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North Carolina Community Banks: Survival Strategies for Turbulent Times

I. INTRODUCTION

Community banks in North Carolina are facing new challenges in an already uncertain market. Although the melodies of the string quartet playing "Song d' Automne" can still be heard, it is impossible not to notice that the ship is sinking.[1] After struggling to comply with regulations imposed by the Sarbanes-Oxley Act (SOX),[2] community banks are now facing significant new regulations and risk-based capital requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[3] and Basel III.[4] The increased cost of compliance and higher capital requirements are placing great strains on community banks, and many must either find a buyer to infuse new capital[5] or be subject to failure.[6]

[1] The band aboard the Titanic was playing "Song d' Automne" (Song of Autumn) while the Titanic sank, according to an interview given to The New York Times by the Titanic's junior wireless operator, Harold Bride, upon his arrival to New York via the rescue ship Carpathia. Harold Bride, *Thrilling Tale by Titanic's Surviving Wireless Man*, N. Y. TIMES (Apr. 28, 1912), http://query.nytimes.com/mem/archive-free/pdf?_r=1&res=9C02E3DD103AE633A2575BC2A9629C946396D6CF.

[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in sections of 15 U.S.C. §§ 7201-7266).

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of the U.S. Code).

[4] Press Release, Bank of Int'l Settlements, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Sys. (Dec. 2010) [hereinafter Basel III], *available at* http://www.bis.org/publ/bcbs189_dec2010.htm.

[5] *See* Press Release, N. C. Office of the Comm'r of Banks, First Bank in Troy, NC, Acquires Deposits of the Bank of Asheville (Jan. 21, 2011), *available at* http://www.nccob.gov/public/docs/News/Press%20Releases/thebankofashevillepressrelease.pdf (expressing displeasure at the closure of another state bank, but highlighting that it was acquired by a North Carolina bank); *see also* Barbara A. Rehm, *Community Bankers Face a Choice: Sell Out, Fold or Change*, AM. BANKER (June 2, 2012), http://www.americanbanker.com/bankthink/operating-revenue-community-banks-1038365-1.html?CMP=OTC-RSS.

[6] *See* Dave Clarke, *FDIC Expects 50 to 60 U.S. Bank Failures This Year*, REUTERS, Apr. 17, 2012, *available at* http://www.reuters.com/article/2012/04/17/financial-regualtion-fdic-idUSL2E8FHFSY20120417 (stating that "[c]ommunity banks, many of which have less than $1 billion in assets, have had the most trouble keeping their doors open . . ."); *see also* Rehm, *supra* note 5.

In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal)[7] repealed the restrictions on interstate branching and interstate banking[8] set forth by the Douglas Amendment[9] of the Bank Holding Company Act (BHCA).[10] Riegle-Neal allowed large banks to open new branches and acquire existing banks in states where they were not domiciled.[11] By repealing portions of the Glass-Steagall Act (Glass-Steagall)[12] in 1999, the Gramm-Leach-Bliley Act (GLBA)[13] lifted prohibitions on common ownership of investment banks and commercial banks by bank holding companies and promoted consolidation in the financial industry. Unfortunately, even in an increasingly consolidated market,[14] many community banks have no potential acquirers.[15] The recent success of community bank mergers seems to suggest that the best hope for community banks in North Carolina may be to band together.

This Note will focus on the various options available to North Carolina community banks in need of additional capital or struggling

[7] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified in scattered sections of 12 U.S.C.).

[8] LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 659 (4th ed. 2010).

[9] The Douglas Amendment limited a bank holding company to acquiring no more than 5% of voting stock in any out-of-state bank. Charles Morris, *The Competitive Effects of Interstate Banking*, 69 FED. RES. BANK OF KAN. CITY ECON. REV., Nov. 1984, at 3, 4, *available at* http://www.kc.frb.org/PUBLICAT/EconRev/EconRevArchive/1984/4q84morr.pdf.

[10] 12 U.S.C. § 1841 (1956). The BHCA amended the McFadden Act of 1927, which allowed banks to branch in any state but were restricted by the laws of that state. Morris, *supra* note 9.

[11] BROOME, *supra* note 8, at 659.

[12] The Glass-Steagel Act is part of the Banking Act of 1933 (establishing, amongst other things, the Federal Deposit Insurance Corporation (FDIC)). Pub.L. 73-66, 48 Stat. 162 (1933).

[13] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[14] Brought about in part by the Gramm-Leach-Bliley Act, Pub.L. 106-102, 113 Stat. 1338 (1999), that effectively repealed Glass-Steagall, part of the Banking Act of 1933, 48 Stat. 162 (1933). Gramm-Leach-Bliley allowed the merging of commercial banks and investment banks, which, in addition to promoting consolidation in the market, arguably helped cause the financial crisis. *Compare* James Rickards, *Repeal of Glass-Steagall Caused the Financial Crisis*, ECON. INTELLIGENCE (Aug. 27, 2012), http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-glass-steagall-caused-the-financial-crisis, *with* Barry Ritholtz, *Repeal of Glass-Steagall: Not a cause, but a multiplier*, THE BIG PICTURE (Aug. 11, 2012, 9:00 AM), http://www.ritholtz.com/blog/2012/08/repeal-of-glass-steagall-not-a-cause-but-a-multiplier/.

[15] Interview with Anthony Gaeta, Adjunct Professor of Law, UNC School of Law, in Chapel Hill, N.C. (Sept. 6, 2012) (notes on file with the North Carolina Banking Institute Journal).

from the increased costs of regulatory compliance. It will argue that without potential purchasers, community banks may need to band together through mergers to obtain the critical size needed to absorb new compliance costs and to attract private equity capital.[16]

Part II will provide the background of the legislative events leading up to the current community banking crisis and the effects of the legislation.[17] Next, Part III will explore the options available to North Carolina community banks in order to raise capital and successfully comply with new and existing regulations.[18] The potential benefits and problems with each of these strategies will be explored in this section, as well as the potential problems that may arise if any of these strategies are employed.[19] Additionally, Part III will consider how the Federal Reserve's Final Policy Statement on Qualifications for Failed Bank Acquisitions in 2009 (Final Policy Statement)[20] affects M&A activity among community banks. Finally, Part IV will discuss the adverse effects that the shrinking number of community banks may have on communities, and whether there are entities, such as larger interstate banks or credit unions, that can fill the void left by community banks.[21] The question remains, will the disappearance of community banks devastate North Carolina communities by decreasing the availability of mortgage and small business loans, or is the inevitable disappearance of community banks simply a natural and welcomed stage in the evolution of the banking industry?[22]

[16] *Id.*

[17] *See infra* Part II.

[18] *See infra* Part III.

[19] *See infra* Part III.

[20] Final Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440 (FDIC Sept. 2, 2009), *available at* www.fdic.gov/regulations/laws/federal/2009/09FinalSOP92.pdf [hereinafter Final Policy Statement]. *See also Statement of Policy on Qualifications for Failed Bank Acquisitions Q&As*, FDIC, http://www.fdic.gov/regulations/laws/faqfbqual.html (last updated Apr. 23, 2010) [hereinafter Final Policy Statement Q&A].

[21] *See infra* Part IV.

[22] *See* Steve Cocheo, *The Community Bank of the Future: What's It Going to Look Like?*, AM. BANKERS ASS'N BANKING J., May 2010, *available at* http://www.ababj.com/briefing/the-community-bank-of-the-future-what-s-it-going-to-look-like.html (discussing the future relevance of community banks).

II. THE EFFECTS OF INCREASED REGULATIONS ON COMMUNITY BANKS

A. *Acts and Regulations*

1. Riegle-Neal Interstate Banking and Branching Efficiency Act

In 1994, Riegle-Neal amended the BHCA, and opened the door to interstate bank branching.[23] Interstate branching allowed large out-of-state banks to establish branches in other states, often by acquisition of a community bank in that state.[24] Out-of-state banks were also then able to establish de novo branches in the new state.[25] The number of potential competitors for local community banks significantly increased as a result of interstate branching.[26] Certain provisions of Riegle-Neal allowed bank holding companies to acquire banks in other states even if the acquisition conflicted with state laws.[27]

One provision of Riegle-Neal was specifically designed to protect community banks by prompting federal review of any branch that has less than one-half the state's average ratio of in-state loans to in-state deposits.[28] This protected communities by ensuring that out-of-state banks would not simply take deposits from one state and use them to make loans in another state, but would instead use the deposits to "meet the needs of that community."[29] That restriction may have prevented large banks from siphoning money out of one state and into another, but community banks suffered as a result of the competition brought about by interstate branching.[30] Moreover, because banks were able to create de novo branches, competition increased[31] and acquisition

[23] *See* H.R. Rep. No. 103-448, at 19 (1994), *reprinted in* 1994 U.S.C.C.A.N. 2039, 2042 (stating that "geographic restraints on banking have been in place for more than half a century.").

[24] BROOME, *supra* note 8, at 660.

[25] *Id.* at 659.

[26] *See* Morris, *supra* note 9, at 7-8.

[27] 12 U.S.C.A. § 1842(d)(1)(A) (effective July 21, 2011).

[28] 12 C.F.R. § 25.41 (2013).

[29] FDIC, COMPLIANCE MANUAL, SECTION X-4.1, PROHIBITION AGAINST USE OF INTERSTATE BRANCHES PRIMARILY FOR DEPOSIT PRODUCTION (2006), *available at* http://www.fdic.gov/regulations/compliance/manual/pdf/X-4.1.pdf.

[30] *See* Charles Morris, *supra* note 10, at 7-8.

[31] *See* Elliott Davis, LLC, Community Banking Advisor, Bank Reform – The Good, the Bad, and the Assorted (Fall 2010), http://www.elliottdavis.com/assets/Community-Banking-Advisor-Fall-2010.pdf.

became less of an option for struggling community banks.[32]

2. Gramm-Leach-Bliley Act

The GLBA was designed to protect consumers' personal and financial information.[33] However, the GLBA is perhaps best known as the repeal of Glass-Steagall. By repealing Glass-Steagall, the GLBA eliminated substantial regulation and allowed bank holding companies to innovate, merge, and grow into large, complex, and highly leveraged entities.[34] A bank holding company that met minimal qualifications under the GLBA could be designated a financial holding company, allowing it to acquire companies that were engaged in "financial-in-nature" activities, including investment banks and insurance companies.[35] The expansion of financial holding companies into a broader array of financial activities helped to foster the mortgage-backed securities market that contributed to the financial crisis of 2008,[36] which led to the seven hundred billion dollar federal bailout[37] and the enactment of Dodd-Frank.[38]

3. Sarbanes-Oxley Act

SOX was adopted in the wake of the failure of Enron and was intended to improve the reliability of disclosures by public companies, including financial institutions.[39] Improving the reliability of disclosures is a reasonable goal, but SOX had some negative effects on

[32] *See* Gary Whalen, *The Impact of the Growth of Large, Multistate Banking Organizations on Community Bank Profitability* 9 (OCC, Working Paper No. 2001-5, 2001), *available at* http://www.occ.treas.gov/publications/publications-by-type/economics-working-papers/2008-2000/wp2001-5.pdf.

[33] *Privacy Act Issues Under Gramm-Leach-Bliley*, FDIC, http://www.fdic.gov/consumers/consumer/alerts/glba.html (last updated Jan. 29, 2009).

[34] Ritholtz, *supra* note 14.

[35] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 103, 113 Stat. 1338, 1342 (1999).

[36] *See* Rickards, *supra* note 14.

[37] The Emergency Economic Stability Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

[38] *See* Bernard Shull, *Too Big to Fail: Motives, Countermeasures, and the Dodd-Frank Response* 3 (Levy Econ. Inst. of Bard C., Working Paper No.709, 2012), *available at* http://www.levyinstitute.org/pubs/wp_709.pdf.

[39] *Sarbanes-Oxley Essential Information*, SOX-ONLINE, http://www.sox-online.com/basics.html (last visited Jan. 29, 2013).

community banks, notably the cost of compliance and the increased cost of records management.[40] A main concern of community banks is section 404 of the Act,[41] which states, "Issuers are required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting."[42] Section 404 placed a tremendous and disproportionate burden on publicly held community banks, which directly led to a decrease in profitability and competitiveness.[43] In the three years following SOX, over seventy-five community banks filed to go private to avoid SEC regulation.[44] The Jumpstart Our Business Startups Act of 2012 (JOBS Act)[45] allowed small public banks to raise capital without spending hundreds of thousands of dollars on SEC registration and compliance by raising the number of shareholders a bank may have before being required to register with the SEC from 500 to 2,000.[46] Additionally, if a bank is registered but meets certain standards, it may deregister.[47] However, there is a downside to deregistration. If a bank chooses to deregister, its stock will no longer be publicly traded, making its stock less liquid and less appealing to potential buyers.[48] In a stock-for-stock acquisition, a seller will want the acquirer's stock to be readily sellable in a liquid market.[49] In short, deregistering seriously limits any bank's ability to merge, acquire, or be acquired. Even after the JOBS

[40] *See* Jo Lynne Koehn & Stephen C. Del Vecchio, *The Ripple Effect of the Sarbanes-Oxley Act*, THE CPA J., 2004, *available at* http://www.nysscpa.org/cpajournal/2004/204/essentials/p36.htm.

[41] *See* Letter from Christopher Cole, Regulatory Counsel, Independent Community Bankers of America, to Nancy M. Morris, Fed. Advisory Comm. Mgmt. Officer, SEC, and Off. of the Sec'y, PCAOB (May 8, 2006), *available at* http://www.icba.org/files/ICBASites/PDFs/cl050806a.pdf.

[42] *A Guide To Sarbanes-Oxley Section 404*, SOXLAW (2004), http://www.soxlaw.com/s404.htm (last visited October 19, 2012).

[43] *See* Cole, *supra* note 41.

[44] *Id.*

[45] Jumpstart our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306 (2012).

[46] *Id.*, at 326; *see also* Danielle Douglas, *JOBS Act Could Give Some Banks a Boost*, CAP. BUS. (April 8, 2012), http://www.washingtonpost.com/business/capitalbusiness/jobs-act-could-give-some-banks-a-boost/2012/04/06/gIQAP2ud4S_story.html.

[47] Jumpstart our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 326 (2012).

[48] Gaeta Interview, *supra* note 15 (stating that because a publicly traded company's stock is much more ambulatory than a private company, it is preferable to investors and purchasers).

[49] *Id.*

Act, the effects of SOX, although weakened, are still broadly and substantially felt.[50]

4. Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank is the most significant banking legislation since the Great Depression,[51] and many community banks feel that they received the short end of the stick.[52] Specifically, community bankers assert that (1) it was the large investment banks that caused the financial crisis of 2008 and it is unfair to impose new regulations on small community banks as a response to something that they had no hand in creating; and (2) the heavy regulatory burden imposed by Dodd-Frank is disproportionately damaging to smaller banks.[53]

Many aspects of Dodd-Frank have caused concern among community bankers. For example, Dodd-Frank gives the Federal Reserve (Fed) the authority to examine subsidiaries of bank holding companies (BHCs) and savings and loan holding companies (SLHCs).[54] Additionally, BHCs must meet increased capital requirements in order to conduct interstate mergers.[55] Under Dodd-Frank, the Fed will make capital regulations countercyclical, meaning that capital requirements will fluctuate based on economic expansion and contraction.[56] Simply

[50] *See* James K. Gentry, *Sarbanes-Oxley Impact Extends Far Beyond Public Companies*, BUISNESSJOURNALISM.ORG (Dec. 11, 2011), http://businessjournalism.org/pages/biz/2006/06/sarbanesoxley_impact_extends_f/.

[51] Client Alert, Morrison & Foerster LLP, The Dodd-Frank Act: A Cheat Sheet (2010), *available at* http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf [hereinafter Dodd-Frank Cheat Sheet].

[52] *See Rising Regulatory Compliance Costs and Their Impact on the Health of Small Financial Institutions: Hearing Before the Subcomm on Fin. Inst. and Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 49 (2012), *available at* http://financialservices.house.gov/uploadedfiles/112-122.pdf (prepared statement of William Grant on behalf of the American Bankers Association) [hereinafter Grant].

[53] *See* Victoria McGrane, *Small Banks Are Blunt in Dislike of New Rules*, WALL ST. J., Aug. 7, 2012, *available at* http://online.wsj.com/article/SB10000872396390443545504577563352622533704.html; *see also id.*

[54] 12 U.S.C. § 5361(a)(1)(A) (Supp. IV 2010); *see also* Press Release, Indep. Cmty. Bankers Ass'n, ICBA Releases Community Bank Reference Guide to Dodd-Frank (Jan. 25, 2012), *available at* http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=99100.

[55] 12 U.S.C. § 1842(d)(1)(A) (Supp. IV 2010); *see also* Press Release, Indep. Cmty. Bankers Ass'n, ICBA Releases Community Bank Reference Guide to Dodd-Frank (Jan. 25, 2012), *available at* http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=99100.

[56] Press Release, Indep. Cmty. Bankers Ass'n, ICBA Releases Community Bank

put, in good economic times, banks will be required to build a capital buffer to be drawn from in bad economic times. It follows that more complex requirements will trigger an increase in the compliance costs. There will be new small business loan data collection requirements as well,[57] in addition to the SOX reporting requirements that, again, will create more administrative and compliance costs.

With Dodd-Frank came the creation of a new regulative agency, the Consumer Financial Protection Bureau (CFPB), which, while only having enforcement authority over banks with $10 billion or more in assets,[58] will have the ability to create rules to prevent "unfair, deceptive, or abusive practices"[59] that will be universally applied to banks of *any* size.[60] A community bank's current regulator will enforce CFPB rules,[61] but it is yet to be seen how extensive those rules will be.[62] Many rules have been finalized and will become effective in 2013, and more are likely to be adopted.[63] The CFPB does have the ability to exempt any class of providers, products, or services from a rule,[64] but it is not often that a government agency uses its power to exempt anyone from its rules.[65] Further, it is unclear how much affect, if any, the Volcker Rule[66] will have on community banks. However, if it is implemented, it could restrict banking entities from investing in hedge funds or private equity funds.[67]

Despite the potential negative effects of Dodd-Frank on

Reference Guide to Dodd-Frank (Jan. 25, 2012), *available at* http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=99100.

[57] *Id.*

[58] 12 U.S.C. § 5516(a) (Supp. IV 2010).

[59] 12 U.S.C. § 5531(b) (Supp. IV 2010).

[60] 12 U.S.C. § 5511 (Supp. IV 2010).

[61] 12 U.S.C. § 5516 (Supp. IV 2010).

[62] *See* Kelsey Weaver, *Debate: How Will the CFPB Impact Banks?*, BANKDIRECTOR.COM (June 20, 2012), http://www.bankdirector.com/board-issues/legal/debate-how-will-the-cf-pb-impact-banks/.

[63] CFPB Electronic Fund Transfers (Regulation E), 12 C.F.R. § 1005 (2012).

[64] 12 U.S.C. § 5512 (Supp. IV 2010).

[65] Telephone Interview with Mike Patterson, CEO, CapStone Bank (Sept. 13, 2012) (notes on file with the North Carolina Banking Institute Journal) (stating that the government imposes regulations, but rarely removes them).

[66] The Volker rule "prohibits banks from engaging in short-term trading of any security, derivatives and certain other financial instruments from a bank's own funds. And it prohibits owning, sponsoring, or having certain relationships with a hedge fund or private equity fund." *Volker Rule: CNBC Explains*, CNBC (Apr. 19, 2012), http://www.cnbc.com/id/44891917/Volcker_Rule_CNBC_Explains.

[67] Dodd-Frank Cheat Sheet, *supra* note 51.

community banks, there are some provisions that may be beneficial. For example, coverage under the deposit insurance reform that now assesses insurance costs based on assets less tangible capital will permanently raise deposit insurance limits to $250,000,[68] which will reward smaller and conservatively capitalized banks. Additionally, interest-bearing transaction accounts, such as business checking accounts, are now authorized,[69] which may increase deposit capital. Moreover, Dodd-Frank required that a study be conducted by the SEC on the burden that SOX 404(b) places on businesses with a market capitalization of between $75 million and $250 million, as well as a second study to be conducted by the GAO[70] to compare the capital costs of exempt and non-exempt companies.[71] Community banks with less than $75 million are currently exempted from the attestation requirement of SOX 404(b). However, although the SEC has recommended keeping SOX 404(b) compliance requirements for businesses with more than $75 million,[72] the GAO study, which is due in July 2013, could cause an increase in the threshold for exemption to as high as $1 billion.[73] Increasing the threshold could lower compliance costs for many community banks, however slight.

It is difficult to precisely identify the possible implications of the 848 pages of legislation, 3,894 pages of proposed regulations,[74] and the 400 plus rules[75] that make up Dodd-Frank, but one thing seems certain: the cost of compliance that North Carolina banks are facing is

[68] *Id.*

[69] *Id.*

[70] U.S. Government Accountability Office.

[71] Dodd-Frank Wall Street Reform and Consumer Protection Act § 989G(b), Pub. L. No. 111-203, 124 Stat. 1376, 1948 (2010).

[72] OFFICE OF THE CHIEF ACCOUNTANT OF THE SEC, STUDY AND RECOMMENDATIONS ON SECTION 404(B) OF THE SARBANES-OXLEY ACT OF 2002 FOR ISSUERS WITH A PUBLIC FLOAT BETWEEN $75 AND $250 MILLION 49 (2011), *available at* http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

[73] According to the American Institute of CPAs, various bills have been introduced in Congress that would expand the Dodd-Frank exemption, including an amendment to the JOBS Act proposed by congressman Ed Royce of California that would have exempted all public companies with a public float of less than $1 billion from the 404(b) requirements (which he later withdrew). *Section 404(b) of Sarbanes-Oxley Act of 2002*, AM. INST. OF CPAS, http://www.aicpa.org/Advocacy/Issues/Pages/Section404bofSOX.aspx (last visited January 17, 2013).

[74] Grant, *supra* note 52.

[75] *Id.*

substantial and potentially devastating.[76] For example, First United Bank and Trust, a Maryland bank with assets of $1.38 billion, conservatively estimates $2.5 million in compliance costs per year.[77] Additionally, it estimates that 64% of its approximately 400 employees will have compliance obligations to fulfill.[78] Larger banking entities may have a compliance department or in-house counsel in addition to at least one law firm on retainer, but community banks usually lack such resources.[79] William B. Grant of the American Bankers Association (ABA) believes that in addition to the cost of compliance, some rules themselves, such as mortgage lending rules and municipal advisor registration, will ultimately drive community banks out of business.[80]

Many believe that Dodd-Frank was in essence a trade-off: regulatory imposition on "Too Big To Fail" (TBTF) banks in return for a $700 billion TARP[81] bailout.[82] This has projected the perception that larger banks will receive government backing in times of crisis, which has hurt smaller community banks and has made it harder for them to raise deposit capital.[83] Indeed, some community bank board members do not bank with the institution that they represent because they want the security of banking at a TBTF institution.[84]

[76] *See generally id.*

[77] *Id.*

[78] *Id.*

[79] Gaeta Interview, *supra* note 15.

[80] Grant, *supra* note 52.

[81] The Troubled Asset Relief Program was authorized to purchase and guarantee troubled assets from any financial institution by the Emergency Economic Stabilization Act of 2008 (EESA), which was passed to "promote the stability and liquidity of the financial system." *What is TARP and Why Did We Need It?*, U.S. DEP'T. OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/about/Pages/What-Is-Tarp.aspx (last visited Jan. 17, 2013).

[82] *See Has Dodd-Frank Ended Too Big to Fail?: Hearing Before the H. Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight and Gov't Reform,* 112 Cong. 92 (2011) *available at* http://oversight.house.gov/wp-content/uploads/2012/04/3-30-11-Subcommittee-on-TARP-Financial-Services-and-Bailouts-of-Public-and-Private-Programs-Hearing-Transcript.pdf (prepared statement of Prof. Anthony B. Sanders).

[83] *See* Stephen Gandel, *Banks Left Out of TARP Bailout Could Face Extinction*, TIME BUSINESS (Nov. 13, 2008), http://www.time.com/time/business/article/0,8599,1858844,00.html (stating that consumers will flee from banks that do not receive TARP assistance, "taking deposits and forcing [them] to be liquidated or be sold.").

[84] Gaeta Interview, *supra* note 15.

5. Basel III

As much as the banking community is concerned about Dodd-Frank, the new capital standards of Basel III should not be overlooked. Basel III imposes standards that fall into three categories: risk-based capital requirements, liquidity, and stress test. By 2013, banks will need to reserve 3.5% share capital,[85] 4.5% Tier-1 capital,[86] and 8% total capital; and by 2019, banks will need to have 4.5% share capital, 6% Tier-1 capital, and 8% total capital.[87] Furthermore, the conservation buffer[88] must be built up to 2.5% by 2019.[89] In sum, banks will have to hold 10.5% of their risk-weighted assets in capital.[90] Additionally, for the first time, banks will be required to explicitly include operational risks as a determinant of required capital.[91] Because banks will be required to have more capital to back loans, they will likely have to reduce loans if they cannot raise capital elsewhere. Such a dramatic increase in capital requirements will make it difficult for community banks to lend as before,[92] which will potentially lower profits.[93] Lower profits may deter investors and thus perpetuate a circular capitalization problem that many banks will not escape without private equity investments, merging, or being acquired.[94]

As required by Basel III, the liquidity coverage ratio and the stress test work together to promote conservative lending practices. The liquidity coverage ratio is mandatory by January 1, 2015,[95] and ensures

[85] Share capital is the amount of capital that has been raised by selling company stock. Basel III, *supra* note 4.

[86] Tier 1 capital is core capital, including equity capital and disclosed reserves. Basel III, *supra* note 4.

[87] BASEL III, *supra* note 4. *See also Expected Timeline of Basel III Implementation*, DELOITTE (last visited Jan. 18, 2013), http://www.deloitte.com/view/en_NL/nl/industries/financial-services-industries/basel/timeline/index.htm [hereinafter *Basel Timeline*].

[88] A conservation buffer is an amount of capital that is built up as a reserve so that it may be drawn upon in times of economic stress. BASEL III, *supra* note 4.

[89] BASEL III, *supra* note 4. *Basel Timeline*, *supra* note 87.

[90] *Basel Timeline*, *supra* note 87.

[91] Loriana Pelizzon & Stephen Schaefer, *Pillar 1 vs. Pillar 2 Under Risk Management*, *in* THE RISKS OF FINANCIAL INSTITUTIONS 377, (Mark Carey and René M. Stulz eds., 2007), *available at* http://www.nber.org/chapters/c9614.pdf.

[92] Patterson Interview, *supra* note 65.

[93] *Id.*

[94] *Id.*

[95] *Basel Timeline*, *supra* note 87.

that a bank has sufficient liquidity to accommodate its funding needs for a full thirty days.[96] This puts serious restrictions on types of assets that a bank may lend against and makes it harder to give the loans needed in order to make certain profits, and in turn attract potential investments.[97] The stress test is the implementation of the Net Stable Funding Ratio (NSFR), and will be introduced as a minimum standard as of January 1, 2018.[98] The NSFR is the minimum standard of assets a bank must keep that are deemed stable over a one-year period.[99] The stability expectation of assets is based on liquidity risk factors.[100] For example, cash would be considered stable funding whereas a loan that will mature in less than one year is not. The NSFR encourages banks to utilize stable sources of funding for their activities in the hopes of promoting resilience.[101] In sum, the liquidity coverage ratio and the NSFR will lower the total amount that community banks are able to lend, which will in turn lower profits earned from interest.

B. Community Banks are Already Suffering

Requiring increased risk-based capital and high levels of liquidity, along with limiting sources of funding, imposes a large strain on already-struggling community banks.[102] Four hundred eighty-one banks have failed since 2000, and 454 of those occurred during or after 2008.[103] Failures peaked in 2010, and although they have been in

[96] Sophie Baker, *Basel III creates lending arm wrestle*, FIN. NEWS (Sept. 11, 2012), http://www.efinancialnews.com/story/2012-05-28/basel-3-creates-lending-arm-wrestle.

[97] Patterson Interview, *supra* note 65.

[98] *See The Net Stable Funding Ratio*, DELOITTE, http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/6.%20Basel%20flyer%20-%20NSFR.pdf (last visited Jan. 18, 2013); *see also Basel Timeline*, *supra* note 87.

[99] *See The Net Stable Funding Ratio*, *supra* note 98.

[100] *Id.*

[101] Pepper Hamilton LLP, Basel III's Net Stable Funding Ratio, http://www.pepperpodcasts.com/pepper_podcasts/2011/07/basel-iiis-net-stable-funding-ratio.html.

[102] Telephone Interview with Beth DeSimone, General Counsel, FNB United Corp (Sept. 11, 2012) (notes on file with the North Carolina Banking Institute Journal) (stating that capital is the number one issue of concern for community banks).

[103] Between 2000 and 2007, there were a total of 27 failures, followed by 25 in 2008, 139 in 2009, 156 in 2010, 91 in 2011, and 41 as of September 7, 2012. FDIC, FAILED BANK LIST, *available at* http://fdic.gov/bank/individual/failed/banklist.html (covering bank failures between Jan.1, 2000 and Aug. 27, 2012).

steady decline, the number of failures in 2012 alone far exceeded the total number of failures in the seven years before the financial crisis. A great number of these failures have been banks with between $100 million and $250 million in assets. In North Carolina, Waccamaw Bank in Whiteville, Blue Ridge Savings Bank in Asheville, The Bank of Asheville, Cooperative Bank in Wilmington, and Cape Fear Bank in Wilmington have all failed in recent years.[104]

Community banks are facing a multitude of threats: the legal and financial costs of Dodd-Frank compliance, the capital and liquidity requirements of Basel III, a struggling commercial real estate market, the lack of deposit capital caused in part by competition from credit unions and TBTF "government backed" banks, and a lower deposit base due to the expiration of the Transaction Account Guarantee (TAG)[105] program.[106] It may be only a matter of time before North Carolina community banks are caught in a perpetual cycle of undercapitalization, with the only hope for relief potentially coming from private equity investments, merging, or being acquired.[107]

[104] *Banks that have failed in North Carolina*, BANKRATE.COM, http://www.bankrate.com/finance/banking/failed-banks-north-carolina.aspx (last visited Oct. 19, 2012).

[105] TAG was designed to instill confidence in banks and increase deposits, but it expired on December 31, 2012. The TAG placed an FDIC guarantee on bank accounts of any size, as long as the account earns no interest. The ceiling had formerly been set at $250 thousand. According to the Federal Reserve Bank of St. Louis, 20% of all bank deposits were held under this program. The main concern is that deposit bases will drastically decline now that the program has expired. TAG was both beneficial and detrimental to banks. On one hand, the banks were given a large deposit base, but on the other, they were not able to charge interest on those accounts. Some believe that the TAG program is not good for banks because although it gives companies an insured and easily accessible place to put money, once the economy is doing well, all the money in TAG accounts will be pulled out so that it can be placed in an interest bearing account. For more information, see Peter J. Wallison, *End the TAG Program – It Puts Banks and the Economy at Risk*, AM. BANKER (Dec. 3, 2012), http://www.americanbanker.com/bankthink/end-the-tag-program-it-puts-banks-and-the-economy-at-risk-1054869-1.html; *see also* Michelle Clark Neely, *Is the End Near for the Popular Transaction Account Guarantee Program*, THE FED. RES. BANK OF ST. LOUIS, http://www.stlouisfed.org/publications/cb/articles/?id=2266.

[106] Alan Kline, *End of TAG Could Drive Consolidation*, AM. BANKER (Sept. 19, 2012), http://www.americanbanker.com/issues/177_182/end-of-tag-could-drive-consolidation-1052816-1.html?CMP=OTC-RSS&utm_source=twitterfeed&utm_medium=twitter (explaining that when the unlimited insurance on non-interest bearing accounts expires at the end of 2012, deposits may be withdrawn, which could lead to bank failures).

[107] Gaeta Interview, *supra* note 15.

III. Potential Relief for Community Banks

A. *Large Banks and Bank Holding Company Acquisitions*

Currently, large bank entities and BHCs are reluctant to acquire community banks, however, this was not always the case.[108] After Riegle-Neil, consolidation occurred at a rapid pace,[109] creating an enormous amount of competition for the remaining banks. Community banks now face a market that is saturated with banks whose assets are in the billions.[110] Many large banking entities have reached a "critical mass" in certain geographic areas[111] and are simply not interested in acquiring any more community banks because it would not be financially beneficial.[112] In fact, with a strangle-hold on the market, interstate banks seem content to watch the life slowly fade from the eyes of community banks everywhere.

B. *Private Equity Fund Investments and Acquisitions*

Private equity (PE) funds appear at first glance to be a potential savior for struggling community banks. First, and perhaps most importantly, PE funds have the ability to raise large amounts of capital.[113] In fact, since 2010, PE funds have invested more than $500 million in North Carolina community banks, which has yielded positive results.[114] Some banks have no option but to turn to PE, which is already getting credit for reinvigorating the economy by supporting struggling banks so that they are able to keep lending.[115] Some believe

[108] *Id.*

[109] *See* Albert E. DePrince, Jr., *Impact of the IBBEA on the Structure of the U.S. Bank System: 1993-2003* 3 (Mid. Tenn. St. Univ., Dep't of Econ. and Fin. Working Paper Series, Jan. 2005), *available at* http://capone.mtsu.edu/berc/working/WP-DePrince-0105.pdf.

[110] Interview with Richard D. Callicut II, President, Bank of North Carolina (Sept. 21, 2012) (notes on file with the North Carolina Banking Institute Journal).

[111] Gaeta Interview, *supra* note 15.

[112] *Id.*

[113] *Id.*

[114] Paul Davis, *How Private Equity Is Reinvigorating North Carolina Banking*, AM. BANKER (June 14, 2012), http://banksstreetpartners.com/article.da?id=49 (stating that unemployment fell to 9.4% in April, 2012, down from 11% in June, 2010, according to U.S. Bureau of Labor Statistics, and PE investment is credited with a supporting role in the improvement).

[115] *Id.*

that raising capital to fund growth, meet expected capital requirements, and cover losses that are still on the books, is the biggest issue for community banks.[116]

There are several reasons why community banks could be attractive investments for PE funds. In 2008, the percentage of a bank's equity that private investors could own without exerting "control" over a bank was raised.[117] This increased the amount PE funds can invest in a community bank and still avoid federal banking regulation as a bank holding company.[118] Additionally, the Office of the Comptroller of Currency (OCC) implemented a "shelf charter," which remains inactive, or "on the shelf," until an investor can acquire a failed institution.[119] Originally, a PE fund would have to go through a lengthy charter approval process, which put PE funds at a disadvantage to interstate banks and ultimately deterred PE funds from bidding on community banks.[120] The shelf charter is a temporary charter that allows non-bank entities to immediately acquire deposits and assets of failed banks, thus making PE bids more competitive.[121] Additionally, with a larger pool of bidders, failed banks are more likely to get a higher purchase price.

However, the PE fairytale may be too good to be true. Despite the good news of PE funds helping community banks in North Carolina, many believe that community banks are simply too small and illiquid to interest most PE investors.[122] Furthermore, community banks do not

[116] Andy Peters, *Momentum Builds to Get More Capital into Smallest Banks*, AM. BANKER (Mar. 23, 2012), http://banksstreetpartners.com/article.da?id=30; *see also* DeSimone Interview, *supra* note 102 (stating that new capital requirements are one of the biggest concerns for community bankers).

[117] Frank Righeimer Martin, *Private Equity Investments in Failed Banks: Appropriate Investors Welcome*, 14 N.C. BANKING INST. 404, 410 (2010).

[118] "Bank holding company" is defined in the Bank Holding Company Act of 1956 (BHCA) as "any company which has control over any bank." 12 U.S.C.A. § 1841(a)(1). A company can be deemed a BHC if it is determined that the activities which a company is engaged in is "so closely related to banking as to be a proper incident thereto." 12 U.S.C.A. § 1843(c)(ii)(8). If an investment company or fund were determined to be a BHC, it would be limited in the other activities it may take part in and would be subject to strict SEC regulation. *See* BROOME, *supra* note 8, at 658.

[119] Press Release, Office of the Comptroller of Currency, OCC Approves Use of Second Shelf Charter to Acquire Three Failed Banks (July 16, 2010), *available at* http://www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-82.html; *see also* Martin, *supra* note 117, at 410.

[120] Martin, *supra* note 117, at 410.

[121] *Id.*

[122] Gaeta Interview, *supra* note 15; Patterson Interview, *supra* note 65; Callicut Interview, *supra* note 110.

currently provide the returns on investment to which PE funds are accustomed.[123] Community banks used to provide, on average, a 15% return on equity for investors.[124] Following the 2008 financial crisis, banks were forced to write off bad debt incurred by the commercial real estate market crash. As a result, return on equity dropped to an average of 7-8%.[125]

Despite the OCC's attempts to facilitate PE investments in failing banks, PE funds are still wary about potential regulations.[126] To avoid being labeled "in control" of a bank, and the accompanying BHCA regulations, a holding company would have to "avoid exceeding 25% of any class of voting securities of the bank."[127] A PE investor can choose no more than one board member and own no more than 24.9% of all voting shares if they are to be "non-controlling."[128] Furthermore, if a PE investor holds more than 10% of a bank's securities, there is a rebuttable presumption that the investor does have "control."[129] If PE can only purchase 24.9% of a bank valued at less than $1 billion, have limited control over management, and not receive the profits that they desire, it may not be worth the risk.[130]

Under the FDIC's Final Policy Statement,[131] any investments in failing banks may be subject to a three-year holding period, during which time the purchased interest cannot be sold.[132] This is good for banks but bad for investors. The rule suggests that the Fed is wary of shortsighted PE investments in failing banks.[133] A PE investor's goal is to invest in a bank and turn it profitable in the shortest amount of time

[123] Patterson Interview, *supra* note 65.

[124] Gaeta Interview, *supra* note 15; Patterson Interview, *supra* note 65.

[125] Gaeta Interview, *supra* note 15.

[126] *Id.*

[127] Martin, *supra* note 117, at 407.

[128] Private Equity Newsletter: Structuring Private Equity Investments in FDIC "Problem" Institutions, DAVIS POLK & WARDWELL LLP (Mar. 29, 2010), http://www.davispolk.com/files/Publication/c816ca5d-f74b-450e-bde1-b1528a80135e/Presentation/PublicationAttachment/ab42637d-8c08-4c5f-803c-02fbb56c1292/032910_PE_NL.pdf.

[129] Gaeta Interview, *supra* note 15.

[130] *Id.*

[131] Andrew Gaydosh, *Final Statement of Policy on Qualifications for Failed Bank Acquisitions*, 74 Fed. Reg. 45440 (Aug. 20, 2009), *available at* www.fdic.gov/regulations/laws/federal/2009/09FinalSOP92.pdf.

[132] Final Policy Statement Q&A, *supra* note 20.

[133] Gaeta Interview, *supra* note 15.

possible, usually in five to eight years,[134] perhaps even at the expense of long-term viability, so that it can be sold quickly and for a profit.[135] The Fed is concerned that PE's interest in short-term profitability will encourage lowered lending standards, which, despite making the bank immediately more profitable on paper, could lead to its failure in the future; that is, after the PE fund has sold its bank shares.[136]

C. Community Bank Mergers

Perhaps the best option for North Carolina's struggling community banks is to combine their resources. Mergers are already prevalent in North Carolina and in other nearby states. For example, Old Line Bancshares, a Maryland bank with assets of $846 million, recently announced its plans to buy WSB Holdings, its second in-state acquisition in two years.[137] The acquisition is in direct response to the growing threat of acquisitions by out-of-state banks. In 2001, out-of-state banks controlled 43% of the deposit market share in Maryland, but by 2011, that number had risen to 79%.[138] Because potential buyers are not interested in the remaining acquisition targets, it may be up to community banks to band together to grow in order to compete in an increasingly consolidated market.[139] This trend is already occurring in North Carolina. In 2012, Bank of North Carolina, a bank with thirty-seven offices and approximately $3 billion in assets, entered into a purchase agreement to acquire Hampton Roads Bankshares, after already acquiring KeySource Bank earlier in the year.[140] KeySource CEO Don Draughton stated that one reason the bank was looking to grow is to provide protection from expected costs imposed by Dodd-Frank.[141]

[134] Callicut Interview, *supra* note 110.

[135] Gaeta Interview, *supra* note 15.

[136] *Id.*

[137] Rachel Witkowski, *Maryland Bankers Urged to Merge*, AM. BANKER (Sept. 12, 2012), http://www.americanbanker.com/issues/177_176/maryland-bankers-turn-inward-to-save-themselves-1052549-1.html.

[138] *Id.*

[139] *See cf. id.*

[140] Callicut Interview, *supra* note 110.

[141] Laura Oleniacz, *KeySource, Bank of North Carolina to Merge*, THE HERALD SUN (Dec. 2011), *available at* http://www.heraldsun.com/view/full_story/16862948/article-KeySource—Bank-of-North-Carolina-to-merge.

If a community bank is looking to grow, loss sharing may provide the incentive and security needed to purchase failed community banks or their assets. By guaranteeing a certain percentage of a failing bank's assets, the FDIC can get a higher price for the sale of the bank's assets.[142] In return, the purchaser gets the assurance of having a percentage of their investment backed by the FDIC.[143]

Unfortunately, many problems emerge from community bank mergers.[144] For one, there can be issues if either the buyer or the seller is not publicly traded.[145] Investments from the community are common when a community bank is chartered, and stock in initial offerings has historically sold in North Carolina for approximately $11 per share.[146] In the past, community banks sold for 2 to 3 times their book value, but now they are now selling for well below it.[147] Stockholders are reluctant to sell for $6 what they purchased for $11, and directors may be reluctant to make such a request. Additionally, it may be problematic for the merged community bank to determine who will serve as officers and who will sit on the new, consolidated board of directors.[148]

Despite the problems that arise from a "merger of equals,"[149] community bank mergers may be the best, if not the only hope for many struggling community banks. The question is, how big is big enough? There was a time when it was generally accepted that a $150 million asset bank was sufficiently profitable.[150] Now many bankers (especially investment bankers) say that a strong bank needs at least $1 billion in assets,[151] and some believe that banks need to be at the $5 billion mark to be sufficiently profitable.[152] In examining the nationwide statistical data of assets and deposits held by banks that failed in 2011, a pattern

[142] *See* Loss-Share Questions and Answers, FDIC, http://www.fdic.gov/bank/individual/failed/lossshare/index.html (last updated Dec. 3, 2012).

[143] *Id.*

[144] Gaeta Interview, *supra* note 15 (stating his opinion based on more than thirty years of M&A experience).

[145] *See Supra* Part II.A.3.

[146] Gaeta Interview, *supra* note 15.

[147] *Id.*

[148] *Id.*

[149] *See id.* (noting that there is "no real merger of equals").

[150] *Id.*

[151] *Id.*

[152] Callicut Interview, *supra* note 110.

emerges. Approximately fifty percent of the ninety-two failures in 2011 were banks that had between $100 million and $250 million in assets.[153] The number of bank failures with $250 million to $500 million in assets comprised approximately seventeen percent of the bank failures that year, only approximately thirteen percent had assets of $500 million to $1 billion, and nine percent had assets over $1 billion.[154] The bigger the entity, the more easily an institution is able to withstand compliance costs and maintain minimum capital requirements. Based on the data from 2011, a strong argument can be made that a bank's chance of failing significantly drops once it reaches $250 million or more in assets. Specifically, in 2011, banks with under $250 million in assets were three times more likely to fail than banks above that asset threshold.[155]

D. A Combination Strategy

No matter the cause of the problem, it is clear that many community banks in North Carolina will need to raise capital to survive, whether by PE investment, acquisition, or community bank merger. Realistically, all three avenues will likely be necessary to the survival of North Carolina's struggling community banks. For example, in September 2012, ECB Bancorp (ECB), an Englehard, North Carolina company with $917 million in assets, announced that it would sell to Crescent Financial Bancshares (CRFN), based in Raleigh, North Carolina.[156] CRFN is substantially owned by Piedmont Community Bank Holdings, which is a PE-backed banking company.[157] The deal to acquire seventy-eight percent of ECB's tangible book value will close in 2013, pending shareholder approval.[158] Dwight Utz, ECB's president and CEO, explained that the sale was in the best interest of the company after it failed to raise a planned $80 million in PE funds, which it had

[153] *See Bank Failures In Brief*, FDIC, *available at* http://www.fdic.gov/bank/historical/bank/2011/index.html (last updated Jan. 11, 2013).

[154] *See Bank Failures in Brief*, *supra* note 153.

[155] *Id.*

[156] Robert Barba, *ECB Bancorp CEO Seizes Opportunity to Sell to Well-Funded Rival*, AM. BANKER (Sept. 25, 2012), http://www.americanbanker.com/issues/177_186/ecb-bancorp-ceo-seizes-opportunity-to-sell-to-well-funded-rival-1053014-1.html.

[157] *Id.*

[158] *Id.*

planned to use to buy several North Carolina branches from the Norfolk, Virginia based Hampton Roads Bankshares.[159] The investment fell through because one of the investors failed to obtain regulatory approval.[160] This transaction is an example of how mergers or acquisitions can work in conjunction with PE investments, and considering the current climate; community banks in North Carolina will need to seize every available opportunity.

IV. THE FUTURE OF COMMUNITY BANKS

A. *Universal Banking Regulations: A Necessary Evil?*

The common theme of community bankers today is the feeling that they are being punished in response to a financial crisis that was caused by the actions of large investment banks.[161] Despite the disdain among community banks for Dodd-Frank and new banking regulations, there are those who feel that more effective regulation of the entire banking industry is essential to avoiding another financial disaster.[162] For one, the large number of small bank failures demonstrates that many community banks were not as stable as they believed themselves to be. Banks that were too concentrated in the commercial real estate lending market were devastated when that market crashed.[163] The banks that were conservative and well capitalized are still around today, and the banks that were not, are not.[164]

Finally, community banks have been serving their communities for decades in ways that large interstate banks simply cannot.[165] Is it

[159] *Id.*

[160] *Id.*

[161] *See* Grant, *supra* note 52, at 2; s*ee also The Adverse Consequences of the Dodd-Frank Act on Community Bank Customers and Borrowers Before the S. Comm. On Oversight and Investigations of the H.Comm. on Fin. Services*, 112th Cong. 2 (July 19, 2012) (testimony of Jim R. Purcell, Chairman and C.E.O. of The State Nat'l Bank of Big Spring), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-112-ba09-wstate-jpurcell-20120719.pdf.

[162] John C. Williams, President's Speech, *Bank Regulation in the Post-Crisis World*, CAL. BANKERS ASS'N (May 4, 2012), *available at* http://www.frbsf.org/news/speeches/2012/john-williams-0504.html?utm_source=mailchimp&utm_medium=email&utm_campaign=presidents-speech-2012-05-04.

[163] Gaeta Interview, *supra* note 15.

[164] Patterson Interview, *supra* note 67.

[165] *See generally* Grant, *supra* note 52, at 2.

fair, then, to impose these regulations indiscriminately? To answer this question, we must look at the effects of community bank regulation on the primary customers of community banks: individual and small businesses in the local community.

B. The Potential Effects on Communities and Small Businesses: Who Can Fill the Void?

1. Consumer Banking

The struggles of community banks in North Carolina will have a minimal effect on most everyday consumers.[166] They will likely notice local branches going out of business, leaving vacant commercial buildings, equipped with a drive-through windows and vacuum tube systems. Undoubtedly, other entities will fill in to meet the banking needs of most general customers.[167] Credit unions and large banks, with strategic branch placement, will continue to provide standard deposit accounts, credit cards, home mortgage loans, and personal loans. However, it may be more difficult for some borrowers to be approved for credit. Credit unions, as non-profit and tax-exempt entities, have very conservative lending standards,[168] and big banks are not willing to provide "reputational lending" to the same extent as community banks.[169] Other than stricter lending standards, consumers should be able to continue to enjoy relatively the same banking options that they always have.

Despite having access to the same banking options as before, the disappearance of community banks in North Carolina will forever change the dynamic between local banks and their customers.[170] Community banks know their customers well and are able to offer more personalized service and advice.[171] But, according to Richard D.

[166] Patterson Interview, *supra* note 65.

[167] DeSimone Interview, *supra* note 102 (stating other banks may be able to provide standard account services, but the biggest void that community banks will likely leave is in the availability of small business loans).

[168] *Id.* (stating that capital is the number one issue of concern for community banks).

[169] Callicut Interview, *supra* note 110 (stating that the days of lending based off personal relationships is likely over).

[170] *Id.*

[171] *See* Louis Hernandez, *Community Banks A Better Partner For Business: Opinion*, CNBC (Feb. 15, 2012),

Callicut II, the President of Bank of North Carolina, the times have passed when a community banker can say as a legitimate consideration for a loan, "I know that guy, I know his family, and I know that he is good for it."[172]

2. Commercial and Small Business Loans

The main way in which the public will feel the impact of community bank failures will be in the decreased availability of funding for small businesses and commercial real estate.[173] Local banks have an interest in helping local businesses grow in order to stimulate the local economy, which in turn attracts more business.[174] This is illustrated by the fact that as a percentage of total assets, community banks have a much higher percentage of small business loans than large banks.[175] Furthermore, as of December 2009, community banks made over half of all small business loans under $100,000.[176] Many of the loans small business owners depend on to start new businesses, or expand existing businesses, will not be available if community banks disappear[177] because conservative credit unions limit the number of business loans they issue and big banks rarely consider reputational factors in lending decisions.[178] Additionally, very few banks will be interested in lending for residential or commercial real estate development because of the volatility and the high risk associated with such loans.[179] Unfortunately, the community banks that do survive will likely not be in a position to make the loans that used to be common in small communities because

http://www.cnbc.com/id/46398866/Community_Banks_A_Better_Partner_For_Business_Opinion.

[172] Callicut Interview, *supra* note 110.

[173] DeSimone Interview, *supra* note 102 (stating that capital is the number one issue of concern for community banks).

[174] *See* Hernandez, *supra* note 171.

[175] *See id.*

[176] Interview by Judy interview of President Barack Obama, PBS (Dec. 22, 2009), *available at* http://www.pbs.org/newshour/bb/business/july-dec09/banks_12-22.html.

[177] *See* John Tozzi, *Weak Banks Drag on Small Business Lending*, BLOOMBERG BUSINESSWEEK (Aug. 28, 2012), *available at* http://www.businessweek.com/articles/2012-08-28/weak-banks-drag-on-small-business-lending (stating that weak community banks are bringing down small business lending).

[178] Callicut Interview, *supra* note 110.

[179] Gaeta Interview, *supra* note 15.

of risk standards and capital requirements;[180] but, those that do remain will be more important than ever in providing their communities with the services that large banks and credit unions cannot.

Small businesses suffer when community banks fail, and communities suffer along with them.[181] Small businesses are the "backbone of the community," and as such, when small businesses are in decline, local economies struggle, local government revenue declines, and unemployment rises.[182] Affected communities may take years to recover, if they are able to recover at all.[183]

V. CONCLUSION

Community banks in North Carolina are facing uncertainty. Regulations imposed by Dodd-Frank, compounded with existing regulations, place monumental compliance obligations on banks with very limited resources. Additionally, Basel III capital requirements and liquidity standards will make it hard for any small bank to be profitable. In order to survive, community banks need to raise capital. Large banks and BHCs are not acquiring community banks like they were when prohibitions on interstate branching were initially lifted, which leaves community banks with limited options.

PE funds have significantly helped North Carolina community banks in the past several years. However, PE's short-term investment horizon does not always align with the long-term perspective of many community banks. Moreover, most community banks are simply too small for PE to (1) turn the expected profit, (2) take the risk of failure, (3) take the time and resources to acquire, or (4) risk being subject to an onslaught of banking regulations. Certainly, PE will continue to play a role in the banking industry and a role in the salvation of community banks, but all in all, PE funds do not appear to be the answer. Instead, community bank mergers may be the best way for smaller banks to raise capital, reach a size in which they are able to afford the cost of

[180] Callicut Interview, *supra* note 110.

[181] Gregg Fairbrothers & Catalina Gorla, *Social Value and Core Value: Small Businesses and Local Communities*, FORBES (July 5, 2012), http://www.forbes.com/sites/greggfairbrothers/2012/07/05/social-value-and-corevalue-small-businesses-and-local-communities/.

[182] *Id.*

[183] *Id.*

compliance, and turn an appropriate profit. It is probable, however, that PE investments, acquisition by large banks and BHCs, and community bank mergers will all play a role in the salvation of North Carolina's community banks.

The future looks bleak for community banks in North Carolina. It is possible that most will simply not survive. If that is true, big banks and credit unions will still remain to fulfill most communities' banking needs. However, small businesses will suffer, and as a result, the communities that are losing their local banks will suffer. Maybe consolidation and the disappearance of community banks is simply the next stage in the evolution of the banking industry. However, what is certain is that the community banks that funded the building of local communities in North Carolina will never be the same.

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