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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Capital Formation at Community Banks

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The Federal Deposit Insurance Corporation ("FDIC") recently released the results of a study of community banking in the United States during the past twenty-five years. The study was a data-driven effort to identify and explore issues and questions about community banks. The study is designed to provide a platform for future research and analysis by the FDIC and other interested parties. Chapter 6 of the study discusses the role of capital at community banks with a focus on how community banks build their capital over time.

Capital levels at community banks increased sharply in the early 1990's as the industry recovered from the banking and thrift crisis that began in the 1980's as banks conformed to new capital standards under the first Basel capital agreement and FDIC directives. By the end of 2011, the total risk-based capital ratios for community banks exceeded 15 percent and were approaching historic highs.

Capital formation at banks takes place through two main channels. The first is the internal generation of new capital through retained earnings. Retained earnings are the amount of net income remaining after common and preferred dividends are paid. To the extent that most banks report positive earnings each year, they are usually in a position not only to pay dividends to their shareholders, but also to add to their capital stock through retained earnings. The second channel through which capital formation takes place at banks is the raising of capital from external sources.

Community banks obtained almost 48 percent of their total capital formation through retained earnings. As a share of prior period equity, community banks increased capital through retained earnings at about 3.6 percent per year. In the last ten years, retained earnings made up 41 percent of additions to equity capital at community banks. At year-end 2011, an estimated 84 percent of community banks were privately held. The remaining 16 percent, representing about 34 percent of community bank assets, were in organizations that were publically traded, although typically not on a major exchange.

The second main source of capital for community banks is from external sources. External capital raises include both the issuance of new equity investments to investors or the issuance of debt and down streaming of funds from a bank holding company to a subsidiary bank. Just over 10 percent of year-end financial reports filed by all banks during the study period showed material increases in equity capital from external sources. When community banks raise capital from external sources, many do so through private placements that are subscribed by the current owners and directors of the bank or other local investors who have unique knowledge of and interest

in the institution. The 2012 report by the Government Accountability Office ("GAO") analyzes sources of capital for small banks. The GAO found that a majority of banks they surveyed expressed confidence that they could raise new capital from their board members or members of their community. A smaller percentage expressed confidence that they could successfully raise capital by issuing common stock through either a public offering or a private placement.

Much of the increase in capital raised by community banks between 2000 and 2007 was driven by the increased issuance of Trust Preferred Securities ("TruPS"). First issued in the early 1990's, TruPS are debt-like instruments issued by bank holding companies to raise funds that may then be down streamed to bank subsidiaries as equity capital. Payments to TruPS investors are tax deductible for the bank holding companies that issued them, and the issuances are not dilutive to existing shareholders. TruPS began to be more widely issued after a 1996 ruling by the Federal Reserve Board allowing them to be counted as Tier 1 capital at the holding company level.

Between 2000 and 2007, TruPS made up almost half of the volume of public equity issuance for community banks. Although many community banks were too small to issue their own TruPS in public markets, by the early 2000's, investment banks were increasingly securitizing small TruPS into Collateralized Debt Obligations ("CDOs").

By October 2010, about one-third of the dollar volume of TruPS used to collateralize CDOs had either defaulted or deferred dividend payments. The deteriorating performance of many of the community bank TruPS and declining investor confidence in CDOs made community bank TruPS difficult to issue in highly risk-adverse capital markets. Subsequent regulatory changes have further discouraged the issue of TruPS.

The substantial increase in external capital raising after 2007, which was largely made possible by two federal programs designed to facilitate bank access to capital during the period of financial market instability. First, the Troubled Asset Relief Program ("TARP") was authorized in October 2008. The Treasury Department created the Capital Purchase Program ("CPP") under TARP to stabilize the financial system by directly providing capital to financial institutions. In 2008 and 2009, the Treasury invested approximately $205 billion under the CPP by purchasing preferred stock or subordinated debentures in 707 financial institutions. Second, the Small Business Lending Fund ("SBLF") was created in 2010. The Treasury invested $4 billion of SBLF funds into 307 banks in 2011, of which 137 of these banks used SBLF funds to repay CPP capital.

Two of the most common situations causing community banks to raise capital are when community banks become troubled and when they acquire other banks and grow rapidly. Together, these two situations account for a large percentage of institutions that raised external capital during the study period. Across the entire study period, troubled institutions accounted for 33 percent of all capital raises and 25 percent of the volume of capital raised at community banks.

The study found that during periods where assets and earnings are growing at roughly the same rates, community banks can generate most of the capital they need from internal sources. Accordingly, the most important factor in insuring that capital is made available to facilitate the growth of community banks is a steady stream of earnings from which to generate new capital.

As the effects of the financial crisis recede, community banks are beginning to re-establish a more normal pattern of adding to their equity capital through both internal and external sources.

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