JOINT HEARING ON "H.R. 1697, THE COMMUNITIES FIRST ACT," ON NOVEMBER 16, 2011, BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT, AND THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES, OF THE COMMITTEE ON FINANCIAL SERVICES, U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY OF ARTHUR E. WILMARTH, JR.

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Thank you very much for inviting me to participate in this important hearing. My testimony will address the following topics related to the community banking industry: (1) the unique role of community banks as the most important source of external credit for small and medium-sized enterprises ("SMEs"), and the negative impact of consolidation in the banking industry on community banks and SMEs; (2) the differential treatment provided to "too big to fail" ("TBTF") megabanks and community banks during the financial crisis, and the adverse effects of continuing losses in the commercial real estate ("CRE") market on community banks; and (3) provisions of H.R. 1697 that could assist community banks in dealing with their current challenges and thereby strengthen the ability of community banks to serve as continuing sources of credit to SMEs.

1. Community Banks Play a Vital Role in Our Economy as Primary Providers of Outside Credit to SMEs But Are Threatened by Industry Consolidation

The dual banking system in the United States is a decentralized, diverse system comprising more than 7,000 banks, including thousands of community banks, scores of midsized regional banks, and a small group of large, multistate banking organizations. Community banks play a crucial role in providing credit and other financial services to

consumers and SMEs.[1] In contrast to the United States, Canada and the United Kingdom each have fewer than 100 banks. The highly concentrated banking systems of both nations are dominated by a handful of big banks. Very few community banks exist in Canada and the U.K.[2] Due in large part to the significant role played by community banks, the U.S. banking system has performed much better than the Canadian and U.K. systems in serving the needs of SMEs.[3]

Community banks have long served as the leading source of outside (as contrasted with inside) credit for SMEs. In 2010, community banks with assets of less than $10 billion held only 23% of the banking industry's assets but accounted for 56% of

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[1] Arthur E. Wilmarth, Jr., "The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection," 23 *Annual Review of Banking and Financial Law* 225, 263-65 (2004) (available at http://ssrn.com/abstract=577863) [hereinafter Wilmarth, "Dual Banking System"); *see also* Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000; Competition, Consolidation, and Increased Risks," 2002 *University of Illinois Law Review* 215 (2002) (available at http://ssrn.com/abstract=315345) [hereinafter Wilmarth, "Transformation"], at 254-72.

[2] Canada has only about 70 banks, and the six largest banks dominate Canada's domestic banking markets. C.J. Shaw, "Big Bank Merger Review in Canada," 21 *Journal of International Banking Law and Regulation* 474, 475 (2006); Arthur E. Wilmarth, Jr., "Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks," 77 *Iowa Law Review* 957 (1992) hereinafter Wilmarth, "Too Big to Fail"), at 1052. Similarly, the U.K. has fewer than 100 banks, and the four largest banks dominate the U.K.'s domestic banking markets. Shelagh Heffernan, "UK bank services for small business: How competitive is the market?", 30 *Journal of Banking and Finance* 3087, 3089 (2006); Wilmarth, "Too Big to Fail," supra, at 1052

[3] Wilmarth, "Dual Banking System," *supra* note 1, at 263-65; Wilmarth, "Too Big to Fail," *supra* note 2, at 1038-40, 1052-55 (stating that "[t]he highly concentrated banking systems in both countries have long been characterized by oligopolistic behavior," *id.* at 1052); *see also* Shaw, *supra* note 2, at 476 (noting that "[l]ike public utilities, the large [Canadian] banks are perceived to co-exist in a business environment which is (or very close to) oligopoly"). The largest Canadian banks have received widespread public criticism for their high profits, excessive fees and poor service to consumers and SMEs. *See* Gaétan Breton & Louise Côté, "Profit and the legitimacy of the Canadian banking industry," 19 *Accounting, Auditing & Accountability Journal* 512, 521-31 (2006). Analysts have concluded that the "big four" U.K. banks display oligopolistic conduct in charging excessive prices for services to consumers and SMEs. *See* Heffernan, *supra* note 2; Shelagh A. Heffernan, "How do UK financial institutions really price their banking products?", 26 *Journal of Banking and Finance* 1997 (2002). For additional reports criticizing major Canadian and U.K. banks, *see* sources cited in Wilmarth, "Dual Banking System," *supra* note 1, at 264 n.146

outstanding bank loans to SMEs.[4] By serving as the most important source of external credit for SMEs, community banks promote economic growth in the United States. SMEs account about half of the total private sector output, employ a majority of the private sector workforce, and account for (i) about two- thirds of net new jobs and (ii) more than a third of all private sector innovations.[5]

A 2004 study confirmed the link between community banks, the success of SMEs and economic growth. Based on a review of banking systems in 49 countries, that study found that countries recorded faster growth rates in their gross domestic profit ("GDP") if community banks accounted for a larger share of their banking system. The study concluded that the superior ability of community banks to provide relationship loans to SMEs was the most likely explanation for the observed correlation between community bank strength and faster GDP growth.[6]

However, the survival of the community banking sector and its ability to serve the needs of consumers and SMEs cannot be taken for granted. Many community banks have disappeared during the consolidation trend of the past two decades. More than 5,400 bank mergers occurred in the United States between 1990 and 2005, involving more than $5.0 trillion in banking assets. During the same period, the percentage of banking assets

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[4] Tanya D. Marsh, "Too Big to Fail vs. Too Small to Notice: Addressing the Commercial Real Estate Debt Crisis" (Mar. 3, 2011), at 50, available at http://ssrn.com/abstract=1775984; *see also* Stephen Happel & Bill Lynch, "Viewpoint: Leverage Limits Hurt Credit for Small Biz," *American Banker*, Jan. 19, 2011, at 8 (stating that, in 2009, community banks held 11% of total industry assets but made 38% of small business and farm loans).

[5] Wilmarth, "Transformation," supra note 1, at 257-58; Major L. Clark, III and Radwan N. Saade, "The Role of Small Business in Economic Development of the United States: From the End of the Korean War (1953) to the Present" (Sept. 2010), U.S. Small Business Admin., Office of Advocacy, at 6.

[6] Allen N. Berger et al., "Further Evidence on the Link between Finance and Growth: An International Analysis of Community Banking and Economic Performance," 25 *Journal of Financial Services Research* 169 (2004).

held by the ten largest U.S. banks rose from 25% to 55%.[7] Extensive consolidation also occurred in many local, statewide and regional markets.[8] Many of the mergers during that period resulted in the disappearance of community banks.[9]

The consolidation trend intensified during the financial crisis, as regulators arranged several emergency mergers between large banks that produced even larger banks.[10] As a result of those mega-mergers, the four largest U.S. banks controlled 56% of domestic banking assets at the end of 2009 (up from only 35% in 2000), while the ten largest banks controlled 75% of such assets.[11]

The consolidation trend has called into question the long-term viability of the community banking sector. As described below, community banks have also suffered disproportionate harm from the current financial crisis, in large part because of the preferential treatment given by the federal government to TBTF megabanks. If the community bank sector continues to struggle, the availability of small business credit is likely to decline further. Even before the financial crisis began, highly concentrated local

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[7] Kenneth D. Jones & Robert Oshinsky, "The effect of industry consolidation and deposit insurance reform on the resiliency of the U.S. bank insurance fund," 5 *Journal of Financial Stability* 57, 58 (2009).

[8] Wilmarth, "Transformation," *supra* note 1, at 252-53, 293-96; *see also* Gerald A. Hanweck & Bernard Shull, "The bank merger movement: efficiency, stability and competitive policy concerns," 44 *Antitrust Bulletin* 251, 252-57 (1999).

[9] More than 3,500 bank mergers occurred between 1994 and 2003. More than 3,200 of the target institutions acquired in those transactions were community banks with assets of less than $1 billion. The average size of the acquiring banks in those mergers was $11 billion. Steven J. Pilloff, "Bank Merger Activity in the United States, 1994-2003," Federal Reserve Board Staff Study 176 (May 2004), at 4-5.

[10] Arthur E. Wilmarth, Jr., "The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem," 89 *Oregon Law Review* 951, 958, 958 n.15 (2011) [hereinafter Wilmarth, "Dodd-Frank"] (discussing acquisitions of Wachovia by Wells Fargo, of National City by PNC, of Washington Mutual by JP Morgan Chase, and of Countrywide by Bank of America), available at http://ssrn.com/abstract-1719126. .

[11] *Id.* at 985.

banking markets that were dominated by large banks produced less credit for SMEs.[12] Moreover, after the financial crisis broke out, big banks made significantly larger cuts in their small business loan portfolios compared to smaller banks.[13]

2. Community Banks Received Limited Government Assistance and Suffered Disproportionate Harm during the Financial Crisis

The federal government provided massive amounts of financial assistance to TBTF megabanks during the financial crisis but gave very limited assistance to smaller banks. The 19 largest U.S. banks (each with more than $100 billion of assets) received $220 billion of capital assistance from the Troubled Asset Relief Program ("TARP"), and those banks issued $235 billion of FDIC-guaranteed, low-interest debt. In contrast, banks with assets under $100 billion received only $41 billion of TARP capital assistance and issued only $11 billion of FDIC-guaranteed debt.[14]

Moreover, the Federal Reserve System ("Fed") provided $1.2 trillion of emergency credit assistance to financial institutions through various programs. The Fed extended the vast majority of that credit assistance to large U.S. and foreign banks and provided very little help to smaller institutions. Indeed, the Fed extended $669 billion of emergency

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[12] Steven G. Craig & Pauline Hardee, "The impact of bank consolidation on small business credit availability," 31 *Journal of Banking and Finance* 1237 (2007).

[13] *See, e.g.,* Harry Terris, "Second-Quarter Lending Trends Remain Poor," *American Banker*, July 2, 2010, at 5 (reporting that outstanding commercial loans fell 8.4% at the 25 largest banks during the second quarter of 2010, compared to a decline of only 3% at smaller banks); Damian Paletta, "U.S. News: Lending Declines as Bank Jitters Persist," *Wall Street Journal*, Nov. 25, 2009, at A10 (reporting on a press conference at which FDIC Chairman Sheila Bair stated that "large banks – which account for 56% of industry assets and received a large share of the government's bailout funds – accounted for 75% of the decline" in small business lending in the third quarter of 2009).

[14] Arthur E. Wilmarth, Jr., "Reforming Financial Regulation to Address the Too-Big-to-Fail Problem," 35 *Brooklyn Journal of International Law* 707, 737-38 (2010) [hereinafter Wilmarth, "Reforming Financial Regulation"], available at http://ssrn.com/abstract=1645921.

credit assistance (more than half of the total amount) to the ten largest U.S. commercial and investment banks.[15]

Most importantly, the federal government guaranteed that none of the 19 largest banks would be allowed to fail. When federal regulators announced their "stress tests" in early 2009, they declared that the Treasury Department would provide any additional capital that was needed to ensure the survival of all 19 banks. They also stated that they would not impose regulatory sanctions on the top 19 banks under the "prompt corrective action" ("PCA") regime established by Congress in 1991, despite the non-discretionary nature of those sanctions. Instead of issuing public enforcement orders, federal regulators entered into private and confidential "memoranda of understanding" with Bank of America and Citigroup despite the gravely weakened conditions of both banks. Thus, federal regulators gave white-glove treatment to the 19 largest banks and unequivocally promised that they would survive.[16]

In stark contrast, federal regulators imposed PCA orders and other public enforcement sanctions on hundreds of community banks and allowed many of those institutions to fail.[17] Almost 350 FDIC-insured depository institutions failed between January 1, 2008 and March 31, 2011.[18] Only one of those institutions – Washington Mutual, a large thrift institution – had more than $50 billion of assets.[19] In view of the massive TBTF protections that the federal government provided to our largest banks, it is

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[15] Bradley Keoun & Phil Kuntz, "Wall Street Aristocracy Got $1.2 Trillion in Secret Fed Loans," *Bloomberg.com*, Aug. 22, 2011.
[16] Wilmarth, "Dodd-Frank," *supra* note 10, at 958-59, 983; Wilmarth, "Reforming Financial Regulation," *supra* note 14, at 712-13, 743-44.
[17] Wilmarth, "Reforming Financial Regulation," *supra* note 14, at 744, 744 n.145.
[18] 5 *FDIC Quarterly* No. 2 (2011), at 16 (Table II-B).
[19] 2 *FDIC Quarterly* No. 4 (2008), at 14 (referring to the failure of Washington Mutual Bank, with $307 billion of assets, on Sept. 25, 2008).

small wonder that those banks enjoy a decisive advantage in funding costs over smaller banks. As former FDIC Chairman Sheila Bair pointed out in a speech on May 5, 2011, "In the fourth quarter of [2010], the average interest cost of funding earning assets for banks with more than $100 billion in assets was about half the average for community banks with less than $1 billion in assets."[20]

When the federal government finally promised to help community banks, it failed to deliver. On February 2, 2010, President Obama announced a new program that would use $30 billion of TARP funds to assist community banks in making small business loans.[21] However, in September 2011, the Treasury Department program shut down the Small Business Lending Fund after providing only $4.2 billion – just 14% of the promised amount – to community banks. Members of Congress strongly criticized the Treasury Department for long delays in approving applications by community banks and for imposing onerous conditions on applicants.[22]

Supporters of community banks also maintain that federal regulators have applied a double standard in enforcing capital standards and other safety-and-soundness requirements against community banks. Regulators have imposed significantly higher

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[20] Sheila C. Bair, "We Must Resolve to End Too Big to Fail," 5 *FDIC Quarterly* No. 2 (2011), at 25, 26 (reprinting speech delivered on May 5, 2011); *see also* David Cho, "Banks 'Too Big to Fail' Have Grown Even Bigger: Behemoths Born of the Bailout Reduce Consumer Choice, Tempt Corporate Moral Hazard," *Washington Post*, Aug. 28, 2009 (reporting that "[l]arge banks with more than $100 billion in assets are borrowing at interest rates 0.34 percentage points lower than the rest of the industry," compared to a borrowing advantage of 0.08% in 2007 before the financial crisis began).

[21] Cheryl Bolen, "Troubled Asset Relief Program: White House Explains $30 Billion Plan To Expand Bank Loans to Small Businesses," 94 *BNA's Banking Report* 262 (Feb. 9, 2010).

[22] Kevin Wack, "Lending Fund Puts Geithner on the Defensive," *American Banker*, Oct. 19, 2011.

leverage capital requirements for community banks compared to larger banks, and regulators have also demanded severe write-downs for problem loans.[23]

Community banks currently face their most serious challenge in dealing with troubled CRE loans. Many community banks and regional banks have high concentrations of CRE loans in their portfolios.[24] Moreover, a high percentage of those CRE loans are secured by commercial properties located in regional and local markets that cannot attract new financing from issuers of commercial mortgage-backed securities ("CMBS"). Issuers of CMBS have focused primarily on newer and larger office and retail projects in affluent urban areas. While a limited number of CMBS refinancings have occurred since 2007, virtually all of those transactions have been done for higher-quality and more prestigious properties. In contrast, most of the smaller and older office and retail buildings in less desirable neighborhoods and smaller cities have been unable to attract new credit since the outbreak of the financial crisis.[25]

Unfortunately, federal regulators seem to have few concerns about the prospect of continued community bank failures due to losses on troubled CRE loans. A major reason for this apparent lack of concern is that CRE losses currently do not threaten the viability of TBTF megabanks. For example, a senior Fed official recently stated that "while

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[23] Happel & Lynch, *supra* note 4 (stating that regulators have required many community banks to maintain equity capital ratios equal to 10% of total assets, compared to a standard of 6% for the largest banks); Thecla Fabian, "Bank Supervision: House Financial Services Panel Analyzes Complaints of Bank Examination Practices," 97 *BNA's Banking Report* 62 (July 12, 2011) (describing congressional support for the "frustration" expressed by community bankers with "an increasingly harsh examination environment created by federal bank regulators in the wake of the recent financial crisis").

[24] *See* Congressional Oversight Panel, February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability (Feb. 10, 2010) [hereinafter COP Report], at 38-44; Marsh, *supra* note 4, at 48-55; Harry Terris, "Concentration," *American Banker*, Jan. 19, 2010, at 8.

[25] Marsh, *supra* note 4, at 27-36, 46-55; COP Report, *supra* note 24, at 36-44.

problems in the CRE market will be an ongoing concern for a number of banking organizations and a negative factor in economic growth and lending, [regulators] do not see CRE losses as a threat to systemically important financial institutions."[26]

The current hands-off approach taken by federal regulators with respect to CRE lending problems stands in sharp contrast to the actions of their predecessors during the banking crisis of the 1980s. During that crisis, federal banking agencies adopted carefully-structured forbearance programs to help soundly-managed community banks that were threatened with failure due to heavy concentrations in agricultural and energy loans. Of the 334 banks that participated in those programs, 265 survived or merged without FDIC assistance and 69 failed.[27] The survival of nearly four-fifths of the participating banks indicates that a similar, carefully-targeted forbearance program should be established for soundly-managed commercial banks with high concentrations of CRE loans. As an FDIC study observed, "[t]here are many risks in offering forbearance, but carefully managed programs can prevent institution failures and reduce costs to the [deposit] insurance fund."[28]

3. The Virtues of a Two-Tiered Approach to Regulating Community Banks

The past two decades have made clear that community banks and megabanks follow very different business models. Community banks provide "high touch,"

[26] Marsh, *supra* note 4, at 52-53 (quoting testimony by Patrick Parkinson, Director of the Fed's Division of Banking Supervision and Regulation, on Feb. 4, 2011 before the Congressional Oversight Panel).

[27] In 1986, federal regulators established a "Capital Forbearance Program" for community and regional banks that were weakened by agricultural and energy loans. "Eligible banks had to have a capital ratio of at least 4 percent, and their weakened capital position had to be the result of external problems in the economy and not mismanagement, excessive operating expenses, or excessive dividends." 1 *Managing the Crisis: The FDIC and RTC Experience* 23-24 (Fed. Deposit Ins. Corp. Aug. 1998).

[28] *Id.* at 24.

relationship-based lending and cash management services to SMEs as well as personalized banking services (including wealth management) to consumers. In contrast, megabanks provide impersonal, highly automated lending and deposit programs to SMEs and consumers, and megabanks also focus on complex, higher-risk transactions in the capital markets.[29] I have therefore proposed that Congress should establish a two-tiered structure for regulating these distinct categories of banks.[30] Other commentators have agreed that Congress should reject a "one size fits all" regulatory policy and instead should adopt a tailored policy that gives due attention to the special requirements of community banks.[31]

At the present time, community banks face particularly difficult challenges in raising new capital and dealing with troubled CRE loans. Several provisions of H.R. 1697 have the potential to help community banks in these areas. Specifically:

Section 205 would enable banks with assets of $10 billion or less to amortize mark-to-market losses on impaired loans secured by real estate or on real estate acquired through foreclosure (in each case, with respect to real estate loans originated from 2003 through 2007). As a practical matter, this section would authorize a forbearance program similar to the program for agricultural banks in the 1980s. To avoid including banks with management problems, this section could be limited to banks that are rated as "well-managed" by their regulators. In addition, residential real estate loans could be excluded

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[29] For discussions of the sharply different business models adopted by community banks and megabanks, see Wilmarth, "Dodd-Frank," *supra* note 10, at 1035-38; Wilmarth, "Transformation," *supra* note 1, at 261-70, 372-407.

[30] Wilmarth, "Dodd-Frank," *supra* note 10, at 1035-52.

[31] *See, e.g.,* William M. Isaac & Robert H. Smith, "Viewpoint: Burying Small Banks Alive," *American Banker*, April 1, 2011, at 8; Barbara A. Rehm, "Editor at Large: It's Time to Right-Size Regulation," *American Banker*, Mar. 24, 2011, at 1; Barbara A. Rehm, "Editor at Large: Reg Hurdle Gets Higher, Small Banks Grow Fewer," *American Banker*, Jan. 26, 2011, at 1.

from this section if there are concerns about any potentially adverse impact on home mortgage foreclosures.

Section 206 would allow banks to average appraisals on real estate securing loans over a rolling five-year period. This scope of this section is not limited to banks with assets of $10 billion or less, but the provision could be modified to accomplish that result. In addition, as indicated above, Congress could require banks to be rated as "well-managed" in order to receive favorable treatment under this section.

Sections 401 through 403 would provide favorable tax treatment to community banks in targeted areas and would thereby assist them in attracting new capital from investors.

Sections 501 through 503 would provide expanded Subchapter S treatment for a larger group of community banks and would allow such institutions to issue preferred stock and to accept investments from IRA shareholders. Again, those sections should provide community banks with increased access to new capital.

Thank you again for the opportunity to present this testimony.

Arthur E. Wilmarth, Jr. (11/15/11)

United States House of Representatives
Committee on Financial Services

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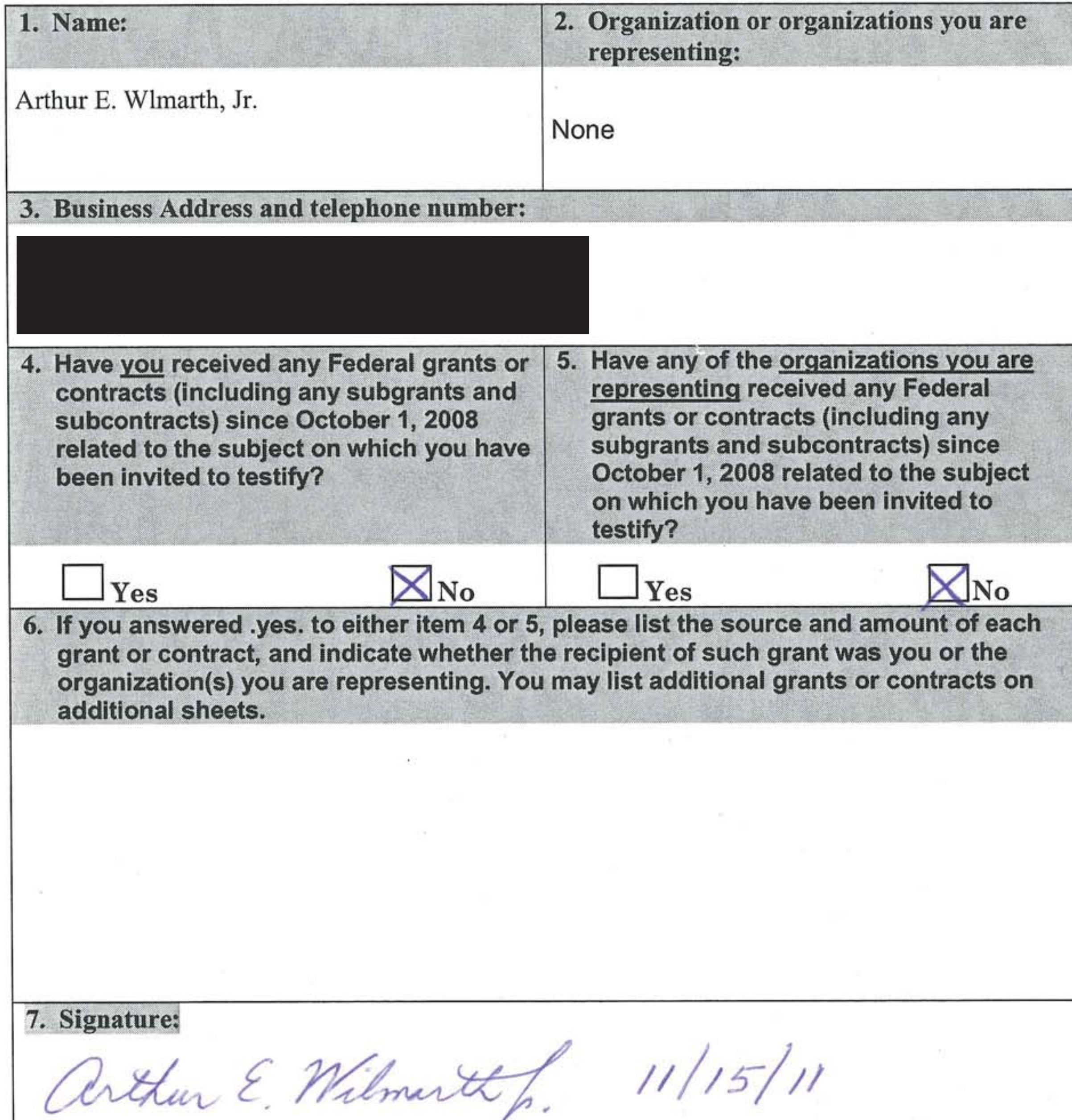

1. Name:	2. Organization or organizations you are representing:
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