

Community Banking in the 21st Century



A Tiered System of Regulation Is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks

**Arthur E. Wilmarth, Jr.
Professor of Law
George Washington University Law School**



Trends affecting Community Banks and Megabanks

- **During the consolidation trend of the past three decades, the number of community banks and their share of banking industry assets have both fallen by more than half. There are now about 6,000 community banks, and they hold only about one-sixth of banking industry assets.**
- **Consolidation has been driven by deregulation, technological changes and hundreds of community bank failures during the banking crisis of 1980-92 and again during the financial crisis of 2008-12.**
- **During the financial crisis and its aftermath, the federal government accelerated consolidation by pursuing a one-sided policy that gave extraordinary assistance to megabanks and little help to community banks.**
- **Treasury provided \$290 billion of capital assistance to the 19 largest U.S. banks (each larger than \$100 billion) and AIG (the largest insurer). Many of the bailout funds given to AIG were used (with federal approval) to pay off AIG's obligations to big U.S. and European banks and securities firms.**
- **The FDIC guaranteed \$290 billion of debt securities issued by the 19 largest banks and GE Capital.**

Trends affecting Community Banks and Megabanks

- **The Fed provided huge amounts of emergency credit to large financial institutions. The Fed's emergency lending programs reached a single-day peak of \$1.2 trillion in December 2008. Of that amount, more than half (\$670 billion) was lent to the 10 largest U.S. banks and securities firms.**
- **When all Fed loan transactions are added together, the Fed provided a cumulative total of \$19.5 trillion in emergency credit. Almost 90% of that amount -- \$16.4 trillion – went to 14 large U.S. and European financial institutions. (Felkerson, 2011)**
- **In contrast, federal officials provided only \$16 billion of TARP capital assistance to banks with assets under \$10 billion. Community banks also issued very little FDIC-guaranteed debt, because most smaller banks do not issue publicly-traded debt securities.**
- **Congress passed the Small Business Jobs Act in 2010 and authorized Treasury to invest up to \$30 billion more in community banks. Treasury shut down the Small Business Lending Fund after investing only \$4.2 billion in community banks. Treasury rejected more than 600 of the 935 banks who applied for help, because Treasury said it was not certain that those banks were “viable.”**

Trends affecting Community Banks and Megabanks

- In contrast, the federal banking agencies announced in February 2009 – at the time of the first stress test – that they would provide ALL capital assistance needed to ENSURE THE VIABILITY of the 19 largest banks.
- The Fed's zero-interest-rate policy (ZIRP) and quantitative easing (QE) programs helped big banks, which (i) obtain much of their funding from market-sensitive, short-term wholesale liabilities, (ii) generate much of their revenues from noninterest (fee) income, and (iii) held large volumes of risky, mortgage-related securities on their balance sheets when the financial crisis began. ZIRP and QE helped big banks by pushing down both short-term and long-term interest rates.
- In contrast, ZIRP and QE hurt community banks, which (i) receive most of their funding from core deposits, whose interest rates move slowly in response to changes in market interest rates, and (ii) generate most of their revenues from their net interest margin (NIM) on loans. ZIRP and QE significantly reduced NIM for community banks, and the decline in NIM was the most important factor behind the decline in the relative performance of community banks compared to larger banks. (FDIC, 2012)

Trends affecting Community Banks and Megabanks

- **Federal regulators did NOT issue prompt corrective action (PCA) orders or other capital enforcement orders against ANY bank larger than \$30 billion, even though the PCA statute is NOT discretionary and REQUIRES regulators to apply an escalating series of sanctions against ALL undercapitalized banks. Regulators also gave big banks extended deferrals on write-downs of impaired assets, including second liens on “underwater” homes.**
- **In contrast, regulators issued more than 1400 PCA orders and other capital enforcement orders against banks smaller than \$30 billion between 2008 and 2010. (Hill, 2012). Regulators also did not give community banks any forbearance on taking write-downs against impaired assets (especially commercial real estate loans).**
- **Federal regulators allowed only ONE depository institution larger than \$100 billion to fail – Washington Mutual (Wamu). In that one case, regulators arranged for the immediate sale of Wamu’s assets and transfer of Wamu’s deposits (including uninsured deposits) to JPMorgan Chase. In contrast, regulators stood by while more than 450 community banks failed between 2008 and 2012.**

New Challenges for Community Banks

- **Community banks were the victims of the financial crisis, while large financial institutions were the catalysts. The performance of community banks as residential mortgage lenders was far superior to the performance of big banks. Community banks were hurt by the collapse of the commercial real estate market, which was triggered by the bursting of the subprime housing bubble created by large financial institutions.**
- **Community banks face very costly new compliance burdens under Dodd-Frank, especially under the CFPB's Qualified Mortgage/Ability to Repay (QM) regulation and the CFPB's Mortgage Servicing regulation, as well as the federal banking agencies' new capital regulation for mortgage servicing assets (MSAs).**
- **Community banks play crucial roles in supporting small businesses and local economies. Community banks make about half of small business loans and about one-fifth of all home mortgage loans. Community banks follow a "relationship lending" business model and provide customized lending services. In contrast, larger banks follow a highly automated, "cookie cutter" approach to making both small business and consumer loans.**

New Challenges for Community Banks

- **In 2012, community banks operated the ONLY banking offices, or ALL BUT one or two banking offices, in more than 1,200 counties. Those counties accounted for more than one-third of all U.S. counties and contained a total population of over 16 million people. Thus, many rural counties and some metropolitan areas would have very limited banking services if community banks disappear.**
- **Community banks slightly increased their share of the small business lending market between 2008 and 2012, and they expanded their small business lending more rapidly than other banks between 2013 and 2014.**
- **However, the share of small business lending done by community banks has declined substantially over the past 20 years as the banking system has consolidated. As big banks have grown more dominant, loans to large firms have grown much faster than loans for small businesses.**
- **From 1995 to 2012, bank lending to large firms grew from \$350 billion to \$900 billion, or 150%. In contrast, bank lending to small businesses grew from \$175 billion to \$280 billion, or only 60%. Despite the financial crisis, bank lending to large firms still grew by \$400 billion, or 75%, between 2004 and 2012. However, bank lending showed NO meaningful growth for small businesses between 2004 and 2012. (Sheets & Sockin, 2012)**

New Challenges for Community Banks

- **Recent studies by U.K. government agencies and by the Canadian Federation of Independent Business have shown that the highly concentrated U.K. and Canadian banking systems (each dominated by 4 or 5 big banks) provide inadequate credit and inferior services to small businesses and consumers. U.S. policymakers should take immediate steps to preserve the viability of our community banking sector and eliminate the economic distortions caused by TBTF treatment for megabanks.**
- **We must reduce compliance burdens on community banks:**
 - **Expand the Small Creditor Exception in the QM Regulation and the Small Servicer Exception in the Mortgage Servicing Regulation so that both exceptions apply to all banks smaller than \$10 billion (indexed for inflation).**
 - **Reduce the punitive impact of the new capital regulation on MSAs held by banks smaller than \$10 billion.**
 - **Congress and federal bank regulators should make banking rules simpler and more flexible for community banks, consistent with safety and soundness and reasonable consumer protection.**

Establishing a Tiered System of Regulation

- **A tiered system of regulation is needed to preserve relationship lending by community banks and to remove TBTF subsidies exploited by megabanks.**
- **The first tier of tier of “traditional” banking organizations would engage in all banking-related activities permitted under Section 4(c)(8) of the Bank Holding Company Act, including deposit-taking, lending, fiduciary and payment-related services. First-tier banks would continue to accept core deposits and make relationship loans to consumers and small businesses.**
 - **First-tier banks could also act as agents in selling securities, insurance and other financial products, and could underwrite and deal in “bank-eligible” securities (including revenue bonds) permissible for national banks.**
 - **First-tier banks could NOT underwrite or deal in bank-ineligible securities, insurance or derivatives.**
 - **First-tier banks would retain their existing deposit insurance and supervisory arrangements.**

Second-Tier Banking Organizations

- **The second tier of “nontraditional” banking organizations would include financial holding companies (FHCs) registered under the BHC Act and other large companies that own FDIC-insured institutions. All of today’s megabanks would become second-tier organizations.**
- **Second-tier organizations would be required to conduct their deposit-taking activities through “narrow banks,” whose assets would be limited to highly-rated short-term debt instruments that are eligible for investment by money market mutual funds.**
- **Narrow banks would not be allowed to make loans or accept uninsured deposits. Second-tier FHCs would make loans through nonbank subsidiaries funded by the capital markets, consistent with the securitization and syndicated lending businessmodels currently used by megabanks.**
- **Narrow banks would not be allowed to make any transfers of funds to nonbank affiliates EXCEPT lawful dividends paid to their parent holding companies. Regulators would be absolutely prohibited from approving any such transfers. This prohibition would prevent the FDIC’s safety net subsidy from being exploited by nonbank affiliates of megabanks.**

Second-Tier Banking Organizations

- **Congress should repeal the “systemic risk exception” in the Federal Deposit Insurance Act, which allows the FDIC to protect uninsured creditors of failed megabanks. The FDIC should not be allowed to use the deposit insurance fund to support any bailouts of uninsured creditors of megabanks.**
- **Second-tier FHCs could engage, through nonbank subsidiaries, in “financial in nature” activities, including underwriting and dealing in bank-ineligible securities, underwriting insurance, and underwriting and dealing in derivatives.**
- **However, to maintain the separation of finance and commerce, second-tier FHCs could not trade or invest in physical commodities, or engage in merchant banking or private equity investing.**
- **Second-tier FHCs and other designated SIFIs should be required to pay risk-based premiums, over 10 years, to pre-fund the Orderly Liquidation Fund (OLF) at a level of at least \$300 billion. A pre-funded OLF would help to ensure that the FDIC will not have to borrow from the Treasury (i.e., the taxpayers) if it needs funds to resolve the failure of a SIFI through the Orderly Liquidation Authority.**

Second-Tier Banking Organizations

- **Second-tier FHCs should structure their compensation plans so that at least half of all compensation for senior executives and other key employees is paid in the form of long-term contingent convertible bonds (CoCos). The CoCos should not be payable until at least 3-5 years after the senior executive or key employee has ended his or her employment. The CoCos would be convertible into equity if the capital of the FHC fell below a specified level.**
- **Thus, CoCos would give senior executives and key employees the potential for limited gains and unlimited losses. In contrast, existing compensation plans typically provide unlimited gains and limited losses, thereby encouraging excessive risk-taking. Payment in CoCos would be much more effective in aligning the interests of senior executives and key employees of FHCs with the interests of creditors, the FDIC and taxpayers.**
- **My proposal would remove many of the explicit and implicit TBTF subsidies that benefit large financial conglomerates. Without such subsidies, market discipline would probably force large FHCs to become smaller and more focused, in the same way that market discipline forced many industrial and commercial conglomerates into breakup or spinoff transactions after 1980.**