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# CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

**FEATURED IN THIS ISSUE:** Third-Quarter 2012 Banking Performance | The Big Banks: Too Complex To Manage?

# Trends in OREO: Community Banks Still Have a Long Way To Go

*By Daigo Gubo and Gary Corner*

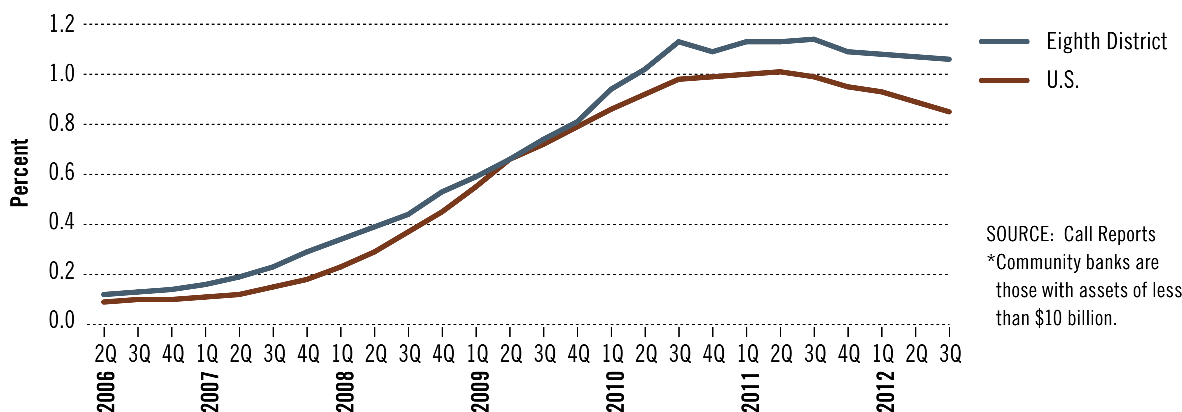
OREO (other real estate owned) at community banks increased sharply during the 2007-2009 recession because of high loan default levels—the result of a deterioration in economic conditions and what appears to be a relaxation of underwriting standards before the financial crisis.[1] Increases in OREO on bank balance sheets, however, continued well beyond the official end of the recession, peaking between 2010 and 2011. Consistent with a legacy concentration of real estate loans, community banks have experienced the highest ratios of OREO-to-assets on their books. Today many banks are still working on reducing their elevated levels of OREO. Liquidating properties, however, is proving to be a significant challenge to community bankers given the current soft real estate market conditions.

As illustrated in Figure 1 below, community banks nationally and across the District experienced a peak in their OREO holdings in the second quarter of 2010. OREO holdings then appeared to plateau until the middle of 2011. Since the third quarter of 2011, OREO levels have declined. Despite these recent declines in OREO, the current volume of these properties is much higher than what it was before the start of the financial crisis. As of the third quarter of 2012, community

*continued on Page 6*

FIGURE 1

Community Bank* OREO/Total Assets Trends




SOURCE: Call Reports
*Community banks are those with assets of less than $10 billion.

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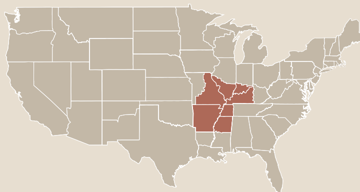
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



**Selected St. Louis Fed Sites**

**Dodd-Frank Regulatory Reform Rules**
www.stlouisfed.org/rrr

**FRED** (Federal Reserve Economic Data)
www.research.stlouisfed.org/fred2

**Community Development's Household Financial Stability Initiative**
www.stlouisfed.org/HFS



# The Financial Crisis and Household Balance Sheets:

## A New Research Effort at the St. Louis Fed

*By James Bullard*

*James Bullard is president and CEO of the Federal Reserve Bank of St. Louis.*

The Great Recession set in motion numerous adverse repercussions, with damage to household balance sheets being especially pronounced. As reported by the St. Louis Fed's Bill Emmons and Bryan Noeth in a recent study, household wealth declined nearly $17 trillion in inflation-adjusted terms, or 26 percent, from mid-2007 to early 2009, with only about two-fifths of that loss recovered by early 2012. Emmons and Noeth found that wealth losses hit older, wealthier Americans (who had the most to lose) the hardest in terms of absolute dollars but affected younger, less educated and minority households the most in terms of percentage.[1]

Not surprisingly, the adjustments required by the damage to household balance sheets are ongoing and are likely to take years to complete. In fact, this is the first U.S. recession in which household "deleveraging"—the slow, painful process of families paying down their debts and rebuilding their savings—has played a key role. Steep declines in housing prices, along with historically high levels of household debt before the crash, made this recession particularly severe. The International Monetary Fund recently reported that "housing busts preceded by larger run-ups in gross household debt are associated with significantly larger contractions in economic activity."[2] The unprecedented debt overhang leaves the Federal Reserve with a seemingly paradoxical policy, at least with respect to many households: Monetary policy has kept interest rates low to encourage borrowing in the context of an economy with too much borrowing.

As Fed policymakers continue to work through this paradox, a clear challenge remains to define mechanisms whereby Americans, especially low- and moderate-income Americans, can rebuild their balance sheets, which will help both struggling families and the stagnant economy move forward. Too many Americans were unbanked or underbanked, too many did not save enough, too many ran up their debts or accumulated risky debt, and too many did not diversify their assets beyond housing. How can we turn each of these balance sheet failures around? How can we help families consider their entire balance sheet?

To help meet these challenges, the St. Louis Fed has begun the Household Financial Stability research initiative, which focuses on three key questions:

- **What is the state of household balance sheets in this country**—what can we say, quantitatively, about the health of household balance sheets in aggregate but especially by age, race, education level, income and other demographic factors?

QUARTERLY REPORT

# Third-Quarter 2012 Banking Performance[1]

| | 2011: 3Q | 2012: 2Q | 2012: 3Q |
|---|---|---|---|
| **RETURN ON AVERAGE ASSETS[2]** | | | |
| All U.S. Banks | 0.71% | 1.05% | 1.00% |
| All Eighth District States | 0.63 | 0.91 | 0.89 |
| Arkansas Banks | 1.11 | 1.07 | 1.13 |
| Illinois Banks | 0.44 | 0.73 | 0.68 |
| Indiana Banks | 0.89 | 1.07 | 1.12 |
| Kentucky Banks | 0.82 | 1.21 | 1.08 |
| Mississippi Banks | 0.72 | 0.90 | 0.91 |
| Missouri Banks | 0.69 | 0.90 | 0.91 |
| Tennessee Banks | 0.12 | 0.83 | 0.84 |
| **NET INTEREST MARGIN** | | | |
| All U.S. Banks | 3.94% | 3.89% | 3.86% |
| All Eighth District States | 3.89 | 3.84 | 3.84 |
| Arkansas Banks | 4.31 | 4.16 | 4.19 |
| Illinois Banks | 3.73 | 3.64 | 3.63 |
| Indiana Banks | 3.94 | 3.91 | 3.90 |
| Kentucky Banks | 4.12 | 4.09 | 4.05 |
| Mississippi Banks | 3.98 | 4.04 | 4.05 |
| Missouri Banks | 3.71 | 3.68 | 3.71 |
| Tennessee Banks | 3.89 | 3.90 | 3.92 |
| **LOAN LOSS PROVISION RATIO** | | | |
| All U.S. Banks | 0.60% | 0.37% | 0.35% |
| All Eighth District States | 0.70 | 0.41 | 0.41 |
| Arkansas Banks | 0.50 | 0.37 | 0.36 |
| Illinois Banks | 0.93 | 0.56 | 0.57 |
| Indiana Banks | 0.47 | 0.28 | 0.22 |
| Kentucky Banks | 0.52 | 0.34 | 0.40 |
| Mississippi Banks | 0.56 | 0.24 | 0.25 |
| Missouri Banks | 0.58 | 0.39 | 0.38 |
| Tennessee Banks | 0.88 | 0.36 | 0.36 |

| | 2011: 3Q | 2012: 2Q | 2012: 3Q |
|---|---|---|---|
| **NONPERFORMING ASSETS RATIO[3]** | | | |
| All U.S. Banks | 4.95% | 4.27% | 4.11% |
| All Eighth District States | 5.32 | 4.70 | 4.48 |
| Arkansas Banks | 5.83 | 5.10 | 5.05 |
| Illinois Banks | 6.56 | 5.72 | 5.35 |
| Indiana Banks | 3.89 | 3.30 | 3.18 |
| Kentucky Banks | 3.69 | 3.72 | 3.69 |
| Mississippi Banks | 4.50 | 3.91 | 3.81 |
| Missouri Banks | 4.78 | 4.41 | 4.08 |
| Tennessee Banks | 5.71 | 4.89 | 4.70 |
| **LOAN LOSS COVERAGE RATIO[4]** | | | |
| All U.S. Banks | 59.54% | 66.68% | 66.91% |
| All Eighth District States | 57.37 | 64.28 | 66.36 |
| Arkansas Banks | 56.44 | 68.89 | 69.11 |
| Illinois Banks | 47.82 | 53.00 | 55.50 |
| Indiana Banks | 62.74 | 70.38 | 69.18 |
| Kentucky Banks | 69.41 | 71.79 | 71.71 |
| Mississippi Banks | 66.86 | 77.89 | 78.17 |
| Missouri Banks | 72.05 | 77.09 | 83.49 |
| Tennessee Banks | 58.41 | 67.36 | 68.64 |

Compiled by Daigo Gubo

SOURCE: Reports of Condition and Income for Insured Commercial Banks

NOTES:
1 Because all District banks except one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.
2 All earnings ratios are annualized and use year-to-date average assets or average earnings assets in the denominator.
3 Nonperforming loans plus OREO are those 90 days past due or in nonaccrual status or other real estate owned.
4 The loan loss coverage ratio is defined as the loan loss reserve (ALLL) divided by nonperforming loans.

- **Why does it matter**—what are the economic and social outcomes, at both the household and macro levels, associated with varying levels of savings, assets and net worth?
- **What can we do to improve household balance sheets**—what are the implications of our research for public policy, community practice, financial institutions and households?

Many in the Federal Reserve System have been studying family balance sheets for years. What we hope to offer is a broad conceptual framework, a common table where those throughout the System and beyond learn and work together. We plan to publish research offering new perspectives on balance sheets and why they matter.

See www.stlouisfed.org/hfs for full details on the initiative's team, *In the Balance* publication, research and other activities.

As we continue to recover from the economic crisis, we are challenged to innovate and to think about new ways to help American families and the U.S. economy thrive. We are excited about the contribution that our new Household Financial Stability research initiative can make to this important challenge.

ENDNOTES

1 "Household Financial Stability: Who Suffered the Most from the Crisis?" *The Regional Economist*, July 2012.

2 International Monetary Fund, *World Economic Outlook: Growth Resuming, Dangers Remain*, April 2012, p. 91.

# Will Money Market Mutual Funds Get an Extreme Makeover?

*By Michelle Neely*

The regulatory response to the 2007-08 financial crisis is far from over, as much of the rulemaking stemming from the Dodd-Frank Act remains incomplete. Money market mutual funds (MMMFs) were subject to some modest regulatory changes in 2010, but many observers argue that the industry is in need of a more substantial overhaul. The $2.9 trillion MMMF industry is objecting, pointing out that the effects of the 2010 reform should be thoroughly examined before further changes are adopted and that radical changes would threaten the industry's survival.

Although the problems experienced by the money market industry during the financial crisis were not widely known by the public, the government felt compelled to intervene. Just one day after Lehman Brothers declared bankruptcy in September 2008, the Reserve Primary Fund's share price fell below a dollar because the fund's holdings of Lehman-issued commercial paper became worthless. Investors swamped the fund with redemption requests, causing the fund to be closed and eventually liquidated. Analysts at the Boston Fed conservatively estimate that at least 20 other funds would have "broken the buck" if not for direct support from fund sponsors during the financial crisis.[1] The U.S. Treasury also stepped in, setting up a guarantee program for MMMF investors to stem redemptions at other prime money funds and shore up the industry; that program expired in September 2009.

## What They're Saying about MMMFs

"Additional steps to increase the resiliency of money market funds are important for the overall stability of the financial system."
FEDERAL RESERVE CHAIRMAN BEN BERNANKE, APRIL 2012

"Never again should policymakers be forced to choose between a financial meltdown or a taxpayer bailout of money market funds."
FORMER FDIC CHAIRPERSON SHEILA BAIR, NOVEMBER 2012

"Investors are telling us loud and clear that any of the SEC's concepts—floating the funds, requiring capital buffers or imposing asset freezes—will drive them out of money market funds and essentially kill the product."
KARRIE MCMILLAN, GENERAL COUNSEL FOR THE INVESTMENT COMPANY INSTITUTE, MAY 2012

"Four years after the instability of MMMFs contributed to the worst financial crisis since the Great Depression, with the failure of the SEC to act, (the FSOC) should now move forward with the tools provided by Congress."
TREASURY SECRETARY TIMOTHY GEITHNER, SEPTEMBER 2012

### SEC Attempts Revamp

In 2010, the Securities and Exchange Commission (SEC) adopted a number of regulatory changes meant to strengthen the industry by reducing risk. Portfolio quality, stress-testing, liquidity and diversification requirements were imposed, along with limits on portfolio maturity and mandates for disclosure and reporting. A recent analysis by SEC staffers of the 2010 reforms indicates that MMMFs are less likely to "break the buck" now than they were before the reforms because the SEC-mandated maximum weighted average maturity (WAM) of portfolios has fallen from 90 days to 60 days. The staffers found that the 2010 changes have made funds more resilient to portfolio losses and investor redemptions but that none of the reforms would have prevented the 2008 meltdown of the Reserve Primary Fund.

Although the 2010 reforms have seemingly lessened the risk of losses to investors, many observers believe they did not go far enough to prevent runs. SEC Chairman Mary Schapiro, who recently left the agency, spearheaded an internal effort to impose more stringent requirements on money market mutual funds. The most controversial reform effort she championed was to allow the net asset value (NAV) of an MMMF share to float, reflecting its market value, rather than being fixed at $1, as is currently the practice. A floating NAV would put money market funds on par with other types of mutual funds. Schapiro abandoned

that effort and others in August 2012 when she could not produce the three votes necessary to enact those changes.

### Enter the FSOC

The Financial Stability Oversight Council (FSOC) took up MMMF reform following the SEC impasse. In November, the FSOC voted unanimously to put out for public comment three reform options that align with those proposed by the SEC; while the FSOC is prepared to enact reforms, the FSOC has made it clear that it would prefer that the SEC took action. The three proposals are 1) require funds' NAVs to float; or 2) require funds to hold a capital buffer to manage losses plus place restrictions on the number of shares redeemable at one time; or 3) require funds to have capital buffers of 3 percent in addition to some other measures. The FSOC noted that the final proposal could be a mix of the three options suggested, with the goal of maximizing industry stability. The comment period for the proposal closes in mid-February. Based on comments received, the FSOC will provide a recommendation to the SEC, which then has 90 days to respond. The SEC can agree with the FSOC recommendation, propose its own or explain in writing why it won't do either.

Since the FSOC's proposals came out in mid-November, two events have heightened the pressure on the SEC and the MMMF industry. As part of its recommended overhaul of the shadow banking system, the Financial Stability Board (FSB)—an umbrella organization of central bankers—called for the MMMF industry to eliminate its stable pricing mechanism, where feasible, to stanch runs.[2] Functionally equivalent measures to a floating NAV should be adopted, according to the FSB, in cases where stable pricing is deemed necessary. The FSB's stance adds an international regulatory voice to that of U.S. banking and financial markets regulators.

More recently, the FSOC has discussed the idea of designating MMMFs or their sponsors as systemically important financial institutions (SIFIs), thus posing a potential threat to U.S. financial stability.[3] A SIFI designation under Section 113 of the Dodd-Frank Act would lead to tighter regulation of the money market industry, as well as direct supervision by the Federal Reserve. Individual bank regulators could also act on their own by imposing capital charges on MMMFs that are bank-sponsored.

### Industry Resists Remodel

The money market fund industry has for the most part opposed the reform proposals suggested by the SEC, the FSOC and the FSB. The Investment Company Institute (ICI), the trade group for the mutual fund industry, has criticized all three primary regulatory changes suggested—floating NAVs, capital requirements and redemption holdbacks. The ICI maintains these changes would not necessarily make the industry safer but would put money funds at a competitive disadvantage relative to other cash management products. Some of the larger mutual fund companies have offered proposals of their own to head off what they view as more draconian changes.

U.S. financial regulatory authorities are united in their desire to impose tighter regulations on money market mutual funds. If the SEC does not pass a reform package, Treasury Secretary Timothy Geithner has said the FSOC will.[4] Most observers believe some sort of reform effort will be approved by the end of 2013. With the money fund industry so firmly against floating share prices, the most likely outcome will be some sort of capital requirement, perhaps coupled with limits on redemptions in times of financial stress.

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*Michelle Neely is an economist at the Federal Reserve Bank of St. Louis.*

ENDNOTES

1. "The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011," Steffanie Brady, Ken Anadu and Nathaniel Cooper, Working Paper RPA 12-3, Federal Reserve Bank of Boston, Aug. 13, 2012.
2. "Strengthening Oversight and Regulation of Shadow Banking," Financial Stability Board, Nov. 18, 2012.
3. "FSOC Eyes New Option on Money Funds, Weighs Mortgages, Derivatives Transactions," Chris Bruce, *Bureau of National Affairs Banking Daily*, Dec. 14, 2012.
4. "Regulators Set Mandate for Reform of Money-Market Mutual Funds," Donna Borak, *American Banker*, Nov. 14, 2012.

FIGURE 2

## Eighth District Community Bank* OREO/Total Assets Trends by Loan Category

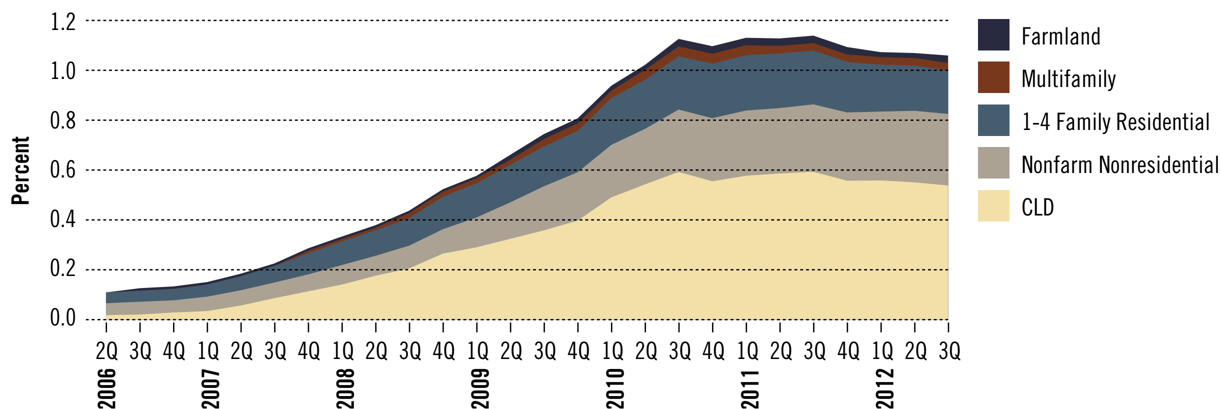
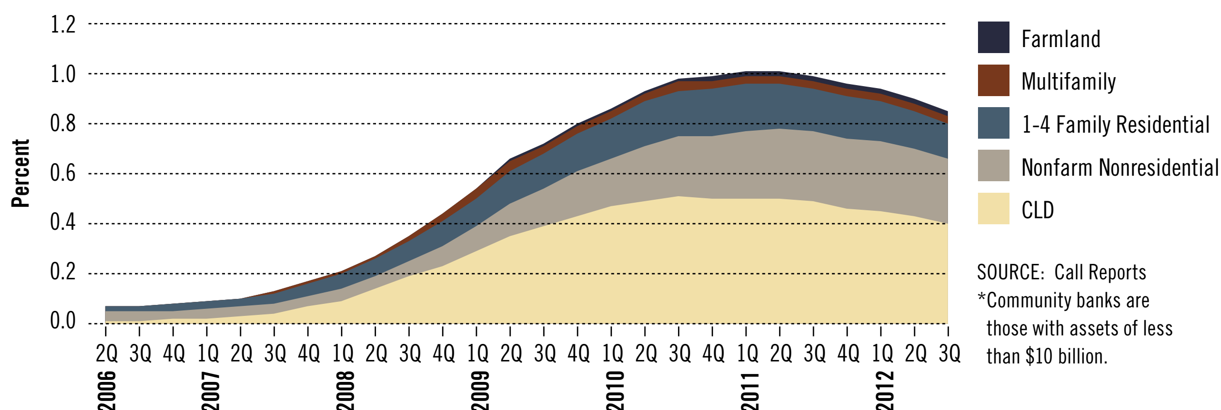



FIGURE 3

## U.S. Community Bank* OREO/Total Assets Trends by Loan Category




SOURCE: Call Reports
*Community banks are those with assets of less than $10 billion.

## OREO Trends

*continued from Page 1*

banks headquartered in the District had 1.06 percent of their assets in OREO. Nationwide, community banks had only 0.85 percent of their assets in OREO.

### OREO Composition

Loans initially collateralized by construction and land development (CLD) properties represent the highest share of OREO properties on bank balance sheets, followed by nonfarm nonresidential properties. This is understandable given that CLD and nonfarm nonresidential properties make up most of the commercial real estate held on community bank balance sheets. Figures 2 and 3 above show OREO composition at community banks nationwide and at community banks headquartered in the District. The general composition of OREO at both groups of banks is very similar. The key difference is that District institutions remain burdened by a higher ratio of OREO as a percentage of their total assets.

### OREO Concentrations by State

As illustrated on the map on Page 7, community banks headquartered in states in the Eighth District have, on average, fairly moderate ratios of OREO to assets. Community banks in Indiana and Kentucky have ratios of less than 1 percent. The remaining five states—Arkansas, Illinois, Missouri, Mississippi and Tennessee—each have average OREO-to-assets ratios of 1 percent to 1.49 percent. On a state level, Georgia has the highest average ratio of OREO to assets on its community banks' balance sheets. This is not surprising, as it also is the state with the largest number of bank failures.

As would be expected, lower OREO ratios are correlated with lower problem asset ratios. Problem asset ratios at community banks headquartered in Indiana and Kentucky are the lowest

among District states at 3.18 percent and 3.69 percent, respectively.[2]

### Policy Statement and Risk Management on OREO

With the rise in foreclosures, the cost of maintaining and disposing of OREO property can become a significant drag on a bank's performance. Through the third quarter of 2012, community banks across the nation incurred $1.38 billion in annualized OREO expenses, which effectively trims 6 basis points off their return on average assets. District community banks fared slightly worse, losing $0.35 billion on an annualized basis on OREO, which trims 7 basis points off their return on average assets. The impact of OREO on asset quality and earnings highlights how important it is that banks appropriately market their OREO holdings to prospective investors.

On April 5, 2012, the Federal Reserve issued a Policy Statement on Rental of Residential OREO Properties (SR 12-5/CA 12-3) to clarify that banking organizations are permitted to rent OREO properties as part of an orderly disposition strategy. The move was aimed at providing more flexibility in OREO marketing and improving the sales value of properties. On June 28, 2012, the Federal Reserve issued Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of OREO (SR 12-10/CA 12-9) to help address questions regarding the management of OREO by institutions regulated by the Federal Reserve. Generally speaking, the Federal Reserve permits bank holding companies to hold an OREO asset for up to five years, with an additional five-year extension available under certain circumstances. However, the policy statement emphasizes that bank management must have sound strategies and processes in place for the management and disposal of OREO properties.

### Long Way To Go on OREO

Foreclosed properties spiked significantly during the financial crisis. As a result, many community banks now have significant holdings of foreclosed-upon construction and land development properties on their balance sheets. Since CLD loans proved to be one of the riskiest asset classes for community banks, naturally it holds that effectively disposing of such properties from OREO inventories is challenging. Despite the recent clarification from the Federal Reserve regarding the rental of OREO as part of an orderly disposition strategy, the stubbornly elevated levels of OREO on bank balance sheets suggest that community banks still have a long way to go before these levels return to where they were prior to the financial crisis.

*Gary Corner is a senior examiner and Daigo Gubo is a policy analyst at the Federal Reserve Bank of St. Louis.*

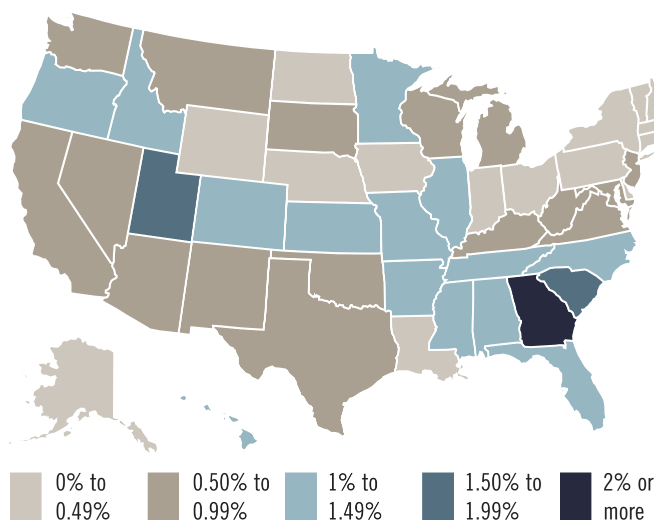
ENDNOTES

1 Properties that are classified as other real estate owned (OREO) are those held by banks as the result of a foreclosure or a deed in lieu of foreclosure.

2 Problem asset ratios are nonperforming loans and OREO to total loans and OREO.

**FIGURE 4**

## Average OREO Concentrations by State




SOURCE: Call Reports

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Supervision and Regulation Letters

SR 12-5/CA 12-3
www.federalreserve.gov/bankinforeg/srletters/sr1205.htm

SR 12-10/CA 12-9
www.federalreserve.gov/bankinforeg/srletters/sr1210.htm

# The Big Banks: Too Complex To Manage?

The phrase "too big to fail" re-entered common use in 2008 after Fannie Mae and Freddie Mac were put into government conservatorship on Sept. 6; the government rescued the large insurance firm AIG starting on Sept. 16; and nine major banks announced on Oct. 14 their intention to subscribe to the Troubled Asset Relief Program (TARP), in which the Treasury would purchase the banks' preferred stock. More unflattering phrases have become associated with megabanks over the past couple of years.

"Misbehaviors" connected to the big banks magnified the problems already posed by such large, complex financial organizations, which have concerned legislators and regulators for years. Have they successfully created game plans for "too-big-to-fail" firms? Are big banks needed, or do the misbehaviors indicate that such megabanks should not even exist? These and more questions were explored during the Oct. 1 Dialogue with the Fed, part of the St. Louis Fed's ongoing evening discussion series for the general public.

St. Louis Fed economist William Emmons led the Dialogue, titled "Robo-signing, the London Whale and Libor Rate-Rigging: Are the Largest Banks Too Complex for Their Own Good?" Joining Emmons for the Q&A that followed were Mary Karr, senior vice president and general counsel of the St. Louis Fed; Steven Manzari, senior vice president of the New York Fed's Complex Financial Institutions unit; and Julie Stackhouse, senior vice president of Banking Supervision and Regulation at the St. Louis Fed. See the videos and Emmons' presentation slides at www.stlouisfed.org/dialogue.

FIGURE 1

### Which Forms of Governance *Appear* To Be Effective for Complex Banks?

| Corporate Governance Mechanisms | | |
|---|---|---|
| **Internal governance mechanisms** | **In the best corporations** | **Among U.S. megabanks** |
| Corporate culture | ✓ | |
| Board oversight | ✓ | |
| Managerial self-interest | ✓ | ✓ |
| **External governance mechanisms** | | |
| Product-market discipline | ✓ | ✓ |
| Shareholder discipline | ✓ | ✓ |
| Depositor/bondholder/ counterparty discipline | ✓ | |
| Supervision and regulation | | ✓ |
| **Overall effectiveness of governance** | ✓✓✓✓✓✓ | ✓✓✓✓ |

## *Why* Were Big Banks Rescued During the Crisis?

The financial crisis reinvigorated the active debate on the "social good" of megabanks—whether they alone can do things smaller financial organizations can't and whether they truly are more effective and efficient. (See "Economies of Scale and Scope" on Page 10 for some details.) The primary point of contention, however, is systemic risk.

Very large and complex banks are considered to have systemic risk because the failure of a megabank would hurt not just the company itself, its creditors and its employees but potentially the entire financial industry and the economy. In other words, they *are* "too big to fail" without creating dire consequences for the economy.

"Sometimes institutions *need* to fail. That is essentially what capitalism is about: that when a firm is no longer viable it should be able to leave the market (e.g., fail)," Emmons said. "But we were caught flat-footed in 2008 when the financial system almost collapsed and we had no safe, effective way to wind down failing megabanks." Consequently, the federal government propped up many large and complex financial institutions—including AIG, Fannie Mae and Freddie Mac—to avoid the damage of chaotic collapses. The lack of a structure to deal with a megabank failure has troubled many policymakers and lawmakers who, as discussed later, are attempting to craft such a mechanism.

## Misbehaviors: A Failure of Discipline?

The revelations of recent controversies such as robo-signing, the London Whale and Libor rate-rigging—explored in "Big Bank Misbehaviors" in the online version of this article at www.stlouisfed.org/cb—as well as other problems not mentioned here indicate

that something critical was lacking in the discipline of large, complex banks.

"Discipline" is a combination of an institution's internal and external governance. Internal governance includes corporate culture, oversight by the bank's board and managerial self-interest, while external governance comes via supervision and regulation, as well as discipline by product markets, shareholders, depositors, bondholders and counterparties.

Was the internal discipline effective? Not really, Emmons explained: "Some of those misbehaviors point in this direction, that the internal corporate cultures at the largest banks are not an effective mechanism for keeping the banks on the straight and narrow." As indicated in Figure 1 on Page 8, internal discipline generally appears to work well in the best corporations but not as well among the U.S. megabanks, while external governance generally seems to have worked better for megabanks, Emmons said. "The basic message is that there are some real weaknesses on the internal side, and to the extent that we can be effective as supervisors and regulators, we can probably provide fairly effective external sources of discipline," he said.

"I think it's also true that board oversight is often lacking," Emmons said. It's a perennial issue at small banks and a bigger issue for midsized banks but seems especially challenging for megabanks, as their board members are nonexperts recruited from other economic sectors yet are expected to provide effective oversight of very large and complex organizations. "It's true that the megabanks operate in very competitive product and labor markets, which pushes them to be more efficient. But the other internal governance weaknesses noted above and their overwhelming complexity appear to make them 'too big to manage effectively,'" he said.

Both Emmons and Manzari addressed shareholders in response to a question from the Dialogue audience. They noted that small shareholders are exerting some discipline through selling their stock but that there are restrictions on what large shareholders can do and that the type of governing influence that shareholders can have on firms has yet to play out in this changing regulatory environment.

> "We were caught flat-footed in 2008 when the financial system almost collapsed and we had no safe, effective way to wind down failing megabanks."
>
> ECONOMIST WILLIAM EMMONS

### Dealing with Large, Complex Banks

But why didn't federal regulators catch the misbehaviors and other issues before they became major problems? Complexity. For example, Manzari, responding to a Dialogue audience question, said that supervising a handful of megabanks is definitely more complicated than supervising hundreds or thousands of smaller institutions.

- **Numerous regulators for one megabank** – "Every jurisdiction has some sort of prudential supervisory agencies. A firm that does business in the United States, the U.K., Europe and Asia will have a range of different entities involved in the supervision of that firm. That puts a big premium on communication and collaboration of those different agencies."
- **No uniform set of rules across agencies** – A nationally chartered bank in the U.S. faces a uniform set of rules, and you don't have state-to-state differences. However, there is no globally unified regulatory framework for all international firms. "There is an effort to harmonize capital standards (and) liquidity standards, but still you get different rules in different regimes," Manzari said.

Illustrating Emmons' prior exposition on megabank discipline, Manzari added that "The very complexity of megabanks often creates relationships inside the firm that become apparent only after the problem manifests itself."

Addressing supervision of smaller banks, Stackhouse noted that while the supervisory process is easier, there is also a very clear resolution mechanism. Since the financial crisis, more than 400 small banking organizations have

*continued on Page 10*

## Big Banks

*continued from Page 9*

failed. "A recent failure in St. Louis hit the papers for exactly one day, and I think it's pretty much forgotten about because that's how well (the resolution process) worked," she said. "We're not there yet with large institutions."

### How To (Maybe) End "Too Big To Fail"

So, how will we deal with the megabanks? Emmons outlined two basic approaches: radical and incremental. The radical approach involves structural changes imposed on the banks themselves or the creation of a different legal definition of what a bank is and what it can do. Radical proposals include:

- **Reduce their complexity and size** – Revive the 1933 Glass-Steagall Act (partially repealed by the 1999 Gramm-Leach-Bliley Act) prohibiting combining commercial banking with investment banking or insurance underwriting. Also, reduce their size by placing limits on banks' assets or deposits. However, Emmons said this proposal likely wouldn't succeed because combining commercial and

## Economies of Scale and Scope

To help explain why the misbehaviors matter and how they illuminate "too big to fail," Emmons explored why certain banks became global giants. Given that all banks perform payments and credit, big banks argue that they need to be large and complex because they can better take advantage of economies of scale and scope:

- Economies of scale – The average cost per unit of doing one thing declines as the scale of operation increases, such as diversifying default risk in the loan portfolio or paying only the net amount owed on payments clearing and settlement.
- Economies of scope – The average costs per unit of doing different things decline as a result of doing them together, such as one-stop financial shopping, banking and insurance; commercial and investment banking; or market-making and trading on a bank's own accounts.

But does a bank need to be large and complex to succeed? Not necessarily, according to what ongoing St. Louis Fed research suggests. Emmons explained that most scale economies appear to be captured by banks that have between $30 billion and $50 billion in assets, banks that are much smaller than those shown in the first two columns of Figure 2 above.

Emmons said the research suggests that big banks' scope efficiencies may be good for the firms themselves, but not necessarily for the rest of society. Granting that big banks dispute such research as flawed

FIGURE 2

### Size and Complexity of the Seven Largest U.S. Financial Holding Companies

| As of 2011: Q4 | Consolidated Total Assets (in billions) | Percent of Total | Number of Subsidiaries | Percent of Total |
|---|---|---|---|---|
| JPMorgan Chase & Co. | $2,266 | 15.8% | 3,391 | 17.3% |
| Bank of America Corp. | 2,137 | 14.9 | 2,019 | 10.3 |
| Citigroup Inc. | 1,874 | 13.1 | 1,645 | 8.4 |
| Wells Fargo & Co. | 1,314 | 9.2 | 1,366 | 7.0 |
| Goldman Sachs Group Inc. | 924 | 6.4 | 3,115 | 15.9 |
| Metlife Inc. | 800 | 5.6 | 163 | 0.8 |
| Morgan Stanley | 750 | 5.2 | 2,884 | 14.7 |
| **All 4,660 bank holding companies** | **$14,359** | **100%** | **19,603** | **100%** |

SOURCE: "A Structural View of U.S. Bank Holding Companies," D. Avraham, P. Selvaggi and J. Vickery, New York Fed *Economic Policy Review*, July 2012.

because it doesn't have enough data from megabanks, Emmons said that the megabanks' claim that they "passed a market test" during and after the crisis is "simply not true."

Returns to big-bank shareholders have been poor over time, as bank stocks experienced a 90 percent decline from the beginning of financial crisis, much more than the overall stock market. "There has been some recovery, but they are trailing the market," Emmons said. "So, whether using 2000 or 2007 as the starting point, bank stocks have vastly underperformed the rest of the market—even with government support."

Emmons said, "Most, if not all, of the megabanks would have failed without government support during the financial crisis. In other words, in a truly free market, most or all of those banks would have exited." And large companies are at best lukewarm supporters of big banks, he said.

For a fuller discussion, see the presentation slides and videos as well as "Too Big To Fail: The Pros and Cons of Breaking Up Big Banks" at www.stlouisfed.org/publications/re/articles/?id=2283 in the October 2012 *The Regional Economist.*

investment banking was not the main source of problems; in fact, many of the "too-big-to-fail" institutions that caused problems during the crisis would have been allowed to operate under Glass-Steagall.

- **Create "narrow banks"** – Separate payments functions from all other financial activities. Such a bank would take deposits and make payments but not make loans except those that have very little default risk. Emmons said this proposal wouldn't be successful either because such banks are not likely to be viable. Narrow banks likely would seek to make riskier loans to improve their profitability, while non-narrow banks would seek to enter the payments business in one way or another.

"In fact, we have chosen not to pursue radical approaches to solving the 'too-big-to-fail' problem," he said. "Instead, we're implementing incremental—albeit significant—reforms of the existing legal, regulatory and governance frameworks in which banks operate." Meanwhile, bankers, regulators and legislators won't know whether the regulatory reform efforts will actually work until they are actually used. Those efforts, which have sparked a lot of profound debate throughout the financial industry, include:

- **The 2010 Dodd-Frank Act** – The law includes living wills for orderly dissolution, capital requirements, stress tests, risk-based assessments on deposit insurance, FDIC orderly liquidation authority, the Volcker Rule and investor protections. "These are all pushing banks to be more effective in internal discipline," Emmons said. (See www.stlouisfed.org/regreformrules, our Dodd-Frank Act site.)
- **Basel III Accord** – The third round of the Basel Accords is looking to improve the quality of bank capital and make other changes related to capital so that big banks demonstrate that they "have more skin in the game," Emmons said.

Emmons also offered another proposal: Make a strictly enforced "death penalty" regime, a law mandating that any bank requiring government assistance would be nationalized, with a plan to sell it back to new shareholders at some point in the future. "The crux of the matter would be carrying through this pledge to re-privatize the institution," he said. "It should reduce the incentives to take risk because the 'death penalty' is such a severe penalty that it would act as a deterrent." Emmons noted that TARP (the Troubled Asset Relief Program) was a half-step in this direction, in which the federal government took non-controlling equity positions in mega-banks—preferred instead of common equity—and didn't wipe out shareholders or management.

"It's not so radical of a proposal because we did impose a 'death penalty' on Fannie Mae and Freddie Mac: Their shareholders and management were wiped out. General Motors and Chrysler were forced into bankruptcy, and AIG was effectively nationalized," he said.

"If this were to be the plan, we would need (to continue the metaphor) an undertaker standing by—an institution that would be ready to exact this discipline on the firms," he said, pointing to other nations' permanent "sovereign wealth funds" that can take equity positions in firms.

### The Jury Is Still Out

While investigations and lawsuits continue, regulations are written for new laws, and the industry wrestles with proposed capital and other standards, the question remains: Will any of this solve "too big to fail," successfully rein in systemic risk or prevent future "misbehaviors"? Simply put, we don't know yet.

"I think it's really important to realize that these are the early days in terms of the reform efforts for the financial system, and many firms still have to navigate a pretty complex set of changes to the regulatory landscape, how the world is unfolding and how they're going to generate profits," Manzari said during the Q&A portion.

Stackhouse noted that of the 400 or so regulations and rules required by the Dodd-Frank Act, only about one-third are actually in place. "The financial community, large banks in particular—those with over $50 billion in assets—have a lot ahead of them," she said. "The Dodd-Frank Act right now is the mechanism on the table to deal with these very large firms. The jury is still out on how that particular rule making will take place and how effective it will be."

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