Community banks can be of any size. However, they follow four basic principles:

- Management focuses on ‘high-touch’ relationships between the bank and its customers, employees and stockholders.
- Management pursues core financial strategies that focus on capital adequacy, a reliance on core deposits, originating loans and holding them in portfolio and holding a minimum amount of liquid assets.
- There is a strong link between ownership and management.
- They compete in limited geographic markets.

The current economic and regulatory environment makes it an absolute necessity that bank directors and managers follow core strategies to grow their banks while appropriately managing risk as they continue to serve their various constituencies.

“Community banks are the lifeblood of many small towns, cities and states. They are often locally-owned and managed such that customers know their bankers personally. Members of the board of directors are typically small business owners and public figures with positive reputations in the community. Bank officers serve on many community boards and foundations and banks are important contributors to schools and local nonprofit organizations. Economic growth in the area often varies directly with local community banks’ willingness and ability to lend.”

TIMOTHY KOCH is Professor of Finance at the Moore School of Business, University of South Carolina and President of the Graduate School of Banking at Colorado. He is co-author of Bank Management, a leading college textbook, and speaks regularly to bankers throughout the U.S.
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COMMUNITY BANKING
FROM
CRISIS TO PROSPERITY

Timothy W. Koch

Makawk Books
A Division of TWK Strategies
Irmo, SC
To Susan, Michala and Andy
For making my journey fascinating and enjoyable

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I have had the opportunity to work with outstanding academics, bankers and bank consultants throughout my career. The ideas and recommendations that I offer in this book reflect my interpretations and biases from numerous conversations and debates with many of these individuals. I am particularly grateful to the following individuals who contributed directly to this book via their insights and observations; Donna de St. Aubin, Sue Evans, Charlie Funk, Jeff Gerrish, Scott Hein, Glen Jammaron, Nick Ketcha, Ed Krei, Don Musso, Karl Nelson and Mike Stevens. I want to especially thank Ed Krei for his insights on bank investments and Don Musso, Nick Ketcha and the Managing Directors of FinPro for extensive analysis and discussions regarding enterprise risk management, value creation and regulation. Finally, I end the book with an analysis of First Community Bank’s organizational structure, strategy and performance throughout the recent financial crisis. Mike Crapps was instrumental in clarifying details related to the bank’s strategic objectives and response to regulatory issues.

In 1980, I was offered the opportunity to teach at the Stonier Graduate School of Banking and at one point thereafter I taught at each of the six general graduate schools of banking offered throughout the United States. In 2001, I was named President of the Graduate School of Banking at Colorado (GSBC) in which capacity I continue to serve. In this role, I have the opportunity to visit with GSBC trustees, faculty and students whenever I need an expert on topics beyond my comfort zone, for which I am especially grateful. In addition, during the early stages of the financial crisis, I served on the FDIC’s Advisory Committee on Community Banking along with 13 presidents and CEOs of community banks and was thus introduced to the regulatory view of key issues affecting community banks and the associated reactions from senior managers of community banks. In 2010, I became a director of TIB, a bankers bank headquartered in Dallas, Texas. Finally, I also serve as Professor of Finance at the Moore School of Business, University of South Carolina having previously taught at Texas Tech University and Baylor University. The basic idea for the book originated when I was on sabbatical from the University of South Carolina.

The views expressed in this book are mine and are not necessarily those of the trustees or representatives of the Graduate School of Banking at Colorado or the University of South Carolina. Any errors are my responsibility.

Timothy W. Koch
Professor of Finance, University of South Carolina
President, Graduate School of Banking at Colorado
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Introduction

With the recent financial crisis, many individuals and much of the media view banks and the business of banking negatively. Critics emphasize a broad range of bad practices, such as excessive risk taking, particularly by making subprime loans, confusing borrowers with complex financial products, charging excessive fees, the inappropriate use of derivatives and paying excessive compensation to senior managers. An often-voiced solution to these alleged abuses is additional regulation which will presumably force institutions to treat customers more fairly and better align risk taking with the wishes of stockholders and the federal government, which insures bank deposits and regulates management practices.

However, the casual reference to “banks” and “banking” is imprecise. It is based on the premise that all banks are the same. As demonstrated throughout this book, community banks differ sharply from other financial institutions. There are four different general categories of banks in the United States. They are the (1) Too Big To Fail (TBTF) institutions, (2) large regional banks, (3) community banks and (4) shadow banks that operate in the shadow banking system. Each operate in a different way and serve different clienteles:

- **Too Big To Fail Banks.** These are the largest financial institutions whose primary business may be lending, investment banking (securities underwriting, asset management and proprietary trading), insurance or consumer finance.

- **Large Regional Banks.** These are large financial institutions that operate in regional and national geographic markets and offer fewer banking services than the TBTF institutions. Banking services include deposits, loans, leases, credit cards, securities underwriting and brokerage, market making, asset management and insurance sales. These firms generate substantial revenues from both net interest income and fee income, but typically have little international exposure.

- **Community Banks.** These are smaller commercial banking organizations that typically operate within a relatively small trade area, offer banking services that emphasize loans and deposits, generate the bulk of earnings from net interest income and emphasize personal relationships between customers, stockholders, managers and employees.
• **Shadow Banks.** These are noncommercial bank financial institutions that are actively involved in financial intermediation by which funds are transferred from investors to borrowers. They might originate loans but generally do not want to hold the loans in portfolios. They might securitize loans and place them with investors. They often acquire securities based on the perceived risk versus return as signaled by rating agencies and the security underwriters. They may be insurance companies, pension funds, hedge funds, money market funds, government-sponsored enterprises (GSEs), off-balance sheet entities with names such as structured-investment vehicles (SIVs), or payday lenders.

Institutions across the four categories have dramatically different business models. Not surprisingly, they contributed differently to the ongoing financial crisis, received different levels of governmental assistance and have performed differently coming out of the economic downturn. One of the principal themes of this book is that the financial crisis was caused largely by the actions of the TBTF Banks and Shadow Banks. Yet, the U.S. government quickly and consistently provided assistance to many of these institutions to keep them from failing. Consider how Fannie Mae and Freddie Mac are currently structured under conservatorship rather than being allowed to fail. Similar assistance has never been available to many large regional banks and community banks. TBTF banks presumably carry systemic risk in that their failure may bring about the collapse of the global financial system.¹ Failures of other institutions are presumably less critical to the smooth functioning of the money and capital markets. We thus saw federal regulators approve bank holding company applications in record (short) time so that Goldman Sachs, Morgan Stanley, American Express and MetLife, among others, could get loan guarantees and access to borrowings from the Federal Reserve Banks. Without access, a liquidity crisis would likely have forced these firms to fail to perform on transactions obligations. Similar holding company requests by community banks typically take months to be processed.

Market participants and bank regulators recognize the discriminatory treatment. It is an advantage of size and a critical benefit from the interconnected relationships between key individuals in government and senior managers and directors of TBTF banks.² Community banks are allowed to fail while the federal government protects TBTF banks regardless of the roles played in causing the crisis. In response, the Obama administration proposed substantive changes in regulation to address some of the incentives that managers of TBTF Banks have and to force a fairer treatment of individual consumers. In mid-2010, Congress passed the Dodd-Frank Regulatory Reform Act (DFA) which formalized many game-changing rules. One series of provisions provides for the identification and orderly liquidation of systemically important financial institutions (SIFIs) if certain conditions are satisfied.³ Banks that qualify as SIFIs under current regulation are listed at the end of the chapter. Not all of these organizations are too big to fail, but those subject to stress tests presumably are as well as some of the other large organizations not currently required to conduct annual stress tests. Given the close relationships between government officials and principals of these large firms, many financial experts do not believe that TBTF firms will be liquidated.
As proposed, the profitability and risk-taking activities of the largest institutions will likely decline over time—at least until we forget. Unfortunately, many of the provisions of DFA and additional attention to consumer compliance regulations harm community banks who contributed relatively little to the problems. Owners and managers of many of the smallest banks believe that the administration and regulators are consciously trying to reduce the number of independent banks. These legislative and regulatory reforms follow substantial increases in Federal Deposit Insurance Corporation (FDIC) deposit insurance premiums. While insurance coverage increased to $250,000 per account from the previous $100,000, surviving banks paid a special assessment to supplement the insurance fund which was followed by the prepayment of more than three years of premiums to provide cash for the FDIC to close failed institutions. Premium increases are even greater for banks that the FDIC designates as riskier. For some community banks, the increased deposit insurance premiums wiped out the bulk of 2008 and 2009 earnings.

One of the provisions of DFA created the Consumer Financial Protection Bureau (CFPB). The CFPB’s mandate is to protect consumers by ending unfair practices in direct consumer lending and credit card lending. Ominously, many of the rules implementing provisions have yet to be determined. The American Bankers Association identified 30 provisions of the bill that harmed community banks largely by increasing compliance costs. Increased compliance costs may drive some of the smallest banks out of business because they will be unable to cover the costs if revenues do not rise substantially in the near future. If this conjecture is true, small banks may eventually disappear typically by merger or acquisition. Whether intentional or not, it doesn’t seem right that small banks that often serve small, rural communities suffer most under the new rules.

Because banks have access to FDIC-insured deposits, excessive risk-taking potentially harms the deposit insurance fund if a bank fails. The new rules are designed to return banking to its core principles and thereby protect the insurance fund. These core principles involve meeting the credit and other financial needs of customers while carefully managing risk. Effective risk management, in turn, focuses on loan diversification, core deposit funding, holding ample liquid assets, having access to wholesale borrowings and operating with large amounts of equity capital. This is the future of community banking.

This book attempts to explain the operations of traditional community banks. While it touches on the causes and consequences of the financial crises that emerged in 2007, it does not try to explain them in detail. Rather, it analyzes a model of community banking which, if followed, will enable community banks to not just survive the difficult regulatory and economic environment, but to thrive. It emphasizes effective risk management practices. Where appropriate, it documents differences between the four categories of banks and offers a critique as to what is appropriate and inappropriate for insured institutions. An appreciation of these differences leads to a recognition of the types of regulation, policies, and practices that will prevent future crises, promote healthy competition and lead to sustained economic growth throughout the country.
Appendix: List of Systemically Important Financial Institutions

RP: Must submit a Resolution Plan  
ST: Must conduct annual stress tests

U.S. Headquartered Banking Organizations*

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Resolution Plan</th>
<th>Stress Tests</th>
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<tbody>
<tr>
<td>Bank of America (FIA Card Services)</td>
<td>RP</td>
<td>ST</td>
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<tr>
<td>Bank of NY Mellon</td>
<td>RP</td>
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<td>Goldman Sachs</td>
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<td>Morgan Stanley</td>
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<td>State Street</td>
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<td>Ally Financial</td>
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<td>American Express</td>
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<td>MetLife**</td>
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<td>Capital One Financial</td>
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<td>Fifth Third Bank</td>
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<td>KeyCorp</td>
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<td>Regions Financial</td>
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<tr>
<td>SunTrust Banks</td>
<td>ST</td>
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<tr>
<td>U.S. Bancorp</td>
<td>ST</td>
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<tr>
<td>Wells Fargo</td>
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Other U.S. Banks with Total Assets Greater than $50 Billion
- TD Bank
- HSBC Bank USA
- RBS Citizens
- The Northern Trust Company
- Union Bank
- BMO Harris Bank
- Charles Schwab Bank
- Sovereign Bank

Manufacturers and Traders Trust Company
- Discover Bank
- Compass Bank
- Comerica Bank
- Bank of the West
- USAA Federal Savings Bank
- Deutsche Bank Trust Company Americas
- Huntington National Bank

Other U.S. Headquartered Systemically Important Financial Institutions (SIFIs) Identified by the Financial Stability Oversight Council (FSOC)

- AIG
- GE Capital
- Prudential Financial

* In 2009, the federal government conducted formal stress tests to assess whether these 19 institutions needed to raise additional capital. They are widely presumed to be TBTF.

** In February 2013, MetLife sold its depository business to GE Capital and received official clearance to deregister as a bank holding company.