BETTER MARKETS

BANKING REPORT

Strengthening Community Banks Creates an Economy That Works for All Americans

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INTRODUCTION: Community Banks' Indispensable Role

Community banks are vital to Main Street Americans, enabling many to achieve their goals and dreams. It is not an exaggeration to say that they are the lifeblood and beating heart of thousands of communities across America, not only by providing loans but also in supporting innumerable civic activities. Their role in communities—from coast to coast and from red state to blue state—drives broad-based growth within the real economy. That's because they are hyper-focused on local communities with a core mission of simply serving the financial needs of those communities.

From safeguarding the savings of families and small businesses to providing the loans necessary to facilitate wealth creation, community banks have fulfilled their core mission dependably throughout history. With ever-widening income and wealth gaps (for example, 50 percent of Americans hold only 2.5 percent of total wealth), supporting small businesses and family wealth creation at the community level are more vital now than ever. That means anyone serious about an economy that lifts up all Americans must be serious about strengthening community banks.

By design the success of community banks is entirely dependent on the success of the communities they serve, as opposed to larger banks that can—and do—close branches and move elsewhere, based on profitability for the remote corporate parent rather than the needs of the community. The community bank "relationship banking" model relies on local knowledge for providing loans to households and businesses, often with minimal financial histories—loans that larger banks would ignore. And they are able to do this while also minimizing bank risk compared to larger banks, which means fewer defaults and more money available to be invested locally, especially during economic downturns.

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Because of this, community banks are the foundation of economic growth and stability for many communities. Their unique model creates a virtuous feedback loop whereby deposits at community banks are invested as loans to local families and small businesses, resulting in local growth being boosted and wealth being created. That wealth is then deposited back into community banks—and the cycle repeats, further supporting local economic growth.

What is most remarkable is that community banks do all this even though they are at a disadvantage. There is an unlevel playing field due to policies that benefit the largest banks and fail to appropriately support the critical mission of community banks, leaving them struggling to keep up. That is why the assets of community banks as a whole have not grown in decades (see Figure 2), whereas the very largest banks have grown tremendously, resulting in less broad-based economic prosperity and more wealth and income concentration.

Policies must be changed to ensure that the disadvantages community banks face are addressed by appropriately recognizing their size and unique business model as well as their special role in our communities and the economy. Carefully designed policies will allow community banks to sustain and grow their vital services and market share. This would provide a meaningful and significant win for communities throughout the country that are struggling to keep up with the growing wealth and income disparities and rising costs of day-to-day living.

An Action Plan to Help Communities by Helping Community Banks

It's past time that Washington policymakers support community banks as much as community banks support their communities.

As discussed in more detail below, community banks have been facing a set of challenges that could be improved through targeted changes to policies. The challenges include:

- A significantly shrinking share of banking system deposits and assets.
- Difficulty keeping up with technological advancements.
- Difficulty meeting minimum standards for mitigating cybersecurity risks and financial crime.

Community banks are disadvantaged because the current policy framework fails to appropriately recognize their unique role in the system. The framework also fails to account for both the smaller size and specialized business model of community banks, both of which are necessary to fulfill that role. Resetting the policy framework starts with a very important step: having a clear and universal definition of a community bank. As we have said previously, policy makers should adopt the definition currently utilized by the Federal Deposit Insurance Corporation (FDIC).

From there the policy framework can be changed in a few key ways:

- Expanding deposit insurance for community banks, ideally through reciprocal deposits.
- Modifying community bank capital requirements such that investments of profits into improving their businesses lead to lower capital requirements. For example, capital requirements would be lowered (up to a limit) by the amount of retained earnings invested in technologies that improve risk management or operational efficiency.
  - While community bank capital requirements would be reduced, the enhancements would lower their overall risk, and there would be accompanying guardrails to further reduce risks (see appendix).
  - A simple reduction to capital requirements as some are proposing (i.e., without the condition of using reductions for enhancements) would not be effective and instead would generally create bad incentives (e.g., ejection of capital to shareholders as the largest banks have done, which might attract investors that seek to consolidate community banks and maximize profits rather than improve their business models).
- Promoting the formation of consortia among community banks so that they gain economies of scale by sharing certain operational resources that are hard to find or to afford individually. This could be done through explicit promotion in the supervisory framework, capital benefits in the regulatory framework, and centralized support provided by the banking agencies or legislatively.
- Providing centralized services that allow for shared information and best practices (e.g., databases related to know-your-customer efforts).
- Streamlining supervisory reviews of certain technological services provided by common third parties.

While these are the most material modifications to the policy framework discussed in this report, more are presented further below.

The Importance and Value of Community Banks

Community banks are a key component of the U.S. banking landscape. Unlike the largest banks that each operate thousands of branches across multiple states and earn much of their income from trading and financial market-related activities, community banks are distinguished by the strong tie to the communities they serve, providing them with the competitive advantage of vital local knowledge.

This underlies the essence of their business model. The success of community banks is entirely dependent on the success of the communities they serve. That is why they put in the extra effort to understand the needs and unique situations of community members and small businesses, allowing loans to be given to borrowers that would be left out by larger banks.

Community banks have proven over and over that they are dedicated to and successful in meeting the financial services needs of their local communities. FDIC research summarizes:

> Community banks tend to focus on loans as relationships, originating loans that require local knowledge, a greater personal touch, individual analysis, and continued administration rather than loans that can be made according to a formula.

In 2024, there were about 4,500 banks in operation in the U.S., and more than 4,000 of those were community banks. Said differently, more than 9 out of every 10 banks in the U.S. are community banks, focused on serving Main Street families and small businesses at more than 26,000 branch locations across the country.

> *The success of community banks is entirely dependent on the success of the communities they serve... they put in the extra effort to understand the needs and unique situations of community members and small businesses...*

Their presence is felt not just through physical branches. The owners of community banks are themselves local families and other members of the communities. These owners, along with managers and employees, are intimately involved in the day-to-day of their communities as friends and neighbors, sponsoring Little League teams, participating in clubs, or even just shopping in the local grocery store.

Community Banks' Focus on Lending to Local Households and Businesses Results in More Lending than the Largest Banks

The basic model of community banks is simple—to understand intimately the financial needs of their communities and serve those needs. There is no "fortress balance sheet," no ultra complex derivatives, no securitizing and selling of loans *en masse* into financial markets, no smokescreens designed to extract wealth, and no advanced algorithms maximizing profit and capital allocation. At their core, community banks safeguard customers' deposits and invest those deposits back into the communities in the form of loans to households, small businesses, and farms. And, unlike the largest banks that sell loans into financial markets, community banks hold their loans to ensure customers need only to deal with them, and not some unknown loan servicer.

This is most evident when examining how community banks allocate their deposits as compared to the largest banks. In fact, ***community banks invest 75 percent of their deposits into direct lending to the real economy as compared to only about 40 percent for the four largest banks***.[1] The rest of deposits for the largest banks go towards activities that involve financial markets, some of which eventually benefits the real economy but at a higher cost to borrowers. For example, around 8 percent of the largest banks' deposits go to loans to financial institutions that only serve to expand the wealth of the already-wealthy, such as hedge and private equity funds.

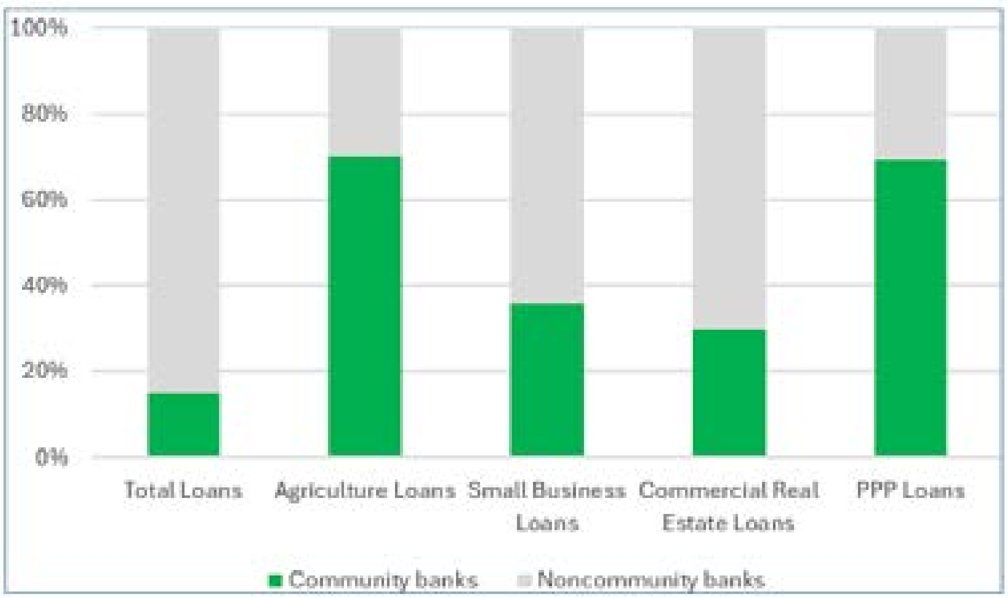
[1] Author's calculations based on data from the FFIEC 031 and 041 and the FR Y-9C.

No matter how the data are summarized, it is unquestionable that community banks invest more of customer deposits into the real economy. This matters a lot to the real economy because bank lending is by far the safest, most affordable type of credit available. Bank lending also has the unique advantage of effectively expanding the money supply and—by extension—increasing the amount of credit available to the real economy, something nonbank lending is unable to do.

Community Banks Have Proven Success in Serving Families, Local Communities, and Small Businesses with Their Unique Relationship Banking Model

For three types of loans that are very important to the economic success of communities large and small—agriculture lending, small business lending, and commercial real estate lending—community banks are at least twice as active as noncommunity banks. As shown in Figure 1, community banks account for 70% of all agriculture loans, 36% of all small business loans, and 30% of all commercial real estate loans, all well above their 15% share of total loans.

Figure 1: Community Bank Share of Key Lending Types



Source: FDIC Community Banking Study (2020) and FDIC Quarterly, Vol. 14 No.4 (2020)

Moreover, community banks were by far the largest facilitators of the Paycheck Protection Program, established in the wake of the COVID-19 pandemic to provide support to small businesses and Main Street families across the country.

The outsized proportions of community banks for these types of loans is the result of their much higher use of so-called "soft" information—factors that are difficult to reduce to a numeric metric. The use of soft information is necessary because many loan applicants for these types of loans have limited financial histories that don't fit neatly into the more automated and numerically driven loan origination processes typically used by larger banks.

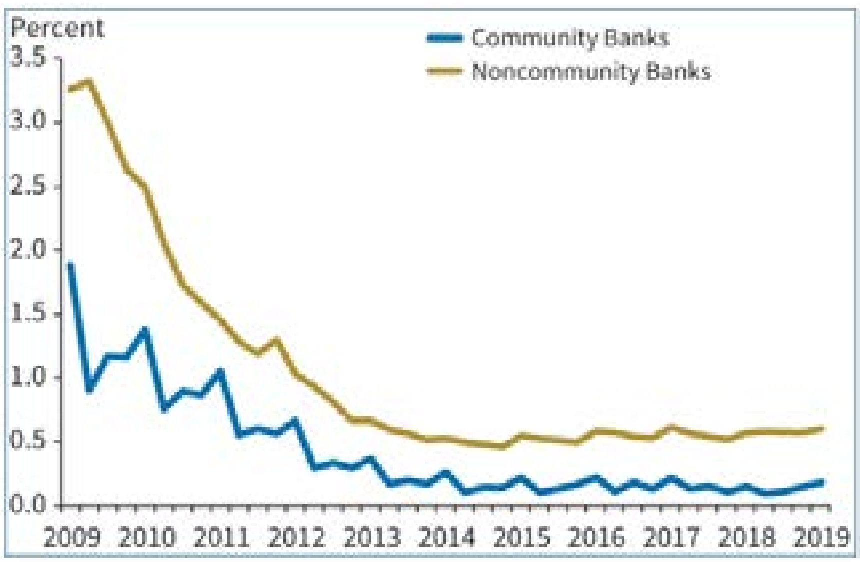
It takes time and effort to understand the importance of soft information to a borrower's creditworthiness, and time is money to large banks. Community banks, on the other hand, consider such efforts to be an integral part of their relationship banking business model. In this way, they can offer loans to borrowers that would not qualify for loans from large banks.

The Relationship Banking Model Leads to Better Assessments of Creditworthiness and Lower Losses

The relationship banking model not only results in more originations, but also leads to a better understanding of the creditworthiness of borrowers. Community banks' credit quality has consistently been stronger than that of noncommunity banks. That's why acquirers of community banks are willing to pay a premium for their loan portfolios—there is extra value in the soft information.

This strong focus on understanding their borrowers combined with their reluctance to engage in the riskiest types of loans, especially credit card loans, has resulted in much lower loan loss rates compared to larger banks that rely on basic borrower metrics and engage heavily in credit card loans (because they have the highest fees, margins and profits). Across types of loans—including residential real estate loans and consumer loans—community banks consistently have reported lower loss rates than larger banks (see Figure 2). This was especially true in the years directly following the 2008 Financial Crisis ("2008 Crash").

Figure 2: Quarterly Net Charge-Off Rate



Source: FDIC

Community Banks Are Better Equipped than Large Banks to Serve and Provide Resilience to Their Communities in Bad Times

With lower losses in both good and bad times, community banks can maintain resources to continue lending to their customers through periods when lending is needed the most. Research shows that during the catastrophic fallout after the 2008 Crash, community banks prevented regions from experiencing the worst of recession conditions by providing new loans and maintaining delinquent loans:

> Community banks, with a ***greater capacity to lend to firms through economic downturns***, maintained existing delinquent loans at the onset of the Great Recession. ***This enabled firms to maintain employment levels and, in some cases, expand. This prevents regions from experiencing recession conditions.*** Second, counties with greater banking access experience recession conditions for longer. This result is ***driven by non-community banks rather than community banks***. This may indicate that regions with more non-community banks may be more dependent on these institutions, and that these institutions have a decreased capacity to help regions recover from the

recession. More specifically, one could imagine that following recession entry, non-community banks may have restricted their lending to a greater extent than community banks. Firms located in these regions, with a decreased credit supply, were unable to hire workers following recession entry. ***Thus, regions with a greater non-community banking presence had a decreased capacity to recover from the Great Recession.***

Community Bank Lending Leads to Better Economic Outcomes

Fewer Americans are sharing in the American Dream and instead are struggling to manage their day-to-day lives. While headline growth of the economy remains steady, nearly all the benefits of that growth are accumulating to the top income earners. As detailed in the sections above, community banks help to achieve economic growth and benefits that are broad-based across Americans of all backgrounds and financial situations.

Put simply, if not for community banks, there would be many households and small businesses that would be unable to obtain low-cost bank credit or have the opportunity to build wealth and a better life. Looking at it the other way, a stronger presence of community banks would allow even more Americans to have the potential to share in the American Dream.

> *Put simply, if not for community banks, there would be many households and small businesses that would be unable to obtain low-cost bank credit or have the opportunity to build wealth and a better life.*

For example, small businesses have higher failure rates in their early stages, making it generally more difficult for them to obtain credit from banks. But small businesses that seek credit from small banks report a higher success rate of being approved for a loan. Community banks can use their physical proximity and local knowledge to evaluate the creditworthiness of the small business owners.

The goal should not be just overall economic growth but growth that is durable and broad-based across all Americans. Ensuring more Americans can access safe, durable, affordable credit through community banks that is reinvested in communities must be part of this goal.

The Regulatory Disadvantage for Community Banks

Banks have a unique role in our economy in providing safe, affordable credit and —in effect—expanding the money supply to support growth. Because of this special role, banks are provided with multiple forms of government support that correspondingly come with special regulations to help prevent depositor losses, banking runs and crises, and taxpayer bailouts.

Over time, however, the largest banks have lobbied to tip the regulatory framework in their favor, disadvantaging community banks. As a result, the framework has created clear market incentives that result in large banks becoming ever larger and small banks unable to keep up, ultimately stagnating or shrinking.

The shrinking share of community banks is not a true reflection of the "free market" but rather is due in large part to regulations that fail to account for the unique and critical economic role of community banks and the small size and special business model necessary to fulfill that role.

Regulatory Disadvantages Harm Community Banks and Local Communities

Community banks face several disadvantages in the regulatory framework. Unfortunately, based on recent proposals as well as the wish list of the largest banks, the disadvantages will become even greater. The ultimate goal of the largest banks and their lobby is not simply to reduce regulation but rather to ensure a regulatory advantage.

The greatest disadvantage is related to capital requirements. Compared to the equivalent requirement for the very largest banks, the applicable capital requirement for many community banks[2]—the community bank leverage ratio (CBLR)—is ***1.8 times higher***.[3] And this gross disparity is about to become much larger: this summer a proposal was introduced that will lower large bank capital requirements, making the community bank capital requirement ***2.1 to 2.5 times higher than the requirement for the largest banks***.[4]

For community banks that do not "opt in" to the community bank leverage ratio, their leverage capital requirement will be about the same as the equivalent leverage requirement for the largest banks. And after other expected policy changes are made to benefit the largest banks, the other applicable capital requirements soon will differ only modestly between community banks and the largest banks.

Put simply, once the large bank deregulatory agenda is complete (and the banking regulators appear committed to completing it quickly), community banks will have capital requirements that are similar to or significantly higher than requirements for the largest, most complex banks. This is despite community banks having almost no systemic risk, and the largest banks having tremendous systemic risk—as proved by the 2008 Crash and 2023 banking crisis.

Once the large bank deregulatory agenda is complete...community banks will have capital requirements that are similar to or significantly higher than requirements for the largest, most complex banks.

Other key disadvantages to community banks also are the result of a failure to recognize their unique role and structure combined with an active effort to reduce requirements for the largest banks at all costs. For example, a recent proposal seeks to weaken the supervisory process for large banks by not only giving large banks better ratings even when they have serious risks but also by limiting the actions supervisors can take to address those risks. This would make the supervisory process for large banks look similar to the process for community banks, disadvantaging community banks by failing to recognize their massive differences.

Due to the Disadvantages Large Banks Have Grown While Community Banks Have Stagnated

Despite their large share of the total number of banks in the U.S., community banks' share of total banking assets is dwarfed by the large and growing share of assets held by the largest banks (see Figure 3). The combined total assets held by banks with less than $10 billion in assets has stayed stable at around $2.5 trillion over the last three decades while the count of "large banks"—those with more than $100 billion in total assets—and their aggregate assets have grown exponentially from:

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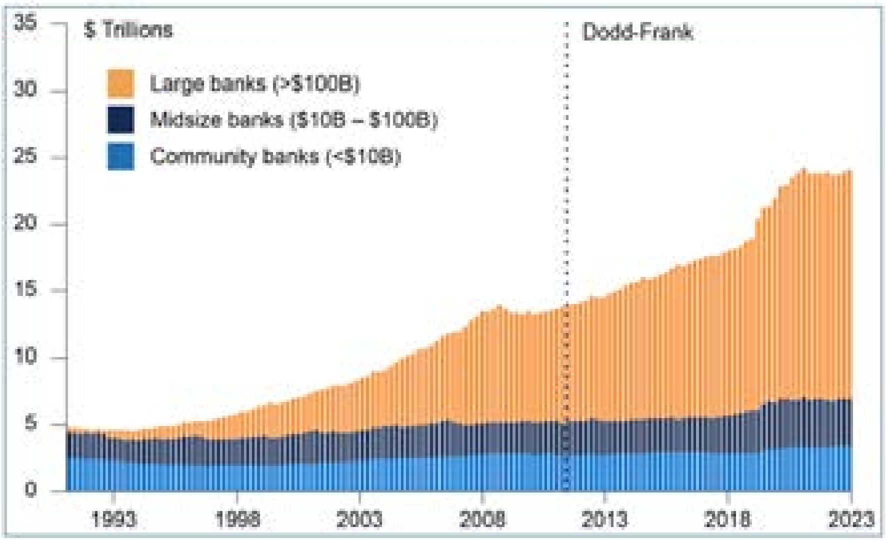
[2] Over 40 percent of all community banks have opted into the community bank leverage ratio, and of the smallest—those with less than $1 billion in assets—just over 50 percent have opted in.

[3] Based on the community bank leverage ratio requirement vs. the enhanced supplementary leverage ratio requirement. While there are key differences in the definitions, the comparison is appropriate based on the difference in activities between community banks and global systemically important banks.

[4] Based on the estimated enhanced supplementary leverage ratio requirements included in the recent proposal to modify that requirement (90 Federal Register 30780).

- Five large banks with combined assets of $800 billion in 1993, to
- Eighteen large banks with combined assets of $8.8 trillion in 2008, to
- Thirty-two large banks with combined assets of more than $17 trillion in 2023.

Figure 3: Total Bank Assets by Asset Size Range



Source: FDIC Research Information System

Current Challenges Faced by Community Banks

Community banks face multiple challenges with their business models, driving many community banks into mergers and acquisitions or closure and sale of assets. A key driver of these challenges is community banks' lack of economies of scale relative to large banks, making it more difficult for community banks to attract and retain funding and keep up with rising standards for risk management and compliance. Community banks are also falling behind on the technology front compared with larger banks that have the scale to more easily afford and integrate newer technologies. To summarize, the major issue areas are:

- **Funding availability and costs:** Stagnant or decreasing deposit base and increasing cost of deposit funds from competition, especially from large banks.
- **Lagging technology:** Difficulty keeping up with implementing technological advancements, both for customer engagement and internal business management/risk management.
- **Succession failures:** Difficulty in forming viable succession plans, due to:
  - a lack of local talent to replace retiring senior management, or
  - insufficient capital sources to replace local/family capital sources that are cashing out.
- **Bank Secrecy Act & Anti-money laundering (BSA/AML) and cybersecurity challenges:** A lack of economies of scale makes it difficult to meet minimum standards of BSA/AML and cybersecurity risk mitigation.

- **Regulatory challenges**, such as:
  - Multiple fixed thresholds/definitions for rules that apply to community banks;
  - An M&A assessment process that fails to recognize the importance of the convenience and needs of communities in M&A transactions involving community banks; and
  - Certain regulations that might be detrimental to community banks or simply antiquated.

Policy Solutions for a Brighter Future for Community Banks

The policy framework for community banks must be modified to recognize the unique role of community banks within our economy and the size and specialized business model necessary to fulfill that role. The policy recommendations presented below are based on a few key modifications:

- Expanding deposit insurance for community banks, ideally through reciprocal deposits.
- Reducing community bank capital requirements for but only for enhancements that improve operations and risk management.
  - Note that a simple reduction to capital requirements as some are proposing (i.e., without the condition of using reductions for enhancements) would not be effective and likely would create perverse incentives, e.g., ejection of capital to shareholders as the largest banks have done, which might attract investors that seek to consolidate community banks and maximize profits rather than improve their business models.
- Promoting the formation of consortia among community banks so that they gain economies of scale by sharing certain operational resources that are hard to find or to afford individually. This could be done through explicit promotion in the supervisory framework, capital benefits in the regulatory framework, and centralized support provided by the banking agencies or legislatively.
- Providing centralized services that allow for shared information and best practices (e.g., databases related to know-your-customer efforts).
- Streamlining supervisory reviews of certain technological services provided by common third parties.

However, any policy framework must have a solid foundation: defining to which institutions the policies apply.

A Universal Definition for Community Banks Is the Foundation for a Community Bank Policy Framework

A single definition of what it means to be a community bank is critical as it would be a foundation on which a community bank policy framework sits. Currently, there are different community bank definitions across agencies and within legislation. This creates unnecessary complications both for policymakers and the banks themselves and can make it difficult to understand the cumulative effects of policies.

The FDIC's definition should be accepted and used universally. It has been in existence for more than a decade and, at a high level, captures what it means to be a community bank. It includes important metrics such as a bank's activities and geographic footprint. It also includes an asset size threshold that adjusts with inflation (unlike with other current thresholds that apply to community banks), ensuring that there is no need for periodic adjustments to the threshold. Furthermore, long history of the FDIC's definition has the added benefit of a rich dataset that can be used to assess policies—previous, current, and proposed.

Protecting the Community Bank Deposit Share and Promoting Growth

For the benefit of broad-based and durable economic growth, policies should be adjusted to support community banks in at least keeping, and ideally growing, their market share. This would directly benefit the real economy by ensuring:

- More direct lending is made to small businesses and households (as noted community banks allocate more deposits to real economy lending than big banks), and
- That lending is more local and capital stays within communities rather than being extracted.

Deposits can be attracted by expanding deposit insurance, offering enhanced customer services, and/or offering higher deposit rates. Deposit rates are difficult to address through policy and so are not discussed.

Considering how dramatically the share of community banks within the banking system has diminished, there could be a significant increase in deposits while still maintaining community bank status. For example, even if they were able to draw in half of the over $7 trillion held by money market funds, all community banks would still be community banks.

Expanding FDIC Deposit Insurance Directly through Legislation

Deposit insurance could be expanded legislatively for community banks, but the costs and benefits must be weighed carefully. In fact, the debate around increasing deposit insurance has already begun—legislation to expand deposit insurance on so-called transaction accounts for banks up to $250B is currently being considered.[5] However, there is no such thing as a free lunch, and even deposit insurance has costs that are actual—payments to the deposit insurance fund (DIF)—and potential—increased moral hazard. Therefore, ***any consideration of increasing deposit insurance should only apply to community banks*** so that benefits to the economy can be maximized, through increased community bank lending, and costs to financial stability can be minimized.

Accounts with more than $250,000 currently are concentrated in the largest banks—the top 1 percent of banks by assets hold about two-thirds of these large accounts. Even a moderate expansion of deposit insurance protection would help to draw these large deposits into community banks.

As with the proposed legislation and as discussed in a 2023 FDIC study on deposit insurance, the deposit insurance increase should apply only to the transaction accounts of businesses and municipalities. Accounts like these are often vital to a small business or a local municipality that relies on the funds for activities such as payroll or purchasing supplies from other small businesses. One important factor that is not in proposed legislation or the FDIC study—*any proposed increase in deposit insurance ideally should be phased in to prevent the type of risks that accompany rapid growth*.

Additional payments to the DIF that would result from increased insurance could be offset through a reduction to community bank capital requirements. That is, retained earnings could be redirected from equity capital towards DIF payments. While capital would be reduced, community banks already have high levels of capital, appropriate guardrails would be in place (see appendix), and increased deposit insurance would improve the risk profile of the banks.

[5] There is also H.R. 4551, sponsored by Rep. Maxine Waters, which—among other modifications—would update the deposit insurance framework to support small business transaction accounts during failure of community financial institutions.

Expanding Deposit Insurance through Reciprocal Deposits

A better alternative to increasing the deposit insurance threshold through legislation would be to increase the usage of reciprocal deposits by community banks. Reciprocal deposits are generally safe and do not have the same "hot money" dynamic of brokered deposits—the high potential for rapid withdrawals—since reciprocal deposits involve swapping equivalent amounts of deposits between banks rather than a one-way movement of deposits. Research shows that during the 2023 bank crisis, banks participating in reciprocal deposit networks paid lower deposit rates, grew larger, and expanded their local deposit market share.

Many banks already use reciprocal deposits, and unsurprisingly, adoption increased significantly after the 2023 bank crisis. However, only a fraction of total deposits in the system are reciprocal—around $425 billion of $17.5 trillion. For banks less than $1 billion in assets, reciprocal deposits make up $40 billion of their total $950 billion in deposits.[6] In part, that is because there is a limit—the lesser of $5 billion or 20 percent of total deposits. So, for example, if banks under $1 billion in assets increased their reciprocal deposits to the 20 percent threshold, they would have about $190 billion insured, up from $40 billion.

Deposit reciprocation primarily is done through third-party service providers and so is not costless. Similar to increased DIF payments, payments to third-party service providers for deposit reciprocation could be paid for by reducing capital requirements for community banks if retained earnings are redirected towards increasing reciprocal deposits. While capital would be reduced, community banks already have high levels of capital, appropriate guardrails would be in place (see appendix), and increased deposit insurance would improve the risk profile of the banks.

Additionally, the $5 billion/20 percent limit for reciprocal deposits should be increased legislatively, but only should be done for community banks (unlike what is currently being considered in Congress) so that benefits to the economy can be maximized, through increased community bank lending, and potential costs to financial stability can be minimized. Again, the increased cost of reciprocation would be offset through reduced capital requirements.

Enhanced customer service

Customer services would be enhanced by greater usage of technology (more in the next section). Technology solutions can be utilized to enhance services specific to certain clients such as municipalities.

Enhancing Technology to Improve Customer Service and Business Operations

Technological enhancements would create efficiencies, improve financial and risk management and compliance, and allow for better services and specialized services to be offered to customers. This would reduce costs and risks and help to attract customers and deposits. Modifications to policies should be made to incentivize community banks to improve their technology (systems, interfaces, etc.). Of course, technological enhancements should be made in accordance with maintaining the safety and soundness of the banking system.

Achieving Technology Economies of Scale through Consortia

One challenge in upgrading technology is that community banks lack the economies of scale that larger banks have. Relative to costs for larger banks, technological upgrades at community banks can be very costly. Also, many community banks are unable to hire the talent necessary to understand

[6] Authors' calculations based on FFIEC Call Report data.

the technologies and associated risks. The formation of consortia among community banks to share resources and expertise can provide those economies of scale.

Some community banks are already using shared resources, especially sharing subject matter experts that understand technology and associated risks. Also, this idea is not new to the agencies. Options for collaboration and avenues for collaboration in the regulatory framework were discussed by the Office of the Comptroller of the Currency in a 2015 paper.

First, the banking agencies should modify their supervisory expectations such that the expectations actively promote the formation of consortia through which resources can be shared among community banks. That is, the agencies should explicitly state that such consortia are not only allowed but encouraged as long as safety and soundness is met. In fact, if done properly, such consortia would greatly benefit safety and soundness.

Second, expenses on activities within a consortia could be applied towards reductions to capital requirements, similar to what has been discussed above. Third, the banking agencies or a legislatively-created effort could provide a centralized network that would assist community banks in the formation of consortia or the sharing of resources.

Encourage Enhanced Technology through Capital Requirements

Investment in technological infrastructure or fintech services could be partially offset by reducing capital requirements for community banks if retained earnings are redirected towards enhancing basic technological infrastructure or acquiring operational-enhancing services from third-party providers. While capital would be reduced, community banks already have high levels of capital, appropriate guardrails would be in place (see appendix), and enhanced technology would increase efficiency, competitiveness, and profitability.

Streamlined Supervisory Assessments

The banking agencies should modify their supervisory expectations for third-party risk management by explicitly stating that certain lower risk, higher value bank-fintech arrangements that already are being used by multiple banks are in essence pre-approved. For example, many banks already are using fintech services to enhance their websites or for account opening or other basic services and many of those banks use the same third-party service providers.

While it is important that each bank individually manages its third-party risks—and that supervisory expectation should continue—certain third-party services could be "pre-cleared" from a supervisory perspective. That is, if a basic fintech service from a given third party is used by multiple banks and that arrangement has been cleared from a supervisory perspective, then the supervisory knowledge from those clearances should be applied to arrangements between that same fintech and other banks. This would streamline the bank-fintech third party risk management supervisory assessment process.

This can be done since each fintech offers the same service to all client banks, and so the risk management processes should be very similar bank to bank, and a single supervisory team or set of teams could be assigned to review only those services.

Improving Ability to Meet BSA/AML and Cybersecurity Standards

Unfortunately for community banks, minimum BSA/AML and cybersecurity standards do not scale linearly with the size of a bank, i.e., basic standards do not decrease with the size of a bank. Therefore, the lack of economies of scale for many smaller community banks causes difficulties in standing up and operating these efforts. Policies can be modified to alleviate the difficulties.

Achieving Economies of Scale through Supervisory Encouragement of Consortia

Like the policy solution offered above for technological enhancements, the agencies should actively promote the formation of consortia through which BSA/AML and cybersecurity resources can be shared among community banks. That is, the agencies should issue explicit supervisory statements that such consortia are not only allowed but encouraged, in accordance with safety and soundness. In fact, if done properly, such consortia would greatly benefit safety and soundness. For example, some community banks already are using shared corporate officers, e.g., one cybersecurity officer that serves the function for multiple community banks.

Also, expenses on activities within a consortia could be applied towards reductions to capital requirements, similar to what has been discussed above. Furthermore, the banking agencies or a legislatively-created effort could provide a centralized network that would assist community banks in the formation of consortia or the sharing of resources.

Supporting Economies of Scale through Centralization

The banking agencies or a legislatively-created effort could put in place a centralized hub for banks related to BSA/AML and cybersecurity through which information and best practices can be shared. Shared information could include identified bad actors, anonymized incidents, and identified methods. The centralized hub could be funded through assessments, similar to deposit insurance and FedNow. This would especially benefit community banks and be much less expensive and simpler than each community bank hiring specialized staff. Assessments could be paid for in part through reduced capital requirements, with a similar structure to those noted above.

Encourage Enhanced BSA/AML and Cybersecurity through Capital Requirements

Investment in BSA/AML and cybersecurity systems and processes could be partially offset by reducing capital requirements for community banks if retained earnings are redirected towards enhancing those processes. While capital would be reduced, community banks already have high levels of capital, appropriate guardrails would be in place (see appendix), and operational risk would be decreased.

Improving Succession Planning

Succession planning can be difficult for many community banks, especially smaller community banks that are mostly owned by family or a small number of members of the community. As senior leadership retires, it can be difficult for community banks to find and attract talent, especially in rural or remote locations. Additionally, investors may be difficult to find when older shareholders seek to sell material amounts of outstanding shares. Certain policies could help on both fronts.

Improving Supervisory Expectations for Succession Planning

The agencies should enhance the current supervisory process related to succession planning by making clear the expectation that planning must be forward-looking, i.e., several years in advance. Also, succession plans should include estimated salary expectations for recruiting management talent (especially to more rural areas) and the impact of those salaries on profitability and safety and soundness. Furthermore, there should be an expectation of efforts to build talent pipelines by creating awareness partnerships with local and regional universities.

Improve Access to Capital Sources through Regulation

One source of capital for community banks could be large banks, which typically have capital levels in excess of minimum regulatory requirements. This would be a more obvious source of capital since large banks have a presence throughout the country and provide banking services to many community banks. Specifically, large banks could be allowed to invest a specified maximum percentage of their excess common equity tier 1 ("CET1") capital (i.e., so-called capital headroom) into community banks while still counting that investment towards their CET1 capital under the following conditions:

- The community bank stock purchased by large banks is noncumulative perpetual preferred stock (i.e., missed dividends do not accumulate and no voting rights and is part of the community bank's tier 1 capital, not CET1 capital).
- The investment is limited to a specified percentage of the community bank's total tier 1 capital.
- The investment is limited to a specified percentage of the purchasing bank's excess CET1 capital.
- The stock issuance and purchase are restricted to instances where:
  - A certain percentage of community bank stock is offered for sale by existing shareholders, or
  - The stock purchase would facilitate the acquisition of one community bank by another (and not by a noncommunity bank).
- The stock must be sold within a specified time period to an individual investor (i.e., not an organization such as an investment fund).

Improve Access to Capital Sources and Talent through Centralization

The agencies—or a single agency—could establish an effort similar to the FDIC's Mission Driven Bank Fund but specifically for community banks in need of succession capital and talent.

Reducing Regulatory Disadvantages

Revise Merger Criteria to Assess the Effects on Local Communities and Consumers

A merger's ability to meet the convenience and needs of the community should be elevated in the M&A assessment process when a community bank is being acquired. The primary mission of a community bank is to serve its community, and so it is critical that the mission is maintained or improved after acquisition.

This is especially important when a noncommunity bank is seeking to acquire a community bank. That is because:

- Community bank acquirers of other community banks are ***more likely to keep acquired branch offices open after acquisition*** compared to noncommunity bank acquirers. More than 90% of closed community bank branch offices that were acquired by community banks were still open one year after the acquisition, higher than the retention rate for noncommunity bank acquirers.
- Moreover, research shows that community investment ***increases*** in areas where acquired community bank branches remain open, and that increase is stronger when a community bank is acquired by another community bank.

Treat community banks the same as the largest banks in the supervisory appeals process

All banks deserve equal access to a fair and independent appeals process for supervisory decisions by regulatory agencies. Put differently, the largest banks should not be given advantages or preferences in the supervisory appeals process because of their size or influence while community banks' appeals are ignored or minimized. The FDIC has rightly recognized the need to improve the appeals process and recently put an effort in motion to make changes.

Regularly review bank regulations

Better Markets has consistently supported and contributed to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("EGRPRA") efforts. Generally, rules that are antiquated or do not meet their intended purpose should be modified or—if necessary—rescinded, but safety and soundness must be maintained in this process. As Better Markets has detailed, some deregulatory changes made in prior EGRPRA reviews directly contributed to the 2023 banking crisis.

However, there are other changes that can be made to reduce burden on community banks without threatening safety and soundness throughout the banking system. For example, Regulation H (specifically, 12 CFR 208.21(a)) prevents banks from investing in premises if the aggregate of such investments and associated loans exceeds the bank's perpetual preferred stock plus common stock. Since the capital of most community banks comes from retained earnings and not stock, this regulation can be overly restrictive. The rule should be modified to include retained earnings.

Conclusion

Community banks have been ignored in the policymaking process for far too long, resulting in their presence shrinking within our financial system and economy. That trend is very problematic, as their reduced presence leads to communities suffering the consequences of less broad-based economic prosperity and more wealth and income concentration. Conversely, that means a greater presence of community banks leads to greater prosperity for more Americans and more opportunities to achieve their goals and dreams.

Policy changes are needed to ensure that becomes reality. Carefully designed policies will allow community banks to sustain and grow their vital services and market share. The policy changes outlined in this report are just the beginning but would go a long way in resetting the policy landscape to ensure that community banks can thrive and put the interests of Main Street over Wall Street.

Appendix: Capital Reductions for Community Banks and Associated Guardrails to Mitigate Adverse Consequences

As discussed above, capital requirements for community banks could be reduced for instances in which profits are redirected towards enhancements that improve operations and risk profiles. These reductions would be accompanied by guardrails that mitigate issues that historically have resulted from loosening regulation and growth promotion (e.g., issues of the savings and loan or the 2023 banking crisis). Such guardrails would include:

- Limiting allowable capital reductions.
- Phasing in allowable capital reductions.
- Limiting growth, both overall assets and the assets within individual business lines.
- Limiting activities that are known to be especially risky (e.g., complex financial transactions).
- Additional supervisory scrutiny during regularly scheduled examinations for each of the areas in which community banks have enhanced their business models.

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Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside, and protect investors and consumers.

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