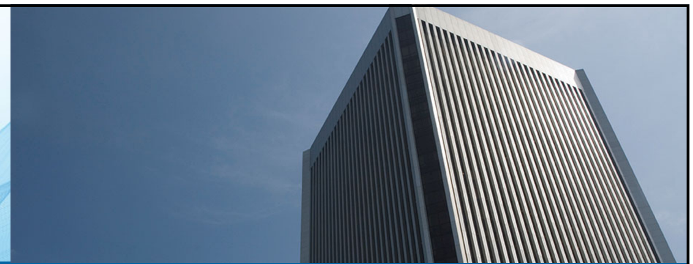


Taking CAMELS for a "Test Drive"

FEDERAL RESERVE BANK OF RICHMOND
Richmond • Baltimore • Charlotte

AJ Duke
July 25, 2022

Disclaimer

The views and opinions expressed in this presentation are solely those of the speaker and do not necessarily represent those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Agenda

- Introduce CAMELS
- Complete Dogwood Bank & Trust case study
- Compare & Contrast Banks Rated Composite 1, 2, 3, 4 & 5
- Dispel Common Myths about Examiners

What day is it?

1	Strong
2	Satisfactory
3	Less than Satisfactory
4	Deficient
5	Critically Deficient

CAMELS

- **Capital**
- **Asset Quality**
- **Management**
- **Earnings**
- **Liquidity**
- **Sensitivity to Market Risk**

Composite

- **Risk Management**

Dogwood Bank & Trust - Background

- 6/30/2019 - 2
- 12/31/2020 - 3
- 12/31/2021 – current exam

More about Dogwood

- $650 million in assets
- Main office and one branch located in Dogwood, Virginia
- Beach City, August 2018 - 75 miles away
- Majority of Asset Quality problems were originated in the new office.
- Bank is currently subject to an enforcement action

Your Assignment

- **12/31/2021 Safety and Soundness exam analysis has just been completed**
- **Analyze the results and rate each CAMELS component and the bank overall**

Ratings	12/31/2021	12/31/2020
Capital		3
Asset Quality		3
Management		3
Earnings		4
Liquidity		2
Sensitivity to Market Risk		2
Composite		3
Risk Management		3

Asset Quality

- Underwriting
- Credit Risk Management & Risk Identification
- Loan Policy
- Classifications & Delinquencies
- Loan Loss Reserve (ALLL)
  - Soon to be CECL
- Concentrations of Credit
- Investment Portfolio

Asset Quality Red Flags

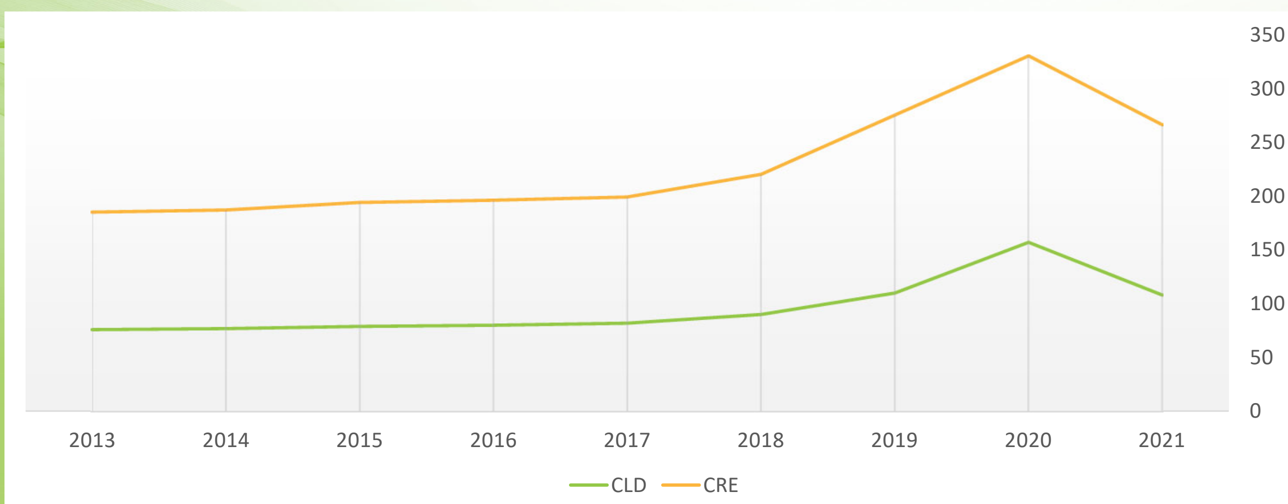
- Improper incentives
- Change in portfolio mix
- Increasing growth rates in total loans or individual categories
- Increase in loan yields
  - Above peer group
- Increase in classifications & special mention
- Increase volume of extensions
- Large volume of technical exceptions
- Increase past due/nonperforming
- Significant increases in ALLL provisions
- Stable or declining ALLL at the same time net loan losses trend upward
- Loans identified by internal/external loan review that are not included in problem loan lists
  - Loans downgraded by examiners
- Increasing levels of Other Real Estate Owned

Dogwood – AQ –2020 Exam

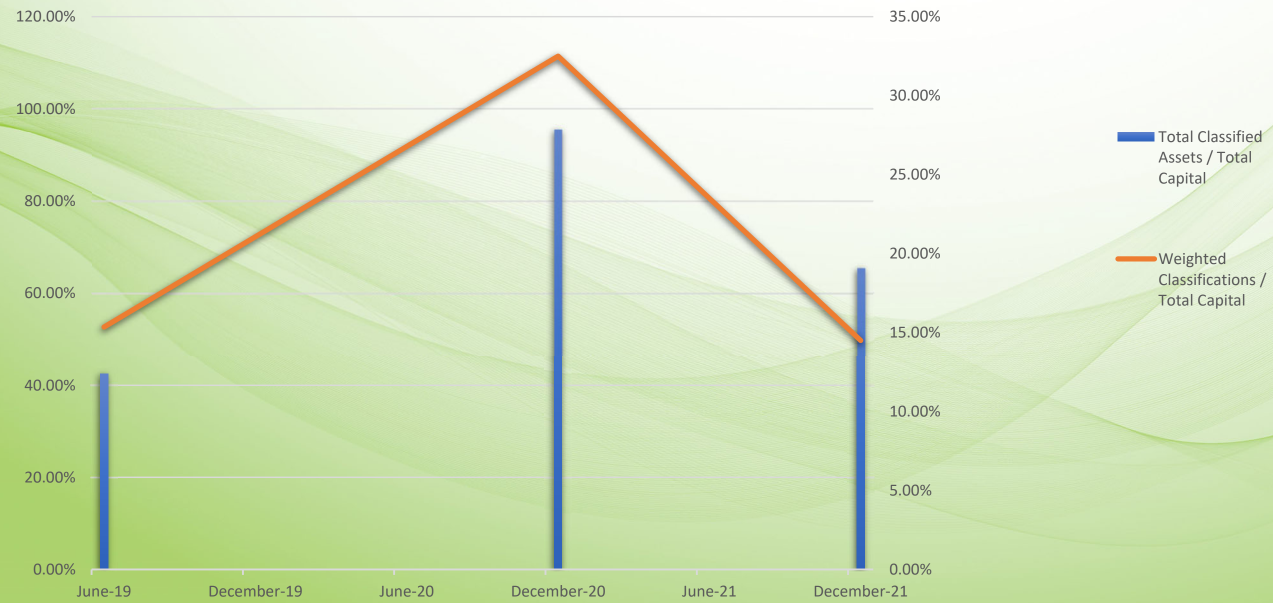
- Aggressive Construction & Land Development (CLD) lending growth, especially in Beach City
- Lax credit administration and credit review processes
- Examiners downgraded 15 relationships
- Five appraisal violations
- Unable to find experienced problem asset personnel
- 62% of C&LD loans were classified
- ALLL methodology and level inadequate

C&LD and CRE Portfolio Balances

Amounts in Millions



Classifications 2020 vs 2021



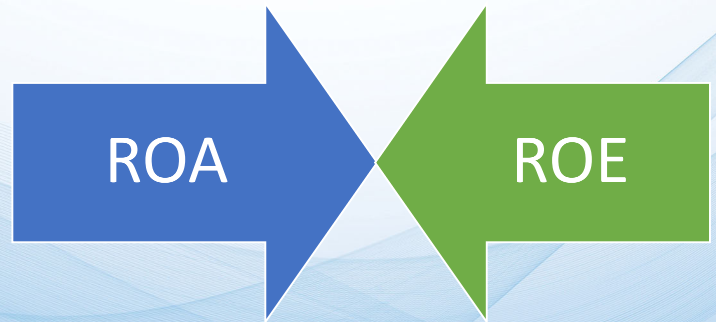
Dogwood – AQ –2021 Exam

- Hired experienced Credit Risk Officer
  - Focused on identifying and addressing problem credits
  - Board receiving monthly updates
  - ALLL methodology has show some improvement
- Improvements noted in appraisal program and no additional violations uncovered at this review.
- Acknowledged concentration risk management needs improvement but no significant progress made.
- **Most problem assets are classified Substandard**

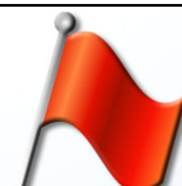
1—A rating of 1 indicates strong asset-quality and credit-administration practices. Identified weaknesses are minor and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is of minimal supervisory concern.
2—A rating of 2 indicates satisfactory assetquality and credit-administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.
3—A rating of 3 is assigned when asset-quality or credit-administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk-management practices.
4—A rating of 4 is assigned to financial institutions with deficient asset-quality or credit administration practices. The levels of risk and problem assets are significant and inadequately controlled, and they subject the financial institution to potential losses that, if left unchecked, may threaten its viability.
5—A rating of 5 represents critically deficient asset-quality or credit-administration practices that present an imminent threat to the institution's viability.

Earnings

- Quality and Composition
- Level and trend
- Vulnerability to market risk
- Budgeting
- Provide for Capital & ALLL



Earnings Red Flags



- Large swings in the ROA, NIM, or non-interest income from prior periods
  - And compared to peer
- Significantly higher or lower interest AND/OR non-interest expenses (aka Overhead)
- Significant variances from budgeted amounts
  - Income from new business lines

Dogwood – Earnings Results

- At 2020 exam, ALLL methodology was deemed inappropriate and unacceptable.
  - Management was required to add an additional $5 million to the ALLL, which effectively wiped-out net income for 2020.
- For 2021, return on assets (ROA) recovered to 0.70%.
  - In line with budget expectations
- Exposure to interest rate risk is not excessive.

	2020	2021	Peer
ROA	0.05	0.70	0.97
NIM	3.15	3.30	3.41
Overhead / AA	2.25	2.55	2.62
Provision / AA	0.10	0.05	0.02

1—A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2—A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3—A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

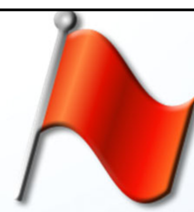
4—A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. These institutions may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5—A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Capital

- Level
- Growth Expectations & Commitments
- Quantity & Quality of Earnings
- Reasonableness of Dividends
- Access to Capital
- Asset Quality (AQ rule of thumb)
- Strength of risk management practices

Capital Red Flags



- Ratios below “well capitalized”
- Assets growing faster than capital
- Declining capital levels or ratios
- Asset quality concerns / increasing loan losses
  - Concentrations
  - Inadequate ALLL
- Significant growth in off-balance-sheet commitments
- High dividend payout ratio

Community Bank Leverage Ratio Framework

- Reduces Burden
- Qualifying community banks

Ratio	$\frac{\text{Tier 1 capital}}{\text{Average total consolidated assets}}$
Requirement	Greater than 9%

Dogwood – Capital Results

- Considered Well Capitalized, cannot “opt-in” to CBLR
- Reluctant to raise capital due to concerns over dilution
  - Family is discussing additional investment.

	2020	2021	Well Capitalized
Tier One Leverage	6.2	6.4	5.0
Common Equity	7.0	7.1	6.5
Tier One RBC	9.5	9.8	8.0
Total Risk-based Capital	10.9	11.0	10.0

1—A rating of 1 indicates a strong capital level relative to the institution's risk profile.
2—A rating of 2 indicates a satisfactory capital level relative to the institution's risk profile.
3—A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.
4—A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.
5—A rating of 5 indicates a critically deficient level of capital. The institution's viability is threatened, and immediate assistance from shareholders or other external sources of financial support is required.

Liquidity

- Adequacy of sources
- Ability to meet needs
- Stability of deposits
- Reliance on "non-core" funding
- Liquid Assets
- Loans & Commitments
- Access
- Risk Management & Monitoring
  - Contingency Planning

Liquidity Red Flags

- Reliance on non-core funding
  - Wholesale funding
  - Borrowings
  - Internet deposits, brokered deposits, etc.
- Declining core deposits.
- Funding concentrations
- Significant decreases in short-term investments

Dogwood – Liquidity Results

- Bank has sufficient short-term assets and access to funding sources to meet expected funding needs in near term.
- Forward looking cash flow analysis is adequate.
- Deposit base is relatively stable and diversified; reliance on brokered funds is slightly higher than average.

1—A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
2—A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.
3—A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may show significant weaknesses in funds-management practices.
4—A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.
5—A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

- Interest Rate Risk
- How sensitive are earnings and capital to changes in interest rates?
  - Rates Up
  - Rates Down
- Ability to identify, measure, monitor, and control exposure to market risk given size, complexity, and risk profile.
  - Adequacy of policies and procedures (limits?)
  - Appropriateness of models and assumptions

Sensitivity Red Flags

- Model results outside of policy limits
- Unrealistic policy limits
- Significant increases or decreases in the percent of long-term assets
- Significant decrease in the percent of core deposits
- Increasing unrealized losses
- IRR Model
  - Not customized
  - Over-reliance on vendor

Dogwood – Sensitivity to Market Risk

- 2020 – Bank engaged new vendor to model IRR
  - Mgmt criticized for not customizing model parameters
- 2021 – Model still using stock assumptions
  - Level of risk is within tolerance range
  - Noncomplex balance sheet structure
- Policy is adequate for noncomplex

Sensitivity Rating

1—A rating of 1 indicates that market-risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.
2—A rating of 2 indicates that market-risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.
3—A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.
4—A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.
5—A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

Management

- Quality of Board and Senior Management oversight; Corporate Governance
- Effectiveness of strategic planning and ability to adapt to changing business conditions
- Management depth and succession
- Compliance with laws and regulations
- Overall performance of the institution and its risk profile
- Specialty ratings – Information Technology, Trust, Consumer Compliance
- Risk Management – separate rating

Risk Management

Identify – Measure – Monitor – Control

- Active board and senior management oversight
- Adequate policies, procedures, and limits
- Adequate risk management, monitoring, and MIS
- Comprehensive internal controls and audits

The Six Risks

- **Credit**
- **Market**
- **Liquidity**
- **Operational**
- **Compliance**
- **Legal**

Management / Risk Mgmt

- Dominance of one individual
  - Lack of succession plan
- Minimal discussion in board minutes
  - Little or no challenge by board
- Not following strategic plan
- Weak policies
  - Not up-to-date
- Dismissive of examiners, auditors, or consultant recommendations
  - Risk Management and/or Internal Audit that lacks clout

2020 Exam Findings

- President Waters controlled virtually all aspects of the operation.
  - Responsive to examiners recommendations
- Failed to recognize credit risk from Beach City branch
- Policies generally adequate
- Management is operating outside of loan policy guidelines
  - Board awareness or approval of policy exceptions is not evident
- Renewals and extensions masked the true risk in the loan portfolio
  - Caused the increase in the ALLL provision.
- Fledgling Internal Audit department

2021 Exam Findings

- Heavily involved in day-to-day operations.
- Board has taken a more active role
- Hired experienced Credit Risk Officer (CRO)
  - Improvements AQ / credit risk management
- Monthly updates from CRO and Internal Auditor regarding problem loans, ALLL methodology, and other areas with weaknesses outlined in exams
- Strategic planning has been minimal
  - Intends to limit growth and focus on reducing risk in real estate portfolio and conduct an economic analysis of the bank's markets
- Several previous recommendations such as loan exception tracking report have been implemented.
- Subcommittee established to review and update all bank policies over the next four quarters.

1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2—A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3—A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4—A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5—A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Risk Management Rating

1—(Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the institution's activities, including those from new products and changing market conditions. The board and management are active participants in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the necessary information and analysis to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, monitor, and control risks to the institution.

2—(Satisfactory). A rating of 2 indicates that the institution's management of risk is largely effective, but lacking to some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution's business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention. Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

3—(Fair). A rating of 3 signifies risk management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management are considered fair, and have precluded the institution from fully addressing a significant risk to its operations. Certain risk management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control adequately all
significant risks to the institution. Weaknesses may include continued control exceptions or failures to adhere to written policies and procedures that could have adverse effects on the institution. The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the institution if corrective actions are not taken by management.

4—(Marginal). A rating of 4 represents marginal risk management practices that generally
fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective
action by the board and management. A number of significant risks to the institution have not been adequately addressed, and the risk management deficiencies warrant a high degree of supervisory attention. The institution may have serious identified
weaknesses, such as an inadequate separation of duties, that require substantial improvement in its internal control or accounting procedures or in its ability to adhere to supervisory standards or requirements. Unless properly addressed, these conditions may result in unreliable financial records or reports or operating losses that could seriously affect the safety and soundness of the institution.

5—(Unsatisfactory). A rating of 5 indicates a critical absence of effective risk management
practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient and management and the board have not demonstrated the capability to address deficiencies.
Internal controls may be sufficiently weak as to jeopardize seriously the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and about potential losses that could result if corrective measures are not taken immediately. Deficiencies in the institution's risk management procedures and internal controls require immediate and close supervisory attention

Composite Snapshots

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- Committed outreach and education programs
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Questions

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The Case for the Community Banking Business Model: Lessons Learned from COVID-19

by Jessica Olayvar, Supervisory Analyst, Supervision, Regulation, and Credit, Federal Reserve Bank of Richmond

In March 2020, community bankers across the country began to realize the threat posed by COVID-19 and were forced to quickly make myriad decisions. Management teams carefully considered their options before deciding to close lobbies, deploy remote technology to employees, and hold board meetings virtually. These decisions were only the tip of the iceberg for what was to come. Outside of the operational logistics, community bank leaders began to implement contingency plans and carefully watch liquidity metrics, and increased loan loss reserves in anticipation of deterioration in credit conditions. The prompt and conservative response of community banks during this critical time has since been recognized by many. For example, in September 2020, Esther George, president of the Federal Reserve Bank of Kansas City, spoke about the way community banks remained vigilant at the outset of the pandemic by strengthening their balance sheets in preparation for a downturn.[1]

In response to the anticipation of a potential downturn, the Federal Reserve System and other regulatory agencies released a joint statement on March 26, 2020, encouraging banks to work with customers adversely affected by the pandemic, through either responsible small-dollar lending or loan modifications and workout strategies.[2] Many community banks took immediate action by accommodating affected borrowers with loan deferrals or modifications. Just a couple weeks later, these same banks would play an instrumental role in implementing the Paycheck Protection Program (PPP), following the passage of the Coronavirus Aid, Relief, and Economic Security Act (CARES) Act.

Today, as the economy continues to rebound from two years of fluctuations and unknowns, one thing is certain: Community banks continue to support their customers and advance the strength of their local economies. As competition, mergers and acquisitions, regulatory burden, and margin compression threaten the future of the community banking business model, the need for it has never been clearer. The pandemic posed enormous challenges to community banks, and it was because of — not despite — their business model that they were able to support small businesses.

Financial Resilience

Community banks have long established their ability to weather economic downturns, in many cases more successfully than much larger banks. A 2012 analysis by the Federal Reserve Bank of Dallas indicated that during the Great Recession, community banks in all but six states (Nevada, Arizona, Florida, Georgia, Michigan, and Illinois) had, on average, fewer loan problems than their largest competitors.[3] In addition, in June 2012, community banks held around twice as many business loans as a percentage of total assets as the nation's largest banks (28 to 31 percent for community banks, 12 percent for large banks). Nevertheless, those community banks generally had a smaller percentage of business loans (nonfarm, nonresidential, plus commercial and industrial) that were noncurrent or charged off.

A recent study in *Research in International Business and Finance* found that FDIC–chartered community banks with assets under $1 billion were more financially resilient than their large bank counterparts in various ways during the first three quarters of 2020.[4] The study used return on assets (ROA), return on equity (ROE), and net interest margin (NIM) as metrics for comparison and found that both the ROA and ROE declined significantly less at community banks with assets under $1 billion. Furthermore, during the affected periods, the study found that community banks' NIM declined less than large institutions' NIM. In both this recent study and the plethora of analyses conducted on community banking performance during a recession, financial resilience is credited largely to one key characteristic: Community banks know their borrowers and the local business environment, and this knowledge is a significant advantage over large institutions during challenging economic periods.

Commitment to Small Businesses

As noted above, many retrospective studies note that high-quality loan portfolios are the foundation of successful community bank performance. Some researchers have ascribed this to the community banks' noncomplex hierarchies and ownership structure, meaning each individual in a business line is closer to the customer, tends to have more at stake, and thus takes fewer risks. This was further illustrated in the aforementioned study in which the researchers found that, at the start of the pandemic, community banks' risk-weighted assets declined more quickly than those of larger banks, suggesting a more conservative risk management approach at community banks.

Furthermore, community bankers most often live in or near the communities they serve, giving them a strong, personal knowledge of both their customers and market conditions. This deep understanding of the local economy and focus on relationship banking, rather than transactional banking, gives community banks unique insights in assessing the potential risks of a given transaction. Additionally, the focus on building a relationship with borrowers is attractive to prospective customers, specifically small businesses. In a September 2020 speech, Governor Michelle W. Bowman noted that, prior to the pandemic, community banks accounted for over 40 percent of all small business lending despite accounting for only 15 percent of total assets in the banking system.[5]

Throughout the pandemic, community banks have shown the importance of relationship banking. In her speech, Governor Bowman noted that in her discussions with community bank CEOs, she heard stories about how bankers conducted extensive customer outreach, including bankers who personally reached out to every one of their bank's business and consumer loan customers to offer deferrals as needed. Later, as the CARES Act was passed, community banks played an important role in implementing the PPP and, to a lesser extent, the Main Street Lending Program. Nationwide participation for these programs totaled $799.8 billion and $17.5 billion, respectively.[6],[7] As large banks turned away customers, often due to overwhelmed systems and call centers, community banks stepped in to help small businesses.[8] According to the FDIC, as of June 30, 2020, community banks held 31 percent of PPP loans held by the banking industry; this is a significant share given that community banks held 12 percent of total industry assets and 15 percent of total industry loans.[9] Relationship banking, more so than sophisticated banking systems or unlimited resources, allowed community banks to effectively implement these stimulus programs.

For many community banks, administering the multiple rounds of the PPP loans was an "all-hands-on-deck" effort. The responsibility to help neighbors and local businesses was a heavy burden for community bank employees, as many worked around the clock under difficult circumstances to manually process applications. Nevertheless, many community banks were able to process PPP applications for small businesses at a faster pace than larger banks could.[10] With less red tape and shorter queues, community banks exhibited greater PPP processing agility than larger banks.

Contributions to the Financial System

The long-term effects of the CARES Act are still unclear. However, a study by two Federal Reserve economists published in January 2021 estimated that PPP loans saved 13 million jobs.[11] As we have seen, community banks played a big role in processing PPP loans. Beyond their support to the economic recovery from the pandemic, community banks contribute to the health of the economy in other ways.

In 2018, the Federal Reserve Bank of Philadelphia published a paper that considered the impact of mergers and acquisitions of community banks on small businesses' access to credit.[12] The results of the study noted that the overall impact of community bank mergers is dependent upon where the acquirers and target institutions were located prior to the merger. When these institutions became targets of a merger or acquisition by a nonlocal acquirer, the study found, small businesses in the targeted bank's market area experienced lending gaps that were not filled by the remaining banking sector. This suggests the importance of community banks' lending activities and the potentially adverse economic externalities of merger activity.

In 2012, the Federal Reserve Bank of Dallas published a series of essays written by financial experts highlighting the links between a robust financial system and a strong community banking sector. In the essay series, the authors contend that compared with larger firms, community banks had stronger underwriting practices and asset quality, focused on small businesses, and were supportive of customers during times of financial crises. To quote the end of one essay, "Recent experience suggests that reestablishing a more prominent role for traditional banking, as exemplified by community banks, could help the nation achieve greater financial stability. Policymakers should take note."[13]

Conclusion

The pandemic resulted in an unprecedented shock to the U.S. financial system. In April 2020, more than 20 million jobs were eliminated, and unemployment reached 14.7 percent. By comparison, during the Great Recession job losses in one month peaked at 800,000 in March 2009 and unemployment reached a record high of 10 percent in October 2009.[14] Yet, during the past two years, community banks have continued to demonstrate their financial resilience and commitment to serving small businesses. As the memories of the initial shock from the pandemic fade, we will continue to recognize the importance of community banks in providing banking services and credit to their communities in a safe and sound manner.

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[1] The September 25, 2020, speech, "Community Banks: Stability in Crisis and Catalysts for Recovery," given at the virtual Independent Bankers of Colorado Annual Convention, is available at www.kansascityfed.org/documents/7429/2020-george-colorado-09-25.pdf.

[2] The joint statement is available at www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200326a1.pdf.

[3] See Jeffrey W. Gunther and Kelly Klemme, "Financial Stability: Traditional Banks Pave the Way," Federal Reserve Bank of Dallas, 2012, available at www.txcte.org/resource/financial-stability-traditional-banks-pave-way.

[4] See M. Kabir Hassan, M. Sydul Karim, Shari Lawrence, and Tastaftiyan Risfandy, "Weathering the COVID-19 Storm: The Case of Community Banks," *Research in International Business and Finance,* Vol. 60, April 2022, available at www.sciencedirect.com/science/article/pii/S0275531921002294.

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