: "Consistent with the notion that these costs were a normal part of business, the interview participants noted that their overall business model and strategic direction had not changed or been affected by the regulatory compliance cost issues. In addition, the majority of interview participants stated that they had not discontinued offering products or services because of regulatory compliance, with the exception of overdraft protection and certain high-risk mortgage products."[20]

Three pieces of more quantitative evidence suggest that compliance costs are not currently a major brake on banking activity.

First, the latest financial results from community banks continue to show improvement. In the first quarter of 2016, community banks reported $5.2 billion in net income, which was up 7.2 percent year-on-year. Net operating revenue was up 6.9 percent from the first quarter in 2015.

Second, there are definite signs of expansion by existing banks. For example, Canadian banks are reportedly expanding their presence in the U.S. market.[21] Strong regulation in the U.S. is seen as a plus, relative to other potential international destinations.

Third, there is plenty of entry into non-banking parts of finance, for example in what is termed "on-line marketplace lending". This product line is currently quite small but growing fast and, at least until the recent problems at Lending Tree became public, it was relatively easy to raise venture capital in this sector.[22]

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[19] For a recent comprehensive and accurate assessment, see "The Cost of the Crisis: $20 trillion and Counting," a report by Better Markets, July 2015.

[20] https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

[21] Jackie Stewart, "What's Next for Canadian Banks Intent on U.S. Expansion" American Banker, July 8, 2016.

[22] The largest lenders originated over $10bn in loans in 2015. Total consumer credit in the US is around $3.5 trillion, which is typically interpreted as room to grow for this sector. See U.S. Treasury, Opportunities and Challenges in Online Marketplace Lending, May 10, 2016.

Committee on Oversight and Government Reform
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SIMON JOHNSON is the Ronald A. Kurtz (1954) Professor of Entrepreneurship at the MIT Sloan School of Management, where he is also head of the Global Economics and Management group, a member of the Executive Personnel Committee, and chair of the Sloan Fellows MBA Program Committee. He co-founded and currently leads the popular Global Entrepreneurship Lab (GLAB) course, working with start-up companies around the world.

Johnson is also a senior fellow at the Peterson Institute for International Economics in Washington, D.C., a co-founder of BaselineScenario.com, and a member since inception of the FDIC's Systemic Resolution Advisory Committee. He has also been a member of the private sector Systemic Risk Council since it was founded by Sheila Bair in 2012; this group is now chaired by Sir Paul Tucker. In July 2014, Johnson joined the Financial Research Advisory Committee of the U.S. Treasury's Office of Financial Research (OFR). From April 2009 to April 2015, he was a member of the Congressional Budget Office's Panel of Economic Advisers.

"For his articulate and outspoken support for public policies to end too-big-to-fail", Johnson was named a Main Street Hero by the Independent Community Bankers of America (ICBA) in 2013. In April 2015, the Washington Examiner placed Johnson at #11 on their list of New Voices for 2015. In November 2015, Johnson joined the advisory council of Intelligence^2 Debates.

Over the past seven years, Prof. Johnson has published more than 300 high impact pieces in the New York Times, Bloomberg, The Washington Post, The Wall Street Journal, The Atlantic, The New Republic, BusinessWeek, The Huffington Post, The Financial Times, and Project Syndicate.

"The Quiet Coup" received over a million views when it appeared in The Atlantic in early 2009. His book *13 Bankers: the Wall Street Takeover and the Next Financial Meltdown* (with James Kwak), was an immediate bestseller and has become one of the mostly highly regarded books on the financial crisis. Their follow-up book on U.S. fiscal policy, *White House Burning: The Founding Fathers, Our National Debt, and Why It Matters for You*, won praise across the political spectrum.

From March 2007 through the end of August 2008, Prof. Johnson was the International Monetary Fund's Economic Counsellor (chief economist) and Director of its Research Department. He also helped to found and run the NBER Africa Project; four volumes are forthcoming from the University of Chicago Press.

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