GAO Highlights

Highlights of GAO-13-704T, a testimony before the Committee on Banking, Housing and Urban Affairs, U.S. Senate

June 13, 2013

FINANCIAL INSTITUTIONS

Causes and Consequences of Recent Community Bank Failures

Why GAO Did This Study

Between January 2008 and December 2011—a period of economic downturn in the United States—414 insured U.S. banks failed. Of these, 85 percent (353) were small institutions with less than $1 billion in assets. Small banks often specialize in small business lending and are associated with local community development and philanthropy. The failures of these banks have raised questions about contributing factors. Further, the failures have raised concerns about the accounting and regulatory requirements needed to maintain reserves large enough to absorb expected loan losses (loan loss allowances)—for example, when borrowers are unable to repay a loan (credit losses).

This statement is based on findings from GAO's 2013 report on recent bank failures (GAO-13-71) required by Pub. L. No 112-88. This testimony discusses (1) the factors that contributed to the bank failures in states with the most failed institutions between 2008 and 2011; (2) the use of shared loss agreements in resolving troubled banks; and (3) the effect of recent bank failures on local communities. To do this work, GAO relied on issued report GAO-13-71 and updated data as appropriate.

View GAO-13-704T. For more information, contact Lawrance Evans, Jr. at (202) 512-4802 or evansl@gao.gov.

What GAO Found

Ten states concentrated in the western, midwestern, and southeastern United States—areas where the housing market had experienced strong growth in the prior decade—each experienced 10 or more commercial bank or thrift (bank) failures between 2008 and 2011. The failures of small banks (those with less than $1 billion in assets) in these states were largely driven by credit losses on commercial real estate (CRE) loans, particularly loans secured by real estate to finance land development and construction. Many of the failed banks had often pursued aggressive growth strategies using nontraditional, riskier funding sources and exhibited weak underwriting and credit administration practices. The Department of the Treasury and the Financial Stability Forum's Working Group on Loss Provisioning observed that earlier recognition of credit losses could have potentially lessened the impact of the crisis. The accounting model used for estimating credit losses is based on historical loss rates, which were low in the prefinancial crisis years. In part due to these accounting rules, loan loss allowances were not adequate to absorb the wave of credit losses that occurred once the financial crisis began. Banks had to recognize these losses through a sudden series of increases (provisions) to the loan loss allowance that reduced earnings and regulatory capital. In December 2012, the Financial Accounting Standards Board issued a proposal for public comment for a loan loss provisioning model that is more forward looking and would incorporate a broader range of credit information. This would result in banks establishing earlier recognition of loan losses for the loans they underwrite and could incentivize prudent risk management practices. It should also help address the cycle of losses and failures that emerged in the recent crisis as banks were forced to increase loan loss allowances and raise capital when they were least able to do so.

The Federal Deposit Insurance Corporation (FDIC) used shared loss agreements to help resolve 281 of the 414 bank failures during the recent financial crisis to minimize the impact on the Deposit Insurance Fund (DIF). Under a shared loss agreement, FDIC absorbs a portion of the loss on specified assets of a failed bank that are purchased by an acquiring bank. FDIC officials, state bank regulators, community banking associations, and acquiring banks of failed institutions GAO interviewed said that shared loss agreements helped to attract potential bidders for failed banks during the financial crisis. FDIC compared the estimated cost of the shared loss agreements to the estimated cost of directly liquidating the failed banks' assets and estimated that the use of shared loss agreements saved the DIF over $40 billion.

GAO analysis of metropolitan and rural areas where bank failures occurred and econometric analysis of bank income and condition data suggested that the acquisitions of failed banks by healthy banks mitigated the potentially negative effects of failures on communities. However, the focus of local lending and philanthropy may have shifted. Also, bank officials whom GAO interviewed noted that in the wake of the bank failures, underwriting standards had tightened. As a result, credit was generally most available for small business owners with good credit histories and strong financials. Further, the effects of bank failures could potentially be significant for communities that had been serviced by only one bank or where only a few banks remain.