

FEDERAL POLICY, MARKET DISTORTIONS, AND THE CHALLENGES FOR COMMUNITY BANKS

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ABSTRACT

Community banks are an important part of the American financial services sector.² They provide essential services to a significant number of Americans, particularly in rural areas. They pose less of a threat to the safety and stability of the American financial system than large banks because of their relatively uncomplicated and transparent activities, and their size limits the potential impact of any single bank failure. Because they are tied so closely to particular communities, they have natural disincentives for predatory lending and similar consumer protection abuses.

Community banks are under stress. Their raw numbers and share of banking industry assets have dropped significantly in the past thirty years.³ They are less attractive to investors because they are less profitable than other financial services firms.⁴ They are not accused of having contributed to the financial crisis in any meaningful way, yet are required to shoulder increased regulatory burdens as a result.⁵ Some argue that the inability of community banks to effectively compete is a natural phenomenon, and that they will eventually be replaced by more efficient and profitable firms.⁶ Others argue that the

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² Janet L. Yellen, *Tailored Supervision of Community Banks*, Speech to the Independent Community Bankers of American 2014 Washington Policy Summit (May 1, 2014) (“community banks ... play an important role in our financial system”); Martin J. Gruenberg, *Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections*, Senate Committee on Banking, Housing and Urban Affairs (February 14, 2013) (“Our research confirms the crucial role that community banks play in the American financial system.”); R. Alton Gilbert, Andrew P. Meyer, and James W. Fuchs, *The Future of Community Banks: Lessons from Banks That Thrived During the Recent Financial Crisis*, FEDERAL RESERVE BANK OF ST. LOUIS REVIEW (March/April 2013) (“Community banks play a vital role in the U.S. economy by allocating credit and providing financial services in their communities – particularly to the small businesses in those communities.”)

³ FDIC COMMUNITY BANKING STUDY (2012) at 2-9 (“Noncommunity banks have accumulated an overwhelming share of industry assets over the past 27 years.”).

⁴ James F. Bauerle, *Capital*, 128 BANKING L.J. 180, 180-81 (2011) (“Community banks in particular are positioned poorly when it comes to raising new capital. Most of them have shareholder constituencies that own shares out of loyalty to the communities where the banks are located rather than out of desire for maximum return on equity. Raising capital in the public equity markets is difficult to impossible for community banks because their cost structures prevent them from achieving the return on investment that disinterested investors require.”)

⁵ See Tanya D. Marsh and Joseph W. Norman, *The Impact of Dodd-Frank on Community Banks*, American Enterprise Institute (May 2013)

⁶ Joseph V. Rizzi, *Community Banks Can Survive and Prosper – If They Adapt*, AMERICAN BANKER, December 17, 2013 (“Some see this as a sign of a declining industry. Rather, as a community bank investor, I see it as a healthy, albeit painful, reflection of the Creative Destruction process.”)

recent increase in industry consolidation is linked to the financial crisis and will soon subside.⁷

This paper argues that the stress on community banks is not natural and it will not subside without major policy changes. The stress has been created by market distortions as a result of federal policies that: (1) award competitive advantages to certain categories of financial intermediaries; and (2) encourage Americans to invest in capital markets rather than in depository accounts. The explicit goals of federal policy regarding the financial system are to ensure safety and soundness, consumer protection, and access to credit. There are few that would argue that a financial system where a handful of firms control the lion's share of assets, and where household assets are largely invested in the potentially turbulent capital markets, achieves any of these goals. The goal of this paper is to take a step back from the current granularity of the discussion surrounding the future of community banks and take a broader view of federal policies which impact the financial system. Recognizing that many of the challenges facing community banks are not natural alters the policy discussion, which is essential if we are serious about protecting the millions of Americans who depend upon community banks for financial services.

INTRODUCTION

The story of the banking sector over the past three decades has been the phenomenal success of a handful of firms.⁸ Between 1985 and 2010, the number of banks with assets greater than \$10 billion nearly tripled.⁹ Meanwhile, the concentration of capital in those large banks increased.¹⁰ At year-end 2013, the four largest banks in America – JPMorgan Chase, Bank of America, Wells Fargo, and Citibank – held more than 40% of total commercial bank assets.¹¹

⁷ Benjamin R. Backup and Richard A. Brown, *Community Banks Remain Resilient Amid Industry Consolidation*, 8 FDIC QUARTERLY 33 (2014)

⁸ FDIC COMMUNITY BANKING STUDY (2012) at 2-9 (“Noncommunity banks have accumulated an overwhelming share of industry assets over the past 27 years.”).

⁹ Richard A. Brown, Chief Economist, FDIC, *The FDIC Community Banking Research Project: Community Banking by the Numbers*, Presentation at the FDIC Future of Community Banking Conference 3 (Feb. 16, 2012), available at <http://www.fdic.gov/news/conferences/community> (Noting that there were 13,361 institutions with less than \$100 million in assets in 1985, and 2,625 in 2010. There were 36 institutions with more than \$10 billion in assets in 1985 and 107 in 2010.) [It should be noted that these numbers have not been adjusted for inflation.]

¹⁰ Mehrsa Baradaran, *Banking and the Social Contract*, 89 NOTRE DAME L. REV. 1283, 1335 (2014) (“Large banks ... are those with assets between \$250 billion and \$2.3 trillion. There are only twelve of these behemoths after the crisis and they represent only 0.2 percent of all banks, but together they hold almost seventy percent of the country's banking assets.”)

¹¹ FDIC STATISTICS REPORT (December 31, 2013). In contrast, the four largest commercial banks held 27.1% of total assets at year-end 2001 and 41.6% of total assets at year-end 2007. FDIC STATISTICS REPORT (December 31, 2001); FDIC STATISTICS REPORT (December 31, 2007).

At the same time, a robust and diverse financial services sector is vital to the American economy.¹² Consumers and businesses require ready access to financial services and meaningful choice in financial products and the companies that provide them.¹³ Policymakers,¹⁴ regulators,¹⁵ and scholars¹⁶ have confirmed and reaffirmed that small, traditional depository institutions like community banks play a significant, and irreplaceable role in the system.

That system, however, is artificially fragmented by government policy and history. There are numerous kinds of financial intermediaries – commercial banks, thrifts, credit unions, pension funds, insurance companies, investment banks, etc. The federal government’s approach to regulation and policy is premised on a silo approach. Commercial banks are different from credit unions, and therefore each will be subject to a particular set of regulations. The problem is that once Congress establishes a category of financial intermediary, it has been loathe to change it. This means that in 2014, some firms in one silo have much more in common with firms in another silo – they are of similar size and organizational complexity, offer similar services to consumers and pose similar risks.¹⁷

¹² See ANJAN THAKOR, SOURCES OF CAPITAL AND ECONOMIC GROWTH: INTERCONNECTED AND DIVERSE MARKETS DRIVING U.S. COMPETITIVENESS (Spring 2011) ([A] rich diversity of financing sources is provided by the U.S. financial system. This diversity helps U.S. consumers and businesses to better manage their risks and lowers their cost of capital. Diversity enables consumers and businesses to effectively match their financing needs to the financing sources, with each financing source providing a different set of services.)

¹³ CENTER FOR CAPITAL MARKETS COMPETITIVENESS, HOW MAIN STREET BUSINESSES USE FINANCIAL SERVICES 5 (April 10, 2013) (“Main Street businesses” “tend to view the preservation of regional and community banks as a positive trend affecting their ability to access services” and “tend to view consolidation of banks as a negative trend affecting their ability to access services.” They “favor trends that preserve choice and diversity within the system.”); Baradaran, *supra* note __ at 1335 (“Bank credit not only allows the economy to grow wealth, but also allows individual families to do so.”)

¹⁴ See, e.g. Senate Bill 2252 Community Bank Preservation Act of 2014 (“A bill to reaffirm the importance of community banking and community banking regulatory experience on the Federal Reserve Board of Governors, to ensure that the Federal Reserve Board of Governors has a member who has previous experience in community banking or community banking supervision, and for other purposes.”)

¹⁵ *The Importance of Community Banking: A Conversation with Chairman Ben Bernanke*, Community Banking Connections (Third Quarter 2012) (“I see a very real need for continuation of the traditional community banking model.”).

¹⁶ Bob Solomon, *The Fall (and Rise?) of Community Banking: the Continued Importance of Local Institutions*, 2 U.C. Irvine L. Rev. 947 (2012); Scott E. Hein, Timothy W. Koch, and S. Scott Macdonald, *On the Uniqueness of Community Banks*, Federal Reserve Bank of Atlanta, Economic Review, First Quarter 2005; U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-881, COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF DODD-FRANK DEPENDS LARGELY ON FUTURE RULE MAKINGS 6 (September 2012).

¹⁷ THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (January 2011) at 56 (“The new regime encouraged growth and consolidation within and across banking, securities, and insurance. The bank-centered financial holding companies such as Citigroup, JP Morgan, and Bank of America could compete directly with the ‘big five’ investment banks—Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns—in securitization, stock and bond underwriting, loan syndication, and trading in over-the-counter (OTC) derivatives. The biggest bank holding companies became major players in investment banking. The strategies of the largest commercial banks and their holding companies came to more closely resemble the strategies of

But we regulate them on a largely one-size-fits all basis, based on the category to which they have been assigned. This kind of approach is fundamentally flawed. It focuses on distinctions without differences, and is blind to significant differences and the market distortions that are created. This paper is focused on commercial banks, and community banks in particular. But the core issue is much larger and eventually requires a fundamental re-imagining of our regulation of financial intermediaries.

It is clear that we do not have a single commercial banking sector. The average size of the top four commercial banks is \$1.5 trillion.¹⁸ The average size of the next 16 banks is \$189 billion.¹⁹ In stark contrast, the average community bank holds \$215 million in assets and 1,814 community banks hold less than \$100 million in assets each, with an average size of \$58 million.²⁰

Much has been written in the past five years about the health and future of community banks, particularly concern regarding the impact of the 2008 financial crisis and Dodd-Frank.²¹ While many policymakers, regulators, scholars, and bankers have noted with alarm that community banks face serious challenges,²² others are unconcerned. For example, banking consultant Joseph V. Rizzi decried the “myth of community banks – institutions with a limited geographic scope providing vital services to their communities.”²³ He argued that if community banks fail, then “it is unlikely that the

investment banks. Each had advantages: commercial banks enjoyed greater access to insured deposits, and the investment banks enjoyed less regulation. Both prospered from the late 1990s until the outbreak of the financial crisis in 2007.”)

¹⁸ FEDERAL RESERVE STATISTICAL RELEASE, INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE, RANKED BY CONSOLIDATED ASSETS AS OF DECEMBER 31, 2013.

<http://www.federalreserve.gov/releases/lbr/current/default.htm>

¹⁹ *Id.*

²⁰ FDIC STATISTICS REPORT (December 31, 2013).

²¹ Yellen, *supra* note 2 (“One theme that has come through loud and clear in this outreach is concern about regulatory burden.”); Esther L. George, *Can Community Banks Still Compete?*, 2012 Community Banking Conference Federal Reserve Bank of Kansas City (November 2, 2012); Ron Feldman, Ken Heinecke, Jason Schmit, *Quantifying the Costs of Additional Regulation on Community Banks*, Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis (2013); Tanya D. Marsh and Joseph W. Norman, *The Impact of Dodd-Frank on Community Banks*, American Enterprise Institute (May 2013); Hester Peirce, Ian Robinson, and Thomas Stratmann, *How are Small Banks Faring Under Dodd-Frank?*, Mercatus Center Working Paper No. 14-05 13 (February 2014); KPMG LLP, *2013 Community Banking Industry Outlook Survey* (2013).

²² CONFERENCE OF STATE BANK SUPERVISORS, COMMUNITY BANKING IN THE 21ST CENTURY: OPPORTUNITIES, CHALLENGES, AND PERSPECTIVES 5 (“Despite past successes, community banks face considerable challenges in the years ahead.”)

²³ Joseph V. Rizzi, *Community Banks Can Survive and Prosper – If They Adapt*, AMERICAN BANKER, December 17, 2013 (“Some see this as a sign of a declining industry. Rather, as a community bank investor, I see it as a healthy, albeit painful, reflection of the Creative Destruction process.”)

services are vital to consumers.”²⁴ “Survival is earned,” Rizzi wrote, “not granted by size, location, or noble calling.”²⁵

In a similar vein, *Slate* economics columnist Matthew Yglesias argued that we simply have too many banks.²⁶ “American public policy is perversely committed to preserving [community banks],” even though they don’t offer “any real competition” and “they could be easily be driven out of business by high regulatory compliance costs.”²⁷ Yglesias concluded:

The policy we should hope for is to simultaneously contain the size and leverage of the biggest banks while encouraging the second tier of regional banks to keep growing. We should want the US Bankcorps and PNCs and Fifth Thirds and BancWests of America to swallow up local franchises and expand their geographical footprints. The ideal would be *effective competition* in which dozens rather than thousands of banks exist, and they all actually compete with each other on a national or regional basis rather than carving up turf.²⁸

Both Rizzi and Yglesias seem captivated by the idea of creative destruction – the idea that in a free market, innovation will win out over inefficiency.²⁹ There will be losers in the short term, but in the long run society will benefit. But here’s the catch – the American financial services sector is not a perfectly competitive market.

Every regulatory regime provides costs and benefits to the regulated industry as well as consumers. One goal of regulation is to achieve the correct balance between those costs and benefits.³⁰ While this balancing is usually considered on an industry-wide basis, imbalanced regulation can create market distortions, privileging some firms and disadvantaging others. Regulation that is not narrowly tailored to address risk can harm

²⁴ *Id.*

²⁵ *Id.*

²⁶ Matthew Yglesias, *America’s Microbank Problem*, SLATE (December 2, 2013) http://www.slate.com/blogs/moneybox/2013/12/02/too_many_banks_micro_banks_are_a_problem_for_america.html

²⁷ *Id.*

²⁸ *Id.*

²⁹ See JOSEPH SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 81-110 (6th ed. 1987)

³⁰ See, e.g. Section 1022(b) of Dodd-Frank, which grants the CFPB the authority to “prescribe rules and issue orders and guidance, as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof” but requires the CFPB in such rulemaking to consider “the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer and consumer financial products or services resulting from such rule; and (ii) the impact of proposed rules on covered persons, as described in section 1026, and the impact on consumers in rural areas.”

consumers by unnecessarily driving up compliance costs, particularly for certain firms, and therefore reducing the competitiveness of markets.

The American financial services sector is a highly regulated market. It is also, as previously noted, an artificially segmented market. Congress has divided financial intermediaries into silos, but those divisions do not match the natural markets. For example, the main competitor of a rural community bank is more likely to be another community bank or a credit union rather than a large, complex financial institution (LCFI). A commercial real estate borrower could obtain a loan from a number of financial intermediaries – a commercial bank, an insurance company, or an investment bank. Treating firms in a single market differently because of their form has the inevitable result of advantaging some firms at the expense of others.

The chief goals of financial services regulations are safety and soundness, consumer protection, and access to credit. Regulatory imbalance is of particular concern with respect to commercial banks because of the enormous differences between the LCFIs and community banks. Studies of the banking industry have shown that smaller banks are at a cost disadvantage compared to larger banks due to economies of scale. One-size-fits-all regulation that is not narrowly tailored to the different risks posed by firms exacerbates those cost disadvantages.³¹

The most disadvantaged firms under the current regulatory regime are community banks. When small banks are unable to survive in this environment, it is not creative destruction – it is just destruction. This destruction hastens consolidation and is leading to a smaller, more concentrated market that offers fewer choices to consumers and businesses.

In their quest for cleansing, critics like Rizzi and Yglesias ignore the fact that on an even playing field, community banks are strong performers. The 2012 FDIC Community Banking Study concluded that community banks actually outperform noncommunity banks in generating net interest income, yields on earning assets, funding costs, credit losses, and noninterest expenses.³² They are arguably better underwriters than the larger banks and better core bankers.³³ Why, then, is the future so uncertain?

³¹ See Tanya D. Marsh, *Reforming the Regulation of Community Banks After Dodd-Frank*, __ IND. L.J. __ (2014).

³² FDIC Community Banking Study, *supra* note __ at 4-2

³³ FDIC Community Banking Study, *supra* note __ at 4-6; Elizabeth A. Duke, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks on Community Banks and Mortgage Lending at the Community Bankers Symposium (Nov. 9, 2012), *available at* <http://www.federalreserve.gov/newsevents/speech/duke20121109a.htm> Id. at 13. (“Over the last several years as mortgage delinquencies reached record levels, the serious delinquency rate of mortgages held by community banks did not go much over 4 percent, far lower than the serious delinquency rates that climbed to almost 22 percent for subprime, fixed-rate loans and more than 46 percent for subprime, variable-rate loans. In fact, over the last several years, on average, mortgages held by community banks outperformed even

Most recent scholarship has focused on the most obvious impact of federal government policy: the cost of one-size-fits-all *banking* regulation, particularly after the Dodd-Frank Act. But this paper takes a broader view and focuses on a less obvious market distortion that stems from our siloed approach to financial intermediaries, particularly the impact of tax policies that incentivize the flow of funds into capital markets at the expense of deposit accounts. Between 1984 and 2011, the share of credit market debt held by American banks declined from 49% to 25%.³⁴ During that same period, the share of banking assets held by community banks declined from 38% to 14%.³⁵

If the story of the banking sector over the past three decades has been the success of the LCFIs, it has also been the story of dramatic expansion in the capital markets.

Financial innovation has expanded capital markets and fueled great growth in the United States. American households have followed the incentives created by the government for decades to borrow through securitized channels, leverage their home equity, and reduce their deposit accounts in favor of investments in mutual funds and securities. The 2008 financial crisis revealed the shortcomings of some of these strategies. Less acknowledged is the long-term impact of these incentives on the health of the community banking sector.

As depository institutions, community banks are dependent on deposits.³⁶ Preferential tax treatment for capital gains and retirement investments have coincided with significant drops in deposit accounts. Community banks have also been hurt by the federal government’s decision to maintain low interest rates over a long period of time, as customers understandably seek higher yields elsewhere.³⁷ Community banks also need access to creditworthy local borrowers. The rise of residential mortgage backed securities, driven by federal policy, decimated the traditional role of community banks in residential mortgage lending.³⁸ The Consumer Financial Protection Bureau’s qualified mortgage rule

fixed-rate, prime loans, the best performing mortgage category. I think this statistic by itself is a strong testament to the responsible lending practices of community banks.”)

³⁴ FDIC COMMUNITY BANKING STUDY, *supra* note ___ at I.

³⁵ *Id.*

³⁶ Community banks are more dependent on deposits than LCFIs, which have significantly more non-interest income due to their broader range of financial products and services. FDIC Community Banking Study, *supra* note ___ at 4-2 (“Because of their heavy dependence on lending as a source of income, community banks have been disproportionately affected by the long-term trend toward lower net interest margins.”)

³⁷ FDIC Community Banking Study, *supra* note ___ at III (“The historically low level of interest rates in recent years has been an important factor pushing down net interest margins at community banks. The heavy reliance of community banks on deposit funding ... has been more problematic in recent years as community banks have found it difficult to pass along ultra-low interest rates to their deposit customers.”)

³⁸ FINANCIAL CRISIS INQUIRY COMMISSION, SECURITIZATION AND THE MORTGAGE CRISIS 24 (April 7, 2010) (“In the decades leading up to the early 1970s, the housing finance system was relatively simple: banks and savings and loans associations made mortgage loans to households ... and held them until they were repaid. Deposits provided the major source of funding for these lenders, as most were depository institutions. ... In the 1970s,

has led to more community banks exiting the residential mortgage lending market. The expansion of commercial mortgage backed securities, and the securitization of small business loans and other consumer loans threaten other core lines of lending for community banks. The growth of securitization and the expansion of mutual funds and employer-based retirement accounts have also allowed the largest banks to generate significant fee income through various financial intermediary roles.³⁹

Therefore, as a result of policies that incentivize the growth of capital markets at the expense of traditional banking, community banks face reductions in both deposits and creditworthy borrowers. In addition, their profitability is judged against LCFIs, which benefit from fees generated by managing these displaced funds.⁴⁰

The American economy needs a healthy, diverse competitive marketplace in financial intermediary services and products.⁴¹ That marketplace is steadily becoming less competitive and less diverse *because of* misguided federal policies that are based on historical and increasingly irrelevant distinctions between firms based on form rather than size and function. We should not frustrate creative destruction and prop up community banks, no matter how noble their calling. Survival is earned. But the rules need to fair; the

the housing finance system began to shift from depository-based funding to capital markets-based funding. ... Key to this shift to capital markets-based funding of mortgage lending were Fannie Mae and Freddie Mac, the government sponsored enterprises (GSEs), which were created by the federal government to develop the secondary mortgage market.”)

³⁹ FDIC Community Banking Study, *supra* note ___ at 4-2; Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 Harv. L. Rev. 1991, 2066-67 (2014) (“[B]ig banks are often quite different financially than small banks. Big banks tend to engage in different activities both in their retail lines and as investors. For example, 85% of credit card issuance is by ten large banks. Many smaller banks simply do not offer credit cards. In terms of investments, one illustration is that almost 71% of bank investments in collateralized loan obligations (CLOs) are from just three megabanks; few community banks invest in this asset class.”)

⁴⁰ In the Second Quarter of 2014, FDIC-Insured Institutions with assets greater than \$10 billion reported a return on equity equal to 9.69%, compared to 7.15% for institutions with less than \$100 million in assets. Community banks had a return on equity of 8.52%. In the past five years, return on equity for community banks has ranged from -1.48% in 2009 to a high of 8.55% in 2013. FDIC QUARTERLY BANKING PROFILE, SECOND QUARTER 2014. In the same quarter, JPMorgan Chase reported a 14% return on tangible common equity. *JPMorgan Chase Reports Second-Quarter 2014 Net Income of \$6.0 Billion, or \$1.46 Per Share, on Revenue of \$25.3 Billion* (July 15, 2014)

<http://investor.shareholder.com/jpmorganchase/releasedetail.cfm?ReleaseID=859636>

⁴¹ Mehrsa Baradaran, *Banking and the Social Contract*, 89 Notre Dame L. Rev. 1283, 1285-6 (2014) (“The public needs a safe and reliable banking system, without which the economy cannot reach optimal performance. Banks also need government support, without which their customers would lack sufficient trust to permit them to function properly. Thus, banks and the government are engaged in a partnership or agreement. The basic agreement consists of a government promise that it will protect banks from runs, liquidity shortages, and investor irrationality, and a promise made by banks that they will operate safely, play their essential role in financing the expansion of the economy, and serve the needs of their customers and local communities.”); Bauerle, *supra* note ___ at 186 (“The working premise of this column is that to support capital formation by privately owned enterprises the nation needs strong banks in addition to those deemed “systemically important.”)

playing field needs to be even. We should demand a public policy that does not create market distortions that make it increasingly difficult for community banks to survive.

I. ADVANTAGES OF COMMUNITY BANKS

There were 6,656 financial institutions insured by the FDIC as of June 30, 2014.⁴² Commercial banks accounted for 5,757 of that total, and there were 899 savings institutions.⁴³ The commercial banks differ greatly in terms of size.

All Commercial Banks	Commercial Banks with Assets less than \$100 million	Commercial Banks with Assets between \$100 million and \$1 billion	Commercial Banks with Assets more than \$1 billion
5,757	1,744	3,469	544

Table 1: Commercial Banks as of June 30, 2014⁴⁴

A bank with less than \$100 million in assets bears little resemblance to a large financial institution like JPMorgan Chase, which holds \$2.5 trillion in client assets and \$1.7 trillion in assets under management.⁴⁵ The term “community bank” is therefore used to differentiate between smaller-scale, local, traditional banking institutions, and large, sophisticated financial institutions.⁴⁶ Federal regulators use various definitions of community banks,⁴⁷ but they generally differentiate community banks from other commercial banks based on size, location, and business model.⁴⁸ Although the FDIC has developed a more nuanced and

⁴² FDIC STATISTICS ON DEPOSITORY INSTITUTIONS REPORT (June 30, 2014).

⁴³ *Id.*

⁴⁴ FDIC STATISTICS REPORT (June 30, 2014) *supra* note ____.

⁴⁵ *JPMorgan Chase Reports Second-Quarter 2014 Net Income of \$6.0 Billion*, *supra* note _____. JPMorgan Chase also reports holding a “record” \$21.7 trillion in assets under custody, up 14% from 2013.

⁴⁶ FDIC COMMUNITY BANK STUDY, *supra* note ____ at 1-1. *See also* NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES, COMMUNITY BANKING REPORT 2 (February 2013) (“At its essence, community banking is based on a simple and traditional business model. Community banks focus on gathering deposits from the communities they serve and exclusively lending back to those communities.”)

⁴⁷ Among the banking industry’s three primary regulators—the Federal Reserve, the Office of the Comptroller of the Currency (the “OCC”), and the Federal Deposit Insurance Company (the “FDIC”)—no single regulatory definition for “community bank” exists. The Federal Reserve defines community banks to include institutions with \$10 billion or less in total assets. *See Duke*, *supra* note _____. The OCC defines community banks as banking organizations with less than \$1 billion in total assets. *See* OFFICER OF THE COMPTROLLER OF THE CURRENCY, COMMUNITY BANK SUPERVISION COMPTROLLER’S HANDBOOK 1 (2010), *available at* <http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/cbs.pdf>. And, lastly, the FDIC formerly defined community banks as banking organizations with less than \$1 billion in assets, but recently revised its definition by moving to a more inclusive, multi-criteria approach.

⁴⁸ There are other depository institutions that are not classified as commercial banks but which are functionally similar to community banks, including credit unions, thrifts, and mutual savings institutions. Because this paper generally relies on FDIC data pertaining to commercial banks, the calculations do not include those other institutions unless specifically noted.

accurate methodology,⁴⁹ the simplest and crudest way to define community banks is as commercial banks with assets of less than \$1 billion.⁵⁰

By any definition, community banks make up the vast majority of American commercial banks. As of June 30, 2014, commercial banks with less than \$1 billion in total assets constituted 90.55% of all commercial banks.⁵¹ Although numerically dominant, community banks held only 8.13% of total commercial bank assets.⁵² Approximately 30% of commercial banks held assets less than \$100 million, while approximately 60% held assets between \$100 million and \$1 billion.⁵³ There are still important differences between a \$100 million bank and a \$1 billion bank, but they have more in common with each other than with the large, complex financial institutions.

	Commercial Banks with Assets less than \$1 billion	Commercial Banks with Assets more than \$1 billion
Total Number	5,213	544
Percentage of Number	90.55%	9.45%
Total Assets	\$1.15 trillion	\$12.96 trillion
Percentage of Assets	8.13%	91.87%

Table 2: Distribution of Commercial Banks as of June 30, 2014⁵⁴

Community banks tend to operate in limited geographic areas—82% of community banks operated within three or fewer counties in 2011.⁵⁵ Community banks are much more likely than larger banks to operate in small towns and sparsely populated regions,⁵⁶ making up more than 70% of banking offices in rural areas.⁵⁷

⁴⁹ See FDIC COMMUNITY BANK STUDY, *supra* note ____.

⁵⁰ The FDIC has developed a far more nuanced approach to defining community banks, noting that “[o]ne problem with defining community banks using a size limit is that any dollar-based yardstick must be adjusted over time to account for factors such as inflation, economic growth, and the size of the banking industry itself. According to any of these measures, \$1 billion is not what it used to be.” *FDIC Community Bank Study*, *supra* note ____ at 1-1. Despite the wisdom of the FDIC’s observation, for the sake of simplicity, this Article will use the straightforward size limit.

⁵¹ FDIC STATISTICS REPORT (June 30, 2014) *supra* note ____.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ FDIC STATISTICS REPORT (June 30, 2014) *supra* note ____.

⁵⁵ FDIC COMMUNITY BANKING STUDY, *supra* note ____ at 3-3.

⁵⁶ Studies show that community banks are four times more likely than large banks to have an office in rural counties. FDIC COMMUNITY BANKING STUDY, *supra* note ____

⁵⁷ *Id.* at 3-5.

Although many community banks are located in suburban and urban counties, community banks are vital to the economic health of rural America and to the agricultural economy.⁵⁸ In rural counties, community banks hold 70% of retail deposits, or 8.3 times their relative share of total assets.⁵⁹ Farmers rely on community banks as sources of both short-term credit for crop production (farm loans) and long-term financing secured by mortgages on agricultural real estate (farmland loans). As of year-end 2013, community banks held 61.8% of all farmland loans.⁶⁰ This includes 74.3% of farmland loans less than \$500,000 and 80.5% of farmland loans less than \$100,000.⁶¹ Community banks also held 54.9% of farm loans, including 74.9% of all farm loans less than \$500,000 and 78.6% of farm loans less than \$100,000.⁶² In other words, community banks had 7 to 9.5 times the level of investment in loans to farmers as their relative asset size.

Lack of substitutes for the banking services provided to rural areas further emphasizes the important role of community banks in farm lending.⁶³ With less than a 30% share of banking offices in rural areas, larger banks tend to be more geographically distant from farming operations.⁶⁴ In 2011, there were more than 1,200 counties (out of a total of 3,238), with a combined population of 16.3 million, whose physical access to mainstream banking services is limited to community banks.⁶⁵ If those community banks fail, merge, or close branches, it is unlikely that another bank will replace them.

Purdue University scholars considered the importance of community banks to rural communities in Indiana, noting that lending institutions will not locate a bank branch in a rural county unless there is “the potential to grow to a scale of operations that will enable the lending institution to operate them profitably.”⁶⁶ Although that scale is difficult to generalize, they noted one 2009 study which fixed the breakeven point at \$40 million in deposits.⁶⁷ This is problematic because the average branch size for deposits in rural Indiana counties is \$32 million and \$34 million for rural/mixed counties.⁶⁸

⁵⁸ See, e.g. Community Banking Report, *supra* note ___ at 4. (“New York’s farms, which have little or no access to large banks, rely heavily on community banks for loans and other financial services.”)

⁵⁹ FDIC COMMUNITY BANKING STUDY, *supra* note ___.

⁶⁰ FDIC STATISTICS REPORT (December 31, 2013) *supra* note ___.

⁶¹ *Id.*

⁶² *Id.*

⁶³ WILLIAM KEETON, FED. RESERVE BANK OF KANSAS CITY, THE ROLE OF COMMUNITY BANKS IN THE U.S. ECONOMY 26-27 (2003), available at <http://www.kc.frb.org/Publicat/ECONREV/Pdf/2q03keet.pdf>.

⁶⁴ FDIC COMMUNITY BANKING STUDY, *supra* note ___.

⁶⁵ FDIC COMMUNITY BANKING STUDY, *supra* note ___ at 3-5.

⁶⁶ Freddie Barnard and Elizabeth Yeager, *The Role of Community Banks in Rural Indiana* (March 2013) <https://extension.purdue.edu/extmedia/EC/EC-768-W.pdf>

⁶⁷ *Id.*

⁶⁸ *Id.*

Consequently, it is difficult for a commercial bank or savings institution to justify operating a full-service branch in many rural counties when the size will likely be below what the institution needs to profitably operate the branch. The justification becomes more difficult if the population growth in that county is stagnant or declining.⁶⁹

It is also more expensive for non-community banks to serve rural borrowers, which makes it even less likely that a non-community bank would be eager to invest in a rural bank branch.

Ascertaining the creditworthiness of rural small businesses can pose a number of challenges, not the least of which is that many rural small businesses are hard-information deficient. In rural local economies, the resale market for fixed investments and specialized assets is thin, which makes the value of seized collateral in the case of loan default uncertain. Rural small businesses are less likely than their urban peers to have audited financial statements, further reducing the amount and usefulness of hard information about their creditworthiness.⁷⁰

The relationship between community banks and rural communities is a source of both strength and weakness to community banks.⁷¹ Between 1980 and 2010, the population of the United States increased by more than 36%, but more than half of all rural counties lost population.⁷² Community banks located in depopulating areas have proven resilient, but face challenges to future growth. For example, the Great Plains states face the most severe depopulation: 86% of those rural counties lost population from 1980 to 2010.⁷³ With aggregate total assets of \$174.6 billion, the 836 community banks headquartered in Great Plains states may be a blip on the balance sheet of a LCFI, but their presence and stability is vital to the future of the communities that they serve.⁷⁴ Their existence also underscores that idea that the success of a closely-held rural community bank should be measured by different metrics than a publicly-traded LCFI, with a broader appreciation of social utility.

The failure of a community bank in a rural area with a declining population is not creative destruction. Such branches are unlikely to be replaced, which can have a significant

⁶⁹ Id.

⁷⁰ DeYoung, Glennon, Nigro, and Spong, *supra* note ___ at 2.

⁷¹ DeYoung, Glennon, Nigro, and Spong, *supra* note ___ at 2. (“Despite two decades of continuous banking industry consolidation that has roughly halved the number of U.S. commercial banks, 59% of all remaining banks are located in rural counties, places that account for only 21% of the U.S. population. Based on conventional measures, nearly all of these banks are operating below minimum efficient scale, with undiversified loan portfolios exposing them to volatile local [agriculture-driven] economies.”)

⁷² John M. Anderlik and Richard D. Cofer, Jr., *Long-Term Trends in Rural Depopulation and Their Implications for Community Banks*, FDIC Quarterly, Volume 8, No. 2 (2014) at 1.

⁷³ Id. at 5.

⁷⁴ Id. at 8.

negative impact on the opportunities available to the community. As Professor Michael Barr explains, “[a]ccess to financial services is critical to success in the modern American economy.”⁷⁵

[A]ccess to a bank account can be an important entry point for participation in the financial services system and progression to a wide range of other services over time. ... The consequences of not having access to mainstream financial services can be severe. ... [W]ithout a bank account, it is more difficult and more costly to establish credit or qualify for a loan. A bank account is a significant factor—more so, in fact, than household net worth, income, or education level—in predicting whether an individual also holds mortgage loans, automobile loans, and certificates of deposit.⁷⁶

Despite these challenges, community banks have remained resilient in large part because of the strength of their business model. Perhaps the most important difference between community banks and LCFIs is the way that they process information about customers and make underwriting decisions. The community bank model is often described as “relationship banking” while the large bank model is referred to a “transactional banking.”⁷⁷

“Transactional banking” involves highly standardized products that “require little human input to manage and involve information that is generally easily available and reliable. Thus, in transactional banking, hard information drives performance.”⁷⁸ Financial institutions that utilize transactional banking rely heavily on mechanical processes such as credit scoring, which involve incorporating hard data into quantitative computer models to make underwriting decisions.⁷⁹ Transactional banking is efficient, particularly when replicated on a large scale, but because it focuses on hard data it largely excludes human judgment from underwriting decisions.

LCFIs serve both commercial and retail customers, but tend to focus on those who are easily and cheaply processed through the transactional banking model. They are interested in commodity banking (i.e. large volume credit cards), large commercial customers, and international customers.⁸⁰ LCFIs rely more on purchased liabilities to fund lending, and community banks rely more on core deposits.

Community banks deploy those deposits into loans through the relationship banking model, which builds on longstanding customer relationships that give the bank

⁷⁵ Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 123 (2004)

⁷⁶ Barr, *supra* note ___ at 138-9.

⁷⁷ Scott E. Hein, Timothy W. Koch, and S. Scott Macdonald, *On the Uniqueness of Community Banks*, *Federal Reserve Bank of Atlanta*, Economic Review, First Quarter 2005 at p. 18.

⁷⁸ *Id.*

⁷⁹ *Id.* at 19.

⁸⁰ Hein, Scott, and Macdonald, *supra* note ___ at 25.

richer access to “soft” information about its customers.⁸¹ Computer models may be used to enhance underwriting, but more authority is given to bank employees to make lending decisions. Soft information, by its nature, is not generally available and is difficult to quantify. It is more expensive to acquire and more expensive to process. However, studies have shown that many borrowers, particularly small businesses, farmers, and individuals, are better served by relationship banking than the transactional banking model.⁸²

Another value of the relationship banking model is that it includes a broader range of services than the simple provision of funds.⁸³ For example, small businesses use community banks for basic financial services as well as the credit to fuel their investment and job-creation efforts. Community banks provide banking services to small businesses—such as deposit taking, checking accounts, and payroll services—while also functioning as a funding source for start-up costs, working capital, and expansion loans.⁸⁴ “In the case of a relationship loan, the lender many times adds real value by providing accounting, business planning, and tax planning expertise.”⁸⁵

The relationship banking model benefits the American economy in two main ways. First, relationship banking results in loans that are more likely to be repaid than transactional banking.⁸⁶ In every category of individual and commercial loan, community banks had lower average net charge-off rates than noncommunity banks from 1991-2011.⁸⁷ During real estate downturns, “loan loss rates were much higher at noncommunity banks than at community banks.”⁸⁸ Second, the relationship banking model relies upon

⁸¹ *Id.* at 17.

⁸² *Id.* at 17. These borrowers are sometimes called “informationally opaque.” Tim Critchfield, et al., *The Future of Banking in America, Community Banks: Their Recent Past, Current Performance and Future Prospects*, 16 FDIC BANKING REV. 3&4 at 4 (2004); Robert DeYoung, Dennis Glennon, Peter Nigro, and Kenneth Spong, *Small Business Lending and Social Capital: Are Rural Relationships Different?* (June 2012) (“[W]e find evidence that small rural banks are especially good at underwriting and monitoring credit to small, informationally opaque firms. Loans made by small rural banks have a significantly lower likelihood of default than loans made by small urban banks. This performance advantage is positively related to the ‘ruralness’ of the borrower-lender relationship: it intensifies as the size of the rural market declines and it weakens when the rural borrower and rural banker are located in different rural markets.”)

⁸³ See, e.g. George, *supra* note ___ at 5 (“[C]ommunity banks fulfill a very important function in establishing close relationships and directing credit to customers whose needs might otherwise go unserved.”)

⁸⁴ NFIB RESEARCH FOUNDATION, FINANCING SMALL BUSINESSES: SMALL BUSINESS AND CREDIT ACCESS (Jan. 2011).

⁸⁵ DeYoung, Glennon, Nigro, and Spong, *supra* note __ at 18-19.

⁸⁶ FDIC COMMUNITY BANKING STUDY, *supra* note ___ at III (“Community banks have almost always incurred lower credit losses than noncommunity banks.”); Esther George, President and CEO, Federal Reserve Bank of Kansas City, *Can Community Banks Still Compete?* (November 2, 2012) (“While many now claim that the value of customer relationships is declining with credit scoring and credit risk models, a recent study at our Bank found that there is real value in relationship lending and in the soft personal information on customers that community bankers typically have.”)

⁸⁷ FDIC COMMUNITY BANKING SURVEY, *supra* note ___ at 4-6.

⁸⁸ *Id.*

repeat business within a limited population, which provides a strong economic disincentive to predatory lending and other practices exploitative of consumers.⁸⁹

Although transactional banking theoretically allows banks to process loans at a lower cost than relationship banking, Federal Reserve data consistently shows that large banks charge higher fees than community banks and have increased their fees more over time.⁹⁰

Traditionally, financial intermediaries like banks have been understood to exist because there are significant barriers between borrowers and lenders, and depository institutes serve a role essential to a functioning economy.⁹¹ It has been noted that in recent decades, the barriers between borrowers and lenders in the United States have been reduced, technology has improved, and competition from alternative intermediaries has grown, including peer to peer lending, private equity, pension funds, and securitization.⁹² These forces, combined with the consolidation within the banking industry, have caused community banks to lose ground in both deposits and lending.⁹³

II. THE CONSOLIDATION OF THE AMERICAN BANKING SECTOR

A. Consolidation Trends

The authors of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)⁹⁴ believed that one of the most significant causation factors in the 2008 Financial Crisis was that a small number of financial institutions had gotten “too big to fail.”⁹⁵ They were reacting to the significant consolidation in the banking sector that had taken place over the past several decades.⁹⁶

⁸⁹ George Hansard, President and CEO of the Pecos County State Bank in Fort Stockton, Texas, a \$150 million community bank, explained the market incentives: “[C]ommunity banks have no desire to make bad loans. Bad loans not only impact the bank’s bottom line, but they also negatively impact the banker’s job, the community, and are also negative to a borrower. And a bad loan makes a good customer a bad customer.” *An Examination of the Challenges Facing Community Financial Institutions in Texas: Field Hearing before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S House of Representatives*, 112th Cong. 106 (2012) (statement of George Hansard, President/CEO, The Pecos Cnty. State Bank, Fort Stockton, Texas).

⁹⁰ Hein, Scott and Macdonald, *supra* note ___ at 17.

⁹¹ Franklin Allen and Anthony M. Santomero, *What do financial intermediaries do?*, 25 JOURNAL OF BANKING & FINANCE 271 (2001).

⁹² *Id.*

⁹³ Noncommunity banks have been able to “[shift] from traditional intermediation functions to fee-producing activities” and therefore increase noninterest income. *Id.* at 279.

⁹⁴ DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁹⁵ See Testimony of Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond on *Examining How the Dodd-Frank Act Could Result in More Taxpayer Funded Bailouts*, June 26, 2013 (“The problem known as ‘too big to fail’ consists of two mutually reinforcing expectations. First, some financial institution creditors feel

By the mid-1990s ... some of the largest commercial banks appeared increasingly like the large investment banks, and all of them were becoming larger, more complex, and more active in securitization. Some academics and industry analysts argued that advances in data processing, telecommunications, and information services created economies of scale and scope in finance and thereby justified ever-larger financial institutions. Bigger would be safer, the argument went, and more diversified, innovative, efficient, and better able to serve the needs of an expanding economy. Others contended that the largest banks were not necessarily more efficient but grew because of their commanding market positions and creditors' perception they were too big to fail.⁹⁷

Between 1980 and year-end 2013, the total number of bank and thrift charters in the United States dropped from 20,000 to 6,812.⁹⁸ Nearly 3,500 institutions failed during that time period, fully 86% of all financial institution failures since the creation of the FDIC in 1934.⁹⁹ A significant amount of consolidation occurred as a result of bank mergers. Between 1990 and 2005, there were 74 mergers involving banks with assets of more than \$10 billion each.¹⁰⁰ During that time period, the ten largest banks increased their share of industry assets from 25% to 55%.¹⁰¹ The combined assets of the five largest American banks more than tripled from 1998 to 2007.¹⁰²

protected by an implicit government commitment of support should the institution face financial distress. ... Second, policymakers at times believe that the failure of a large financial firm with a high reliance on short-term funding would result in undesirable disruptions to financial markets and economic activity.); THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (January 2011) at xix.

(“Many of these institutions grew aggressively through poorly executed acquisition and integration strategies that made effective management more challenging. The CEO of Citigroup told the Commission that a \$40 billion position in highly rated mortgage securities would “not in any way have excited my attention,” and the cohead of Citigroup’s investment bank said he spent “a small fraction of 1%” of his time on those securities. In this instance, too big to fail meant too big to manage.”)

⁹⁶ Benjamin R. Backup and Richard A. Brown, *Community Banks Remains Resilient Amid Industry Consolidation*, 8 FDIC QUARTERLY 2 at 1 (2014) (“Consolidation has been a defining trend in the U.S. banking industry since around 1980.”)

⁹⁷ FCIC REPORT, *supra* note __ at 52.

⁹⁸ There are many reasons for this consolidation. “One of the most important factors driving voluntary consolidation during this period was the relaxation of restrictions on intrastate branching and interstate banking that took place in the 1980s and early 1990s. Based largely on state law, these long-standing restrictions had the effect of artificially inflating the number of banking charters, and their removal was bound to result in consolidation.” In fact, nearly 5,000 banks were consolidated within organizations from 1984 to 2011. *FDIC Community Banking Study*, *supra* note __ at II.

⁹⁹ Fed. Deposit Ins. Corp., *Failures and Assistance Transactions*, Table BF01.

¹⁰⁰ FCIC REPORT, *supra* note __ at 53.

¹⁰¹ *Id.*

¹⁰² *Id.*

At year-end 2013, there were 540 commercial banks in the United States which each held total assets in excess of \$1 billion.¹⁰³ Collectively, these “non-community banks” held 91.6% of total commercial banking assets.¹⁰⁴ Conversely, community banks constituted 90.8% of all commercial banks,¹⁰⁵ yet held only 8.4% of commercial bank total assets.¹⁰⁶

There is a meaningful size differential between the non-community banks. At year-end 2013, 5,876 domestically chartered commercial banks held nearly \$14 trillion in total assets. The five largest commercial banks held 47.3% of that sum, while the 20 largest commercial banks held \$9.1 trillion, or 65.2%.¹⁰⁷

Bank	Assets at 12/31/2001	Assets at 12/31/2013	% Increase
All Commercial Banks ¹⁰⁸	\$6.6 trillion	\$13.7 trillion	108%
JPMorgan Chase	\$538 billion ¹⁰⁹	\$1.95 trillion ¹¹⁰	262%
Bank of America	\$551 billion	\$1.43 trillion	160%
Wells Fargo	\$140 billion	\$1.37 trillion	876%
Citibank	\$452 billion	\$1.35 trillion	197%
US Bank	\$167 billion	\$360 billion	115%
Banks with assets of less than \$1 billion ¹¹¹	\$1.04 trillion	\$1.15 trillion	10.7%

Table 3: Size of Banks in December 31, 2001 and December 31, 2013

¹⁰³ FDIC Statistics Report, *supra* note ____.

¹⁰⁴ *Id.*

¹⁰⁵ Calculated by dividing 5,336 community banks by 5,876 commercial banks.

¹⁰⁶ Calculated by dividing \$1.1 trillion by \$14 trillion.

¹⁰⁷ FEDERAL RESERVE STATISTICAL RELEASE, INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE, RANKED BY CONSOLIDATED ASSETS AS OF DECEMBER 31, 2013.

<http://www.federalreserve.gov/releases/lbr/current/default.htm>

¹⁰⁸ FDIC STATISTICS ON DEPOSITORY INSTITUTIONS REPORT.

¹⁰⁹ FEDERAL RESERVE STATISTICAL RELEASE, INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$300 MILLION OR MORE, RANKED BY CONSOLIDATED ASSETS AS OF DECEMBER 31, 2013.

<http://www.federalreserve.gov/releases/lbr/current/default.htm>

¹¹⁰ FEDERAL RESERVE STATISTICAL RELEASE, INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS OF \$100 MILLION OR MORE, RANKED BY CONSOLIDATED ASSETS AS OF DECEMBER 31, 2001.

http://www.federalreserve.gov/releases/lbr/20011231/lrg_bnk_lst.pdf

¹¹¹ FDIC STATISTICS ON DEPOSITORY INSTITUTIONS REPORT.

Note that between 2001 and 2013, while the total assets held by commercial banks grew by 108%. During that period, the concentration of total assets in the four largest commercial banks increased by 244%.¹¹² The top 20 commercial banks also benefitted from this period of growth—recognizing a 183% increase in their total assets from year-end 2001 to year-end 2013.¹¹³ But a rising tide does not necessarily lift all boats equally. The assets held by community banks grew approximately 11% during that time period. In other words, consolidation widened the gulf between the very largest banks and the vast majority of banks.

Bank	% of Total Commercial Bank Assets 12/31/2001	% of Total Commercial Bank Assets at 12/31/2013
Top 5 Commercial Banks ¹¹⁴	30.0%	47.3%
Banks with assets of less than \$1 billion ¹¹⁵	15.9%	8.4%

Table 4: Relative Size of Banks by Total Assets in December 31, 2001 and December 31, 2013

Another way of looking at this phenomenon is to consider the percentage of total assets held by the five largest commercial banks versus community banks. From 2001 to 2013, the five largest commercial banks increased their share of assets from 30% to 47.3%, while community banks saw their share of assets cut in half.

As time goes on, the differences between the largest commercial banks and the community banks grow more pronounced. In 1984, the average non-community bank was 12 times larger than the average community bank.¹¹⁶ In 2011, the average non-community bank was 74 times larger.¹¹⁷ At the margins, of course, those differences are much more pronounced. Just *one* of the four largest commercial banks is larger than the 5000+ community banks combined.¹¹⁸

¹¹² *Id.* Total deposits increased by 137% during this time period. For banks larger than \$1 billion, total deposits increased by 167% while total deposits only increased by 32% in community banks. For the purposes of the FDIC Statistics on Depository Institutions reports, “total deposits” is defined as “the sum of all deposits including demand deposits, money market deposits, other savings deposits, time deposits and deposits in foreign offices.”

¹¹³ *Id.*

¹¹⁴ Derived from Federal Reserve Statistic Reports, *supra* notes ___ and ___.

¹¹⁵ Derived from FDIC Statistics on Depository Institutions Report.

¹¹⁶ *FDIC Community Banking Study, supra* note ___ at 2-9.

¹¹⁷ *Id.*

¹¹⁸ The smallest of the Big Four, Citibank, holds \$1.3 trillion in total assets, compared to \$1.1 trillion held by the community banks.

B. Does Consolidation Matter?

Although the numbers are striking, there is not universal agreement that consolidation is a bad thing. A report written by Benjamin Backup and Richard Brown of the FDIC in early 2014 concluded that “the recent uptick in the rate of consolidation is attributable to factors that are likely to subside once the effects of the crisis are fully behind us ... and ... that consolidation has had much less impact on the community banking sector than is commonly believed.”¹¹⁹ Although the study indicated that it was using the functional definition of community banks designed by the FDIC, most of the data used in the report appeared to include all federally insured banks and thrift institutions, divided into four categories: those with assets less than \$100 million, between \$100 million and \$1 billion, between \$1 billion and \$10 billion, and greater than \$10 billion.

The report noted many of the consolidation trends mentioned above. For example, one chart is labeled “All Net Consolidation in Charters Since 1985 Has Occurred Among Banks with Assets Less Than \$100 Million.”¹²⁰ It graphically depicts the following data:

Asset Size Group	Percentage Change
Less than \$100 million	-85%
\$100 million to \$1 billion	7%
\$1 billion to \$10 billion	5%
More than \$10 billion	197%

Table 5: % Change in Number of Federally Insured Banks and Thrift Institutions, 1985-2013

A more accurate (if lengthy) chart label would have been “Despite Declines in the Number of Banks Since 1985, Banks with Assets Greater than \$10 Billion Experienced Exponential Growth.” A corollary chart labeled “Only the Smallest Institutions Have Seen an Aggregate Decline in Total Assets Since 1985” graphically depicts the following data:

Asset Size Group	Percentage Change
Less than \$100 million	-76%
\$100 million to \$1 billion	27%
\$1 billion to \$10 billion	4%
More than \$10 billion	972%

Table 6: % Change in Total Assets, 1985-2013

¹¹⁹ Benjamin R. Backup and Richard A. Brown, *Community Banks Remain Resilient Amid Industry Consolidation*, 8 FDIC QUARTERLY 33 (2014).

¹²⁰ Backup and Brown, *supra* note ___ at 36.

A key assertion of the report is that banks with assets between \$100 million and \$10 billion have “increased in number and total assets” and that this “somewhat overlooked” fact suggests “relative stability.”¹²¹ This is significant, the report argues, because at year-end 2013, 68% of community banks had assets between \$100 million and \$10 billion. Unfortunately, the report does not break out the data for the community banks compared to the non-community banks in this large group, nor does it appear to separate out thrifts.

The report also emphasized that a 2012 FDIC report on economies of scale suggests that “most of the cost benefits from scale appear to be achieved for community banks with as little as \$100 million in assets. ... As such, economies of scale do not appear to be working against the majority of community banks.”¹²² It concludes:

The post-crisis period has brought renewed debate as to the future pace of banking industry consolidation and the possible implications for community banks. Despite the concerns of some that a period of heightened consolidation could diminish the prospects of community banks, there are several reasons to think that these concerns may be significantly overstated.¹²³

That optimistic conclusion does not appear to be shared by many in the community banking sector. The 2014 Mercatus Center Small Bank Survey found that 95% of community bankers anticipate consolidation activity to continue over the next five years, and more than 25% anticipate that their own banks will participate in a merger.¹²⁴ As Jeff Plagge, Chairman of the American Bankers Association, recently told a Senate committee:

It is not unusual to hear bankers – from strong, healthy banks – say they are ready to sell because the regulatory burden has become too much to manage. These are good banks that for decades have been contributing to the economic growth and vitality of their towns, but whose ability to continue to do so is being undermined by excessive regulation and government micro-management. Each bank that disappears from the community makes for fewer opportunities in that community.¹²⁵

¹²¹ Backup and Brown, *supra* note ___ at 36.

¹²² Backup and Brown, *supra* note ___ at 37 citing Jacewitz, Stefan and Paul Kupiec. Community Bank Efficiency and Economies of Scale, FDIC Special Study, December 2012. <http://www.fdic.gov/regulations/resources/cbi/report/cbi-eff.pdf>.

¹²³ Backup and Brown, *supra* note ___ at 10.

¹²⁴ HESTER PEIRCE, IAN ROBINSON, AND THOMAS STRATMANN, HOW ARE SMALL BANKS FARING UNDER DODD-FRANK?, MERCATUS CENTER WORKING PAPER NO. 14-05 56 (February 2014)

¹²⁵ TESTIMONY OF JEFF PLAGGE, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, UNITED STATES SENATE 3 (September 6, 2014).

A 2013 survey of community bankers by KPMG corroborates that testimony.¹²⁶ Nearly two-thirds of surveyed bankers reported that it as “likely” that their bank would be involved in a merger or acquisition within the next year. KPMG asked a sample of community bankers what “minimum asset level a community bank needs to remain independent” in the current regulatory and economic environment. More than 75% of respondents answered \$1 billion or more.¹²⁷ The KPMG findings are not an aberration.

The question is, how big is big enough? There was a time when it was generally accepted that a \$150 million asset bank was sufficiently profitable. Now many bankers (especially investment bankers) say that a strong bank needs at least \$1 billion in assets, and some believe that banks need to be at the \$5 billion mark to be sufficiently profitable.¹²⁸

There are several reasons that a community bank might consider merger. The main reasons usually cited are interest rate risk, low loan demand, and regulatory burden.¹²⁹ There is evidence that before Dodd-Frank, compliance costs imposed a significant burden on community banks. A 2004 study concluded that “the cost of complying with just 13 federal regulations was approximately \$3.2 billion, or roughly 24 percent of banks’ income before taxes.”¹³⁰

Community bankers have repeatedly expressed concern that Dodd-Frank will impose new and costly regulatory compliance burdens on community banks. Both the GAO and FDIC, in reports released in September 2012 and December 2012, respectively, concluded that it is impossible at this time to quantify the costs that community banks will

¹²⁶ KPMG LLP, 2013 COMMUNITY BANKING INDUSTRY OUTLOOK SURVEY 12 (2013) <https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/community-banking-industry-outlook-survey-2013.pdf>

¹²⁷ KPMG, *supra* note __ at 14.

¹²⁸ Adam R. Lewis, *North Carolina Community Banks: Survival Strategies for Turbulent Times*, 17 N.C. BANKING INST. 333, 350-51 (2013)

¹²⁹ See, e.g. Kathryn Reed Edge, *Congratulations, It's A Merger!*, TENN. B.J., July 2014, at 22 (“Bankers lament more about the increased cost of consumer compliance regulation than they do about interest rate risk and lack of loan demand. Spreadsheets and balance sheets make sense to them; piling on new, complex and mostly baffling regulations designed to protect consumers from big, bad banks are an increasing source of anger and frustration.”); Alan J. Wilson, *There Goes the Neighborhood: Regulating Away the Community Bank—An Analysis of the Costs of Current Regulations on Community Banks*, 116 W. VA. L. REV. 463, 464 (2013) (“Left unaddressed, the regulatory burdens facing community banks could regulate away their existence.”); Ryan T. O’Shields, *Historic Literature Presages Dodd-Frank Act As A Death Knell for Community Banks*, 67 CONSUMER FIN. L.Q. REP. 326, 327 (2013) (“[T]oday community banks are faced with unprecedented legal and regulatory threats to their continued functioning and even their existence, including particularly the daunting task of 21st century regulatory compliance and the other legal risks either created or increased by the Dodd-Frank Act, a statute which coincidentally also hamstring the ability of community banks to finance that compliance. Forget ‘too big to fail’; the more significant question today is whether community banks are too small to survive.”).

¹³⁰ Dreyer and Weinstock, *supra* note __ at 100, citing Susan E. Dudley, *The Hidden Tax of Regulation* (2004) (unpublished research paper prepared for the George Mason University, Regulatory Studies Program).

incur as a result of Dodd-Frank. There are approximately 8,040 pages of final rules and an additional 6,112 pages of proposed rules.¹³¹ Even though some rules specifically exempt community banks, either broadly or under a specific set of circumstances, it is not an insignificant burden to read those rules (or, more likely, to hire a consultant or attorney to read those rules) and determine whether they apply.

A 2013 study by Ron Feldman, Ken Heinecke, and Jason Schmidt attempted to quantify the cost of the post-Dodd-Frank regulatory burden.¹³² It did so by “modeling the impact of new regulatory costs as the hiring of additional staff, resulting in higher total compensation and lower profitability.”¹³³ The analysis concluded that:

[T]he impact on profitability is most significant for the smallest institutions. The median bank with assets below \$50 million would experience a drop in [return on assets] of nearly 23 basis points, while the median firms in the larger size cohorts would encounter a decline of 11 basis points or less.¹³⁴

As a result:

Nearly 60 percent of the total number of banks that would become unprofitable due to the regulatory change are in the smallest cohort using data from 2012. Moreover, 13 percent of the banks with assets less than \$50 million would become unprofitable, compared with roughly 2 percent or less of the other size groups.¹³⁵

Regardless of whether the cumulative regulatory burden post-Dodd-Frank *actually* increases compliance costs and pushes stressed community banks into mergers, the KPMG and Mercatus Center surveys demonstrate that community bankers certainly *believe* that to be the case, and that belief is encouraging consideration of mergers.

With increasing volumes of banking regulations, banks are using more capital to comply with voluminous and rapidly evolving regulations. The additional compliance cost includes the time spent by employees who are working more on compliance matters than on building client relationships. Additional time spent on regulatory compliance increases the cost of compliance and reduces hours available to focus on client relationships. This decreases the amount of a bank’s loanable funds and decreases the opportunity to sell to bank customers. Coupled with low interest rates, this

¹³¹ TESTIMONY OF JEFF PLAGGE, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, UNITED STATES SENATE 2 (September 6, 2014).

¹³² Ron Feldman, Ken Heinecke, and Jason Schmidt, Quantifying the Costs of Additional Regulation on Community Banks, Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis (2013).

¹³³ Id. at 2.

¹³⁴ Id. at 6.

¹³⁵ Id. at 8.

scenario greatly impacts the profitability of traditional loan and deposit banking services.¹³⁶

Consolidation is a decades-long trend that has reduced the numbers and assets of small banks relative to large banks. It has changed the way that we view community banks. Although they are broadly acknowledged to serve a valuable role in their communities, in comparison to large banks they look anemic. But the challenges faced by community banks are not wholly as a result of a modernizing economy. The federal government has played a role in distorting the market.

III. FEDERAL POLICIES AND MARKET DISTORTIONS

Despite the focus on compliance costs and regulatory burdens, the one-size-fits-all regulatory system is not the only federal policy that is presenting a challenge to community banks. This paper briefly discusses two: (A) policies which advantage and subsidize competitors, and (B) policies which incentivize investment in the capital markets rather than depository institutions.

A. Subsidizing Competitors

Federal policy subsidizes two main competitors of community banks: LCFIs and credit unions.

1. *Large, complex financial institutions (LCFIs)*

LCFI's enjoy both explicit and implicit advantages, courtesy of federal policy, due to their size and business model.¹³⁷ As noted in Part II, large institutions benefit from economies of scale, so a one-size-fits-all regulatory scheme inherently advantages large institutions at the expense of smaller ones. In a February 2013 note to clients, Citi financial services analyst Keith Horowitz described a conversation with JPMorgan Chase CEO Jamie Dimon regarding the impact of new regulations on the financial services sector:

[Dimon] . . . pointed out that while margins may come down, market share [for JP Morgan] may increase due to a 'bigger moat.' . . . In Dimon's eyes, higher capital rules, Volcker, and OTC derivative reforms longer-term make it more expensive and tend to make it tougher for smaller players to enter the market, effectively widening JPM's 'moat.' While there will be some drags on profitability—as prices and margins narrow, efficient scale players like JPM should eventually be able to gain market share.¹³⁸

¹³⁶ Wilson, *supra* note ___ at 464-5.

¹³⁷ Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform that Could Solve the Too-Big-To-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates*, 31 No. 3 BANKING & FIN. SERVICES POL'Y REP. 1 (2012)

¹³⁸ Jessica Pressler, *122 Minutes with Jamie Dimon*, New York Magazine, August 12, 2012, <http://nymag.com/news/intelligencer/encounter/jamie-dimon-2012-8/>.

When an “efficient scale player” tells investors that it anticipates increasing market share due to compliance costs – that’s a government-created market distortion.

Scholars have noted that LCFIs have pursued “aggressive growth strategies” since the 1999 Gramm-Leach-Bliley Act in order to reach a size at which they would be considered to be too big to fail.¹³⁹ They have been motivated both by explicit safety net subsidies including federal deposit insurance and access to the Federal Reserve’s liquidity assistance, and an “implicit [too big to fail] subsidy by using lower-cost funds to finance high-risk activities.”¹⁴⁰ Advocates of narrow banking argue that LCFIs have been exploiting federal deposit insurance for years by using the “regulatory canopy to undertake more complex and dangerous innovations.”¹⁴¹ As the 2008 financial crisis demonstrated, this “proliferation of financial products increased risks substantially. Futures and swaps were used not just to hedge risks, but increasingly to take large bets with little money down.”¹⁴² As Amar Bhidé argues, “[w]ithout deposit insurance—and the reassurances state supervision—most depositors, even sophisticated ones, would shun banks that traded futures. Paltry passbook rates simply wouldn’t compensate for the risks.”¹⁴³

The “implicit [TBTF] subsidy” has been confirmed by a recent study that concluded that “investors did not price the true, intrinsic ability of a [big] bank to repay its debts, but instead priced implicit government support of the bank.”¹⁴⁴ The authors of the study also concluded that “[t]he passage of Dodd-Frank in July of 2010 did not eliminate investors expectation of government support. In fact, expectations of government support rose in 2010 [compared to 2009].”¹⁴⁵ Although the authors of Dodd-Frank made it very clear that the federal government will not bail out systemically important financial institutions in the future, the market is equally clear that it does not believe this to be true.¹⁴⁶

LCFIs are also advantaged because of the manner in which consumer protection laws are structured and enforced. Although consumer protection laws are well-intentioned and address real problems, we should evaluate whether those laws need to be uniformly applied to all banks. If consumer protection laws are too expansive, they cause “disclosure fatigue” on the part of consumers and are so expensive that banks curtail certain lines of

¹³⁹ Wilmarth, *supra* note __ at 5-6

¹⁴⁰ Wilmarth, *supra* note __ at 4.

¹⁴¹ Amar Bhidé, *In Praise of More Primitive Finance*, ECONOMISTS’ VOICE (2009)

¹⁴² Bhidé at 4.

¹⁴³ Bhidé at 3.

¹⁴⁴ Wilmarth, *supra* note __ at 4 citing A. Joseph Warburton & Daniz Anginer, “The End of Market Discipline? Investor Expectations of Implicit State Guarantees” (Nov. 18, 2011), available at <http://ssrn.com/abstract=1961656>.

¹⁴⁵ *Id.*

¹⁴⁶ In fact, as Professor Arthur E. Wilmarth has noted, “[D]odd Frank does not completely shut the door to future government bailouts for creditors of SIFIs.” Wilmarth, *supra* note __ at 1-2.

business. But different kinds of firms have different levels of tolerance to compliance costs. The better approach would be to conduct a cost-benefit analysis of consumer protection rules as applied to different kinds of financial intermediaries.

There is little evidence that community bankers engage in predatory lending or other anti-consumer practices. Community banks are dependent upon the goodwill of their customers and their continued good reputation in their communities. In other words, market forces do much to protect the customers of community banks. It is certainly arguable that market forces do more to protect the customers of community banks than pages and pages of mandatory disclosures that few customers even read. With this in mind, we should ask whether there should be safe harbors from certain reporting and disclosure requirements for community banks below a certain size.

We should also question whether consumer protection laws should be federal rather than state. One observer argued that federal preemption of state consumer protection laws before the 2008 financial crisis created a “race to the bottom,” which permitted the predatory lending and abusive practices in subprime lending.¹⁴⁷ This pattern of preemption continued in Section 1044 of Dodd-Frank.¹⁴⁸ Federal rather than state consumer protection statutes favor large banks, which need consistency for their interstate operations, over small banks, which generally operate in a single state. This is particularly true in the era of the Consumer Financial Protection Bureau, which has signaled that it views standardization as a primary means of protecting consumers.¹⁴⁹ Standardization advantages LCFIs over community banks because it lends itself to transactional banking rather than relationship banking.¹⁵⁰

¹⁴⁷ Danyeale L. Hensley, *Section 1044 of Dodd-Frank: When Will State Laws Be Preempted Under the OCC's Revised Regulations?*, 16 N.C. BANKING INST. 161, 162 (2012)

¹⁴⁸ *Id.*

¹⁴⁹ Esther George, President and CEO, Federal Reserve Bank of Kansas City, *Can Community Banks Still Compete?* (November 2, 2012) (“[T]he Consumer Financial Protection Bureau will be rewriting many of the key regulations related to mortgage lending. This approach of specifying how residential mortgage loans should be structured and underwritten will undoubtedly leave community bankers with far less flexibility and authority to tailor such lending to the characteristics of their communities and customers. ... [I]t is not uncommon to hear community bankers say that they may be forced to cut back substantially on their home lending activities or even eliminate them entirely. Such unintended consequences are costly and impede mortgage lending at a time when housing markets are weak.”)

¹⁵⁰ Letter from Craig G. Blunden, Chair, Pres. & CEO, Provident Savs. Bank, et al., to Timothy F. Geithner, Secretary, U.S. Dept. of the Treasury 2 (Aug. 18, 2009), http://www.aba.com/aba/pdf/gr/CFPA_Geithner_081809.pdf (“Commoditization, contrary to the administration’s assertions, will favor large institutions with economies of scale and larger advertising budgets.”).

2. Credit Unions

There are approximately 7,300 credit unions in the United States, with total assets of approximately \$915 billion.¹⁵¹ Approximately 81% of credit unions hold less than \$100 million in total assets, but over 350 hold more than \$500 million in assets.¹⁵² The cohort of “large” credit unions have an average of \$1.55 billion in total assets per credit unions.¹⁵³ The differences between large credit unions and small credit unions is similar to the differences between community banks and LCFIs.

A distinct difference exists in the performance among the different asset groups. ... [S]maller credit unions are having the greatest challenge with earnings, loan growth, overall delinquency, and membership growth. The larger credit union categories benefit from their economies of scale, as reflected in lower operating expense ratios, and generate greater net income due to these efficiencies.¹⁵⁴

Credit unions were created to provide credit to rural customers, mainly farmers, who had difficulty accessing credit from traditional banks.¹⁵⁵ Credit unions were initially restricted in two key ways: (1) members of credit unions were required to have a “common bond,” which was intended to create incentives for repayment and thus reduce the cost of credit; and (2) credit unions were not permitted to pay interest above a certain rate.¹⁵⁶ In 1937, Congress granted tax exemptions to credit unions, reasoning that subjecting them to the same taxes as commercial banks would place “a disproportionate and excessive burden on the credit unions.”¹⁵⁷ These tax exemptions have been described as a “critical government subsidy.”¹⁵⁸ Congress’ goal was not to “shield banks from competition from credit unions” but to “encourage the proliferation” of credit unions.¹⁵⁹

¹⁵¹ NATIONAL CREDIT UNION ADMINISTRATION, 2010 YEAREND STATISTICS FOR FEDERALLY INSURED CREDIT UNIONS 11.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ Mehrsa Baradaran, *How the Poor Got Cut Out of Banking*, 62 *Emory L.J.* 483, 500 (2013); William R. Emmons & Frank A. Schmid, *Credit Unions and the Common Bond*, 81 *Rev.* 41, 43 (1999) (“Historically, members of credit unions were drawn from groups that were underserved by traditional private financial institutions; these consumers tended to have below-average incomes or were otherwise not sought out by banks.”).

¹⁵⁶ Mehrsa Baradaran, *How the Poor Got Cut Out of Banking*, 62 *Emory L.J.* 483, 503 (2013) (“Congress intended the common bond among the members of a credit union to create “a cohesive association in which the members are known by the officers and by each other in order to ‘ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default.’” Such a cohesive association theoretically allowed “credit unions, unlike banks, [to] ‘loan on character.’”)

¹⁵⁷ Baradaran, *supra* note ___ citing 82 *Cong. Rec.* 358 (1937) (statement of Rep. Steagall); Federal Credit Union Act Amendments, ch. 3, 51 *Stat.* 4, 4 (1937) (amending section 18 of the Federal Credit Union Act).

¹⁵⁸ Baradaran, *supra* note ___ at 502.

¹⁵⁹ *First Nat. Bank & Trust Co. v. Nat’l Credit Union Admin.*, 988 F.2d 1272, 1275 (D.C. Cir. 1993) (“We agree with the district court, however, that Congress did not, in 1934, intend to shield banks from competition from

In 1982, the National Credit Union Administration issued an interpretative statement that significantly loosened the common bond requirement. This “naturally led to increased credit union size, services, and competitive advantage.”¹⁶⁰ In 1998, the Supreme Court struck down the NCUA’s broad interpretation of the common bond requirement.¹⁶¹ Congress responded swiftly with the Credit Union Membership Access Act, which incorporated the NCUA’s interpretation of the common bond requirement into the statute.¹⁶²

Credit unions today are operationally quite similar to commercial banks – from a consumer’s perspective they may be indistinguishable.¹⁶³ Jeff Plagge, Chairman of the American Bankers Association, recently remarked that credit unions “have morphed into full banks in disguise.”¹⁶⁴ He noted that there are over 200 credit unions with assets of more than \$1 billion, each of which is larger than 90% of the commercial banks.¹⁶⁵ Still, however, credit unions enjoy a crucial tax advantage over community banks.

3. *Regulate and Tax Based on Size, not Form*

Community banks therefore are inevitably disadvantaged by federal policy with respect to LCFIs because of their size, and with respect to credit unions because of their form. One policy solution would be to treat financial intermediaries that are depository institutions more uniformly, and then distinguish between them on the basis of size.

This kind of approach would mean that smaller depository institutions (community banks and credit unions alike) would be subject to less regulation and lower compliance costs. It would also open the door to use tax policy to assist smaller community banks in overcoming their disadvantage due to economies of scale. Allow credit unions to grow, but eliminate their tax advantage once they become “large enough.” At the same time, give smaller community banks, which are the most vulnerable and often the most essential to

credit unions. Indeed, the very notion seems anomalous, because Congress' general purpose was to encourage the proliferation of credit unions, which were expected to provide service to those would-be customers that banks disdained.”)

¹⁶⁰ Baradaran, *supra* note ___ at 506 (“After this expansive interpretation, the membership in credit unions increased by 30% from 1982 until 1998. ... The number of credit unions grew fourfold from 1982 until the mid-1990s and combined to control nearly \$330 billion in funds from 70 million members. ... This growth has been primarily attributed to attracting customers from outside the typical common bond requirement. For example, nearly two-thirds of all the members in the AT&T Family Federal Credit Union do not work for AT&T and are considered outside of the company.”)

¹⁶¹ First Nat’l Bank & Trust Co., 522 U.S. 479 (1998).

¹⁶² Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998).

¹⁶³ Baradaran, *supra* note ___ at 508-509.

¹⁶⁴ TESTIMONY OF JEFF PLAGGE, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, UNITED STATES SENATE 12 (September 6, 2014).

¹⁶⁵ *Id.*

the communities that they serve, the kinds of tax advantages that have long been granted to credit unions for the very same reasons.

B. The Growth of Capital Markets

In addition to competition from depository institutions, community banks face competition from non-depository institutions that fund debt through the capital markets.¹⁶⁶ Community banks have been hit on both sides of their intermediation equation – they have lost deposits to various kinds of tax-advantaged securities and accounts, and they have lost creditworthy borrowers to the securitization pipelines. All of this activity has been incentivized by federal policy.

1. Savings vs. Investing

In 2014, no one puts their money in a deposit account and expects to earn a high return. The sustained low interest rate environment has been hard on traditional savings accounts. Nevertheless, traditional deposit accounts are attractive because of their liquidity and safety, thanks to FDIC insurance. Therefore, if the rates of return on a traditional deposit account were roughly equivalent to the rates of return on a mutual fund, it would be reasonable to expect households to put their money in the more liquid and safer of the two options. But in addition to the burden of low interest rates, deposit accounts are disadvantaged by tax policies that were designed to incentivize savings and investment.¹⁶⁷

Federal tax policy reduces the rate of return from traditional saving via deposit accounts, and therefore disadvantages them, in two ways: (1) favorable capital gains tax treatment is not available for interest on deposit accounts, even for sums held in a deposit account over the long term; and (2) the tax-advantages granted to a variety of retirement savings strategies.¹⁶⁸ Though neither are recent developments, both tax policies are incredibly significant and have contributed to consolidation.

¹⁶⁶ Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. Rev. 1, 20 (2010) (“[There are] two significant trends in the financial markets. First, ... a move from regulated [e.g., banks and insurance companies] to less-regulated intermediaries [e.g. securities firms and hedge funds], as well as from traditional products and services [e.g. letters of credit and insurance] to lower-cost alternative, in many cases through the capital markets. [e.g. securitization and CDSs]. Consequently, traditional intermediaries have experienced a decline in market share – with banks, notably, losing ground to less-regulated businesses, and the securities markets becoming a lower-cost source of capital and risk-bearing.”)

¹⁶⁷ Steven Maguire, CRS Report for Congress: *Consumption Taxes and the Level and Composition of Saving* (October 19, 1999) Traditional deposit accounts “generally do not possess any income tax advantages.”

¹⁶⁸ Steven Maguire, CRS Report for Congress: *Consumption Taxes and the Level and Composition of Saving* (October 19, 1999) (“The current tax code clearly favors some types of saving over others. Most economists would suggest that the variety of saving instruments available has complicated the tax code and created distortions in taxpayer behavior.”)

A lower tax rate for capital gains is clearly intended to incentivize investments.¹⁶⁹ It is properly viewed as a disadvantage for community banks for several reasons. First, households allocate their resources between savings and consumption. Investment is more likely to be a substitution for savings rather than consumption.¹⁷⁰ Second, an “investment” in a deposit account is no less an investment in economic growth than an investment in a diversified fund. After all, deposits don’t just sit in the bank vault. They are loaned out to businesses, and households. There doesn’t appear to be any principled reason to differentiate between \$100 placed in a deposit account that is used to fund commercial real estate loans and \$100 used to purchase shares in a mortgage Real Estate Investment Trust. The REIT doesn’t pay corporate tax, and the \$100 in each case is going to fund the same activity. But the tax code incentivizes investment in the more illiquid, uninsured REIT.

There has been significant concern in the past four decades that Americans do not save enough.¹⁷¹ The federal government responded with the creation of tax-preferred methods of retirement savings including Individual Retirement Accounts, 401(k) plans, and Keogh plans. These mechanisms were designed as “savings incentives.”¹⁷² It is not clear that they have accomplished their main goal.

The extent to which increased use of tax-favored retirement plans affects the total personal savings rate ... is an area of contentious debate. Most economists agree that retirement saving through tax-favored plans is offset to some extent by decreased saving or dis-saving (i.e., going into debt) in other areas. Despite widespread agreement that a substitution effect exists, the extent of this substitution is controversial.¹⁷³

The data clearly shows that a substitution effect exists. In the past three decades (1983 – 2013), household financial assets have been increasingly diverted from deposit accounts held at banks into investments in securities, corporate equities, mutual funds, and

¹⁶⁹ Nohel B. Cunningham & Deborah H. Schenk, *The Case for A Capital Gains Preference*, 48 TAX L. REV. 319, 377-78 (1993) (“Most individuals must decide how much they should save and how much they should consume, a decision based, at least in part, on the expected return on the savings. A preference increases the after-tax return on savings and thus saving becomes more attractive as compared to current consumption. Thus, most economists believe that raising the rate of return would result in more private savings.”)

¹⁷⁰ See, e.g. Tim Parker, *7 Easy to Understand EFTs to Replace a Savings Account*, Investopedia (January 25, 2013) (“Keeping money in a savings account might feel safe, but its value is eroding due to inflation. That might change in future years as interest rates rise, but for now, a relatively safe way to put your money to work is through ETFs.”)

¹⁷¹ EMPLOYEE BENEFIT RESEARCH INSTITUTE, EBRI DATABOOK ON EMPLOYEE BENEFITS, CHAPTER 1: EMPLOYEE BENEFITS IN THE UNITED STATES, AN INTRODUCTION at 6.

¹⁷² ERIC M. ENGEN, WILLIAM G. GALE, JOHN KARL SCHOLZ, THE EFFECTS OF TAX-BASED SAVING INCENTIVES ON SAVING AND WEALTH, NBER WORKING PAPER SERIES, WORKING PAPER 5759 (September 1996).

¹⁷³ EMPLOYEE BENEFIT RESEARCH INSTITUTE, EBRI DATABOOK ON EMPLOYEE BENEFITS, CHAPTER 9: PERSONAL SAVINGS; See also ENGEN, GALE AND SCHOLZ, *supra* note ___ at 45 (“We find that saving incentive plans have had little if any effects on household saving behavior. ... In particular, we show that each finding that saving incentives raise saving can be traced to various biases that overstate the effects of savings incentives, and that removing the biases also removes the positive effect of the incentive on savings.”)

retirement plans. In 1983, household investments in deposit accounts represented 177% of household investments in corporate equities and mutual funds. By 2013, household investments in deposit accounts had dropped to 47% of household investments in corporate equities and mutual funds.

During this period, household financial assets increased by 626%, but deposits increased by only 353%. Household investment in corporate equities and mutual funds, however, skyrocketed during this period, increasing by 1115% and 6930%, respectively. Meanwhile, pension entitlements increased by 741% and household retirement assets (including insurance reserves) increased 948%.

	Q4 1983	Q4 2013	Percentage increase
Total financial assets	\$9.2 trillion ¹⁷⁴	\$66.5 trillion ¹⁷⁵	626%
Deposits	\$2.1 trillion ¹⁷⁶	\$9.6 trillion ¹⁷⁷	353%
Corporate equities	\$1.1 trillion ¹⁷⁸	\$13.3 trillion ¹⁷⁹	1115%
Mutual fund shares	\$98 billion ¹⁸⁰	\$6.9 trillion ¹⁸¹	6931%
corporate equities plus mutual funds	\$1.2 trillion	\$20.2 trillion	1593%
Household retirement assets ¹⁸²	\$2.4 trillion ¹⁸³	\$25.4 trillion ¹⁸⁴	958%

Households shifted their savings from deposit accounts to the capital markets because they were incentivized to do so through federal tax policy.¹⁸⁵

¹⁷⁴ FEDERAL RESERVE STATISTICAL RELEASE, Z.1 FINANCIAL ACCOUNTS OF THE UNITED STATES, HISTORICAL ANNUAL TABLES 1975-1984 (hereinafter “Historical Annuals”), L.100 *Households and Nonprofit Organizations*, Line 1, page 61

¹⁷⁵ FEDERAL RESERVE STATISTICAL RELEASE, Z.1 FINANCIAL ACCOUNTS OF THE UNITED STATES, FIRST QUARTER 2014 (hereinafter, “2014 Z.1”), L.100 *Households and Nonprofit Organizations*, Line 1, page 66

¹⁷⁶ HISTORICAL ANNUALS, L.100 at Line 2

¹⁷⁷ 2014 Z.1, L.100 at Line 2

¹⁷⁸ HISTORICAL ANNUALS, L.100 at Line 16

¹⁷⁹ 2014 Z.1, L.100 at Line 16

¹⁸⁰ HISTORICAL ANNUALS, L.100 at Line 17

¹⁸¹ 2014 Z.1, L.100 at Line 17

¹⁸² Households’ retirement assets in tax-deferred accounts, including employer sponsored pension plans, IRAs, Roth IRAs, and annuities.

¹⁸³ HISTORICAL ANNUALS, L.116 *Private and Public Pension Funds* at Line 21, page 75

¹⁸⁴ 2014 Z.1, L.116 *Private and Public Pension Funds* at page 80 at Line 21 (including defined benefit plans, defined contribution plans, individual retirement plans, and annuities at life insurance companies)

Without a doubt, pension funds play an important role in our capital markets and the global economy. This is due, in part, to the fast growth in pension fund assets, both in the public and private sectors.

For example, since 1993, total public pension fund assets have grown from about \$1.3 trillion to over \$4.3 trillion in 2011. Over that same period, total private pension fund assets more than doubled from roughly \$2.3 trillion to over \$6.3 trillion by 2011. As of December 2013, total pension assets have reached more than \$18 trillion. This growth was fueled by many factors, including the rise in government support of retirement benefits, and the increased use by companies of pension plans as a way to supplement wages.¹⁸⁶

That massive transfer of capital needed to be put to work, sparking a period of “rapid change in the financial markets.”¹⁸⁷

2. *Asset Securitization: Residential Mortgage Lending*

Once upon a time, commercial banks were the primary lenders in every segment of the American economy. The relative decreases in deposits, and the growth of securitization have led to a “dramatic shift in the way loans to households and businesses are being financed.”¹⁸⁸ Residential mortgage lending is a bellweather example.

The residential mortgage lending market has evolved significantly over the past century, spurred in large part by government action. That government action has been designed to encourage homeownership, to make it fairer and more broadly available. It is debatable whether those policies have been achieved those goals. Clearly, however, those policies have dramatically reduced the role of community banks in underwriting and

¹⁸⁵ Employee Benefit Research Institute, EBRI Databook on Employee Benefits, Chapter 1: Employee Benefits in the United States, An Introduction, at 1 (“Voluntary employment-based benefit programs became more prevalent as federal tax preferences for employee benefits coincided with rising tax rates, strengthening incentives to provide private benefits.”)

¹⁸⁶ Commissioner Luis A. Aguilar, Securities and Exchange Commission, Evaluating Pension Fund Investments Through The Lens Of Good Corporate Governance (June 27, 2014) http://www.sec.gov/News/Speech/Detail/Speech/1370542193403#_ednref4

¹⁸⁷ Whitehead, *supra* note ___ at 3; See also Katherine Samolyk, *The Future of Banking in America: the Evolving Role of Commercial Banks in U.S. Credit Markets*, 16 FDIC Banking Review 29, 58 (2004) (“On the asset side of nonfinancial-sector balance sheets there have also been fundamental changes in the way individuals hold financial assets, particularly as changes in pension regulations and the availability of mutual funds took hold during the 1980s.”)

¹⁸⁸ Samolyk, *supra* note ___ at 29 and 34 (“In recent decades, the volume of credit-market debt—specifically, marketable securities—issued by financial firms has grown dramatically. Currently, a third of total outstanding credit-market debt is now issued by financial intermediaries, and asset securitization accounts for a large share of this debt. Thus, as lower costs make it increasingly feasible to standardize, unbundle, and repackage credit flows and risks, loans that used to be funded by traditional lenders are increasingly being funded in securities markets.”)

providing residential mortgage loans, and increased the role of capital markets and the largest banks.

Before the Great Depression, residential mortgage lending was mainly provided by commercial banks and savings and loan institutions.¹⁸⁹ These loans were funded by deposit accounts.¹⁹⁰ During this time period, residential mortgages were generally short-term (typically 5-10 years), 50% or lower loan-to-value ratios, with floating interest rates and balloon payments of principal upon maturity.¹⁹¹

During the Great Depression, property values declined 50%. Short-term loans matured and lenders refused to refinance. The inevitable result was foreclosure. At one point, almost 10% of homes in the United States were in foreclosure.¹⁹² The federal government intervened in a number of ways. Significantly, it created the Home Owner's Loan Corporation (HOLC), which purchased defaulted mortgages and then reinstated them, converting variable-rate, short-term, non-amortizing loans into fixed-rate, long-term, fully amortizing mortgages.¹⁹³ These actions strongly influenced norm-setting. The Consumer Financial Protection Bureau's definition of a "Qualified Mortgage" in 2014 reflects these same ideas: a safe mortgage is fixed-rate, fully-amortizing, and long-term (but not too long-term).¹⁹⁴

In the 1940s and 1950s, commercial banks and savings and loans continued to be the primary funders of residential mortgages.¹⁹⁵ Deposits, insured by the FDIC, were the source of funding, which kept interest rates low.¹⁹⁶ Problems arose in 1966 when Treasury bond yields rose for the first time in decades. Deposits flowed out of banks and into Treasury bonds, which caused a mortgage liquidity problem. The government responded in 1968 and 1970 by creating Fannie Mae and Freddie Mac to promote liquidity and stability through mortgage securitization.¹⁹⁷ In 1976, residential mortgage debt totaled \$489 billion, of which 5.7% was securitized. Banks and thrifts were further challenged in

¹⁸⁹ Richard K. Green and Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERS. 93, 97 (Fall 2005)

¹⁹⁰ *Id.*

¹⁹¹ Green and Wachter, *supra* note ___ at 94.

¹⁹² Green and Wachter, *supra* note ___ at 94-5.

¹⁹³ *Id.* at 95.

¹⁹⁴ Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 12 CFR 1026.43(e), (f) <http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/>

¹⁹⁵ Green and Wachter, *supra* note __ at 97.

¹⁹⁶ Green and Wachter, *supra* note ___ at 97. ("Fixed-rate mortgages typically paid between 5 and 6 percent in the market. Between 1945 and 1966, yields on three-month Treasury bills never rose above 4 percent. Depository institutions could thus raise capital from depositors, who could get a safe government-protected yield and a higher return than Treasury bills by putting their funds in a depository institution.")

¹⁹⁷ Green and Wachter, *supra* note 98; Samolyk, *supra* note ___ at 34.

the 1970s by inflation, a federal rule that limited the interest rates that could be paid to depositors, and the influx of competing savings vehicles such as money market funds, pension funds, and mutual funds.¹⁹⁸ Securitization quickly became “a dominant source of funds for long-term residential mortgages.”¹⁹⁹ By 2003, the amount of residential mortgage debt had risen to \$7.3 trillion, of which 57.5% was securitized.²⁰⁰

Today, although residential mortgages remain an important asset for banks,²⁰¹ the origination of residential mortgage lending has become highly concentrated and is more likely to be funded through capital markets than deposits.²⁰² In 2006, approximately 63% of all residential mortgages were originated through the wholesale channel; 53% of wholesale origination was through correspondent relationships.²⁰³

LCFIs benefit from the increase in securitization two ways. First, securitization is a process that is tailor made for commodified, transactional banking. As a result, a small number of institutions dominate originations. A 2011 study determined that 96% of all residential mortgage originations in 2006 were carried out by 40 lenders, and 10 lenders were responsible for 65% of mortgage originations.²⁰⁴

[B]ased on available estimates, approximately \$25 trillion of structured-finance securities and related derivatives were outstanding in the U.S. financial markets at the peak of the credit boom in 2007. Eighteen giant LCFIs, including ten U.S. and eight foreign financial institutions, originated the lion's share of those complex instruments. Structured-finance securities and related derivatives not only financed but also far exceeded about \$9 trillion of risky private-sector debt that was outstanding in U.S. financial markets when the credit crisis broke out.²⁰⁵

¹⁹⁸ *Id.* at 98

¹⁹⁹ *Id.* at 99.

²⁰⁰ Elena Loutschina and Philip E. Straham, *Securitization and the Declining Impact of Bank Finance on Loan Supply: Evidence from Mortgage Originations* 6 (January 2008)
<https://www.imf.org/external/np/seminars/eng/2008/fincycl/pdf/loustr.pdf>

²⁰¹ RICHARD STANTON, JOHAN WALDEN, NANCY WALLACE, *THE INDUSTRIAL ORGANIZATION OF THE U.S. RESIDENTIAL MORTGAGE MARKET* 27 (November 4, 2013)
http://faculty.haas.berkeley.edu/walden/HaasWebpage/18_mortgageio.pdf

²⁰² Stanton, *supra* note ___ at 30. (“[T]he residential single-family mortgage origination market ... is highly concentrated, dominated by the direct origination and funding activities of a small number of firms.”)

²⁰³ Stanton, *supra* note ___ at 3. In correspondent wholesale lending, a firm (the correspondent) originates and funds a mortgage loan pursuant to criteria dictated by the warehouse lender. These loans are ultimately funded by a short-term revolving line of credit provided to the correspondent by the warehouse lender and accompanied by a repurchase commitment if the funded loans meet the pre-set criteria.

²⁰⁴ *Id.* at 16. The top ten lenders in 2006 were Countrywide Financial, Wells Fargo Home Mortgage, Washington Mutual, CitiMortgage, Inc., Chase Home Finance, Bank of America Mortgage & Affiliates, Wachovia Corporation, Residential Capital Group, IndyMac, and GMAC Residential Holding Corporation. All of these entities were banks or thrifts other than GMAC.

²⁰⁵ Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 965 (2011)

Second, LCFIs are well positioned to act as servicers for securitized loans, an important source of non-interest income.²⁰⁶

3. *The Cumulative Impact: Commercial Real Estate Mortgages*

As tax-advantaged retirement accounts siphon off deposits, and the securitization pipeline reduces banks' share of loan activity, what is the cumulative effect? Although it is difficult to believe following the collapse of subprime mortgages, asset backed securities are generally backed by creditworthy borrowers. This is particularly true in certain classes of assets, such as commercial real estate.

Traditionally, commercial real estate mortgage lending, like residential mortgage lending, was the province of local banks. This concentration of commercial real estate debt at the local level was likely a result of the thinking that “all real estate is local” and the lack of a federal agency to create a national market for commercial real estate debt, like Fannie Mae or Freddie Mac did for residential real estate debt. The commercial real estate financing market opened up with the advent of commercial mortgage securitization in the mid-1980s, which dramatically accelerated at the end of the 1990s and beginning of the 2000s, peaking in volume in 2007.²⁰⁷

Today, commercial real estate debt is primarily funded by commercial banks, insurance companies, and commercial mortgage backed securities.²⁰⁸ In 2012, banks originated approximately \$51 billion in commercial and multifamily mortgage loans; life insurance companies originated approximately \$50 billion; and originations for commercial mortgage backed securities were approximately \$44 billion.²⁰⁹

Although “commercial real estate finance markets are back,” the strong emergence of the CMBS market has not benefited all segments of the market equally.²¹⁰ Instead, CMBS originators have demonstrated a strong preference for newer, large office and retail assets²¹¹ in primary and secondary markets, owned by public REITs or large, private, well-capitalized companies.²¹²

²⁰⁶ Samolyk, *supra* note ___ at 30.

²⁰⁷ CRE Finance Council Compendium of Statistics at Appendix A2.

²⁰⁸ See Bianca A. Russo, Commercial Mortgage Securitization, 930 PLI/Comm 1013 (December 2010). Government-sponsored entities (GSEs) represent nearly 15% of total commercial real estate debt outstanding, but that debt is limited to a single asset class – multi-family housing. GSEs are not involved in lending to any other asset class.

²⁰⁹ Jamie Woodwell, *A CREF Renaissance*, MORTGAGE BANKING (January 2014).

²¹⁰ Woodwell, *supra* note ___.

²¹¹ CRE Finance Council Compendium of Statistics at Exhibit 11: CMBS Breakdowns by Deal and Property Type (December 30, 2010)

²¹² In the fourth quarter of 2006, the quarter with the highest origination level, the average CMBS loan was \$21.1 million. Mortgage Bankers Association, Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations (First Quarter 2009). From the first quarter of 2004 through the fourth quarter of 2007, the

CMBS and insurance companies have been successful in attracting the “best” loans for two reasons. First, they both have the capacity to finance assets may be too large for smaller banks. Second, CMBS loans are cheaper than bank loans. As a result, banks are nearly the only source for loans in smaller markets, to less well-capitalized borrowers, and for riskier development and construction loans.²¹³

Community banks have been criticized for their levels of commercial real estate lending, and commercial real estate lending played a key role in the collapse of a significant number of the 322 banks that have failed in the immediate aftermath of the financial crisis.²¹⁴ FDIC analysis indicates that of the 322 banks, more than 86% exceeded the commercial real estate lending concentrations guidance promulgated by bank regulators in December 2006.²¹⁵

Commercial real estate lending therefore highlights the Catch-22 that community banks face. On the one hand,

[S]ocial benefits ... arise from commercial real estate financing by community banks. In many respects, CRE lending exemplifies the type of local knowledge and local decision-making at which community banks excel. Not only is construction activity essential to economic activity and the quality of life in local communities, but community banks are very important providers of credit to the construction industry.²¹⁶

On the other hand, community banks are already inherently limited in their ability to diversify risk because they are linked to the communities they serve. Competition from

average CMBS loan, averaged on a quarterly basis, ranged from \$11.9 million to \$52.9 million. MBA, Quarterly Survey (First Quarter 2009). CMBS originators in this time period had strong geographical preferences, with 50% of CMBS debt on properties located in just five states: California, New York, Texas, Florida, and Illinois. See, Joan H. Story, Lending: Mortgages and Beyond, 582 PLI/Real 413, 415-16 (November 2010). In contrast, the ten smallest states by population collectively represented 1.7% of total CMBS debt outstanding as of December 31, 2010.

²¹³ Alternatives for Promoting Liquidity in the Commercial Real Estate Markets, *supra* note ___ at 20 (Testimony of Todd Lindsey) (“A majority of the smaller balance commercial real estate loans are on the balance sheets of our Nation’s community banks.”)

²¹⁴ It is important to note that regulators include loans for the development of single-family subdivisions in “commercial construction loans” although that product type is not otherwise included in the definition of commercial real estate used in this Article or by other data providers. Patrick Parkinson, COP Feb 4 2011 hearing at p. 1 (“Losses associated with CRE, particularly residential construction and land development lending, were the dominant reason for the high number of bank failures since the beginning of 2008, and further CRE-related bank failures are expected over the next few years.”); Jon Prior, Commercial Real Estate Problems Lead to Latest Bank Failures: Trepp, Housing Wire (September 20, 2010) <http://www.housingwire.com/2010/09/20/commercial-real-estate-problems-lead-to-latest-bank-failures-trepp> (In the second week of September 2010, the FDIC closed six banks. According to industry analysts, commercial real estate loans made up 82% of the \$152 million in nonperforming loans held by the six banks.)

²¹⁵ The Joint Guidance on CRE Lending dated December 12, 2006 defined a commercial real estate concentration as loans which exceeded 300% of total capital. See: FIL 104-2006, <http://www.fdic.gov/news/news/press/2006/pr06114.html>

²¹⁶ FDIC COMMUNITY BANKING SURVEY, *supra* note ___ at V.

capital markets, fueled by tax-advantaged investments, further reduces the ability of community banks to diversify risk through lending, by attracting away some of the best credit risks as well as borrowers who are easiest to service cheaply and efficiently.

CONCLUSION

Federal policy encourages and entrenches the increasing bifurcation of small, traditional community banks and large, diverse financial services companies in ways that undermine both the safety and soundness of the American financial system and the ability of millions of Americans to fully participate in the economy. Community banks face organic challenges, but those challenges are exacerbated by federal policies. The resulting distortions impact the viability of the community banking model by privileging various methods of commodifying financial services – consolidation in the banking industry, the rise of shadow banking, the spread of securitization, and employer-sponsored retirement programs. These policies undermine small, traditional depository institutions and a system of insured deposits, and increase risk for borrowers and investors. Consolidation in banking may be a natural process, but it has been significantly aided by federal policy. Reversing those policies would allow the market to function more efficiently and may also reverse consolidation trends.

Financial conglomerates have never demonstrated their ability to provide beneficial services to customers and attractive returns to investors without relying on federal safety net subsidies during good times and taxpayer-financed bailouts during crises. I believe that LCFIs are unlikely to produce favorable returns if they lose their access to public subsidies. Accordingly, Congress must remove those subsidies and create a true ‘market test’ for LCFIs. If such a test were applied, I expect that market forces would compel many LCFIs to break up voluntarily.²¹⁷

This paper provides a broad, brief sketch of some of the market distortions that create challenges for community banks. Further work in this area is needed to better understand and mitigate these issues.

²¹⁷ Wilmarth, *supra* note __ at 957. (Oregon)