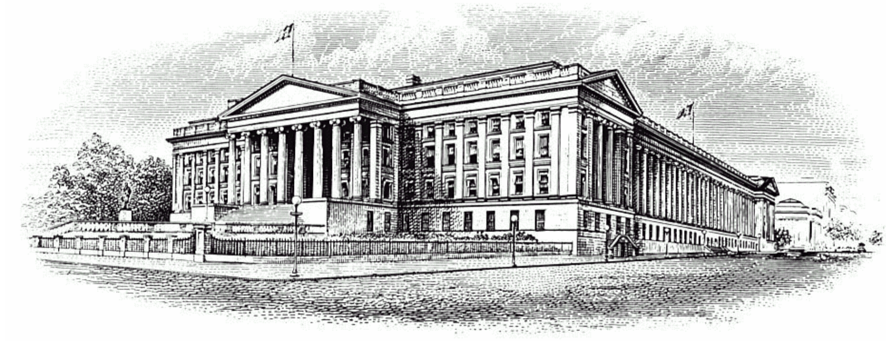

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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Testimony of
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Department of the Treasury
Before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
United States House of Representatives

Chairman Bachus, Ranking Member Sanders, and Members of the Financial Institutions and Consumer Credit Subcommittee, I would like to thank you for this opportunity to testify on the regulatory burden faced by the nation's community banking institutions.

Small banks and thrifts provide households and small businesses services that are greatly valued by the communities in which they are located, particularly for the continuity of service that they present as well as for their close association with customers and the local community, what might even be called neighborliness. Their longstanding focus on individual customer relationships and in-depth knowledge of local area credit needs serve our nation's communities well. Of particular importance in achieving major goals set for us by President Bush, community banks' expertise in local area relationship lending enables them to provide financial services to various kinds of small businesses and hard-to-reach customers that might otherwise be overlooked.

Industry Consolidation and Small Banking Institutions

Undeniably, the U.S. banking industry has experienced significant consolidation in recent years. The 25 largest banking organizations accounted for 58 percent of all bank and thrift assets at the end of 2003, up from 39 percent 10 years earlier. If we chose $1 billion in assets as the dividing line today between small banks and medium and large banks, the total number of small banks and thrifts—those with assets under $1 billion—declined from 12,664 at year-end 1993 to 8,601 at year-end 2003, a decline of almost one third over the past 10 years. A substantial majority of banking acquisitions in the last decade has involved banks with under $1 billion in assets. Some have raised concerns about what these trends may mean for the future of community banking.

And there might be cause for alarm if we looked no further. Fortunately, chartering activity in recent years demonstrates the vitality and attractiveness of community banking. According to the Federal Deposit Insurance Corporation (FDIC), there were over 1,200 new community banks and thrifts established since the beginning of 1992. After accounting for mergers, acquisitions, and only 4 failures, almost 1,100 of these institutions continue to serve their communities today.

The profitability of small banks and thrifts has been relatively stable over the past decade, as measured both by return on assets and return on equity. Of some interest, however, larger banks have expanded their profitability in recent years. In 2003, small banks and thrifts achieved a return on assets averaging 1.14 percent, while those institutions exceeding $1 billion in assets averaged 1.42 percent. Similarly, return on equity was 11.12 percent for small banks, compared to 15.85 percent for those exceeding $1 billion in assets. In contrast, for 1993, the measures of return on assets for small and large institutions were virtually identical, while large institution return on equity exceeded that of small institutions only by about half the difference observed in 2003.

A large part of the reason for this difference may be a good news story: the capital position of small banks is strong. So it is a matter of math: small depository institutions have lower returns on equity than larger institutions in part because they have more equity relative to their assets; that is to say, small banks operate with larger capital cushions than do larger banks. At year-end 2003, small banks and thrifts had an average core capital ratio of almost 9.8 percent – almost twice the amount required for “well-capitalized” status and more than 2 percentage points higher than the average core capital ratio for larger institutions. Strong capital levels empower small banks to meet the particular—and often unique—credit needs of the household and small business borrowers in their communities, while at the same time preserving banking system safety and soundness.

Burden of Regulation on Small Banking Institutions

While we have great confidence in the strength and vitality of small banks and thrifts, their prosperity should not be taken for granted. They continue to face challenges from a variety of sources. A significant challenge to small banking institutions arises from the burden that regulations impose on their ability to compete effectively with larger bank and nonbank companies. Many regulatory requirements impose some degree of fixed costs, but these can weigh more heavily upon the comparatively smaller revenue base of community banks.

This is not a new observation. To try to compensate for this imbalance, many of our laws, regulations, and supervisory practices take into account differences between smaller and larger banking institutions in ways that help to mitigate potential competitive disadvantages for smaller institutions. For example:

- The size and complexity of the largest banking organizations require teams of federal examiners in residence year-round, while examiners visit smaller institutions only on a periodic basis.

- Smaller and less complex institutions generally have somewhat less detailed regulatory financial reporting requirements.
- Under current rules, banks and thrifts that have less than $250 million in assets and are not part of holding companies with banking assets exceeding $1 billion are subject to a streamlined Community Reinvestment Act (CRA) test.
- Smaller depository institutions have more liberal access to Federal Home Loan Bank advances (i.e., with respect to asset portfolio composition and eligible collateral) than do larger institutions.
- At year-end 2003, 2,019 small banks and thrifts received the benefits of Subchapter S corporation tax treatment, up from 604 institutions at year-end 1997.

Reducing Regulatory Burden

Still, we believe that more can and should be done to reduce burdensome regulations on our financial institutions, particularly community banking institutions, without compromising their prudential operations. As I mentioned, we are heartened by the fact that there continues to be an interest in new community bank charters. Ease of entry is a sign of the competitiveness of markets. We must be careful that regulation does not create a significant barrier to the entry of new banking firms and reduce competition among financial services providers.

In 1996, Congress passed the Economic Growth and Paperwork Reduction Act, requiring the banking regulatory agencies to identify statutory provisions and regulations that are outdated, unnecessary, or unduly burdensome, and seek public comment as part of this process. The agencies were then to take steps to reduce such burdens through rulemaking or recommend that Congress enact appropriate legislative changes.

This directive was reinforced by a recent call by President Bush that we should be sure that all federal, state, and local regulations are absolutely necessary. An interagency task force, under the direction of FDIC Vice Chairman John Reich, has taken on this important task. To begin, they grouped banking regulations into 12 categories.   Last summer, the agencies published the first of a series of notices, seeking feedback from the public on three of the 12 regulatory groups: applications and reporting, powers and activities, and international operations. In January of this year, the second notice was published, requesting comment on consumer protection lending-related regulations. This careful and comprehensive approach to the review of regulations could prove fruitful in identifying ways to reduce compliance burdens on banks, especially on small banks, while also relieving corresponding strains on supervisory resources, without sacrificing important supervisory objectives.

Earlier this year, the banking agencies also issued a proposed rule that would make more community banks eligible for a streamlined CRA examination. Institutions with under $500 million in assets, rather than $250 million under current rules, would be eligible for the streamlined test. Furthermore, under the proposal, a bank or thrift meeting the small institution threshold size would no longer be subject to the CRA large bank retail test (which includes investment and service components) simply because it is part of a holding company having over $1 billion in banking assets. The agencies estimate that the proposal would cut in half (to about 11 percent of all banks and thrifts) the number of institutions subject to the large retail institution test.

Congress has joined this regulatory relief effort as well, moving forward several items of legislation to improve the competitive position of the community banking system. For example, the Treasury Department has consistently supported legislative proposals to repeal the prohibition on paying interest on demand deposits. The House of Representatives has several times passed legislation that included this repeal. Repeal of the prohibition on paying interest on demand deposits would eliminate a needless government price control and increase economic efficiency. Community banks with fewer means to maneuver around the current restrictions would be better able to compete with large banks and nonbank financial services providers in attracting business depositors. And repeal would benefit the nation's small businesses by allowing them to earn a positive return on their transaction balances. Larger businesses and larger banks today have been able to offset the lack of interest on checking accounts by using sweep accounts to earn interest or by including price concessions in other bank products.

Conclusion

Few observers would dispute that depository institutions of all sizes face a heavy regulatory burden, and that this burden falls disproportionately on the nation's small banks and thrifts. The costs of regulatory compliance are significant, and include not only burdens directly imposed on the industry, but higher levels of supervisory expenses that are ultimately passed on to banks, consumers, and taxpayers. When regulatory burdens are excessive and fail to add net value, they take a toll on the competitiveness of our financial system and on overall economic efficiency. The Treasury Department encourages efforts by the banking agencies to reduce regulatory burdens on banks of all sizes, an effort that is likely to benefit community banks and their customers in particular, and we stand ready to work with Congress to further these objectives.

Many have commented on the tremendous benefits we derive from our great dual banking system. When they do so, they usually refer to the dual system of state and national bank charters. But I think that we should include in that concept, as a sign of the great health and strength of our financial system, a vibrant, competitive array of banks of all sizes meeting the financial needs of our businesses and communities—which also come in all sizes, large and small. That is not only something worth preserving—it is something worth promoting.