

Financial Stability: Traditional Banks Pave the Way

For a prosperous future, the nation must find lasting financial stability...but where? Not in the big financial institutions at the center of the recent crisis. Not in the misplaced hope of restraining these powerful organizations via regulation. Instead, stability is to be found in a surprising place—all around us. America's numerous community banks, small and traditionally oriented, demonstrated stability during the crisis and its aftermath. Imparting their virtues to the financial system as a whole will require the end of financial institutions that are too big to fail.



Introduction

A stable, well-functioning financial system is a precondition for a healthy economy. In recent years, America has seen what happens when turmoil engulfs the banks and other institutions that handle our money and provide credit to fuel economic expansion. We now confront slow growth, high unemployment and flat incomes. Policymakers appear flustered.



Community Banks Withstand the Storm

Community banks, which rely on strong customer relationships and disciplined lending practices, weathered the financial crisis better than large, nontraditional banks. This superior performance suggests that a back-to-basics approach to banking could help the nation realize financial stability that lasts.



A Lender for Tough Times

Community banks are not only a major source of credit, but also a stable one for businesses. During the recent financial crisis and its aftermath, these smaller, traditional lenders provided credit to many firms, especially small businesses, when they needed it most.



Small Banks Squeezed

With consistent loan quality and resilient lending activity, community banks—and the traditional banking model they represent—can be a much-needed force for financial stability. Unfortunately, they've struggled to maintain market share, partly as a result of unintended consequences of public policy.



Regulatory Burden Rising

U.S. commercial banks face growing regulatory requirements and complexity, especially with the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, which was intended to rein in excesses of the largest banks. The nation would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks.



Leveling the Playing Field

Financial reform must be redirected. The government's financial safety net for the biggest banks should cover only their essential banking activities and their role in the payments system. Once that occurs, market discipline can reassert itself, and all institutions—large and small—can compete on a more level playing field.

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The country won't return to prosperity until the persistent fog surrounding our nation's financial system lifts. This will require not only rebuilding healthy balance sheets, but also addressing the public's diminished confidence in banks as reliable conduits of credit for the practice of American capitalism.

We believe the old and familiar virtues of traditional banking provide the framework. Financial stability rests on a level playing field that rewards sound judgment and integrity and penalizes excessive risk and complexity financed by taxpayer dollars. Government must retain its role as the financial system's watchdog, but it should render no institution immune to market discipline.

In recent years, a small number of globe-spanning behemoths have come to dominate the banking industry. Their size, complexity and risky behavior played a decisive role in the financial crisis and now weigh on the lackluster economic recovery. New laws strive to end "too big to fail" banks but come up short, violating our capitalist principles by interfering with market discipline and perpetuating a threat to the country's financial stability.

When it comes to our financial sector, we've seemingly stumbled into a place where we never wanted to be. Just as disturbing, we don't know how to get out. Do we simply accept that big banks will get bigger? Do we try to rein in their excesses through all-encompassing regulation, even if it risks burdening small and medium-sized banks that had little to do with the financial crisis? Or do we dedicate ourselves to creating a diverse financial system in which no bank is too big to fail?

This report presents five online essays, written by Dallas Fed financial experts, on the theme of rethinking America's banking system:

- "Community Banks Withstand the Storm" examines the inherent stability of smaller, customer-focused institutions.
- "A Lender for Tough Times" shows how smaller institutions support their customers during recessions.
- "Small Banks Squeezed" discusses these institutions' uphill struggle for market share.
- "Regulatory Burden Rising" illustrates the growing burden smaller banks face because of regulations aimed at policing the activities of the big institutions.
- "Leveling the Playing Field" analyzes how market discipline and public policy reform can influence bank size and contain the risk of too big to fail.

The stakes are too high to simply sit back and hope challenges to our system resolve themselves. Only by actively working toward a solution based on market discipline can we expect economic growth to accelerate and the United States to reach its dynamic potential.



Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas



Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

Community banks, which rely on strong customer relationships and disciplined lending practices, weathered the financial crisis better than large, nontraditional banks. This superior performance suggests that a back-to-basics approach to banking could help the nation realize financial stability that lasts.

Community banks began this century lost in the shadow of the big Wall Street financial institutions. During the 2007–09 recession, however, the merits of the community bank model reemerged. With relatively high loan quality, U.S. community banks weathered the severe operating environment—the worst financial crisis since the Great Depression—better than their largest competitors, many of which required special government support. Community banks' failure rate remained far below the rate at which the government propped up the country's biggest banks.



Community banks are organizations with assets of \$10 billion or less. This characterization, although sometimes imperfect, serves as a proxy for institutions following the community bank model, which relies on a strong working knowledge of the local market. A subgroup of smaller community banks—those with assets less than \$1 billion—is analyzed here along with the institutions holding \$1 billion to \$10 billion in assets.

Their performance is compared with two classes of larger banks—those in the over \$10 billion to \$250 billion range and those with assets exceeding \$250 billion.

Loan Quality

The severity of the 2007–09 downturn—with its extensive real estate component—made business difficult for any bank. Even so, community banks displayed relative stability in key measures of loan quality:

- Noncurrent loans
- Net charge-offs (the loan-loss rate)

Looking at business loans backed by nonfarm, nonresidential real estate as well as commercial and industrial loans, community banks experienced fewer problems (*Chart 1*). They mostly avoided the extreme noncurrent and charge-off rates incurred by other types of banks, especially the largest institutions.

The recent recession's significant real estate component played itself out in historically high noncurrent rates for residential mortgage loans. Closed-end, first-lien, one- to four-family loans, traditionally a low-risk lending category, were hit hard. Some banks had to rebook noncurrent loans that had been securitized—that is, bundled with other, similar obligations and sold to investors as mortgage-backed securities. Even within the beleaguered residential real estate category, however, community banks exhibited performance far superior to the nation's largest financial institutions (*Chart 2*).

The superior loan quality among community banks didn't just emerge during the recent financial crisis. The 2001 economic downturn strained banks' loan portfolios but lacked the outsized real estate-based pressures of the 2007–09 recession. Even so, community banks in this earlier period also avoided severe loan quality problems, while noncurrent and charge-off rates among other types of banks, especially the largest ones, rose to high levels (*Chart 3*).

Community Bank Model

The community bank model lies behind this consistently higher loan quality. Locally owned banks establish long-term ties with businesses in their communities. When making lending decisions, community banks tap direct knowledge of customers, going beyond the credit scores, financial statements or other quantitative assessments on which their larger competitors depend. Such lender–borrower relationships become especially important when vital information about borrower creditworthiness is only effectively acquired firsthand.

Of course, we can't expect banks with assets of \$10 billion or less to handle by themselves all the credit and financing needs of a sophisticated, globally competitive economy churning out \$16 trillion a year in output. However, the community bank model serves a useful purpose by illustrating the financial institution attributes that contribute to economic stability. The country needs a diverse financial system, with bigger institutions alongside the community banks, but these larger banks should deliver the same quality performance as community banks and need not be nearly as large as they are today.

In recent decades—especially in the years leading up to the financial crisis—the community bank model became marginalized. To a limited degree, this was to be expected as an increasingly competitive environment, coupled with the removal of restrictions against geographic expansion, led some small banks to seek greater efficiencies by operating on a somewhat larger scale. However, the perceived advantages of larger scale sometimes proved illusory. Big institutions, amid a wave of banking industry consolidation, began dominating credit markets by using transactional, automated approaches to loan underwriting. In many cases, the new credit-market mechanisms inadequately measured lending risk, proving a poor substitute for the community bank model's firsthand knowledge.

Financial conservatism is also a hallmark of successful community banking. It is grounded in the everyday awareness of the chance of failure and government-mandated closure if too much credit is extended to borrowers with insufficient repayment capacity. It is buttressed by the ownership structure of community banks, where much of managers' or directors' wealth is often on the line.

By comparison, some larger banks' lending became overly aggressive at times, perhaps emboldened by a belief that the likelihood of regulator-ordered shutdown was minimal, even if big segments of their loan portfolios soured. The rising volumes of problem loans and the sometimes fragile means used to fund them—for example, off-balance-sheet vehicles and short-term, volatile wholesale monies—brought credit markets to a virtual collapse in 2007–09. The big banks' size and interconnectedness led to “too big to fail” interventions, which shielded troubled big banks from the full consequences of their decisions.

Failures and Special Assistance

Community banks as a group exhibited greater financial stability with relatively strong loan quality, while avoiding the hyper-cyclicality of large, nontraditional institutions. In the recent crisis and its aftermath, only about 5 percent of community banks failed. Within the largest group of banks, controlled by only nine organizations in 2007, two required special open-bank assistance, a “prop-up rate” of about 20 percent. Potential failure of these institutions was deemed a risk to the financial system and the economy—so they received guarantees, liquidity access and capital from the U.S. government.

Recent experience suggests that reestablishing a more prominent role for traditional banking, as exemplified by community banks, could help the nation achieve greater financial stability. Policymakers should take note.

About the Authors

Jeffery W. Gunther is vice president and Kelly Klemme is a financial industry analyst in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

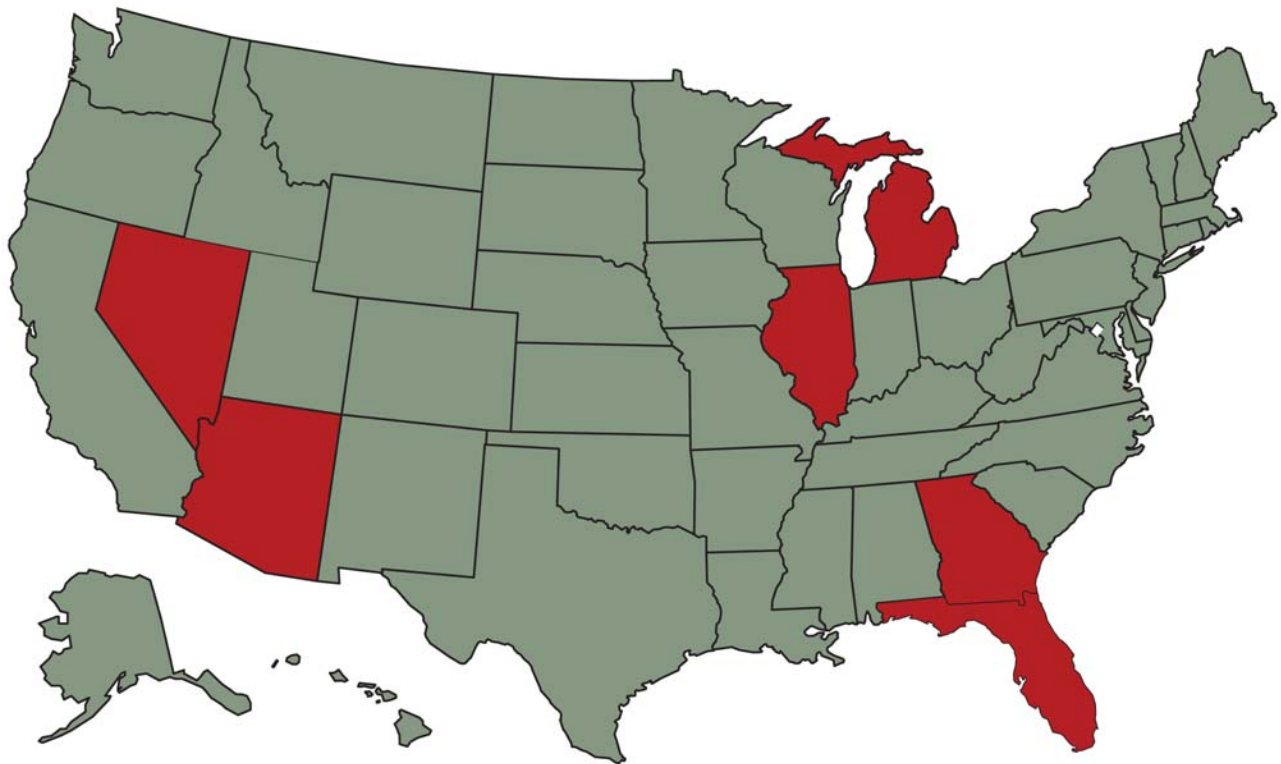
Community Banks Largely Overcome Regional Differences

What if successful community banks were clustered in just a few states with relatively strong regional economies and healthy housing markets? In that case, the group's superior loan quality might merely reflect a relatively favorable operating environment.

Examining the recent financial crisis and recession at the state level provides insight into whether community banks consistently performed well across regions. The aggregate noncurrent rate relative to total business loans is calculated quarterly for community banks in each state from first quarter 2009 to fourth quarter 2011. Quarterly results are averaged for the three years, then compared with the largest banks' nationwide performance.

By this measure, community banks in 44 states performed better than the large banks in terms of holding down loan problems. The six states in which community banks underperformed faced devastated economies. It took this kind of extreme circumstance to render loan quality problems at community banks as severe as those sustained by the largest banks.

Community Banks Have Fewer Loan Woes than Big Banks in All but Six States



NOTES: Data for commercial banks. Community banks have assets of \$10 billion or less. Big banks have assets of \$250 billion or more. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). In states shaded red, community banks had an average aggregate noncurrent business loan rate above that of big banks nationwide for 2009:Q1 through 2011:Q4.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

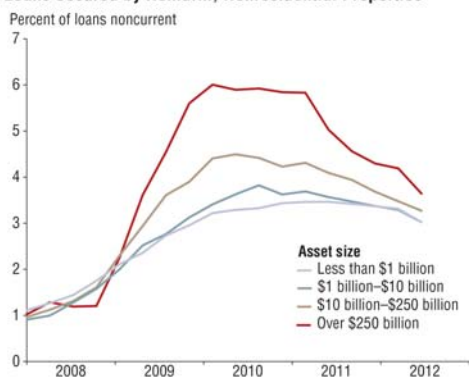
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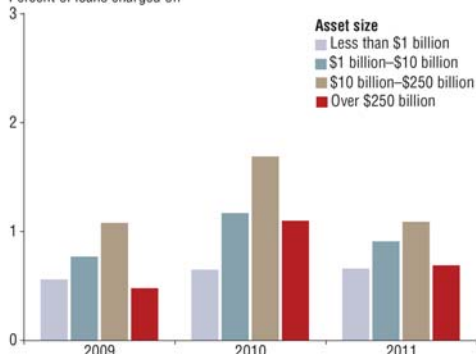
Chart 1

Great Recession: Community Banks Had Fewer Loan Problems than Big Banks

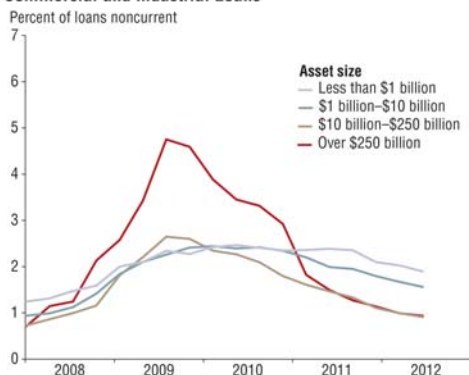
Loans Secured by Nonfarm, Nonresidential Properties



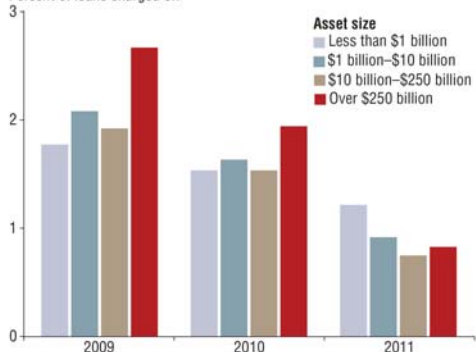
Percent of loans charged off



Commercial and Industrial Loans

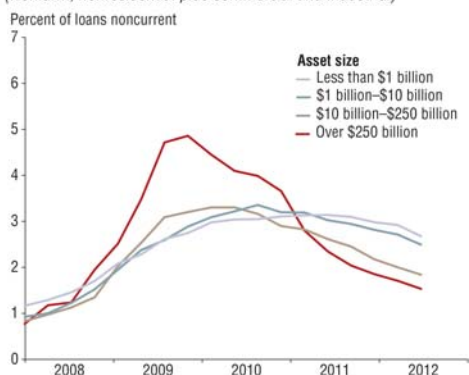


Percent of loans charged off



Total Business Loans

(Nonfarm, nonresidential plus commercial and industrial)



Percent of loans charged off



NOTES: Data for commercial banks. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Loans charged off are net of recoveries. (Data revised February 2013.)

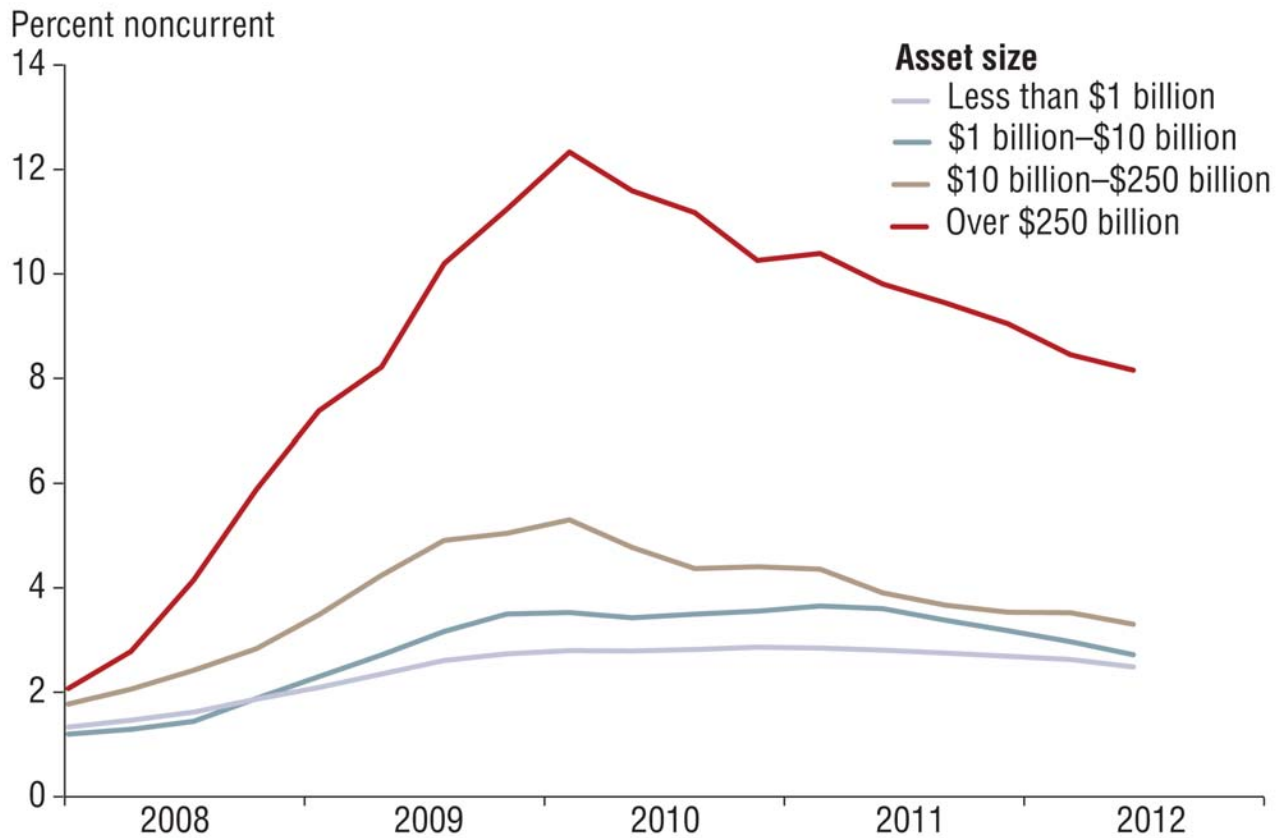
DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

Chart 2

Community Banks Maintain Residential Real Estate Loan Quality in Great Recession



NOTES: Data for commercial banks. Residential real estate loans are closed-end, first-lien, one- to four-family mortgages. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Noncurrent loan rates have been adjusted to exclude loans reboked from Government National Mortgage Association securitizations.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

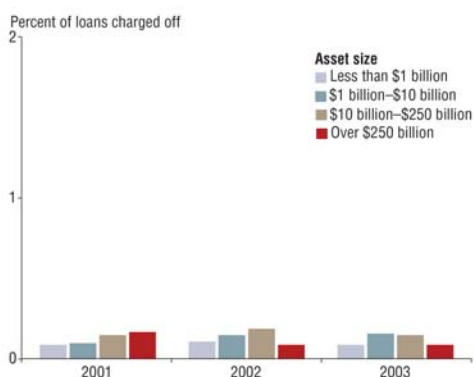
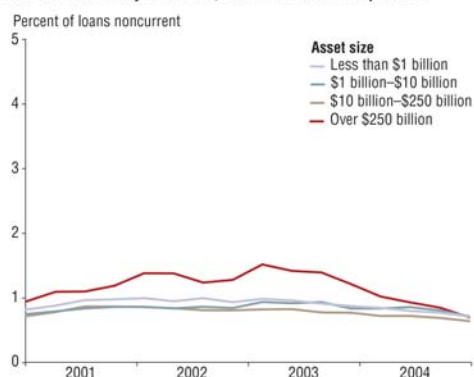
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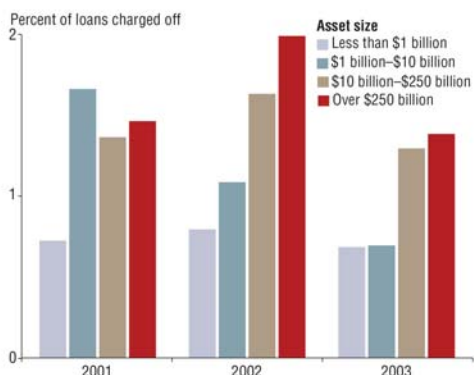
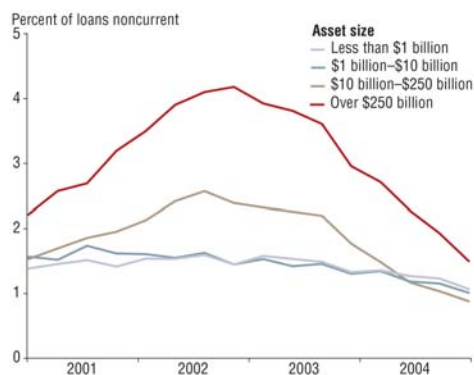
Chart 3

2001 Recession: Community Banks Had Fewer Loan Problems than Big Banks

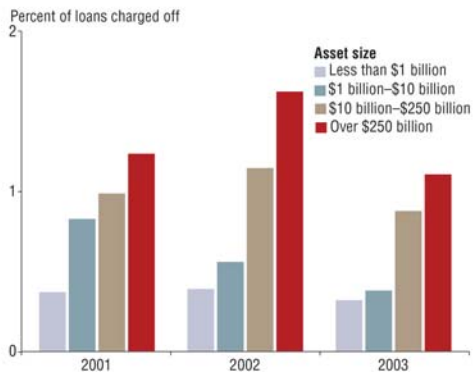
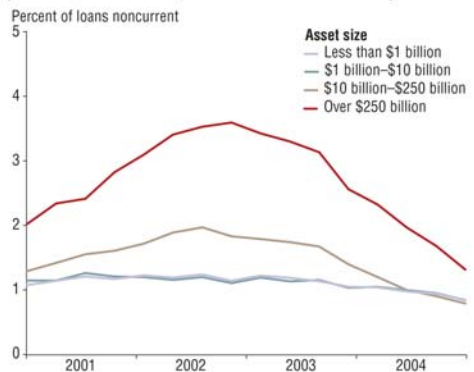
Loans Secured by Nonfarm, Nonresidential Properties



Commercial and Industrial Loans



Total Business Loans
(Nonfarm, nonresidential plus commercial and industrial)



NOTES: Data for commercial banks. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Loans charged off are net of recoveries. (Data revised February 2013.)

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

A Lender for Tough Times

By Jeffery W. Gunther and Kelly Klemme

Community banks are not only a major source of credit, but also a stable one for businesses. During the recent financial crisis and its aftermath, these smaller, traditional lenders provided credit to many firms, especially small businesses, when they needed it most.

Financial stability is key to economic performance—a proposition made starkly clear when banks became a source of trouble during the recession. Before the downturn's start in December 2007, U.S. banks stoked an epic real estate boom with lax lending, setting the stage for a severe financial crisis. Once the worst was over, these institutions inhibited a recovery by tightening credit standards and limiting loans. Like a broken thermostat, banks and the financial system helped overheat the economy and then helped overcool it.



Some types of banks destabilized the credit cycle and economy more than others. The biggest banks, their focus diverted from traditional balance-sheet activities and toward capital markets and short-term gains, incurred spikes in loan defaults and exhibited significant cyclical declines in business loan volume.

Meanwhile, community banks concentrated on traditional banking, taking deposits and extending loans, relying on long-term relationships and time-tested judgment. These smaller banks not only demonstrated relative strength in business loan quality, but also maintained business loan volume to a much greater degree, providing credit to many small businesses when they needed it most. Such lending is vital to the economy.

Community banks are organizations with assets of \$10 billion or less. The smallest community banks are those with assets below \$1 billion.

Their activities are compared with the actions of two classes of larger financial institutions—those in the over \$10 billion to \$250 billion range and others with assets over \$250 billion.

Business Lending Focus

Community banks tend to focus on business lending. Just before the 2007–09 recession, they held overall business loans equal to 30 percent of assets, compared with only 14 percent for the largest banks. This remained true even after the financial crisis. As of June 2012, the subset of smallest community banks held business loans equal to 28 percent of assets, and the group of community banks with assets from \$1 billion to \$10 billion held business loans equal to 31 percent of assets (*Chart 1*). The largest banks were down to about 12 percent.

Just as important, a significant share of this lending goes to small businesses. Community banks as a group have about 13 percent of assets in small business loans, far above the 2 percent for the largest banks. Among the smallest community banks, small business loans command almost 15 percent of assets.

Community banks held 17 percent of industrywide banking assets as of June 2012—but they accounted for more than half of the amount lent to small businesses (*Chart 2*). This importance to the small-business loan market testifies to community banks' competitive edge based on superior firsthand knowledge of borrowers and their credit needs.

Business Lending Durability

Serving the credit needs of small business borrowers in today's challenging times is one thing. But, what happens when the operating environment really turns sour? Who lends to small businesses then?

The housing crisis and recession knocked the financial system off kilter. Small businesses are particularly vulnerable to banking crises because their limited access to broader capital markets increases their dependency on banks. Tightening bank credit will likely curtail small enterprises' activities, jeopardizing the growth and vitality these businesses provide to local communities.

Compared with the big financial institutions, community banks have been more successful in avoiding asset impairment, allowing them to sustain lending activity. At mid-2008, well into the recession, total business lending remained above year-earlier levels for all four bank asset-size categories (*Chart 3*). Over the next two years, however, community bank loan volume held up relative to 2007 levels, while the biggest banks significantly reduced business lending. In 2011 and 2012, business lending tended to recover—but the biggest banks still had not returned to 2008 levels.

A notable pattern also occurred for small business lending: Community banks with assets of less than \$1 billion maintained a relatively steady loan volume (*Chart 4*). For other types of banks, small business activity dipped well below precrisis levels. The smallest community banks offer small businesses a relatively stable source of credit—a critical element of the financial landscape worth nurturing.

Stabilizing Force

Community banks are not only a major source of credit for job-creating businesses but also a stable one. By extending new loans to business customers, renewing existing loans and minimizing loan losses, community banks better maintained loan volume during the downturn. Less-crisis-prone banks help promote a less-crisis-prone economy.

About the Authors

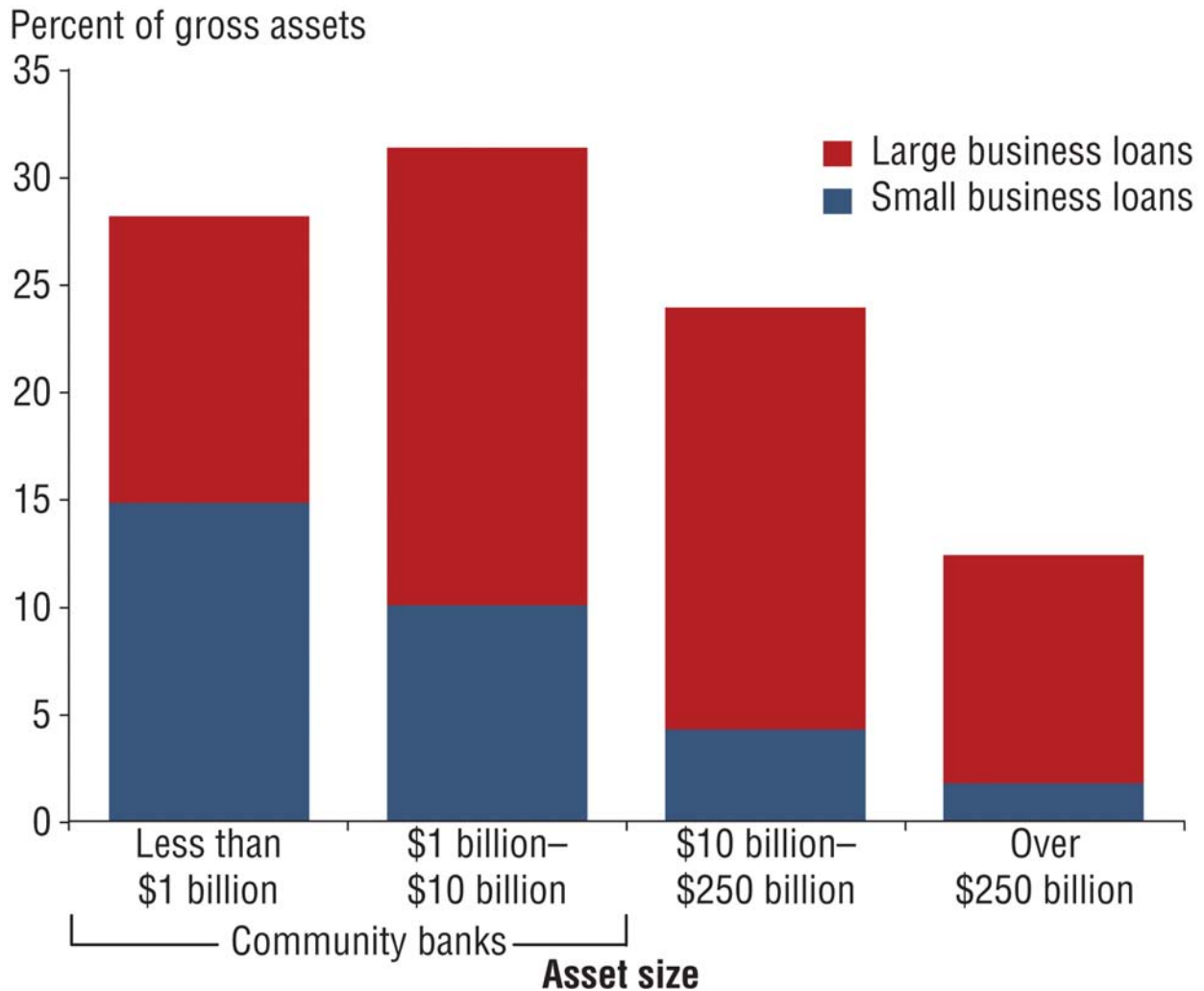
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A Lender for Tough Times

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Chart 1

Community Banks Focus on Small Business Loans



NOTES: Data for commercial banks as of June 30, 2012. Asset size is based on the total assets of a U.S. banking organization (holding company, when applicable). Business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans; small business loans are those with original amounts of \$1 million or less.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

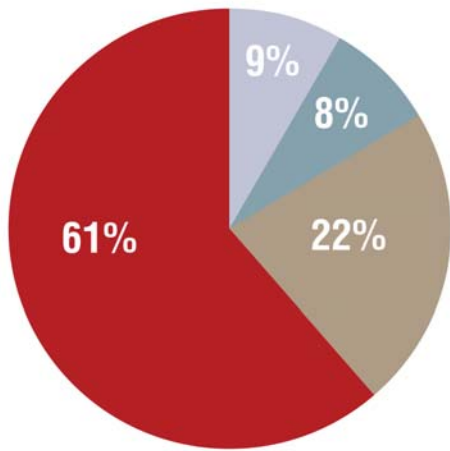
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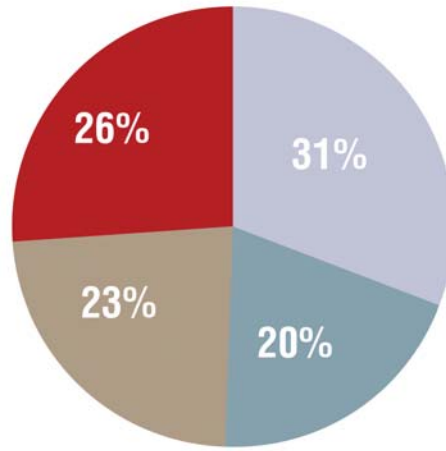
Chart 2

Community Banks Hold Less Than One-Fifth of Industrywide Banking Assets but More than Half of Industrywide Small Business Loans

Commercial bank assets



Small business loans



Asset size



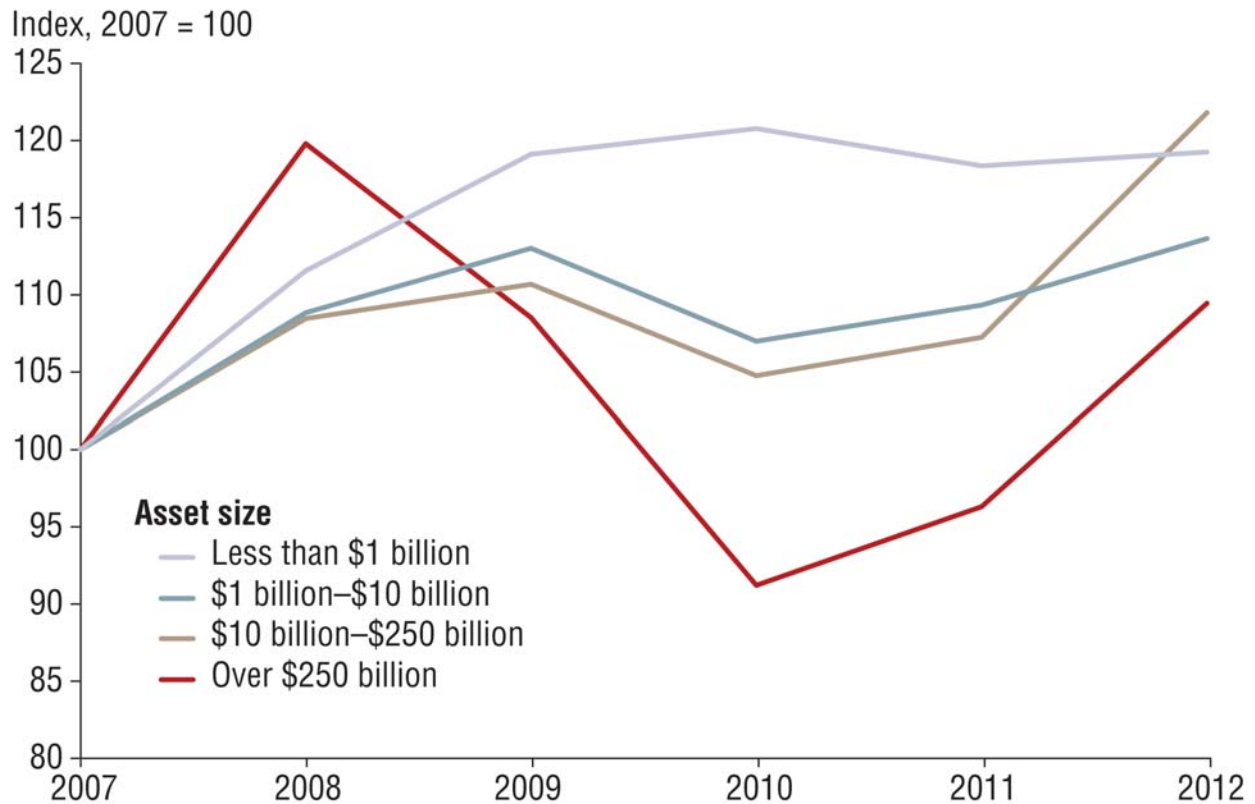
NOTES: Data for commercial banks as of June 30, 2012. Asset size is based on the total assets of a U.S. banking organization (holding company, when applicable). In the assets pie chart, shown are the size groups' shares of industrywide commercial banking operations, excluding nonbank activities. Small business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans, with original amounts of \$1 million or less.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

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Chart 3
Business Loan Volume



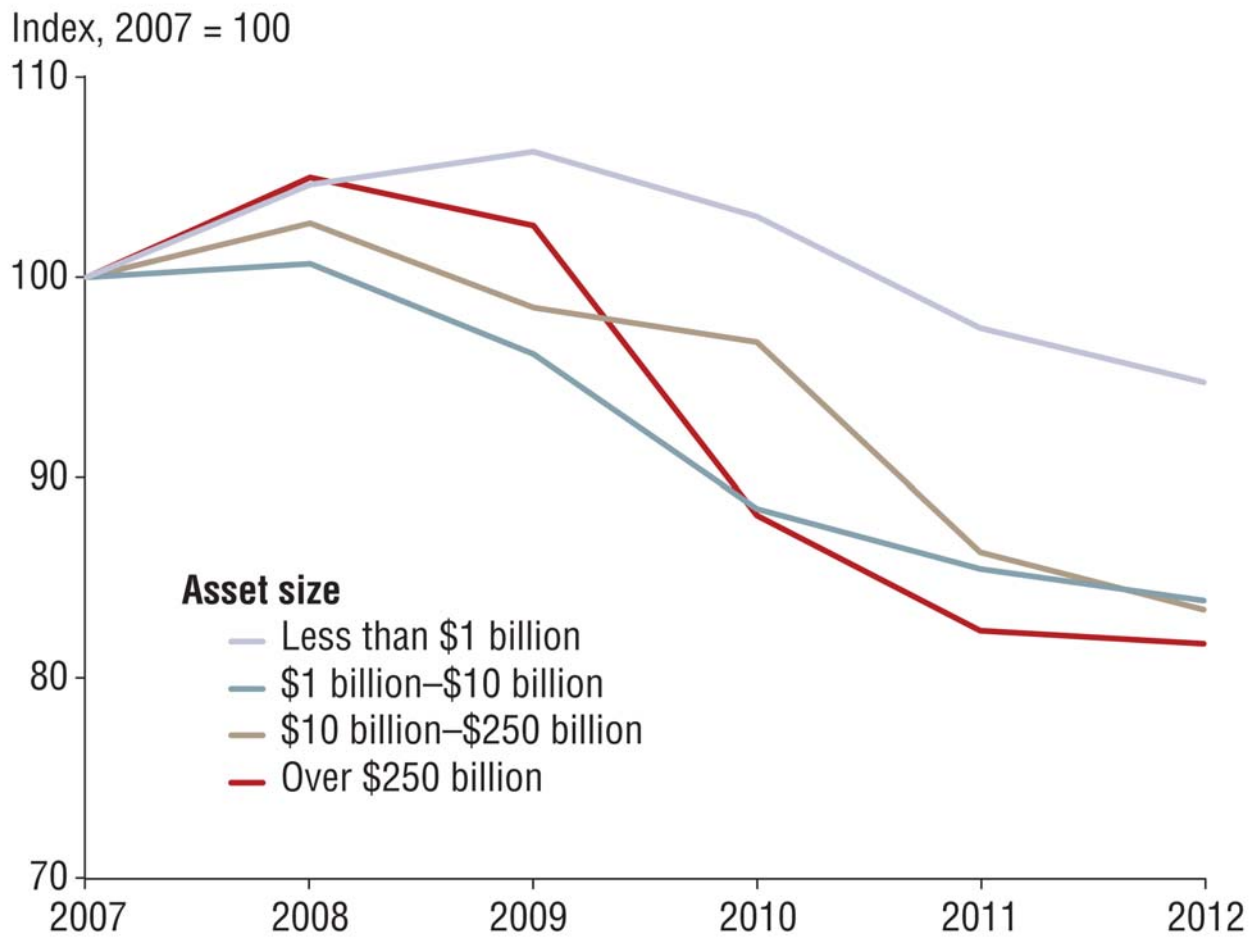
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Chart 4
Small Business Loan Volume



NOTES: Data for commercial banks as of June 30. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Small business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans, with original amounts of \$1 million or less.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

Small Banks Squeezed

By Jeffery W. Gunther and Kelly Klemme

With consistent loan quality and resilient lending activity, community banks—and the traditional banking model they represent—can be a much-needed force for financial stability. Unfortunately, they've struggled to maintain market share, partly as a result of unintended consequences of public policy.

The community bank model has a lot going for it—superior loan quality, lower rates of severe difficulty and greater credit stability through which to finance small businesses. With these advantages, community banks can be a much-needed force for financial stability. Unfortunately, their prominence isn't increasing; at best, they've struggled to maintain market presence amid industry consolidation in recent decades.

Community banks are organizations with assets of \$10 billion or less. In 2004, such banks accounted for about 21 percent of industrywide banking assets. But as the 2007–09 recession began, community banks' market share had dropped to about 19 percent. Over the next five years, their piece of the marketplace fell further—to under 17 percent. Their market share appeared to slip even after accounting for those community banks that grew and moved into a larger size classification (*Chart 1*).



Market Share Impediments

What stands in the way of gains for this high-performing class of banks? Historically, a variety of economic factors have contributed to community banks' stagnating market share. For some financial products and services, larger scale might be needed to achieve fully efficient operations. Also at work recently is a more-troubling force: public policies that keep community banks from reaping the rewards of a business model that works for the financial system and the economy. Two examples are particularly striking.

Too Big to Fail

Especially noteworthy have been financial crisis policies that aided too-big-to-fail (TBTF) banks and resulted in massive public interventions to support and sustain some of the largest institutions. They are the very same banking operations that produced some of the severest losses. Intended or not, these policies worked against community banking and longer-term financial stability.

TBTF policies kept large, deeply troubled banks open, their creditors protected, their shareholders possibly diluted but not wiped out. Propping up large, troubled institutions tended to impede redistribution of market share to smaller, less-trouble-prone banks. The rewards for excessive risk were enhanced; those for prudence were diminished.

A massive rewriting of regulations failed to resolve the TBTF problem. Concentration of deposits among TBTF institutions has increased, not diminished. Funding costs for these institutions have remained less than funding costs for smaller institutions, reflecting persistent TBTF protection of creditors. The regulatory regime still seeks to manage the risk to the financial system that the biggest banking organizations pose. Yet these institutions remain so large and complex—and intertwined with the financial system and economy—that it's doubtful whether regulators would or, indeed, could take decisive action to resolve giant banks if they again encountered serious trouble.

Overregulation

Second, a regulatory backlash resulting from the financial crisis presents the risk of an increasingly one-size-fits-all, heavy-handed oversight regime. For some problems, policymakers are continuing to rely on regulatory and supervisory toolkits similar to those used before the crisis but are adding complexity and expanded documentation requirements.

In other areas, they are implementing new and fairly explicit directives that do not credit community banks for their more-intimate customer relationships. Regulators have taken some steps to avoid penalizing community banks with rules aimed at curbing TBTF excess. Still, the cumulative effect of recent policy proposals could ultimately apply regulatory and supervisory approaches befitting large, transaction-oriented banks to small, relationship-oriented ones. The mismatch would unnecessarily boost regulatory costs for community banks.

Right Course

A more promising alternative exists—using proper incentives to bring discipline to financial markets. If all banking organizations were of manageable size and complexity, with diverse strategies, they could be allowed to stand or fall on their own merits. Prudently managed banks, including the vast majority of community banks, could then reap the rewards of their traditional financial conservatism.

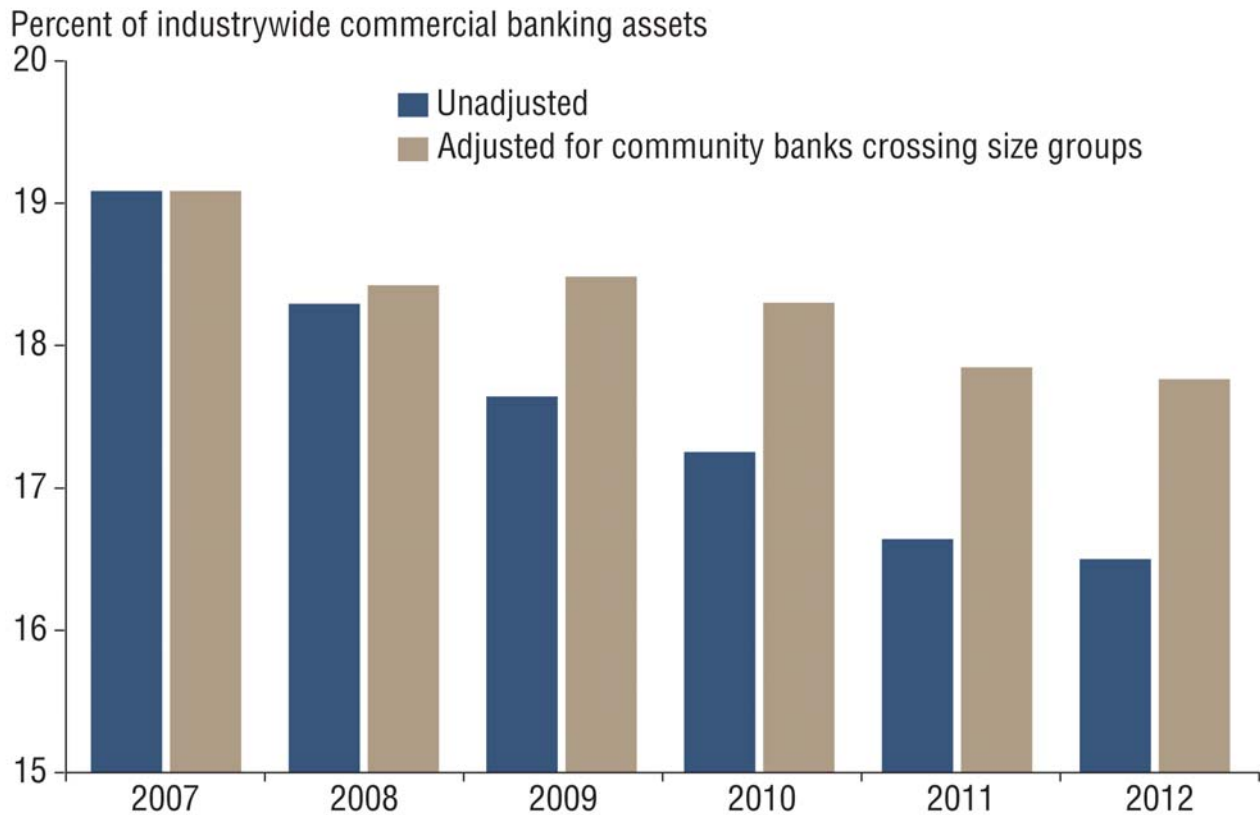
By finding a genuine remedy to TBTF, undue risk taking would be penalized through bank failures, with no banking organization exempt from the threat of aggressive resolution, should it become insolvent. A host of new regulations does not ultimately hold the key to a safe and sound financial system. Rather, there is promise in the basic force behind free markets—the discipline that results from combining the freedom to succeed with the responsibility for losses. If we want the financial system to evolve toward greater stability, we must rely less on boundless regulation and end TBTF by ensuring that no bank is too large, complex or intertwined with the financial system for regulators to close.

About the Authors

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Small Banks Squeezed

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Chart 1**Community Banks Struggle to Maintain Market Share**

NOTES: Data for commercial banks as of June 30. Community banks have assets of \$10 billion or less. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable).

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

Regulatory Burden Rising

By Christoffer Koch

U.S. commercial banks face growing regulatory requirements and complexity, especially with the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, which was intended to rein in excesses of the largest banks. The nation would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks.

The regulatory requirements for U.S. commercial banks have increased over time, most recently with the Dodd–Frank Act, which seeks to curb excesses primarily committed by the largest banks. By comparison, smaller **community banks** incurred much lower loan-loss rates and posed less of a threat to financial system stability (see “Community Banks Withstand the Storm”). The benefits of increased community bank regulation, it would appear, are limited, especially relative to the added costs.

Tighter regulation and supervision impose heavy burdens on smaller-scale and more-labor-intensive community banks. These institutions to a great extent focus on making and monitoring smaller loans and maintaining individual customer relationships. By undermining their competitiveness, recent regulatory reform may have the unintended consequences of bolstering banking industry concentration while weakening an industry segment posing comparatively little threat to financial stability.



More Paperwork

Over the past half-century, the level of detail in regulatory filings required from commercial banks has expanded.[1] One telling measure is the number of pages, excluding instructions, needed to complete what is known as the quarterly Report of Condition and Income, or Call Report for short. What began as a four-page filing in the late 1950s grew into a 30- to 40-page document in the 1980s and 1990s, and most recently to a 71-page report (*Chart 1*).

Preparing the Call Report may not be tremendously burdensome, but the document’s increased heft is indicative of regulators’ probing into more areas. The number of potential items to be reported quarterly increased from 241 in 1960 to 1,955 in 2012 (*Chart 2*). Initially, banks reported information taken from basic income statements and balance sheets. Over the past two decades, the reporting has grown more granular and complex, bringing in numerous off-balance-sheet and memoranda items.

The length of financial laws reveals further evidence of mounting regulatory complexity. The Glass–Steagall Act (1933), which governed U.S. financial intermediaries until its partial repeal in 1999, was 37 pages; the Dodd–Frank Act is more than 800 pages (*Chart 3*). Likewise, international agreements on banking supervision have grown in scope and complexity. The number of pages in the third version of the international Basel capital accord has mushroomed to 20 times the length of the first one.

Expansive Rules

Although long-term regulatory trends reflect a number of evolutionary factors in financial intermediation and practices, rapid acceleration of U.S. reporting requirements over the past four years is partially a response to the recent financial crisis and recession.

Community banks will benefit from some parts of the Dodd–Frank Act—for example, basing deposit insurance premiums on assets rather than deposits. Some of the act’s main features, such as enhanced prudential standards and greater regulatory oversight, will apply only to the largest, systemically important institutions.

(Continued from Financial Stability: Traditional Banks Pave the Way - Regulatory Burden Rising)

Nevertheless, other provisions have largely been applied to big and small banks alike, not fully compensating for the differences in these institutions' business models—to the detriment of small banks. A community bank's knowledge of a small business, once sufficient for a loan, now may not satisfy regulation, rendering the lender unable to provide credit. A template-driven definition of qualified residential mortgages might prevent community banks from using their local real-estate market knowledge. Community banks will also be burdened with provisions covering escrow accounts for higher-priced mortgages, even though most subprime problems originated from the largest banks' securitizations—the bundling of such risky notes into mortgage-backed securities—rather than residential loans held on community bank balance sheets.

Cost Imbalance

Some allowances for community banks have been made in the Dodd–Frank Act, but the cost of implementing the act's regulations on smaller institutions appears high relative to the benefits.[2]

The number of employees per dollar of loans is depicted in *Chart 4* by bank size. Notably higher ratios for smaller banks indicate they are much more labor intensive than larger institutions, reflecting their focus on smaller loans and individualized products and services. The traditional, relationship-based model followed by community banks requires its own regulatory framework, one more streamlined than the increasingly complex and formulaic rules being applied to larger, more transaction-oriented banks. Such a streamlined framework should include flexibility to account for the diversity among community banks, as reflected in their customized approaches to individual customer needs and preferences.

Additionally, smaller banks cannot easily absorb the cost of new regulation. More complicated regulatory compliance will force community banks to increase staff relative to assets to a greater degree than at large banks, further undermining competitiveness. Adjustments to new, complex regulatory requirements represent costs that, spread over fewer assets, are more burdensome for smaller institutions.

Recent changes in bank regulations have focused on curbing excessive risk taking that contributed to a deepening recession and more difficult financial crisis. Associated lending losses were concentrated at larger, and often very large, banks that engaged in highly complex and risky activities. They became “too big to fail.” By comparison, community banks were better able to avoid losses, and their practices did not justify greater regulation. They filled an important niche in financial intermediation. As a result, financial reform appears to have imposed high costs on community banks relative to any benefits of curbing micro- and macroprudential risk.

By unduly imposing greater regulations on the smaller institutions, recent regulatory reform will drive additional community bank consolidation. The country would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks. Some recent proposals call for further efforts to ensure that community banks are overseen differently than are larger and more complex operations.[3] The proposals have merit and deserve serious consideration.

Notes

1. See “The Dog and the Frisbee,” by Andrew G. Haldane and Vasileios Madouros, Bank of England, paper presented at “The Changing Policy Landscape” symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 30–Sept. 1, 2012, www.kansascityfed.org/publicat/sympos/2012/ah.pdf.
 2. For more details on the merits and risks of individual provisions of the Dodd–Frank Act, see “Community Banks and Credit Unions: Impact of Dodd–Frank Act Depends Largely on Future Rule Makings,” Government Accountability Office, September 2012.
 3. See “Community Banks and Mortgage Lending,” speech by Elizabeth A. Duke, Board of Governors of the Federal Reserve System, at the Community Bankers Symposium, Chicago, Nov. 9, 2012, www.federalreserve.gov/newsevents/speech/duke20121109a.pdf.
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About the Author

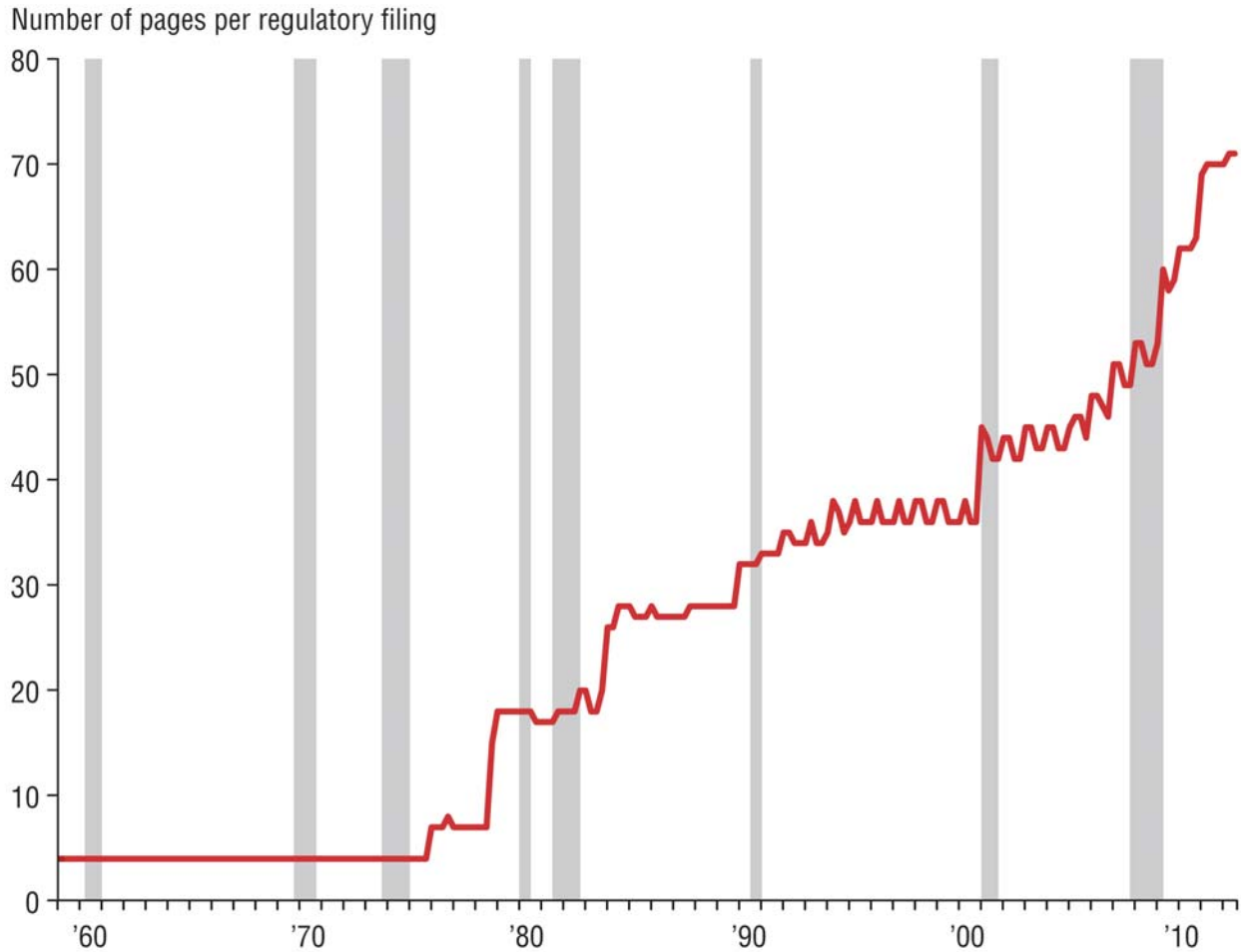
Christoffer Koch is a research economist in the Research Department at the Federal Reserve Bank of Dallas.

Regulatory Burden Rising

By Christoffer Koch

Chart 1

Pages in U.S. Regulatory Filings Rapidly Increase



NOTES: Gray bars indicate recessions. Maximum number of report pages for domestic banks only.
1959:Q4–1983:Q4: Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
1984:Q1–2000:Q4: Forms FFIEC 032, FFIEC 033, FFIEC 034.
2001:Q1–present: Form FFIEC 041.

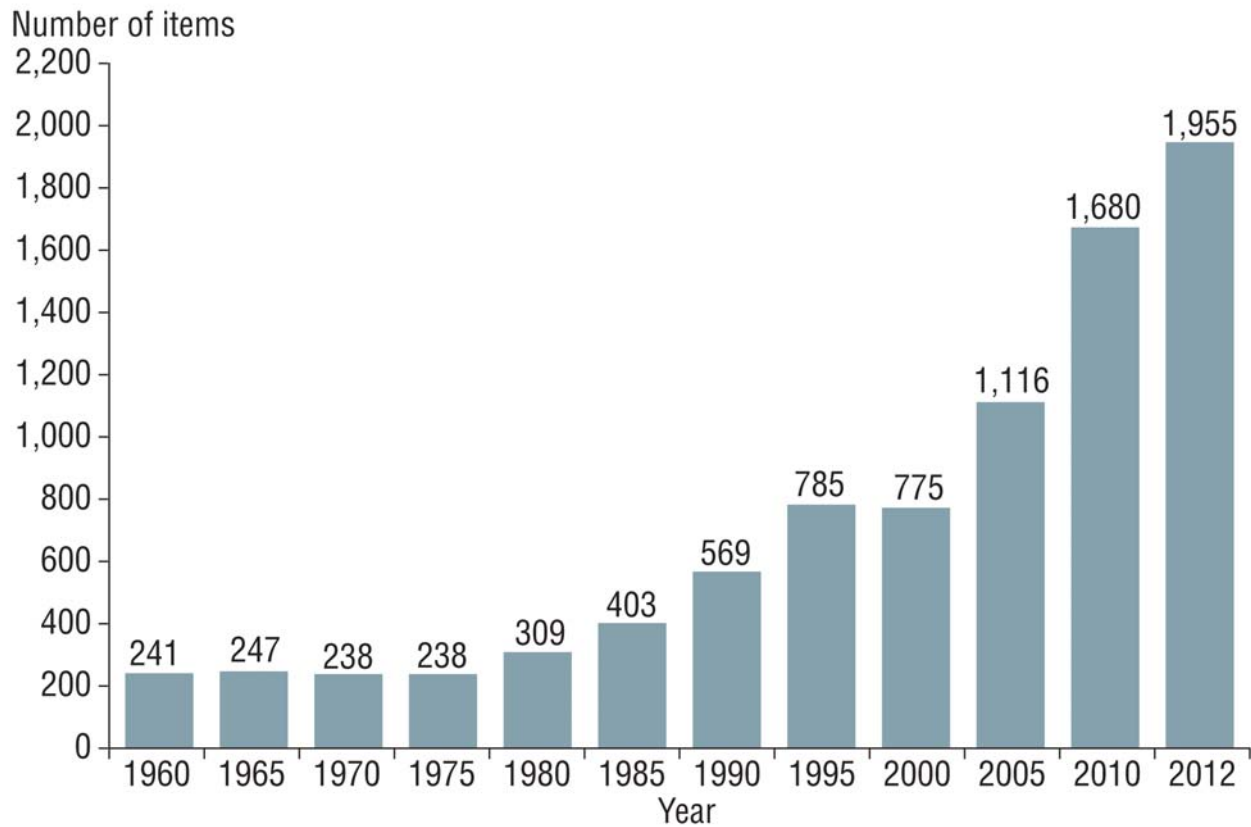
DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

Regulatory Burden Rising

By Christoffer Koch

Chart 2

Items per Filing Rise as Complexity Increases



NOTES: Maximum number of reporting items for domestic banks only. Q4 of each year.

1960:Q4–1980:Q4: Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.

1985:Q4–2000:Q4: Forms FFIEC 032, FFIEC 033, FFIEC 034.

2005:Q4–present: Form FFIEC 041.

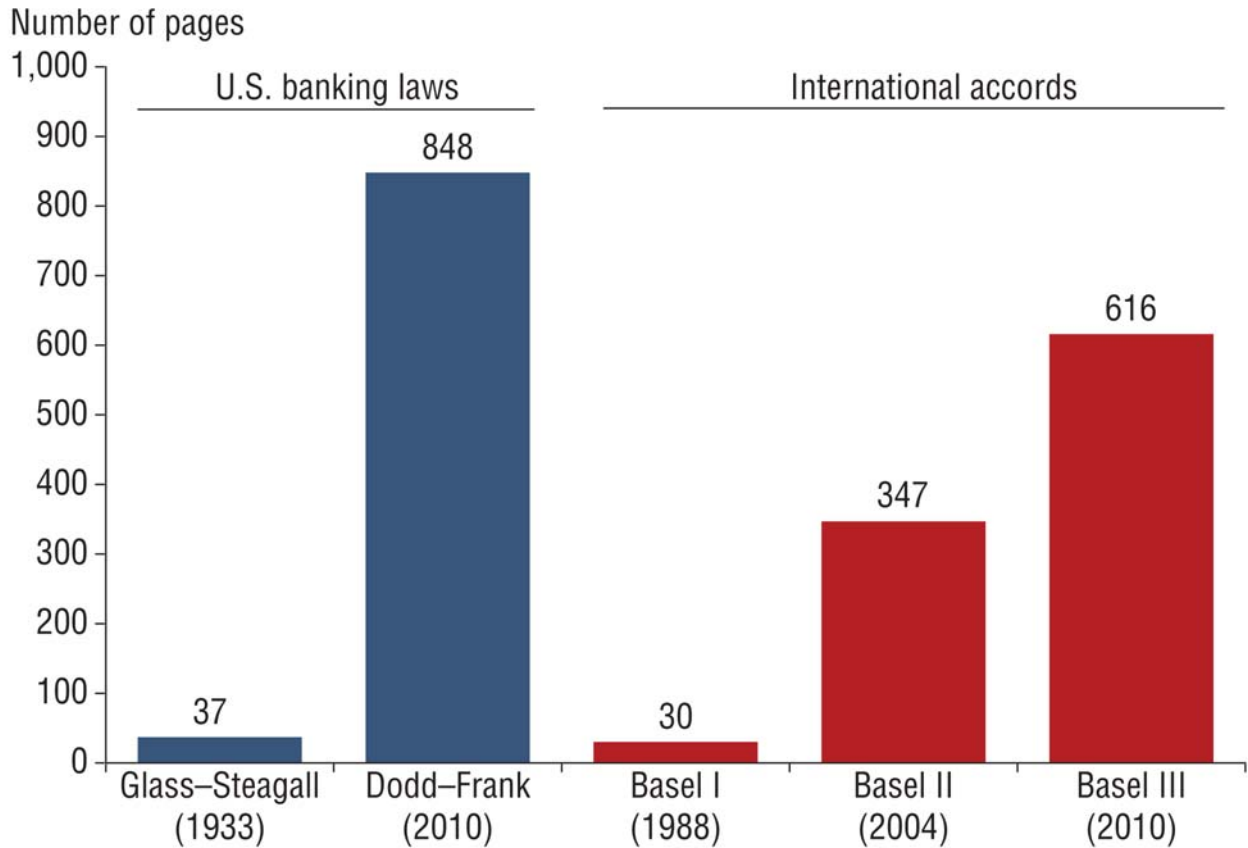
DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

Regulatory Burden Rising

By Christoffer Koch

Chart 3

Rising Page Count Mirrors Heightened Oversight



DATA SOURCE: "The Dog and the Frisbee," by Andrew G. Haldane and Vasileios Madouros, Bank of England, paper presented at "The Changing Policy Landscape" symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 30–Sept. 1, 2012.

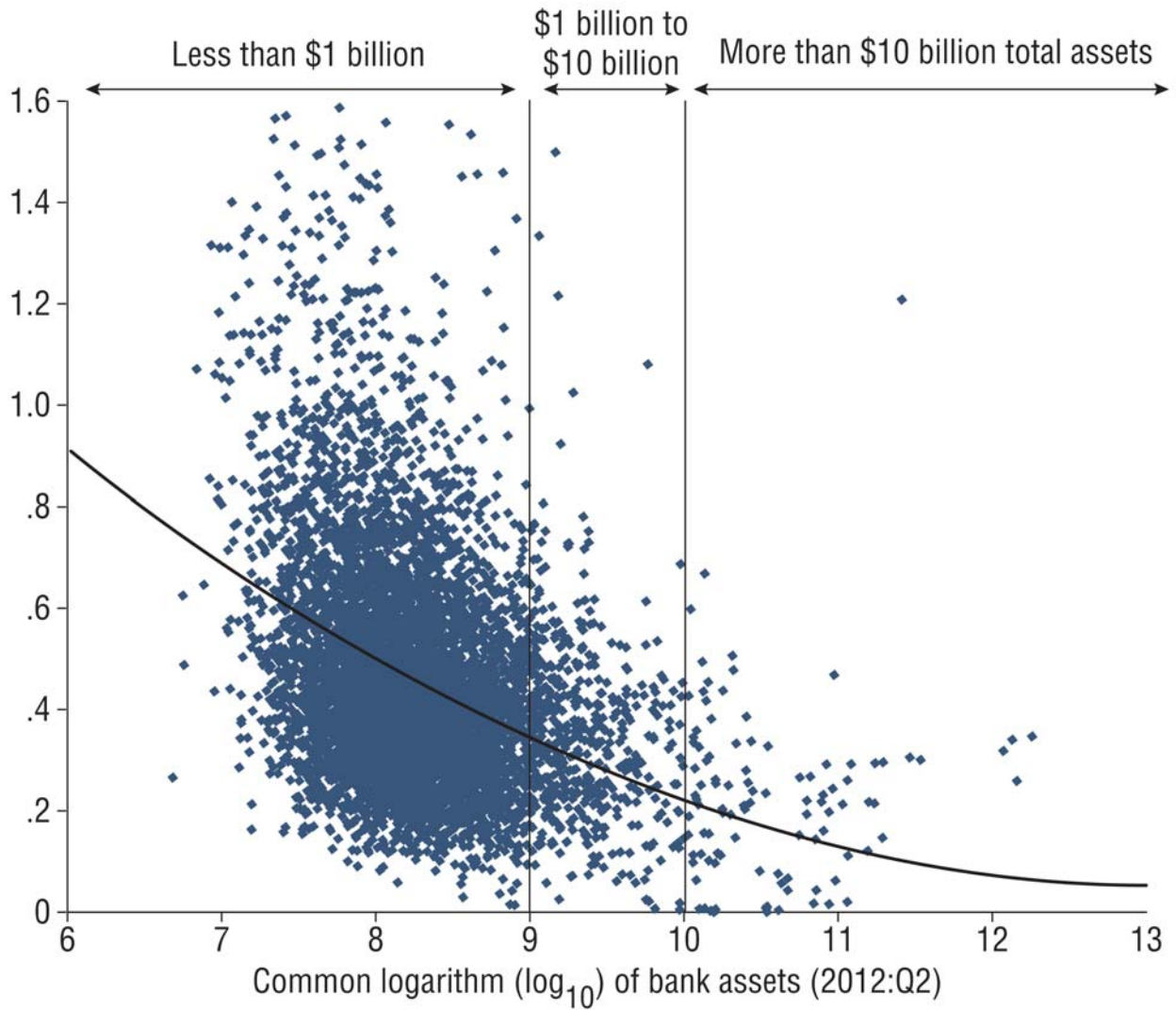
Regulatory Burden Rising

By Christoffer Koch

Chart 4

Smaller Banks Require Relatively More Personnel

Full-time-equivalent employees per \$1 million of bank loans (2012:Q2)



NOTE: A few outliers with above 1.6 FTE/\$1 million loans fall outside plot area.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

Leveling the Playing Field

By Harvey Rosenblum

Financial reform must be redirected. The government's financial safety net for the biggest banks should cover only their essential banking activities and their role in the payments system. Once that occurs, market discipline can reassert itself, and all institutions—large and small—can compete on a more level playing field.

Market discipline, an essential tenet of capitalism, restrains excessive risk taking. It relies on stockholders, creditors and managers believing they're exposed to losses from ill-advised decisionmaking. Penalties for reckless behavior include lost business, higher borrowing costs and falling stock prices; the ultimate punishment is outright company failure. Fear of adverse consequences provides incentives for prudent actions.

The opposite also holds, of course. Erosion of market discipline could lead to impetuous, short-sighted decisions or strategic decisions that take advantage of the lower funding costs stemming from the implied safety net. In the banking sector, market discipline began to fade with implicit extensions of the federal safety net. The growing perception of a protective umbrella over the nation's biggest banks further weakened market discipline. The big banks became "too big to fail" (TBTF)—insulated from the consequences of ill-advised behavior and bad decisions.

Thus shielded, they could raise funds at lower cost, gaining a distinct and sustainable competitive advantage that has driven the country toward ever greater financial industry consolidation. Left behind were America's small and midsized banks, struggling to maintain market share even though they largely stuck with traditional banking activities and contributed little to the financial markets' near-meltdown in 2008.

For well over a century, the banking industry has been subject to regulatory discipline; that is, a legal code that guides behavior, supplemented by supervisory oversight designed to impose prompt corrective action for rules violations. When such intervention fails, regulators shut down banks, or transfer their ownership, to protect depositors from losses. Today, nearly all banks—with the exception of those few deemed TBTF—are subject to the external forces of market and regulatory discipline. This TBTF exception is untenable and needs to be addressed.

Risk Assessment

To analyze how market and regulatory discipline limit excessive risk taking, banks have been assigned to one of three groups:

- The roughly 5,500 small community operations that hold about one-eighth of all bank organization assets
- A middle group of roughly 70 midsized, regional institutions with about one-fifth of industry assets
- The 12 largest banking institutions with more than two-thirds of industry assets

Small Banks: Brutal Efficiency

The smallest group faces varying degrees of pressure from market discipline. The lion's share of deposits is FDIC-insured, so depositors have little incentive to monitor the banks' risk profile. Many of the smaller institutions have few shareholders, some of whom have a significant portion of their wealth invested in the bank's stock. These shareholders have strong incentives to monitor and influence the risk profile. Minority shareholders have the same incentive because of the difficulty of selling their stock; it trades rarely in an illiquid market, especially when bank earnings are squeezed.



2012 Annual Report

(Continued from Financial Stability: Traditional Banks Pave the Way - Leveling the Playing Field)

In spite of considerable shareholder-imposed market discipline, small banks can and do encounter problems. For troubled small banks, regulatory discipline works with brutal efficiency—FDIC teams often arrive on Friday and a new bank opens on Monday, with new owners and managers and no losses to insured depositors. In just the past few years, more than 400 such banks have been closed and subjected to ownership transfer, with shareholders essentially suffering total losses.

Midsized Banks: Restraint Imposed

Midsized regional banks face the industry's greatest market discipline. They often have significant deposits that aren't fully insured and some unsecured debt that would be subject to loss if failure occurred. While their size, geographic reach and product scope make them difficult to close and transfer to new owners over a weekend, many midsized institutions have experienced regulatory discipline in recent decades. So stakeholders—shareholders and uninsured creditors—have enough skin in the game to understand their vulnerability, and they're likely to impose some risk-restraint on bank management. Good executives know this, and it guides their decisions.

Big Banks: Discipline Diluted

For the 12 biggest banks, the perception of TBTF dilutes market discipline. What little market discipline that may have existed prior to the financial crisis of 2008–09 was undermined by the hundreds of billions of dollars of extraordinary government assistance and depositor and creditor guarantees heaped on these huge institutions. The media's incessant use of the word "bailout," coupled with the fact that these big banking firms never formally failed and still exist under the same names and stock-trading symbols, has likely resulted in a *misplaced perception* that their shareholders were protected from losses.

This has reinforced the view that supervisory agencies are powerless because of an inability to impose regulatory discipline. The sheer size of the biggest banks is daunting. On top of that, these institutions are unimaginably complex, with thousands of subsidiaries spread across the globe and roots sunk deeply into the economies of dozens of countries. Regulators couldn't deal with one of these huge banks in a weekend—or even in a month of weekends. Immense size and geographic reach also provide access to political power, so complaints about regulators will be heard. All told, the biggest banks are little constrained by market discipline or the threat of failure (*Table 1*).

Restoring Market Discipline

Purging the financial system of these dangers requires reducing the incentives for excessive risk by resurrecting market discipline. The first step involves recognizing the **moral hazard** inherent in the financial safety net, which should be rolled back to explicitly cover only activities essential to commercial banks and their role in the payments system.

This narrowly defined safety net should include federal deposit insurance and access to the Federal Reserve's lender-of-last-resort facilities, but it shouldn't extend to:

- Bank holding companies
- Broker-dealers
- Insurance subsidiaries
- Finance companies
- Any other nonbank entities

The limits of the safety net should be clearly delineated and credible—put in a one-sentence disclosure statement that's in bold type and capital letters, to be signed by all parties.

With a limited and proper safety net, some of the artificial advantages of size will fade and market discipline will eventually reassert itself.

(Continued from Financial Stability: Traditional Banks Pave the Way - Leveling the Playing Field)

Market discipline and its positive incentives could help reduce the size of the biggest banks by penalizing excessive risk taking and mind-numbing complexity. Just as important, small and medium-sized institutions will have a fairer opportunity to compete for market share—if they continue offering less risk and complexity.

Market discipline works elsewhere in the U.S. economy. Facing make-or-break market pressures, industries continually restructure, refocus, streamline and reorganize—such activities are routine and healthy in a capitalist system. If insiders grow complacent, companies end up undervalued, making them tempting targets for investors seeking to unlock shareholder value by breaking up the enterprises into smaller, more economically viable and manageable pieces. Looking at the largest U.S. banking companies, recent stock prices suggest that markets have a gloomy view of bigness (*Chart 1*).

Clear and Present Danger

Regulatory policy and public policy constrain how much and how rapidly corporate control can change—especially in the biggest institutions. A serious concern, therefore, is that market discipline will take too long to cut the biggest operators down to size—a time during which the economy could face the threat of another financial crisis, this one possibly worse than the last. Policy interventions—for example, a cap on bank size—might be needed to reach the point where any bank, even the largest ones, can fail without endangering the economy.

Defenders of the status quo argue that breaking up big banks would be costly and disruptive. Objections include:

- Inconvenience to customers
- The loss of big banks' size and scope in an era of global business
- A potential shift of business to foreign banks

Moreover, new regulations that address post-financial crisis concerns are scheduled to begin taking effect over the next few years. A case could be made for giving them a chance to work, even if it means tolerating colossal financial institutions.

These arguments ignore a reality: TBTF banks pose a clear and present danger. They've grown large and dominant through favorable government policies. Leveling the playing field will give smaller institutions a fair shake and enhance financial and economic stability.

The 2008 financial crisis cost the U.S. economy \$10 trillion to \$20 trillion in lost output, reduced wealth, extended unemployment, diminished opportunities and increased costs to taxpayers to fund extraordinary government intervention programs. The crisis left the banking industry more concentrated than ever. The Big Five bank holding companies control over half of industry assets. The next crisis could be more costly and bring further consolidation—a Big Two, perhaps, with 65 percent. What's after that—possibly a single dominant banking institution with market share much greater than we would have ever imagined before the financial crisis?

Big isn't always best. Doing nothing will court disaster. The TBTF problem is neither impossible nor too hard to fix; meanwhile, TBTF banks remain too dangerous to ignore.

About the Author

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Leveling the Playing Field

By Harvey Rosenblum

Table 1
Megabanks Face Least External Discipline

| Bank size and complexity vs. impact of external discipline | | | | | |
|---|---------------------------|----------------------------|----------------------------------|--------------------------------|----------------------------|
| | | | | Market discipline from: | |
| | Can fail outright? | Speed of resolution | Regulatory discipline | Shareholders | Unsecured creditors |
| Community banks (5,500) | Yes | Weekend | Often significant | Some, often considerable | Too few to matter |
| Regional/moderate-sized banks (70) | Yes | Few weeks to 18 months | Significant, but slow | Significant, but lagged | Some, possibly significant |
| Megabanks (12) | No | Never closed | Insufficient, may be ineffective | Limited | Perverse |

NOTE: Numbers shown in parentheses are the approximate (rounded) number of bank organizations in each cohort as of June 30, 2012.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

Leveling the Playing Field

By Harvey Rosenblum

Chart 1

Markets Reward Reduced Complexity



NOTE: The “big, but not as complex” group includes banks larger than \$100 billion in assets and predominantly driven by commercial/retail banking activities rather than global banking or investment services and management.

DATA SOURCES: Bloomberg; author’s calculations.

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