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

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Introduction

The financial crisis of 2007-2009 and its aftermath have accelerated a consolidation trend that has transformed the U.S. banking system during the past three decades. During that period, the number of community banks and their share of the banking industry's assets have fallen by more than half, while the largest banks have succeeded in capturing much of the industry's assets.¹ In responding to the financial crisis, the federal government encouraged further consolidation by adopting extraordinary assistance programs and forbearance measures designed to help the biggest institutions. In contrast, federal officials gave relatively little help to community banks and subjected them to strict supervision and enforcement policies. Similarly,

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¹ See *infra* notes 11-13, 28-29 and accompanying text (discussing the impact of consolidation within the banking industry on community banks and megabanks). Two definitions of "community bank" are generally used in banking studies. Some studies define community banks as including all banks with assets under \$10 billion. See, e.g., Jeffrey W. Gunther, & Kelly Klemme, "Community Banks Withstand the Storm," in *Special Report: Financial Stability: Traditional Banks Pave the Way*, Fed. Res. Bank of Dallas, 2012 Annual Report, at 3 [hereinafter Dallas Fed 2012 Report], available at <http://www.dallasfed.org/microsites/fed/annual/2012/ar12d/index.cfm>; Conf. of State Bank Supervisors, *Community Banking in the 21st Century: Opportunities, Challenges and Perspectives* (Oct. 2013), at 12 [hereinafter CSBS Community Banking Study], available at <http://www.csbs.org/news/csbswhitepapers/Documents/FINALPUBLICATION.pdf>. In contrast, the Federal Deposit Insurance Corporation (FDIC) defines community banks to encompass most banks with assets under \$1 billion as well as some larger banks that meet criteria designed to identify a strong orientation toward traditional banking activities (e.g., high loan-to-asset and deposit-to-asset ratios) and limited geographic scope (e.g., operations in not more than three states). Fed. Deposit Ins. Corp., *FDIC Community Banking Study* (Dec. 2012), ch. 1 [hereinafter FDIC Community Banking Study]. Under the FDIC's criteria, 330 banks with assets between \$1 billion and \$10 billion were classified as "community banks" at the end of 2010, while 206 banks in that size range were classified as "noncommunity banks." *Id.* at 1-4 (tbl. 1.3). For purposes of this article, the term "community banks" generally refers to banks with assets under \$10 billion *unless* the supporting citations are drawn from FDIC studies.

the monetary policy followed by the Federal Reserve (Fed) in response to the crisis benefited megabanks while suppressing the earnings of community banks.²

Federal regulators stood by while more than 450 community banks failed between 2008 and 2012. In contrast, regulators allowed only one depository institution larger than \$100 billion – Washington Mutual (Wamu) – to fail during that period. In that one case, the FDIC arranged for the immediate transfer of Wamu’s assets and deposits to JPMorgan Chase (Chase), the largest U.S. bank, which received a \$25 billion capital infusion from the Treasury Department.³ In February 2009, federal regulators announced that the Treasury Department would provide any capital assistance needed to ensure the survival of the nineteen largest banking organizations, each with assets of more than \$100 billion.⁴ No such guarantees were provided to smaller banks.

In July 2010, Congress responded to the financial crisis by enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),⁵ Community banks must comply with many of Dodd-Frank’s new regulatory mandates, even though community banks did not play any significant role in causing the financial crisis. In addition, the Basel III international capital accord, as implemented by federal bank regulators, will impose costly new requirements on community banks.⁶

The foregoing developments threaten the viability of community banks, which provide essential services to small businesses and local economies.⁷ At the same time, Dodd-Frank does

² See *infra* Part I (describing how the federal government’s response to the financial crisis helped megabanks and hurt community banks).

³ See *infra* notes 63-67, 81 and accompanying text (discussing bank failures between 2008 and 2012).

⁴ See *infra* notes 22-23 and accompanying text (describing the public announcement by federal banking agencies in February 2009 that they would ensure the survival of the 19 largest banking organizations).

⁵ Pub. L. No. 111-203, 124 Stat. 1376.

⁶ See *infra* Part II (discussing community banks’ lack of responsibility for the financial crisis and the new compliance burdens they face under Dodd-Frank and Basel III).

⁷ See *infra* Part III (discussing growing doubts about the ability of community banks to maintain their crucial role in supporting small businesses and local communities).

not provide an adequate response to the growing risks posed by megabanks to our national and global economies. Dodd-Frank has not ended the “too big to fail” (TBTF) treatment that benefits megabanks, and big banks and their supporters have already succeeded in weakening the implementation of even the relatively mild remedies called for by Dodd-Frank.⁸

A new tiered system of regulation is urgently needed to correct the perverse effects of our current regulatory regime. My proposal for tiered regulation would reduce regulatory burdens on community banks and would encourage them to maintain their traditional business model of relationship-based intermediation. My proposal would also seek to remove TBTF subsidies from megabanks and other systemically important financial institutions (SIFIs). SIFIs would be required to conduct their deposit-taking activities within “narrow banks” that would be barred from transferring their safety net subsidies to nonbank affiliates. SIFIs would also be required to pay risk-based premiums to pre-fund the Orderly Liquidation Authority (OLA) in order to shield taxpayers from the future costs of resolving failed SIFIs. By removing TBTF subsidies, my proposal would enable financial markets and regulators to exercise much more effective discipline over our largest financial institutions. In addition, SIFIs would be obliged to structure compensation packages for their executives and key employees so that at least half of their total compensation is paid in the form of contingent convertible bonds (CoCos). CoCos would help to align the personal incentives of executives and key employees of SIFIs with the long-term interests of creditors, the FDIC and taxpayers.⁹

My proposed tiered system of regulation would help to restore a more balanced, diverse and resilient banking industry. Community banks have compiled a superior record of meeting

⁸ See *infra* Part IV (explaining why Dodd-Frank has not ended TBTF benefits for megabanks, and discussing successful efforts by megabanks and their political allies to weaken the implementation of Dodd-Frank).

⁹ See *infra* Part V (describing my proposal for a tiered system of regulation).

the needs of their customers while maintaining a more stable business model that serves the longer-term interests of their stakeholders and communities. In contrast, megabanks have shown a strong and persistent tendency to pursue short-term, high-risk business strategies that produce boom-and-bust cycles and impose tremendous costs on our economy and taxpayers. If their TBTF subsidies were removed, megabanks would have strong incentives to spin off risky activities and adopt more conservative and transparent business policies.

I. The Government’s Response to the Financial Crisis Accelerated the Consolidation Trend by Giving Massive Assistance to Megabanks While Doing Little to Help Community Banks

The U.S. banking industry has experienced far-reaching consolidation during the past thirty years. Between 1984 and 2011, the number of community banks fell by more than half,¹⁰ and the share of commercial banking assets held by community banks declined by almost two-thirds.¹¹ During the same period, the share of banking assets held by the four largest U.S. banks mushroomed from 6.2 percent to 44.2 percent.¹² Many factors have driven this consolidation trend, including federal deregulation of geographic and product markets for banks, relaxation of federal antitrust standards governing bank mergers, transformative changes in banking

¹⁰ FDIC Community Banking Study, *supra* note 1, at 2-6 (Tbl. 2.2) (showing that the number of community banking organizations, as defined by the FDIC, declined from 14,408 in 1984 to 6,356 in 2011, while the number of community bank charters fell from 15,663 to 6,799 during the same period); *see also* CSBS Community Banking Study, *supra* note 1, at 12 (stating that the number of banks smaller than \$10 billion declined from 10,300 in 1994 to about 6,000 in 2012).

¹¹ FDIC Community Banking Study, *supra* note 1, at 2-7 (Tbl. 2.3) (showing that the percentage of banking industry assets held by community banks, as defined by the FDIC, declined from 38% in 1984 to 14% in 2011); *see also* Jeffrey W. Gunther & Kelly Klemme, “Small Banks Squeezed,” in 2012 Dallas Fed Report, *supra* note 1, at 15, 17 (Chart 1) (showing that banks smaller than \$10 billion held less than 17% of commercial banking assets in 2011 and 2013).

¹² FDIC Community Banking Study, *supra* note 1, at 2-4.

technologies, and large numbers of bank failures that occurred during between 1984 and 1991 and again between 2008 and 2012.¹³

The federal government's response to the recent financial crisis has given further impetus for the consolidation trend. The federal government provided extraordinary assistance to ensure the survival of the biggest banks while doing relatively little to help community banks. In addition, the Fed's monetary policy since 2008 has benefited big banks while hurting community banks.

The federal government pursued a similarly lopsided approach to supervision and enforcement during the financial crisis and its aftermath. Federal agencies adopted a policy of leniency and forbearance with regard to big banks, and only one depository institution larger than \$100 billion failed during the crisis. In contrast, federal regulators issued hundreds of capital directives and other enforcement orders against community banks and allowed more than 450 community banks to fail. Little wonder that the largest banks have achieved even greater dominance within the banking industry since the outbreak of the crisis in 2007, while the position of community banks has deteriorated.

A. The Federal Government Provided Extraordinary Assistance to Large Banks But Gave Little Help to Community Banks

The federal government responded to the financial crisis by providing massive and disproportionate financial help to the largest financial institutions. Federal agencies provided more than \$850 billion of financial assistance to ensure the survival of Citigroup and Bank of

¹³ FDIC Community Banking Study, *supra* note 1, Chapter 2; *see also* Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks," 2002 *University of Illinois Law Review* 215, 250-57, 312-15 [hereinafter Wilmarth, Transformation] (describing factors encouraging consolidation during the 1980s and 1990s); Arthur E. Wilmarth, Jr., "The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis," 41 *Connecticut Law Review* 963, 975-81, 1011-15 (2009) [hereinafter Wilmarth, Dark Side] (discussing factors encouraging further consolidation during the 2000s).

America (BofA) – two of the three largest U.S. banks. The bailout packages for Citigroup and BofA included capital infusions, asset guarantees, emergency short-term loans, debt guarantees and commercial paper funding.¹⁴

The federal government’s bailout of BofA enabled that institution to absorb Countrywide, the second largest thrift, and Merrill Lynch (Merrill), the third largest securities firm. Regulators also provided financial assistance to support (i) emergency takeovers of two other failing megabanks (Wells Fargo’s purchase of Wachovia and PNC’s acquisition of National City), (ii) Chase’s emergency acquisition of Wamu, the largest thrift, and Bear Stearns, the fifth-largest securities firm, and (iii) emergency conversions of the two largest securities firms – Goldman Sachs (Goldman) and Morgan Stanley – into bank holding companies.¹⁵ Meanwhile, U.S. Bancorp became the fifth-largest bank by acquiring a large failing thrift (Downey Federal) and more than a dozen smaller failed institutions with support provided by a capital infusion from the Treasury Department and loss-sharing agreements with the FDIC.¹⁶

¹⁴ The federal government provided financial help to Citigroup totaling \$543 billion and similar help to BofA totaling \$315 billion. *See* Arthur E. Wilmarth, Jr., “Citigroup: A Case Study in Managerial and Regulatory Failures,” 47 *Indiana Law Review* 69, 71, 110-14 (2014) [hereinafter Wilmarth, Citigroup] (explaining that the federal government gave Citigroup \$45 billion of capital infusions, \$300 billion of asset guarantees, \$100 billion of emergency loans (measured by the peak amount outstanding), \$65 billion of FDIC-guaranteed, debt, and \$33 billion of commercial paper funding); *id.* at 109 n.326, 114 n.362 (stating that the federal government gave BofA \$45 billion of capital infusions, \$120 billion of asset guarantees, \$91 billion of emergency loans (measured by the peak amount outstanding), and \$44 billion of FDIC-guaranteed debt); Linus Wilson & Yan Wendy Wu, *Does receiving TARP funds make it easier to roll your commercial paper onto the Fed?* (Aug. 22, 2011), at 29 (tbl. 7, panel A) (showing that the Fed gave BofA \$15 billion of commercial paper funding), available at <http://ssrn.com/abstract=1911454>.

¹⁵ Arthur E. Wilmarth, Jr., “The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem,” 89 *Oregon Law Review* 951, 958-59, 978-79, 984-85 (2011) (discussing how the federal government assisted the takeovers cited above) [hereinafter Wilmarth, Dodd-Frank]; *see also* Bob Ivry, Bradley Keoun & Phil Kuntz, “Secret Fed Loans Helped Banks Net \$13 Billion,” *Bloomberg.com*, Nov. 27, 2011 (describing how the Fed’s emergency loans helped JPMorgan Chase to acquire Bear Stearns, BofA to acquire Merrill, and Wells Fargo to acquire Wachovia).

¹⁶ “U.S. Bancorp’s Appetite for Failed Banks Shows Its Strength,” *Trefis*, Mar. 14, 2012, 2012 WLNR 5473464 (reporting that U.S. Bancorp had acquired 14 failed banks from the FDIC since 2008, “more . . . than any other competitor”); Michael Rudnick, “U.S. Bancorp nabs First Community,” *Daily Deal*, Jan. 31, 2011, 2011 WLNR 3459001 (reporting that U.S. Bancorp had “added \$36.6 billion in assets since late 2008 via failed bank acquisitions” assisted by the FDIC); Heather Landy, “Davis Comes into His Own as U.S. Bancorp’s Chief,” *American Banker*, Dec. 2, 2010, at 2A (explaining how Richard Davis, the chief executive of U.S. Bancorp, built the

Moreover, the federal government injected more than \$70 billion of capital and provided \$110 billion of further assistance to bail out American International Group (AIG), the world's largest insurance company.¹⁷ The federal government's rescue of AIG provided a conduit for funneling large payments to the world's leading financial institutions. With federal approval and encouragement, AIG used federal bailout funds to pay over \$90 billion to major U.S. and foreign banks and securities firms, thereby satisfying 100% of the obligations that AIG owed to those counterparties under credit default swaps (CDS) and securities lending agreements.¹⁸ Goldman received the largest total payment from AIG, while Merrill Lynch, BofA and Citigroup also received substantial payments.¹⁹

Thus, federal agencies ensured that AIG could pay all of the obligations it owed to large, complex financial institutions (LCFIs). The federal government took a much harsher approach toward smaller investors (including community banks) when the Treasury Department seized

bank into "the fifth-largest U.S. commercial bank"); Kevin Dobbs & Bonnie McGeer, "Thrift Buys Give U.S. Bancorp Calif. Boost," *American Banker*, Nov. 25, 2008, at 6 (reporting that U.S. Bancorp acquired two failed California thrifts, including Downey Financial with nearly \$13 billion of assets, and noting that when U.S. Bancorp announced that it "would receive \$6.6 billion under the Treasury Department's Capital Purchase Program, Mr. Davis said the infusion would give his company new flexibility to 'invest in future growth.'").

¹⁷ Hester Peirce, *Securities Lending and the Untold Story in the Collapse of AIG*, Mercatus Center Working Paper No. 14-12 (May 2014), at 1, 39-45, available at <http://ssrn.com/abstract=2435161>; Cong. Oversight Panel, *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy* (June 20, 2010), at 19-20, 84-99 [hereinafter COP AIG Report], available at

<http://cybercemetery.unt.edu/archive/cop/20110401232818/http://cop.senate.gov/reports/library/report-061010-cop.cfm>; U.S. Gov't Accountability Off., *Troubled Asset Relief Program: The Government's Exposure to AIG Following the Company's Recapitalization*, GAO-11-716 (July 2011), at 8-11.

¹⁸ Peirce, *supra* note 17, at 43, 44 (Tbl. 4) (citing an AIG report showing that AIG paid \$93.4 billion to counterparties after receiving federal assistance). A report by the Congressional Oversight Panel (COP) indicated a somewhat smaller amount for such payments. According to the COP, after AIG received federal assistance it paid \$43.8 billion to counterparties to discharge securities lending obligations and \$43.7 billion to counterparties to discharge CDS obligations. See COP AIG Report, *supra* note 17, at 87-94. The COP stated that AIG had previously used its own funds to post \$18.5 billion of collateral under its CDS deals. *Id.* at 88 (fig. 15), 93 (fig. 17). There is no dispute that, with the approval of federal officials, AIG used federal assistance to pay its counterparties 100% of the amounts owed under its CDS and securities lending deals and that AIG did not demand concessions from those counterparties. *Id.* at 87-88, 92-93, 147-52; Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (Jan. 2011), at 376-79 [hereinafter FCIC Report], available at <http://fcic.law.stanford.edu/report>.

¹⁹ Peirce, *supra* note 17, at 44 (Tbl. 4) (citing an AIG report showing that AIG paid Goldman \$12.9 billion after receiving federal assistance, while other recipients of the largest AIG payments included Société Générale (\$11.9 billion), Deutsche Bank (\$11.8 billion), Barclays (\$8.5 billion), Merrill (\$6.8 billion), BofA (\$5.2 billion), UBS (\$5.0 billion), BNP Paribas (\$4.9 billion), HSBC (\$2.3 billion), and Citigroup (\$2.3 billion)).

control of Fannie Mae (Fannie) and Freddie Mac (Freddie) in September 2008. After establishing conservatorships for both government-sponsored enterprises (GSEs), Treasury declared that the GSEs would no longer pay dividends to existing preferred stockholders. That decision destroyed the value of the GSEs' outstanding preferred stock, much of which Fannie and Freddie had issued at the urging of federal officials in late 2007 and early 2008. Many community banks had purchased that preferred stock with the approval (and, allegedly, the encouragement) of federal bank regulators.²⁰ The sudden collapse in value of the GSEs' preferred stock inflicted \$2 billion of losses on community banks and led to the failures or forced sales of more than a dozen community banks.²¹ The federal government thus made a deliberate choice *not* to provide AIG-type protection for community banks when it seized Fannie and Freddie.

In February 2009, as federal regulators prepared to conduct the first “stress test” for the 19 largest banks, the agencies announced that they would provide any additional capital needed to ensure the survival of those companies. The announcement proclaimed the “determination” of federal regulators “to preserve the viability of systemically important financial institutions so that

²⁰ Tara Rice & Jonathan Rose, *When Good Investments Go Bad: The Contraction in Community Bank Lending After the 2008 GSE Takeover* (Mar. 14, 2014), at 5-10, 37-38 (Appendix B) (explaining that Fannie and Freddie had \$36 billion of outstanding preferred stock in September 2008, of which \$22 billion had been sold in late 2007 and early 2008), available at <http://ssrn.com/abstract=2409328>. For allegations that federal regulators encouraged banks to buy the GSEs' preferred stock, see Donna Block, “FDIC grilled on community bank seizures,” *Daily Deal*, Jan. 21, 2010, 2010 WLNR 1681342; CorTrust Bank President/Chief Executive Officer Mr. Jack E Hopkins, Prepared Testimony before the House Financial Services Committee Hearing on Housing Finance on April 14, 2010, *Financial Markets Regulation Wire*, April 14, 2010 (available on Westlaw).

²¹ Rice & Rose, *supra* note 20, at 3-4, 20; *see also id.* at 3, 13-14 (reporting that 483 community banks owned \$2.3 billion of the \$8 billion of GSE preferred stock held by all banks); *id.* at 8,10 (stating that “a belief in the low risk of these securities was widespread among investors (including banks and other financial institutions) and regulators [T]he decision to wipe out the preferred shareholders was not an obvious one, and while considerable uncertainty surrounded the fate of the GSEs, most parties assumed up until the [federal] takeover that the preferred shareholders would be made whole.”); FCIC Report, *supra* note 18, at 320-21 (discussing bank failures that were caused by the Treasury's decision to cut off dividend payments on Fannie's and Freddie's preferred stock); Julie Andersen Hill, “Shifting Losses: The Impact of Fannie's and Freddie's Conservatorships on Commercial Banks,” 35 *Hamline Law Review* 343, 362-68 (2012) (explaining how the collapse in value of the GSEs' preferred stock caused significant investment losses as well as bank failures and forced bank sales within the community bank sector).

they are able to meet their commitments.”²² The federal government thereby made clear to investors and the general public that the 19 largest banks (each holding more than \$100 billion of assets) were TBTF, at least for the duration of the financial crisis.²³

The 19 largest banks and AIG received \$290 billion of federal capital infusions and issued \$235 billion of FDIC-guaranteed debt. In contrast, banks smaller than \$100 billion received only \$41 billion of capital infusions and issued only \$11 billion of FDIC-guaranteed debt.²⁴ Within the latter group, banks smaller than \$10 billion received just \$16 billion of capital infusions and issued very little FDIC-guaranteed debt.²⁵

The Fed also took unprecedented actions as lender of last resort (LOLR) by establishing a series of emergency lending programs that provided huge amounts of credit to LCFIs. The Fed’s emergency lending programs reached a single-day peak of \$1.2 trillion in December 2008. More

²² Bd. of Governors of Fed. Res. Sys., “Joint Press Release: Joint Statement by the Treasury, FDIC, OCC, OTS, and the Federal Reserve,” Feb. 23, 2009, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090223a.htm>.

²³ Arthur E. Wilmarth, Jr., “Reforming Financial Regulation to Address the Too-Big-to-Fail Problem, 35 *Brooklyn Journal of International Law* 707, 713, 737, 743 (2010) [hereinafter Wilmarth, Reforming Financial Regulation]; see also Joe Adler, “In Focus: Stress Tests Complicate ‘Too Big to Fail’ Debate,” *American Banker*, May 18, 2009, at 1 (“By drawing a line at \$100 billion in assets, and promising to give the 19 institutions over that mark enough capital to weather an economic downturn, the government appears to have defined which banks are indeed ‘too big to fail.’”).

²⁴ Wilmarth, Reforming Financial Regulation, *supra* note 23, at 737-38 (discussing the capital infusions and debt guarantees provided to the largest banks under the Troubled Asset Relief Program (TARP) and other federal programs); see also *id.* at 738 n.122 (stating that the 19 largest banks received \$220 billion of capital infusions from the Treasury, while AIG also received \$70 billion of capital assistance); *supra* note 18 and accompanying text (explaining that much of the federal assistance provided to AIG was used to pay off AIG’s obligations to large U.S. and European financial institutions).

²⁵ Cong. Oversight Panel, *Small Banks in the Capital Purchase Program* (July 14, 2010), at 16 (figure 1), available at <http://cybercemetery.unt.edu/archive/cop/20110401232732/http://cop.senate.gov/reports/library/report-071410-cop.cfm>. The FDIC’s debt guarantee program was “geared towards aiding the larger banks by guaranteeing newly issued senior secured debt through 2012,” and the program provided “a windfall for the largest financial institutions.” Hovde Org., *Hovde Financial Institutions Monthly Overview* (Aug. 2009), at 2-3, available at <http://www.hovdecapital.com/re/documents/HovdeMonthlyOverviewAugust2009.pdf>. The 19 largest banks issued \$235 billion of the FDIC-guaranteed debt, and GE Capital issued an additional \$55 billion of FDIC-guaranteed debt, while other financial institutions issued only \$11 billion of such debt. Cong. Oversight Panel, *Guarantees and Contingent Payments in TARP and Related Programs* (Nov. 6, 2009), at 35-38, 69 (Fig. 6), 75, 76 (Fig. 10), available at <http://cybercemetery.unt.edu/archive/cop/20110401233004/http://cop.senate.gov/reports/library/report-110609-cop.cfm>. Most small and medium-sized banks did not participate in the FDIC’s debt guarantee program because those banks do not issue publicly-traded debt securities. *Id.* at 37 & n.156.

than half of that amount was extended to the ten largest U.S. banks and securities firms, and most of the remainder was lent to large U.S. and foreign banks.²⁶ The Fed provided a cumulative total of \$19.5 trillion of emergency credit to banks between 2007 and 2010, if one adds up all of the individual transactions included in the Fed's emergency lending programs.²⁷ Almost 90 percent of that cumulative total – \$16.4 trillion – was extended to a group of fourteen large U.S. and foreign LCFIs.²⁸

The federal government provided the foregoing capital infusions, asset guarantees, debt guarantees and emergency loans to LCFIs on very generous terms. As a result, those programs “represented very large transfers of wealth from taxpayers to the shareholders and creditors of the largest U.S. LCFIs.”²⁹ The federal government's extraordinary support for the largest banks (including their acquisitions of troubled institutions) produced a domestic banking system in

²⁶ Bradley Keoun & Phil Kuntz, “Wall Street Aristocracy Got \$1.2 Trillion in Secret Fed Loans,” *Bloomberg.com*, Aug. 22, 2011 (reporting that the Fed's emergency lending programs reached a “\$1.2 trillion peak on Dec. 5, 2008” and \$669 billion of that amount was lent to the 10 largest U.S. banks and securities firms).

²⁷ James Felkerson, *\$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient*, Levy Econ. Instit. of Bard College Working Paper No. 698 (Dec. 9, 2011), esp. at 31-33, available at <http://ssrn.com/abstract=1970414> (finding that, in addition to the \$19.5 trillion of emergency loans provided to banks, the Fed extended \$10 trillion of credit to foreign central banks through currency swap lines).

²⁸ *Id.* at 32-33 (showing that the top nine recipients of Fed emergency credit – Citigroup, Merrill Lynch, Morgan Stanley, AIG, Barclays, BofA, BNP Paribas, Goldman and Bear Stearns – collectively received \$13.4 trillion, while the next five most highly-ranked recipients – Credit Suisse, Deutsche Bank, RBS, Chase and UBS – collectively received \$3.0 trillion).

²⁹ Arthur E. Wilmarth, Jr., “Narrow Banking: An Overdue Reform That Could Solve the Too-Big-to-Fail Problem and Align U.S. and U.K. Regulation of Financial Conglomerates,” 31 *Banking & Financial Services Policy Report* No. 3, Mar. 2012, at 3, 5, 20 n.40 (citing four studies documenting the significant gains in wealth that the largest banks received as a result of federal assistance programs during the financial crisis) [hereinafter Wilmarth, Narrow Banking], available at <http://ssrn.com/abstract=2050544>; Mark Gongloff, “Banks Profit from U.S. Guarantee: Lenders' Earnings Reap the Benefit of FDIC Backing on Company Debt,” *Wall Street Journal*, July 29, 2009, at C1 (estimating that the FDIC's debt guarantee program provided interest savings of \$24 billion to the eight largest issuers of guaranteed debt, which included the six biggest U.S. banks, GE Capital and American Express); Ivry, Keoun & Kuntz, *supra* note 18 (finding that the Fed's “below-market rates” on its emergency lending programs generated estimated profits of \$13 billion for the recipient banks, including \$4.8 billion of profits for the six biggest U.S. banks); see also Nicola Matthews, *How the Fed Reanimated Wall Street: The Low and Extended Lending Rates that Revived the Big Banks*, Levy Econ. Instit. of Bard College Working Paper No. 758 (Mar. 15, 2013), at 24-25 (Tbl. 10) (showing that the average interest rates paid by Citigroup, Merrill, Morgan Stanley, BofA and Goldman for the emergency Fed loans they received ranged from a low of 0.7099% (for BofA) to a high of 1.412% (for Goldman), available at <http://ssrn.com/abstract=2233939>; Keoun & Kuntz, *supra* note 26 (noting that the Fed agreed to provide 28-day loans through its Term Auction Facility at a rate of 1.1% on October 20, 2008, while large banks were then charging 3.8% for one-month interbank loans).

which megabanks now possess even greater dominance than they enjoyed prior to the crisis. The four largest U.S. banks – Chase, BofA, Citigroup and Wells Fargo (the Big Four) – increased their share of commercial banking assets from 32 percent in 2005 to 44.2 percent in 2011.³⁰ In addition, the eleven largest U.S. banks controlled two-thirds of commercial banking assets by the end of 2012.³¹

The federal government’s massive support for the largest U.S. financial institutions has similarly enhanced their leading positions in broader segments of the financial markets. The Big Four and Goldman controlled total banking and nonbanking assets equal to 56 percent of U.S. gross domestic product (GDP) in 2011, up from 43 percent five years earlier.³² The dominance of the Big Four is even greater when their off-balance-sheet activities are taken into account. Consider what would happen if U.S. accounting principles were changed to force the Big Four to include on their balance sheets their gross (rather than net) derivatives exposures as well as the securitized mortgages they sell to GSEs with recourse, as international accounting rules currently require. In that case, the Big Four’s total assets would nearly double (as of 2012) from \$7.6 trillion to \$14.7 trillion, an amount equal to 93 percent of U.S. GDP.³³

³⁰ FDIC Community Banking Study, *supra* note 1, at 2-4, 2-5 (Chart 2.8); *see also* Harvey Rosenblum, “Choosing the Road to Prosperity: Why We Must End Too Big to Fail – Now,” in 2012 Dallas Fed Report, *supra* note 1, at 3, 6 (Exh. 2), 7 (showing that “the share of banking industry assets controlled by the five largest U.S. institutions has more than tripled to 52 percent from 17 percent” since 1970).

³¹ Richard W. Fisher, “Correcting ‘Dodd-Frank’ to Actually End ‘Too Big to Fail,’” Statement before the House Comm. on Fin. Services, June 26, 2013 (Fig. 1), available at <http://www.dallasfed.org/news/speeches/fisher/2013/fs130626.cfm>.

³² David J. Lynch, “Banks Seen Dangerous Defying Obama’s Too-Big-to-Fail Move,” *Bloomberg.com*, April 16, 2012 (also reporting that the Big Four and Goldman held total assets of \$8.5 trillion); *see also* Ivry, Keoun & Kuntz, *supra* note 18 (stating that Big Four, Goldman and Morgan Stanley held total banking and nonbanking assets of \$9.5 trillion in 2011, up from \$6.8 trillion in 2006).

³³ Yalnan Onaran, “U.S. Banks Bigger Than GDP as Accounting Rift Masks Rift,” *Bloomberg.com*, Feb. 19, 2013 (explaining the contrasting treatment of big bank assets under U.S. and international accounting principles); *see also* Andrew Cunningham, “World’s Biggest Banks: The Big Get Bigger,” *Global Finance Magazine*, Oct. 2012, at 44 (showing that the Big Four had total assets of \$7.6 trillion at the end of 2011).

The Fed has provided additional help to the largest financial institutions by maintaining a zero-interest-rate policy (ZIRP) for short-term debt and by engaging in three rounds of quantitative easing (QE) to push down interest rates on longer-term debt, including home mortgages.³⁴ Under QE1, which lasted from November 2008 until March 2010, the Fed purchased (i) \$1.4 trillion of mortgage-backed securities (MBS) and debt obligations issued by Fannie and Freddie, and (ii) \$300 billion of Treasury securities.³⁵ Under QE2, the Fed purchased \$600 billion of Treasury securities during 2010 and 2011.³⁶ Under QE3, which began in 2012, the Fed has purchased up to \$85 billion of Treasury securities and MBS each month, although the Fed has gradually reduced those purchases in recent months.³⁷ The Fed's QE programs "ballooned its balance sheet to a record \$4.4 trillion" in August 2014,³⁸ a dramatic increase from the \$924 billion of assets that the Fed held in September 2008.³⁹

The Fed's ZIRP and QE policies have conferred major benefits on the largest banks. Unlike community banks, big banks (i) obtain much of their funding by issuing market-sensitive, short-term wholesale liabilities, and (ii) earn a much higher proportion of their revenues from

³⁴ See, e.g., Stefanie D'Amico et al., *The Federal Reserve's Large-Scale Asset Purchase Programs: Rationale and Effects*, FEDS Working Paper No. 2012-85 (Dec. 7, 2012), at 1-3, 10-11, 29-30 (discussing the Fed's QE programs, and finding that QE1 and QE2 reduced yields on longer-term Treasury securities by 35 basis points and 45 basis points, respectively), available at <http://ssrn.com/abstract=2197519>; John C. Williams, "Will Unconventional Policy be the New Normal?," *FRBSF Economic Letter 2013-29* (Oct. 7, 2013), at 1-3 (describing the purpose of the Fed's QE programs), available at <http://www.frbsf.org/economic-research/publications/economic-letter/2013/october/federal-reserve-unconventional-monetary-policy-large-scale-asset-purchases-forward-guidance/>; William C. Dudley, "Lessons at the Zero Bound: The Japanese and U.S. Experience," Remarks at the Japan Society (May 21, 2013) (same), available at <http://www.newyorkfed.org/newsevents/speeches/2013/dud130521.html>.

³⁵ Michael D. Bauer, "Fed Asset Buying and Private Borrowing Rates," *FRBSF Economic Letter 2012-16* (May 21, 2012), at 1-2 (describing QE1), available at <http://www.frbsf.org/economic-research/publications/economic-letter/2012/may/fed-asset-buying-private-borrowing-rates/el2012-16.pdf>; D'Amico et al., *supra* note 34, at 10-11 (same).

³⁶ Bauer, *supra* note 35, at 2 (describing QE2); D'Amico et al., *supra* note 34, at 11 (same).

³⁷ John C. Williams, "The Economic Recovery and Monetary Policy: The Road Back to Ordinary," *FRBSF Economic Letter 2014-16* (June 2, 2014), at 4-5 (describing QE3), available at <http://www.frbsf.org/economic-research/publications/economic-letter/2014/june/economic-recovery-monetary-policy-normalization/el2014-16.pdf>.

³⁸ Victoria Stilwell & Jeff Kearns, "Yellen Channeling Slick as Surrealistic Economy Shows '67 Claims," *Bloomberg.com*, Aug. 15, 2014.

³⁹ Bob Ivry, "Fed's \$4 Trillion Rescue Helps Hedge Fund as Savers Hurt," *Bloomberg.com*, Dec. 20, 2012.

noninterest (fee) income as opposed to interest income from loans.⁴⁰ Big banks also held large volumes of risky mortgage-related securities on their balance sheets when the financial crisis began in 2007.⁴¹ By pushing down short-term and longer-term interest rates, ZIRP and QE lowered big banks' interest costs on their market-sensitive liabilities and also increased the market values of their mortgage-related securities.⁴² Moreover, the low mortgage rates produced by QE spurred a mortgage refinancing boom in 2012, which generated big profits for four of the five largest banks.⁴³ Those four banks dominated the home mortgage market after acquiring competing lenders with federal assistance during the financial crisis.⁴⁴ Chase, BofA and Wells Fargo earned additional profits by entering into interest-rate swaps in which they took the fixed side of the trades and successfully wagered that ZIRP and QE would keep floating rates below the fixed rates specified in the swaps.⁴⁵

⁴⁰ FDIC Community Banking Study, *supra* note 1, at 4-2 through 4-5; Christine M. Bradley & Lynn Shibut, "The Liability Structure of FDIC-Insured Institutions: Changes and Implications," 18 *FDIC Banking Review* No. 2 (2006), at 1, 18, 20; Gerald Hanweck & Lisa Ryu, *The Sensitivity of Bank Net Interest Margins and Profitability to Credit, Interest-Rate and Term-Structure Shocks Across Bank Product Specializations*, FDIC Working Paper 2005-02 (Jan. 2005), at 24-25, 28, available at <http://ssrn.com/abstract=886727>.

⁴¹ Wilmarth, *Dark Side*, *supra* note 13, at 1028-35 (describing the large volumes of private-label MBS and collateralized debt obligations (CDOs) held by major banks in 2007); Wilmarth, *Dodd-Frank*, *supra* note 15, at 971-75 (same). The term "private-label" refers to residential MBS that were underwritten and issued by LCFIs and did not conform to the underwriting guidelines of Fannie and Freddie. Wilmarth, *Dark Side*, *supra* note 13, at 988.

⁴² Jesse Eisinger, "In U.S. Monetary Policy, a Boon to Banks," *ProPublica*, June 29, 2011; Andrew Huszar, "Confessions of a Quantitative Easer," *Wall Street Journal*, Nov. 12, 2013, at A17. Mr. Huszar, a former Fed official, also argued that QE provided "fat commissions" to the big banks that acted as primary dealers for the Fed, because those banks earned substantial fees for executing the Fed's QE purchases. Huszar, *supra*; Ben Eisen, "Meet Andrew Huszar, the ex-Fed insider who hates QE," *MarketWatch.com*, Nov. 14, 2013.

⁴³ Peter Eavis, "With Rates Low, Banks Increase Mortgage Profit," *New York Times (DealBook blog)*, Aug. 9, 2012 (reporting that "[b]anks are making unusually large gains on mortgages [by] taking profits far higher than the historical norm," due in part to the "concentration of mortgage lending in the hands of a few big banks, primarily Wells Fargo, JPMorgan Chase, Bank of America and U.S. Bancorp"); Kathleen M. Howley & Dakin Campbell, "Banks Pad Profits as U.S. Prolongs Refinancing Boom: Mortgages," *Bloomberg.com*, July 5, 2012; Jody Shenn, "Fed Helps Lenders' Profits More Than Homebuyers: Mortgages," *Bloomberg.com*, Sept. 26, 2012.

⁴⁴ Kathleen Pender, "Red flags as Wells Fargo mortgages grow," *San Francisco Chronicle*, Sept. 2, 2012, at G1 ("Top mortgage originators" tbl.) (showing that Wells Fargo, Chase, U.S. Bancorp and BofA controlled 54% of the mortgage origination market during the first half of 2012); *supra* notes 14-16 and accompanying text (discussing how federal agencies provided assistance during the crisis that enabled those big banks to acquire competing lenders).

⁴⁵ Dakin Campbell, "Rising Rates Seen Squeezing Swaps Income at Biggest Banks," *Bloomberg.com*, Sept. 26, 2013 (reporting that the three big banks had earned \$42 billion on interest-rate swaps since 2008 by taking the fixed side of those trades).

While liability-sensitive big banks have benefited from ZIRP and QE, the same has not been true for community banks. Community banks are more “asset-sensitive” than larger banks, because (i) community banks obtain most of their funding from demand deposits and other core deposits, and (ii) the interest rates community banks pay on their core deposits move much more slowly in response to changes in market interest rates than the yields they earn on loans.⁴⁶ Community banks also earn most of their profits from the net interest margin (NIM) between their loan yields and their deposit costs.⁴⁷ ZIRP and QE have significantly reduced the NIM for community banks, and the decline in NIM has been the most important factor behind the deterioration in the relative performance of community banks compared to larger banks.⁴⁸

When the federal government finally did promise to help community banks, it failed to deliver. In September 2010, President Obama signed the Small Business Jobs Act of 2010 (Jobs Act). The Jobs Act required the Treasury Department to create the Small Business Lending Fund (SBLF), and Congress authorized SBLF to invest up to \$30 billion of new capital in community banks to enhance their ability to make small business loans.⁴⁹ Treasury received applications for SBLF funds from 935 community banks.⁵⁰

⁴⁶ Charles S. Morris & Kristen Regehr, “What Explains Low Net Interest Income at Community Banks?”, Fed. Res. Bank of K.C., *Economic Review*, 2d Qtr. 2014 (forthcoming); see also William Bednar & Mahmoud Elamin, “Rising Interest Rate Risk at US Banks,” Fed. Res. Bank of Cleve., *Economic Commentary* (June 24, 2014) (showing that changes in interest rates have different impacts on big banks and smaller banks, as rising interest rates would primarily affect the liabilities of the 50 largest banks but would affect both the liabilities and assets of smaller banks).

⁴⁷ FDIC Community Banking Study, *supra* note 1, at 4-2 through 4-4; Morris & Regehr, *supra* note 46.

⁴⁸ FDIC Community Banking Study, *supra* note 1, at 4-3, 4-4, 4-9; Benjamin R. Backup, “Community Bank Developments in 2012,” 7 *FDIC Quarterly* No. 4 (2013), at 27, 34-35.

⁴⁹ Off. of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress* (April 25, 2012), at 80, 157 [hereinafter 2012 SIGTARP Report], available at http://www.sig tarp.gov/Quarterly%20Reports/April_25_2012_Report_to_Congress.pdf; see also Kate Davidson, “SBLF Left Weak Banks Behind in Tarp, Watchdog Agency Says,” *American Banker*, April 25, 2012 (reporting that the Jobs Act authorized SBLF to provide “\$30 billion to institutions with less than \$10 billion of assets”).

⁵⁰ 2012 SIGTARP Report, *supra* note 49, at 80, 157.

However, Treasury shut down the SBLF program in September 2011 after providing only \$4.2 billion (just 14 percent) of the authorized capital funds to community banks.⁵¹ Treasury approved only about a third of the applications it received for SBLF funding.⁵² Members of Congress sharply criticized Treasury for the onerous conditions it imposed on community bank applicants and for its long delays in approving SBLF applications.⁵³ Treasury Secretary Timothy Geithner stated that the Treasury did not approve additional applications for SBLF funding because “we had to be careful to make sure that taxpayer resources were going to banks that were viable.”⁵⁴ Mr. Geithner also claimed that the JOBS Act did not allow Treasury to help banks unless they were “viable.”⁵⁵ Treasury’s insistence on “viability” as a prerequisite for helping community banks stood in sharp contrast to the announcement made by Treasury and other agencies in February 2009, when they declared that they would provide any capital assistance that was necessary to *ensure the viability* of the 19 largest banks.⁵⁶

B. Federal Regulators Provided Extensive Forbearance to the Largest Banks But Applied Stringent Enforcement and Examination Policies to Community Banks

In addition to the federal government’s far-reaching programs of financial assistance for large banks, regulators followed a policy of leniency and forbearance with respect to those banks. During a Senate committee hearing on February 24, 2009 – the day after regulators

⁵¹ Kevin Wack, “Lending Fund Puts Geithner on the Defensive,” *American Banker*, Oct. 19, 2011.

⁵² 2012 SIGTARP Report, *supra* note 49, at 157-58 (stating that Treasury approved SBLF funding for only 332 of the 935 community banks that submitted applications).

⁵³ Wack, *supra* note 51; Kate Davidson, “Geithner: Regulators at Fault in SBLF Delays,” *American Banker*, June 23, 2011, at 1 (reporting that Treasury did not approve a single application for SBLF funding during the first nine months of the program’s existence).

⁵⁴ Wack, *supra* note 51 (quoting Secretary Geithner’s statement during a congressional hearing in October 2011).

⁵⁵ *Id.*; Davidson, *supra* note 53 (quoting Secretary Geithner’s testimony during a congressional hearing in June 2011, where he said that community banks must be “viable” to receive SBLF funding under the Jobs Act).

⁵⁶ See *supra* notes 22-23 and accompanying text (discussing the federal agencies’ announcement on Feb. 23, 2009).

pledged to ensure the survival of the 19 largest banks – Fed Chairman Ben Bernanke told committee members that “regulators would not employ ‘prompt-corrective-action’ tools” against any of those banks, even if the first stress test revealed that they were undercapitalized.⁵⁷

Senator Corker responded by questioning whether it was a good policy to send a “signal to the markets . . . that there are institutions in this country that absolutely will not fail and we will go to whatever lengths necessary with public-sector dollars” to prevent their failure.⁵⁸ Chairman Bernanke replied that “[w]e are committed to ensuring the viability of all of the major financial institutions.”⁵⁹

The “prompt-corrective-action” (PCA) regime, to which Chairman Bernanke referred, was enacted in 1991. The PCA regime is *not* discretionary. It mandates that federal regulators *must* impose an escalating series of sanctions (including capital directives and other enforcement orders) against *all* undercapitalized banks.⁶⁰ Nevertheless, consistent with Chairman Bernanke’s statement, federal regulators did not issue PCA orders or other formal capital enforcement orders against any of the largest banks, even though (i) emergency acquisitions were needed to prevent the disorderly failures of Wamu and Wachovia, and (ii) Citigroup and BofA required extraordinary assistance to survive.⁶¹ Instead of issuing public enforcement orders against Citigroup and BofA, federal regulators entered into confidential “memoranda of understanding”

⁵⁷ Steven Sloan, “Bernanke: ‘Don’t Need’ to Nationalize Weak Banks,” *American Banker*, Feb. 25, 2009, at 1 (paraphrasing and quoting Chairman Bernanke).

⁵⁸ *Id.* (quoting Senator Corker).

⁵⁹ *Id.* (quoting Chairman Bernanke).

⁶⁰ See Richard S. Carnell, “A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991,” 12 *Annual Review of Banking Law* 317 (1993).

⁶¹ Arthur E. Wilmarth, Jr., “Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street,” 81 *University of Cincinnati Law Review* 1283, 1346-47 (2013) [hereinafter Wilmarth, Blind Eye]; Julie Andersen Hill, “Bank Capital Regulation by Enforcement: An Empirical Study,” 87 *Indiana Law Journal* 645, 690-93 (2012). Citigroup’s tangible common equity (TCE) ratio fell to 1.5% or less in early 2009, indicating that it was seriously undercapitalized, while BoA’s TCE ratio declined to 2.8% at the end of 2008. Wilmarth, Blind Eye, *supra*, at 1346-47 n.289; Wilmarth Citigroup, *supra* note 14, at 112-13; see also *supra* notes 14-15 and accompanying text (explaining that the federal government provided \$850 billion of assistance to ensure the survival of Citigroup and BofA and also provided support for Chase’s takeover of Wamu and Wells Fargo’s acquisition of Wachovia).

(MOUs) with those banks, as regulators had also done when the same banks were in deep trouble during the banking crisis of the late 1980s and the early 1990s, *before* the PCA regime took effect.⁶²

The federal government allowed only one depository institution larger than \$100 billion – Wamu – to fail between 2008 and 2012.⁶³ Most regulators viewed Wamu with disdain as a poorly-managed thrift that acted recklessly in originating large volumes of risky subprime mortgages and option adjustable-rate (option ARM) mortgages. Regulators decided to let Wamu fail in September 2008 after the FDIC arranged for Chase to acquire Wamu’s assets and to assume all of Wamu’s deposits (including its uninsured deposits).⁶⁴

Wamu was clearly an outlier in terms of the regulators’ willingness to tolerate a large failure that imposed any losses on creditors.⁶⁵ After Wamu failed, federal agencies (i) took all necessary measures in late 2008 to prevent the failures of Wachovia, Citigroup and BofA, even

⁶² Wilmarth, *Reforming Financial Regulation*, *supra* note 23, at 744 (discussing the MOUs that regulators arranged with Citigroup and BofA in 2008 and 2009); Wilmarth, *Transformation*, *supra* note 13, at 304-05 (discussing the MOUs that regulators arranged with BofA and Citicorp during the late 1980s and early 1990s).

⁶³ *See infra* note 81 and accompanying text (showing that Wamu, with \$307 billion of assets, was the only depository institution larger than \$100 billion that failed between 2008 and 2012).

⁶⁴ FCIC Report, *supra* note 18, at 20, 107-08, 117-18, 172, 305-07, 365-66 (describing Wamu’s reckless lending practices and the decision to allow Wamu to fail in September 2008); David Wessel, *In Fed We Trust: Ben Bernanke’s War on the Great Panic* 218-21 (2009) (same). Only one agency – the Office of Thrift Supervision (OTS), the primary regulator of Wamu – criticized the decision to let Wamu fail. *See* FCIC Report, *supra* note 18, at 382 (quoting statement by OTS Director John Reich in November 2008, in which he questioned decisions by federal regulators to allow the failures of IndyMac and Wamu). In 2010, OTS Acting Director John Bowman also criticized the decisions to allow IndyMac and Wamu to fail. Mr. Bowman declared: “Institutions much larger than Washington Mutual – for example, Citigroup and Bank of America – collapsed . . . [T]he OTS did not regulate the largest banks that failed; the OTS regulated the largest banks that were allowed to fail.” Cheyenne Hopkins, “On Foreign Soil, Acting OTS Head Criticizes Reform,” *American Banker*, Nov. 18, 2010.

⁶⁵ The terms for Wamu’s failure were controversial because the FDIC refused to protect Wamu’s unsecured bondholders, a decision that the Treasury Department and New York Fed President Timothy Geithner strongly opposed. After Wamu’s failure triggered immediate run by Wachovia’s uninsured creditors, federal regulators decided that they would not permit any other large depository institution to fail without arranging a transaction that protected *all* creditors. FCIC Report, *supra* note 18, at 365-86; Wessel, *supra* note 64, at 218-41, 259-63.

though all three megabanks were involved in reckless subprime lending,⁶⁶ and (ii) declared in February 2009 that regulators would ensure the survival of all banks larger than \$100 billion.⁶⁷

Federal regulators also provided other generous forms of forbearance to big banks. During the spring of 2009, regulators and members of Congress pressured the Financial Accounting Standards Board (FASB) to issue interpretations that significantly relaxed its fair value accounting rules. Those interpretations allowed major banks to avoid reporting additional mark-to-market losses on their holdings of risky MBS, CDOs and other illiquid securities.⁶⁸ For example, Citigroup held \$55 billion of subprime mortgages, MBS and CDOs in its trading accounts in the fall of 2007, and Citigroup recorded \$26 billion of losses on those assets by the fall of 2008.⁶⁹ Citigroup and other major U.S. and European banks probably would have suffered further significant mark-to-market losses if FASB had not relaxed its rules for valuing illiquid securities in April 2009.⁷⁰ Federal regulators also helped megabanks by granting a one-year postponement (until 2011) of the effective date for new FASB rules that required banks to bring securitized assets held in off-balance-sheet conduits back onto their balance sheets.⁷¹

⁶⁶ FCIC Report, *supra* note 18, at 19, 71-72, 113-18, 130-34, 137-39, 168-69, 260-65, 302-07, 366-71, 379-82; *see also infra* note 99 (discussing irresponsible lending by Citigroup and BofA).

⁶⁷ *See supra* notes 22-23 and accompanying text.

⁶⁸ Wilmarth, *Blind Eye*, *supra* note 61, at 1348-49; *see also* U.S. Gov't Accountability Off., *Financial Institutions: Causes and Consequences of Recent Bank Failures*, GAO-13-71 (Jan. 2013) [hereinafter *GAO Bank Failure Report*], at 73-84, 98-102 (describing fair value accounting rules and discussing the impact of certain changes to those rules that FASB made in April 2009).

⁶⁹ Wilmarth, *Citigroup*, *supra* note 14, at 99-100, 110-12 (explaining that Citigroup held \$55 billion of subprime mortgages, RMBS and CDOs related to its securitization business in the fall of 2007 and, after recording large losses, still held \$29 billion of such assets in November 2008).

⁷⁰ Wilmarth, *Blind Eye*, *supra* note 61, at 1348-49; *see also* Maud van Gaal & Corina Ruhe, "Dutch Sell ING's Mortgage Bonds for \$8.9 Billion," *Bloomberg.com*, Feb. 6, 2014 (stating that the market value of private label RMBS backed by option ARM mortgages declined to "as low as 33 cents [on the dollar] in 2009"); Michael Corkery and Al Yoon, "Crisis Plus Five: A Toxic Bond's Legacy Lives On," *Wall Street Journal*, Sept. 13, 2013, at A1 (reporting that the market value of an issue of subprime RBMS underwritten by Countrywide in 2006 "was down by more than half by the summer of 2009").

⁷¹ Wilmarth, *Blind Eye*, *supra* note 61, at 1349-51.

Moreover, regulators allowed megabanks to defer taking large losses on home equity loans and other second-lien loans secured by “underwater” homes whose first mortgages exceeded their fair market value. The Big Four held \$475 billion of second-lien loans at the end of 2008, but regulators did not require banks to begin taking substantial write-downs on those loans until 2012.⁷² It appears that the second-lien forbearance has continued for big banks. In March 2014, BofA, Wells Fargo and Chase – the “three biggest home equity lenders” – still held \$250 billion of second-lien loans, and a news report warned that many of those loans were at increased risk of default because their payment terms would soon “switch from interest-only to include principal.”⁷³

Federal regulators did not grant any similar type of forbearance to community banks during the recent financial crisis and its aftermath. Regulators issued more than 1400 PCA directives and other formal capital enforcement orders against banks smaller than \$30 billion between 2008 and 2010.⁷⁴ Federal regulators also did not allow community banks to postpone taking write-downs on impaired assets. After reviewing bank failures, the Government Accountability Office (GAO) determined that federal bank examiners forced many community banks to recognize losses on commercial real estate (CRE) loans after market values for the underlying real estate collateral fell below the outstanding balances of the loans. When calculating the magnitude of collateral shortfalls, some examiners reportedly challenged the validity of appraisals obtained by community bank lenders and required larger write-downs.⁷⁵ A

⁷² *Id.* at 1351-55; *see also id.* at 1353 (observing that (i) “In 2011, BofA still carried second-lien loans on its books at 93% of their face value, even though investors typically discounted such loans by 50%”; and (ii) the Big Four still held \$400 billion of second-lien loans on their books in March 2012).

⁷³ John Gittelsohn, “Default Risk Rises on 20% of Boom-Era Home-Equity Loans,” *Bloomberg.com*, Aug. 7, 2013.

⁷⁴ Hill *supra* note 61, at 658-62, 668-77; *see also id.* at 691 (stating that Colonial Bank was the largest bank that received a formal capital order between 2008 and 2010); *infra* note 81 (showing that Colonial Bank failed in August 2009, with \$25 billion of assets).

⁷⁵ GAO Bank Failure Report, *supra* note 68, at 29-34. The GAO determined that, with respect to CRE loans that were not likely to be repaid by projected cash flows from the project, federal regulators “would direct the bank to

former Comptroller of the Currency remarked that “the flexibility the regulatory community has shown vis-à-vis the ‘too-big-to-fail banks – roughly defined as [the 19] banks subject to the [first] stress test – has not been in evidence for the community banking sector.”⁷⁶

The sharp disparity in regulatory treatment for megabanks and community banks is also reflected in the very different examination policies followed by federal regulators with respect to the two categories of banks. For megabanks, regulators “focused on evaluating the risk management policies and procedures . . . as well as the banks’ ‘internal risk models’ and ‘credit risk metrics’” but have “stopped doing traditional ‘full scope’ examinations.”⁷⁷ In contrast, for community banks, regulators applied “transaction testing” with a vengeance, as shown by the GAO’s report on bank failures and a similar report prepared by the FDIC’s Inspector General. Both reports describe the exacting scrutiny that bank examiners gave to individual CRE loans made by community banks.⁷⁸

write down the loan balances to the fair value of the collateral.” *Id.* at 33. Thus, “federal banking regulators required banks to use the fair value of collateral method when determining the appropriate impairment amount of a collateral-dependent loan.” *Id.* at 34. The GAO cited a report received from one state banking association, which claimed that federal bank examiners “questioned some of the appraisals banks had obtained and made adjustments to them, driving larger valuation allowances, and where required, larger write-downs, than may have been warranted.” *Id.* at 31-32. For other reports of complaints by community banks about unduly harsh examination practices by federal regulators, see Thecla Fabian, “Bank Supervision: House Financial Services Panel Analyzes Complaints of Bank Examination Practices,” 97 *BNA’s Banking Report* 62 (2011); Thecla Fabian, “Small Business: Small Business Lending Complicated by Underwater Collateral, New Examinations,” 94 *BNA’s Banking Report* 463 (2010); see also Thecla Fabian, “Community Banks: Large Banks, Shadow Banks Caused Crisis, Community Banks Still Lend, ICBA Tells FCIC,” 94 *BNA’s Banking Report* 103 (2010) (paraphrasing testimony by C.R. “Rusty” Cloutier, a community bank president, who said that “field examiners are overzealous and unduly overreaching and are, in some cases, second guessing bankers and professional independent appraisers and demanding overly aggressive write downs and reclassification of [CRE] loans and other assets”).

⁷⁶ Eugene A. Ludwig, “Viewpoint: Time to Help Community Banks in Crisis,” *American Banker*, Sept. 18, 2009, at 9.

⁷⁷ Wilmarth, Citigroup, *supra* note 14, at 130 (quoting memorandum prepared in May 2010 by former Fed Director of Bank Supervision Richard Spillenkothen); see also *id.* at 131 (quoting testimony at a congressional hearing in May 1997 by Fed Chairman Alan Greenspan, where he stated that the Fed was seeking to avoid “unduly intrusive supervision” and was following “a more risk-focused/less transaction-testing approach” to examinations by giving primary attention to “risk management and control systems” within large banking companies).

⁷⁸ GAO Bank Failure Report, *supra* note 68, at 29-34; FDIC Off. of the Inspector General, *Report to the Congress: Comprehensive Study on the Impact of the Failure of Insured Depository Institutions*, Report No. EVAL-13-002 (Jan. 2013), at 48-58, 68-84, available at <http://www.fdicig.gov/reports13/13-002EV.pdf>.

FDIC Vice Chairman Thomas Hoenig recently criticized federal regulators for abandoning “full-scope examinations” of major banks, and he proposed that bank examiners should “spend more time studying individual [transaction] files to verify the quality of a [large] bank’s internal reports about its risk management capability.”⁷⁹ There has not yet been any indication that the federal banking agencies will adopt Mr. Hoenig’s proposal to apply rigorous “transaction testing” to big banks.⁸⁰

The ultimate divergence in regulatory treatment for megabanks and community banks is shown by the fact that federal regulators guaranteed the survival of the 19 largest banks but stood by while more than 450 community banks failed between 2008 and 2012.⁸¹ During the banking crisis of the 1980s, prior to the enactment of PCA, federal regulators acted much differently and adopted a policy of forbearance for agricultural banks. Regulators sought to avoid unnecessary write-downs on restructured agricultural loans and also provided “capital forbearance” to 301 community banks. More than three-quarters of the banks that received forbearance either survived the crisis or merged without FDIC assistance.⁸² The FDIC later determined that (i) the various bank forbearance programs of the 1980s (including those for agricultural banks and

⁷⁹ Wilmarth, Citigroup, *supra* note 14, at 131 (quoting Mr. Hoenig’s comments during a speech in November 2012 and a subsequent interview in February 2013).

⁸⁰ *Id.* at 131 & n.493 (citing a news report indicating that “some ‘D.C. policy watchers’ were ‘skeptical’ about Hoenig’s proposal for full-scope examinations for big banks”).

⁸¹ See *supra* notes 22-23 and accompanying text (describing the federal agencies’ guarantee of survival for the 19 largest banks in Feb. 2009). According to FDIC records, 465 banks failed between January 2008 and December 2012. 7 *FDIC Quarterly* No. 1 (2013), at 17 (tbl. II-B). Of those failed banks, only nine institutions had assets of more than \$10 billion and only two institutions had assets of more than \$30 billion. See Fed. Deposit Ins. Corp., *Bank Failures in Brief: 2010* (showing that Westernbank failed in April 2010 with \$11.2 billion of assets); *Bank Failures in Brief: 2009* (showing that AmTrust Bank failed in December 2009 with \$12 billion of assets; United Commercial Bank failed in November 2009 with \$11.2 billion of assets; Guaranty Bank and Colonial Bank failed in August 2009 with \$13 billion and \$25 billion of assets, respectively; and BankUnited failed in May 2009 with \$12.8 billion of assets); *Bank Failures in Brief: 2008* (showing that Downey Savings failed in November 2008 with \$12.8 billion of assets; Wamu failed in September 2008 with \$307 billion of assets; and IndyMac Bank failed in June 2008 with \$32 billion of assets), available at <https://www.fdic.gov/bank/historical/bank/>.

⁸² 1 Fed. Deposit Ins. Corp. *History of the Eighties: Lessons for the Future* 49-50, 117-18 (1997) [hereinafter FDIC Banking History] (describing the regulatory forbearance program for agricultural banks and explaining that, of the 301 banks admitted to the capital forbearance program, 201 banks survived the crisis and another 35 merged without FDIC assistance, while 65 failed).

savings banks) would not have been consistent with the subsequently enacted PCA regime, and (ii) a strict application of the PCA regime during the banking crisis of the 1980s would have forced regulators to close more than 200 banks that ultimately survived that crisis.⁸³ During the recent financial crisis, as shown above, federal regulators rigorously followed PCA's no-forbearance regime with respect to community banks but suspended PCA treatment for the largest banks (even though regulators lacked statutory authority for that suspension).⁸⁴

II. Community Banks Were Not Responsible for the Financial Crisis, But the Outcome of the Crisis Has Raised Doubts about Their Ability to Continue Providing Crucial Support for Small Businesses and Local Communities

There is wide agreement that large, complex financial institutions (LCFIs) and credit ratings agencies (CRAs) bear primary responsibility within the private sector for the financial crisis of 2007-2009. However, the crisis triggered a severe and prolonged recession that caused hundreds of failures among community banks. In turn, those failures have raised doubts about the continued ability of community banks to fulfill their central role in supporting small businesses and local communities. The future viability of community banks has also been called into question because of (i) the highly preferential TBTF treatment that megabanks received during the financial crisis, and (ii) the costly new compliance requirements that Dodd-Frank and the Basel III capital accord have imposed on community banks.

A. Community Banks Were Not Responsible for the Financial Crisis, But They Suffered Devastating Losses during the Ensuing Recession

Most analysts and policymakers agree that LCFIs – including the biggest banks, the

⁸³ *Id.* at 51-55 (estimating that the PCA regime would have required closure of 209 banks that survived the crisis).

⁸⁴ *See supra* notes 60-62, 74-76 and accompanying text.

largest securities firms and AIG – were the most important private-sector catalysts for the financial crisis of 2007-2009. With the cooperation of CRAs, LCFIs created the marketing, funding and securitization systems that financed trillions of dollars of subprime and option ARM mortgages and thereby precipitated an unsustainable and catastrophic housing boom.⁸⁵

Megabanks used securitization, along with highly automated marketing and loan approval techniques, to become the unchallenged leaders in residential mortgage lending and other forms of retail lending by 2007, and they further increased their dominance by acquiring troubled lenders (with the federal government’s help) during the crisis.⁸⁶

In contrast, community banks had very little involvement in subprime lending or other forms of securitized lending.⁸⁷ Unlike big banks, community banks typically did not sell high percentages of their residential mortgages for securitization and instead held most of those loans

⁸⁵ Wilmarth, Dodd-Frank, *supra* note 15, at 963-79; Wilmarth, Dark Side, *supra* note 13, at 1002-46; accord Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 5-6, 10-12, 120-74 (2010); Tonya D. Marsh & Joseph W. Norman, *The Impact of Dodd-Frank on Community Banks*, Wake Forest Univ. Legal Stud. Paper No. 2302392 (May 15, 2013), at 22-26, available at <http://ssrn.com/abstract=23022392>; see also Rosenblum, *supra* note 30, at 3, 7, 11 (“TBTF institutions were at the center of the financial crisis”); *id.* at 14 (“TBTF banks remain at the epicenter of the foreclosure mess and the backlog of toxic assets standing in the way of a housing revival”); Speech by Kansas City Fed President Thomas Hoenig, “Regulatory Reform and the Economy: We Can Do Better” (Oct. 6, 2009), at 8 (stating that the “largest [financial] firms . . . were central to this crisis as it expanded and became a global recession”), available at <http://www.kansascityfed.org/SpeechBio/HoenigPDF/Denver.Forums.10.06.09.pdf>.

⁸⁶ Wilmarth, Dark Side, *supra* note 13, at 998-91, 1008-24; Wilmarth, Dodd-Frank, *supra* note 15, at 958-59, 984-85; FDIC Community Banking Study, *supra* note 1, at 5-1, 5-2; GAO Bank Failure Report, *supra* note 68, at 9. Between 1984 and 2011, retail loans (including residential mortgages and other consumer loans) declined from 61% to 36% of all loans held by community banks. During the same period, retail loans rose from 36% to 54% of all loans held by noncommunity banks. FDIC Community Banking Study, *supra* note 1, at 5-1.

⁸⁷ Marsh & Norman, *supra* note 85, at 23-25 (stating that “community banks were very minor players in the subprime lending market” and “participated in only 0.07 percent of residential mortgage securitization activities between 2003 and 2010”); see also Speech by Fed Governor Daniel K. Tarullo, “Large Banks and Small Banks in an Era of Systemic Risk Regulation,” at the North Carolina Bankers Ass’n Annual Convention (June 15, 2009) (“The financial crisis did not originate in smaller banks”), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20090615a.htm>.

in their portfolios.⁸⁸ In addition, most community banks originated home mortgages through their own loan officers and did not rely on mortgage brokers.⁸⁹

This personalized, portfolio-based approach gave community banks strong incentives to screen and monitor their home mortgage loans carefully.⁹⁰ As a result, their residential mortgages had a much lower default rate between 2009 and 2012, compared to mortgages made by larger banks.⁹¹ Indeed, a recent study found that (i) counties in which community banks had a larger than average presence experienced significantly lower rates of home foreclosures from 2005 to 2008, and (ii) the foreclosure-reducing impact of greater community bank presence became even more significant as the mortgage crisis deepened after 2006.⁹²

As the highly automated systems of big banks captured a steadily increasing share of retail lending markets (including home mortgages) after the mid-1980s, community banks were forced to shift more of their lending activities to the CRE market. Community banks significantly increased their holdings of CRE loans between 1984 and 2011.⁹³ Applications by borrowers for CRE loans increased as the housing boom and a stronger economy created rising

⁸⁸ Marsh & Norman, *supra* note 85, at 14; Fed Governor Elizabeth A. Duke, “Community Banks and Mortgage Lending,” Remarks at the Community Bankers Symposium (Nov. 9, 2012) [hereinafter Duke Nov. 9, 2012 Speech], available at <http://www.federalreserve.gov/newsevents/speech/duke20121109a.pdf>. A recent survey by the Independent Community Bankers of America (ICBA) determined that “50 percent of respondents . . . hold all of their mortgage loans in portfolio, and 72 percent of respondents hold at least half of their mortgage loans in portfolio.” Indep. Community Bankers of Am., *Community Bank Regulatory Relief Will Grow Economy and Create Jobs* (April 8, 2014), at 4 (citing results of Sep. 2012 survey) [hereinafter ICBA Regulatory Relief Proposals], available at <http://www.icba.org/files/ICBASites/PDFs/test040814a.pdf>.

⁸⁹ Kathy Fogel et al., “Have community banks reduced home foreclosure rates?”, 35 *Journal of Banking and Finance* 2498, 2500 (2011)

⁹⁰ *Id.* at 2498, 2500.

⁹¹ Marsh & Norman, *supra* note 85, at 24-25 (“Since 2009, portfolio default rates [for residential mortgages] have averaged 0.23 percent at community banks versus 3.62 percent at all [banking] institutions”); Gunther & Klemme, *supra* note 1, at 3, 7 (Chart 2) (showing that “within the beleaguered residential real estate category, . . . community banks exhibited performance far superior to the nation’s largest financial institutions”).

⁹² Fogel et al, *supra* note 89, at 2498-99, 2503-09.

⁹³ Cong. Oversight Panel, *Commercial Real Estate Losses and the Risk to Financial Stability* (Feb. 11, 2010), at 19 [hereinafter COP CRE Report], available at <http://cybercemetery.unt.edu/archive/cop/20110401232630/http://cop.senate.gov/reports/library/report-021110-cop.cfm>; FDIC Community Banking Study, *supra* note 1, at 5-1 (stating that, between 1984 and 2011, CRE loans doubled from 21% to 42% as a share of total loans held by community banks).

demand by tenants for retail and office space during the 1990s and 2000s. However, the sudden collapse of the housing market in 2007 had a disastrous spillover effects on the CRE market.

The housing bust plunged the U.S. economy into a deep recession, causing many retail stores and business offices to close. Widespread closures of stores and offices bankrupted CRE owners and triggered a cascade of falling market values for shopping malls and office buildings.⁹⁴

CRE loans made by community banks during the 1990s and 2000s were typically secured by smaller, less glamorous commercial properties located in towns, smaller cities and suburbs of larger cities. Most insurance companies, real estate investment trusts and other institutional investors (including investors in commercial MBS) did not invest in the types of properties that served as collateral for CRE loans made by community banks. Consequently, when owners of those commercial properties fell behind on their loans from community banks, there were very few if any options for refinancing or selling those properties.⁹⁵ Community banks incurred large losses as growing numbers of their CRE loans defaulted, and losses on CRE loans proved to be a leading cause for many community bank failures.⁹⁶

As Tanya Marsh has observed, there was “no systemic fraud” and “no subprime aspect” in the CRE loans originated by community banks during the period leading up to the financial crisis.⁹⁷ The CRE crisis was the direct result of the bursting of a catastrophic housing bubble – a

⁹⁴ Tanya D. Marsh, “Too Big to Fail vs. Too Small to Notice: Addressing the Commercial Real Estate Debt Crisis,” 62 *Alabama Law Review* 321, 322-24, 328-31, 344-48 (2012); COP CRE Report, *supra* note 91, at 18-36, 80-81; *see also* Ari Levy & Daniel Taub, “Defaulting Commercial Properties Hit Banks on Vacancy-Rate Rise,” *Bloomberg.com*, Mar. 23, 2009 (reporting that “U.S. banks, battered by record losses from the worst housing slump since the Great Depression, must weather increasing loan delinquencies from owners of skyscrapers and shopping malls” because the severe recession was forcing many retail outlets and business offices to close).

⁹⁵ Marsh, *supra* note 94, at 348-57, 373-79; COP CRE Report, *supra* note 93, at 38, 42-44, 62-64, 78-80.

⁹⁶ Marsh, *supra* note 94, at 371-72 (noting that 86% of the 322 banks that failed between January 2008 and December 2010 had high concentrations in CRE lending); GAO Bank Failure Report, *supra* note 68, at 29-31 (discussing evidence that “declining collateral values of impaired collateral-dependent loans – particularly CRE and [acquisition, development and construction] loans – drove both credit losses and charge-offs” that led to the failures of many community banks).

⁹⁷ Marsh, *supra* note 94, at 375.

bubble which LCFIs generated without any meaningful involvement from community banks. Professor Marsh criticizes federal agencies – justifiably, in my view – for “allow[ing] community banks to fail due to circumstances that were ultimately beyond their control, particularly after stepping in to stabilize ‘systemically important’ financial institutions like Citigroup and Bank of America,” which were deeply implicated in the irresponsible lending practices that fueled the housing boom.⁹⁸

As explained above, regulators allowed more than 450 community banks to fail but aggressively intervened to ensure the survival or assisted acquisition of all but one institution that was larger \$100 billion.⁹⁹ Community banks did not deserve their much harsher fate, because their overall performance during the financial crisis was significantly better than the performance of larger banks. In fact, community banks recorded substantially lower levels of noncurrent loans and charged-off loans throughout the crisis, compared with bigger banks.¹⁰⁰ Decisions by federal officials to rescue big banks but not community banks were ultimately driven by

⁹⁸ *Id.*; see also *id.* at 375 n.253 (quoting a comment during a 2010 congressional hearing by Rep. Spencer Bachus (R-AL), who stated that “our larger institutions . . . have been protected and insulated, when, really, a lot of the risk-taking and what happened was a direct result of some of their activities, [while] our smaller banks and our businesses and commercial real estate is [sic] more of a victim of what they did. And it is really not a fair approach that has been taken.”); Wilmarth, Citigroup, *supra* note 14, at 90-105 (describing Citigroup’s reckless subprime lending and securitization practices); Victoria Finkle & Joe Adler, “3 Takeaways from Citi’s \$7 Billion Mortgage Settlement,” *American Banker*, July 15, 2014 (reporting on Citigroup’s agreement to pay \$7 billion to “resolve a whole host of state and federal claims over how the bank packaged and sold mortgage-related assets that soured during the crisis” and defrauded investors); Tom Schoenberg et al., “BofA to Pay \$16.7 Billion to End U.S. Mortgage Probes,” *Bloomberg.com*, Aug. 21, 2014 (reporting that BofA’s \$16.7 billion agreement with federal and state agencies to settle claims that “Bank of America and its Merrill Lynch and Countrywide Financial units sold billions of dollars of mortgage securities backed by toxic loans and misrepresented the risks to investors”); Bonnie Sinnock, “What Bank of America Actually Did Wrong,” *American Banker*, Aug. 29, 2014, at 3 (reporting that the “30-page statement of facts” issued by the U.S. Department of Justice in connection with BofA’s settlement “shows how Countrywide and Merrill Lynch, both of which B of A acquired – as well as B of A itself – removed an increasing number of [mortgage] underwriting requirements over time without clear disclosure to investors”).

⁹⁹ See *supra* notes 22-23, 63-67, 81 and accompanying text.

¹⁰⁰ FDIC Community Banking Study, *supra* note 1, at 4-5, 4-6; Gunther & Klemme, *supra* note 1, at 3, 6 (chart 1); see also *FDIC Quarterly Banking Profile*, 2d Qtr. 2014, at 11 (Tbl. V-A) (showing that, as of June 2014, banks larger than \$10 billion still reported the highest percentages of “Total loans and leases” that were 30-89 days past due or noncurrent or charged-off, compared with banks in the smaller size categories).

regulators' concerns about maintaining financial stability, and regulators gave no weight to the relative performance of larger and smaller banks.¹⁰¹

B. Community Banks Face Costly New Compliance Burdens under the Dodd-Frank Act and Basel III

Some provisions of Dodd-Frank help community banks either by granting exemptions from particular statutory requirements or by giving more favorable treatment to smaller banks. For example, the provisions in Titles I and II dealing with systemically significant financial institutions (SIFIs) apply only to bank holding companies larger than \$50 billion.¹⁰² Title X exempts banks smaller than \$10 billion from direct supervision and enforcement by the Consumer Financial Protection Bureau (CFPB) but still requires them to comply with the CFPB's rules applicable to banks.¹⁰³ Two provisions of Title III assist community banks by raising the per-account deposit insurance ceiling from \$100,000 to \$250,000 and by requiring the FDIC to amend its deposit insurance assessment formula so that larger banks pay a higher (and fairer) percentage of deposit insurance assessments.¹⁰⁴ Two additional provisions benefit smaller banks by (i) removing a requirement that previously compelled small publicly-traded banks to include in their annual audits a report on the effectiveness of their internal controls over financial

¹⁰¹ See *supra* Part 1. As economist James Barth has noted, "Many [community] banks were too small to save Other banks were too big to allow to fail. There is an inequity there." Steve Matthews, "'Ring of Death' Throttles Georgia as Small Banks Close: Economy," *Bloomberg.com*, Mar. 19, 2014 (quoting Prof. Barth).

¹⁰² Marsh & Norman, *supra* note 85, at 29-30; Wilmarth, *Dodd-Frank*, *supra* note 15, at 993-98, 1006-09.

¹⁰³ Dodd-Frank § 1026; see also Marsh & Norman, *supra* note 85, at 32-33 (discussing Section 1026 and other provisions of Title X that apply to community banks); U.S. Gov't Accountability Off., *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881 (Sept. 2012), at 30-35 (same) [hereinafter GAO Dodd-Frank Impact Study].

¹⁰⁴ Dodd-Frank §§ 335, 331; see also GAO Dodd-Frank Impact Study, *supra* note 103, at 22-25 (discussing Sections 331 and 335, and noting the FDIC's views that (i) the new deposit insurance assessment formula mandated by Section 331 has "shifted some of the overall assessment burden from community banks to the largest institutions" and "has resulted in a sharing of the [deposit insurance fund] assessment burden that better reflects each group's share of industry assets," and (ii) the higher deposit insurance coverage limit of \$250,000 "should help community banks attract and retain core deposits").

reporting,¹⁰⁵ and (ii) exempting banks smaller than \$10 billion from the Durbin Amendment's limitation on debit card interchange fees.¹⁰⁶

The foregoing provisions in Dodd-Frank reflect a growing congressional appreciation of the need for a two-tiered approach to regulating community banks and larger banks. However, Dodd-Frank does not go far enough in establishing differing regulatory standards for small and large banks. Instead, Dodd-Frank imposes complex and costly new compliance burdens on community banks.¹⁰⁷

In 2013, the Mercatus Center at George Mason University conducted a survey of community bankers (the Mercatus Small Bank Survey) to determine the impact of Dodd-Frank on small banks.¹⁰⁸ According to the results of that survey, (i) over four-fifths of respondents stated that Dodd-Frank had increased their banks' compliance costs by more than five percent, (ii) many respondents said that their banks would need to hire additional staff members to meet their new compliance requirements, and (iii) over four-fifths of respondents viewed Dodd-Frank's requirements as being even more burdensome for their banks than the Bank Secrecy Act.¹⁰⁹ Other anecdotal reports indicate that growing compliance burdens and costs are major

¹⁰⁵ Dodd-Frank § 989G; *see also* GAO Dodd-Frank Impact Study, *supra* note 103, at 25-27 (discussing Section 989G).

¹⁰⁶ Dodd-Frank § 1075; *see also* GAO Dodd-Frank Impact Study, *supra* note 103, at 27-30 (discussing the Durbin Amendment, but noting concerns among community bankers that the two-tiered interchange fee structure established by the Durbin Amendment might not prove to be viable and therefore might not provide lasting benefits to community banks); Marsh & Norman, *supra* note 85, at 27-28 (same).

¹⁰⁷ Jeff Bater, "Regulatory Reform: Senators Raise Questions of Two-Tiered Regulatory System for Banks Big and Small," 100 *BNA's Banking Report* 1071 (2013); Marsh & Norman, *supra* note 85, at 35-40.

¹⁰⁸ Hester Peirce et al., *How Are Small Banks Faring under Dodd-Frank?*, Geo. Mason Univ. Mercatus Center Working Paper No. 14-05 (Feb. 2014), at 16-19 (describing survey), available at <http://mercatus.org/publication/how-are-small-banks-faring-under-dodd-frank>

¹⁰⁹ *Id.* at 34-37.

factors leading community bankers either to abandon traditional lines of business or to sell their institutions to larger banks.¹¹⁰

New residential mortgage lending rules mandated by Title XIV of Dodd-Frank create particularly challenging obstacles for community banks. Section 1411 requires residential mortgage lenders to determine that their borrowers have “a reasonable ability to repay” their loans together with associated taxes, insurance and mortgage guarantee costs.¹¹¹ Home mortgage lenders that fail to satisfy the “ability to repay” (ATR) requirement are subject to enforcement actions and sanctions by regulators as well as civil claims for damages by borrowers.¹¹² If s residential mortgage loan meets the criteria for a “qualified mortgage” (QM), as specified in the CFPB’s QM regulation, Section 1412 creates either a conclusive or rebuttable presumption that the lender has satisfied the ATR requirement.¹¹³ The CFPB’s QM regulation “is so complex that an inadvertent failure to comply with the QM requirements may become a significant problem,”¹¹⁴ particularly for community banks that do not have large compliance staffs.¹¹⁵ Respondents to the Mercatus Small Bank Survey expressed “general confusion . . .

¹¹⁰ Marsh & Norman, *supra* note 85, at 35-38; Jackie Stewart, “Ranks of Tiny Banks Shrinking as Challenges Mount,” *American Banker*, Feb. 24, 2014, at 2; Jackie Stewart, “A Quarter of Community Banks Expect to Sell Next Year: KPMG,” *American Banker*, Nov. 22, 2013, 2013 WLNR 29274403.

¹¹¹ Dodd-Frank § 1411; *see also* Marsh & Norman, *supra* note 85, at 33 (discussing Section 1411).

¹¹² Marsh & Norman, *supra* note 85, at 34; Raymond Natter, *What Happens If a Mortgage Is Not a QM Loan?* (Dec. 5, 2013), at 2-3, available at <http://ssrn.com/abstract=2371938>.

¹¹³ Marsh & Norman, *supra* note 85, at 34. The CFPB’s QM regulation provides a conclusive presumption in favor of QMs that have an interest rate within 1.5% of the Average Prime Offer Rate (APOR) for first-lien loans, or within 3.5% of the APOR for junior-lien loans. However, higher-priced QMs qualify only for a rebuttable presumption that the lender has satisfied the ATR requirement. Kevin L. Petrasic & Michael A. Hertzberg, “Complying with the CFPB’s Qualified Mortgage Rule: Issues for Implementation,” *Stay Current: A Client Alert from Paul Hastings* (Paul Hastings, Feb. 2013), at 4, available at <http://www.paulhastings.com/publications-items/details/?id=b516de69-2334-6428-811c-ff00004cbded>.

¹¹⁴ Natter, *supra* note 113, at 1.

¹¹⁵ Marsh & Norman, *supra* note 85, at 34 (stating that “the consequences for failing to understand, implement or document [the CFPB’s QM regulation] are high,” and “community banks largely lack the in-house expertise to protect themselves from mistakes that could lead to costly litigation”). The CFPB has issued a “small entity compliance guide” that seeks “to provide an easy-to-use summary of the ATR/QM rule,” but that guide has a length of 50 pages. Consumer Financial Protection Bureau, *Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide* (Jan. 8, 2014), at 9 [hereinafter CFPB ATR/QM Compliance Guide], available at http://files.consumerfinance.gov/f/201401_cfpb_atr-qm_small-entity-compliance-guide.pdf.

about how the mortgage rules apply to them,” and they described the QM regulation and Dodd-Frank’s other new requirements for home mortgages as creating onerous and costly compliance burdens.¹¹⁶

Dodd-Frank’s new ATR and QM standards also present a direct challenge to the traditional business model of community banks. Many community banks provide customized mortgages that are designed to meet the special needs of small business owners and farmers, and many of those mortgages do not satisfy the standard QM criteria with regard to employment, income and collateral. In addition, community banks cannot sell most of those mortgages to GSEs because they do not meet the GSEs’ prescribed criteria for “conforming” mortgages.¹¹⁷ Community banks must therefore retain customized mortgages for entrepreneurs and farmers in their portfolios. To mitigate the interest rate risk of retained mortgages, many community banks include balloon payment terms in their mortgages that require full repayment after five or ten years.¹¹⁸ The ICBA recently estimated that community banks hold more than \$400 billion in balloon payment mortgages that have been extended to over five million borrowers.¹¹⁹

The CFPB’s QM regulation has a strong tendency to “homogenize the market for housing credit by incentivizing lenders to provide mortgage products that favor standard, prime borrowers, or mortgage products that conform to Fannie Mae/Freddie Mac standards.”¹²⁰ The QM regulation’s powerful incentives for “standardized” residential mortgages conflict with the business model followed by community banks, which “emphasizes relationship banking, personalized underwriting, and customization of financial products to meet the specific needs of

¹¹⁶ Peirce et al., *supra* note 108, at 49-52. Some respondents stated that their community banks had already decided to discontinue offering home mortgages because of the new Dodd-Frank rules. *Id.* at 49.

¹¹⁷ ICBA Regulatory Relief Proposals, *supra* note 88, at 3-6; Duke Nov. 9, 2012 Speech, *supra* note 88, at 8-10.

¹¹⁸ ICBA Regulatory Relief Proposals, *supra* note 88, at 3-5.

¹¹⁹ *Id.* at 4-5.

¹²⁰ Petrasic & Hertzberg, *supra* note 113, at 7.

customers and communities.”¹²¹ The QM regulation does include a “small creditor” exception, which provides QM treatment for mortgage loans originated by smaller banks that operate primarily in “rural” or “underserved” counties, if their loans satisfy a number of requirements designed to protect borrowers.¹²² However, the “small creditor” exception is far too narrow to accommodate the mortgage lending practices of many community banks.¹²³ Consequently, the “QM rule poses a daunting challenge” for many community banks that wish to continue making customized mortgages to entrepreneurs and farmers.¹²⁴

Community bankers have also expressed great concerns about Dodd-Frank’s adverse impact on their mortgage servicing activities. Community banks typically retain mortgage servicing rights for a high percentage of the mortgages they originate. Community banks view mortgage servicing rights as an essential component of their business strategy to build long-term relationships with their customers.¹²⁵ However, the CFPB’s new mortgage servicing rules under Dodd-Frank impose highly detailed and costly requirements.¹²⁶ The CFPB’s mortgage servicing rules include a “small servicer” exception, which exempts small servicers from some but not all of the prescribed requirements for mortgage servicing.¹²⁷ However, the small servicer exception applies only to companies (including all affiliates) that service 5,000 or fewer mortgages, and it

¹²¹ Marsh & Norman, *supra* note 85, at 39; *see also* Peirce, *supra* note 108, at 14 (quoting a survey by the Conference of State Bank Supervisors, which found that “many [community] bankers felt that the move toward standardized products and a ‘once-size-fits-all’ supervisory approach were taking away one of the strongest advantages of community banks: the ability to tailor products to fit individualized needs.”).

¹²² CFPB ATR/QM Compliance Guide, *supra* note 115, at 33-36 (describing the small creditor exception, which applies to banks with assets below \$2 billion that originate mortgages predominantly in rural or underserved areas).

¹²³ ICBA Regulatory Relief Proposals, *supra* note 88, at 6-7.

¹²⁴ *Id.* at 3-10 (quote at 6); *accord* Duke Nov. 9, 2012 Speech, *supra* note 88, at 5-14.

¹²⁵ ICBA Regulatory Relief Proposals, *supra* note 88, at 8-9.

¹²⁶ The CFPB has issued a “small entity compliance guide” that seeks “to provide an easy-to-use summary of the Mortgage Servicing Rules,” but that guide is more than 100 pages in length. Consumer Financial Protection Bureau, *2013 Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Rules: Small Entity Compliance Guide* (Jan. 8, 2014), at 11 [hereinafter CFPB Mortgage Servicing Compliance Guide], available at http://files.consumerfinance.gov/f/201401_cfpb_small-entity-compliance-guide_tila-respa.pdf.

¹²⁷ CFBP Mortgage Servicing Compliance Guide, *supra* note 126, at 16-19 (describing the small servicer exception).

therefore fails to cover many community banks that are active in making and servicing home mortgages.¹²⁸

Section 171 of Dodd-Frank requires community banks to comply with new capital standards adopted by federal banking agencies to implement the Basel III capital accord.¹²⁹ In July 2013, the federal banking agencies issued a new capital regulation under Basel III,¹³⁰ and that regulation imposes much higher capital charges on mortgage servicing rights retained by banks. Under the new regulation, which takes effect in 2015, any bank (including a community bank) with mortgage servicing assets (MSAs) that exceed 10 percent of its common equity tier 1 capital will be required to deduct the excess amount from its regulatory capital. In addition, MSAs below the 10 percent threshold will be subject to a 250 percent risk weight.¹³¹ Consequently, in 2015 community banks that are active home mortgage lenders will have “starkly lower capital ratios . . . or [will] be forced to raise new capital, a significant challenge for community banks in the current environment.”¹³²

Increased compliance costs under the new mortgage rules and higher capital charges under the new capital rule are likely to cause many community banks to shrink or abandon their

¹²⁸ ICBA Regulatory Relief Proposals, *supra* note 88, at 8-9; *see also* CFPB Mortgage Servicing Compliance Guide, *supra* note 126, at 16-19 (explaining the small servicer exemption).

¹²⁹ Marsh & Norman, *supra* note 85, at 30. .

¹³⁰ For a detailed overview of the new capital regulation issued in July 2013, see Sullivan & Cromwell LLP, *Bank Capital Rules: Federal Reserve Approves Final Rules Addressing Basel III Implementation and, for All Banks, Substantial Revisions to Basel I-Based Rules* (July 3, 2013), available at http://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital%20_Rules_Basel_III_7_3_13.pdf. The federal banking agencies have issued a guide “to help small, non-complex community banking organizations understand the sections of the capital rule . . . most relevant to their operations.” Bd. of Governors of Fed. Res. Sys. et al., *New Capital Rule: Community Bank Guide* (July 2013), at 1, available at http://www.federalreserve.gov/bankinfo/reg/basel/files/capital_rule_community_bank_guide_20130709.pdf [hereinafter *Capital Rule Community Bank Guide*].

¹³¹ *Capital Rule Community Bank Guide*, *supra* note 130, at 3; Testimony of Samuel A. Vallandingham on behalf of the Indep. Community Bankers of Am. Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services, July 15, 2014, at 4 [hereinafter *Vallandingham Testimony*], available at <http://www.icba.org/files/ICBASites/PDFs/test071514a.pdf>.

¹³² *Vallandingham Testimony*, *supra* note 131, at 5.

mortgage lending and servicing businesses.¹³³ That outcome would be very harmful to consumers, entrepreneurs, farmers and local communities, because community banks originate nearly one-fifth of all new residential mortgage loans each year.¹³⁴ As discussed below, federal regulators should revise their mortgage rules and the new capital regulation for the purpose of achieving a significant reduction in Dodd-Frank’s burdens on community banks.¹³⁵

III. The Preservation of a Healthy Community Banking Sector Should Be a National Priority.

A. Community Banks Play Crucial Roles in Supporting Small Businesses and Local Communities

The small business sector is a highly important sector in our economy, and the health of the small business sector depends in large part on the ability of community banks to fulfill their traditional role as relationship lenders. Small businesses (those with fewer than 500 employees) account for almost half of U.S. private-sector jobs and private sector output.¹³⁶ Small firms created more than three-fifths of all net new U.S. jobs between 1993 and 2013.¹³⁷ Small businesses (particularly start-up and younger firms) have spurred much of the innovation and dynamism in the U.S. economy over the past three decades.¹³⁸

Banks are, and have long been, the most important providers of external credit to small

¹³³ Peirce, *supra* note 108, at 49-52.

¹³⁴ Duke Nov. 9, 2012 Speech, *supra* note 88, at 5-14; ICBA Regulatory Relief Proposals, *supra* note 88, at 2-7; Vallandingham Testimony, *supra* note 129, at 2-6; Marsh & Norman, *supra* note 85, at 13-14, 33-39.

¹³⁵ See *infra* Part 4.

¹³⁶ U.S. Small Bus. Admin., Off. of Advocacy, *Frequently Asked Questions* (Mar. 2014), at 1 (stating that small firms account for “48.5 percent of private-sector employment” and “46 percent of private-sector output”) [hereinafter SBA FAQ], available at http://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf.

¹³⁷ *Id.* (stating that small firms created “14.3 million of 22.9 million net new jobs,” or 63 percent of such jobs, between 1993 and 2013); see also U.S. Small Bus. Admin., *The Small Business Economy 2010: A Report to the President* (2010), at 26 (stating that small firms “accounted for 64 percent of the net new jobs created between 1993 and 2008”) [hereinafter Small Business Economy Report], available at http://www.sba.gov/sites/default/files/sb_econ2010.pdf.

¹³⁸ Small Business Economy Report, *supra* note 137, at 27-28 (citing studies); John Haltiwanger et al., “Who Creates Jobs? Small Versus Large Versus Young,” 95 *Review of Economics and Statistics* 347 (2013).

businesses.¹³⁹ Within the banking industry, the community banking sector has consistently served as a dedicated and essential source of credit to small firms.¹⁴⁰ Community banks currently provide about half of all bank credit extended to small businesses, even though community banks hold less than one-fifth of the banking industry's assets.¹⁴¹

Community banks pursue a “relationship lending” strategy that gives them significant advantages in providing credit to small firms.¹⁴² Relationship lending grows out of the willingness and ability of community banks to gather and evaluate “soft” information about the reputation and creditworthiness of local entrepreneurs. Community banks have superior resources for gathering and evaluating “soft” information about local businesses, because their executives and loan officers usually have long tenures in their positions and extensive personal involvement in the life of their communities.¹⁴³ For example, locally-owned banks and their

¹³⁹ Rebel Cole, *How Did the Financial Crisis Affect Small Business Lending in the United States?* (Dec. 19, 2013), at 1 n.1 (stating that “about 60 percent of all small firms use some form of bank credit”), available at <http://ssrn.com/abstract=1899067>; Charles Ou & Victoria Williams, “Lending to Small Businesses by Financial Institutions in the United States,” in *Small Business in Focus: Finance* (U.S. Small Bus. Admin. Off. of Advocacy, July 2009), at 9-10, 11, available at http://www.sba.gov/sites/default/files/advocacy/09finfocus_0.pdf (stating that commercial banks “accounted for 58 percent of total debt owed by . . . small firms to external lenders” in the early 2000s); Wilmarth, *Transformation*, *supra* note 13, at 258-62 (“Banks provide more than three-fifths of the credit extended to small businesses by persons other than owners and trade creditors, and banks have maintained this dominant market share despite the significant changes that have occurred in the financial services industry [since 1980].”).

¹⁴⁰ FDIC Community Banking Study, *supra* note 1, at I, 1-1 (“Community banks have always been inextricably connected to entrepreneurship. . . . They obtain most of their core deposits locally and make many of their loans to local businesses.”).

¹⁴¹ *Id.* at I, 5-1 (reporting that in 2011 community banks, as defined by the FDIC, “held 14 percent of banking industry assets, but 46 percent of the industry’s small loans to farms and businesses”); Jeffrey W. Gunther & Kelly Klemme, “A Lender for Tough Times,” in 2012 Dallas Fed Annual Report, *supra* note 1, at 9 (stating that banks with assets under \$10 billion “held 17 percent of industrywide banking assets as of June 2012 – but they accounted for more than half of the amount lent to small businesses”).

¹⁴² FDIC Community Banking Study, *supra* note 1, at 1-1 (“The relationship lending approach used by community banks is often the only avenue small borrowers have to obtain loans and access other financial services.”).

¹⁴³ Allen N. Berger et al., “Does function follow organizational form? Evidence from the lending practices of large and small banks,” 76 *Journal of Financial Economics* 237, 239-45, 265-67 (2005); Rebel A. Cole et al., “Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks,” 39 *Journal of Financial and Quantitative Analysis* 227, 228-30, 249 (2004); Wilmarth, *Transformation*, *supra* note 13, at 255-57, 262, 266.

executives, directors and staff members typically provide generous financial support and volunteer leadership for local charitable and civic organizations.¹⁴⁴

Community banks play a particularly important role in supporting local economies and civic groups in rural counties as well as a number of counties included in metropolitan areas where few other banks are present. In 2012, community banks were the *only* banks operating banking offices in 615 counties, and community banks operated offices in 642 additional counties where noncommunity banks *collectively* had only one or two offices. Thus, more than a third of U.S. counties, with a total population of over 16 million people, “would have very limited access to mainstream banking services without the presence of community banks.”¹⁴⁵

Community banks emphasize the importance of providing deposit and cash management services to small businesses, because deposit accounts cement their relationships with local entrepreneurs. Deposit accounts enable community banks to monitor the economic performance of their businesses lending customers. In turn, small businesses frequently choose to establish deposit accounts at banks that have their main offices located nearby.¹⁴⁶

¹⁴⁴ For discussions of the importance of locally-owned banks as sources of philanthropy and civic leaders for community-based charitable and social organizations, see Richard Brunell, “The Social Costs of Mergers: Restoring ‘Local Control’ as a Factor in Merger Policy,” 85 *North Carolina Law Review* 149, 151-55, 214-20 (2006); Peter C. Carstensen, “Public Policy Toward Interstate Bank Mergers: The Case for Concern,” 49 *Ohio State Law Journal* 1397, 1425 (1989); *see also* Josh Adams, “Local banks a key part of community,” *Tennessean* (Nashville, TN), Feb. 9, 2012, 2012 WLNR 2799130 (describing the importance of community banks and their managers and directors as supporters and leaders of local charities and community groups); Kalem Holliday, “Building Communities: One Bank at a Time,” *Savings & Community Banker*, Oct. 1, 2004, at 52, 2004 WLNR 15911752 (reporting results of a survey showing that “[n]early all community banks donate time, money, or both to their communities,” with most community banks supporting more than ten nonprofit or community organizations).

¹⁴⁵ Backup, *supra* note 48, at 34 (providing data and noting that the U.S. has a total of 3,238 counties); *see also* FDIC Community Banking Study, *supra* note 1, at 3-5 (explaining that, in 2011, more than 70 percent of the counties in which community banks either operated all banking offices, or all but one or two offices, were rural counties, but about 15 percent of those counties were included in metropolitan areas).

¹⁴⁶ Cole et al., *supra* note 143, at 247 (finding that “small banks, but not large banks, favor an applicant with which it has a pre-existing deposit relationship”); Wilmarth, *supra* note 15, at 262, 268 (“The ability of local banks to observe small business deposit accounts provides those banks with a significant monitoring advantage over large banks that are headquartered outside the community and, therefore, are less likely to attract deposits from small firms within the locality.”); *see also infra* note 152 and accompanying text (describing another study that found a strong link between deposit accounts maintained by small businesses and relationship lending by community banks).

Community banks “target small businesses as their primary customers for business lending and related services, while large banks view midsized and larger corporations as their preferred customers for financial services.”¹⁴⁷ Large banks prefer to make loans to bigger firms that can provide “hard” quantitative data, including audited financial statements.¹⁴⁸ When large banks do provide credit to small businesses, they frequently do so in the form of business credit cards with “micro” lines of credit under \$100,000. Large banks use business credit cards to make loans to small firms because they can originate those loans – based primarily on the business owner’s personal financial profile and credit history – by using the same quantitative and automated methods (including credit scoring and mass marketing) that they use for their consumer credit card programs.¹⁴⁹

A study by Allen Berger and Lamont Black confirms that large banks generally provide small business credit by using quantitative “hard” technologies, while community banks prefer to make small business loans through a relationship-based approach that incorporates “soft” information.¹⁵⁰ Berger and Black found that large banks in the late 1990s were more likely to extend credit to the smallest size category of small businesses (presumably through business credit card loans) and to provide credit in the form of equipment leases, where large banks could use “hard” technologies and did not have to rely on “soft” information.¹⁵¹ In contrast,

¹⁴⁷ Wilmarth, Transformation, *supra* note 13, at 263; *see also* Gunther & Klemme, *supra* note 141, at 9 (reporting that community banks “have about 13 percent of [their] assets in small business loans, far above the 2 percent for the largest banks”).

¹⁴⁸ Berger et al., *supra* note 143, at 240, 250, 252; Cole et al., *supra* note 143, at 236, 245. Large banks prefer to rely on “hard” information and to use standardized, “cookie cutter” criteria for approving loans because (i) it is difficult for loan officers at large banks to gather and transmit to senior executives “soft” information about small businesses, and (ii) complex hierarchies within large banks create control problems that encourage senior executives to prescribe quantitative criteria that give very limited discretion to loan officers. Berger et al., *supra* note 138, at 239-40, 242-43; Cole et al., *supra* note 98, at 229-30, 249.

¹⁴⁹ Ou & Williams, *supra* note 139, at 9, 14-20; Wilmarth, Transformation, *supra* note 13, at 264-65, 267.

¹⁵⁰ Allen N. Berger & Lamont K. Black, “Bank size, lending technologies, and small business finance,” 35 *Journal of Banking & Finance* 724 (2011) (presenting study based on small business lending data from the late 1990s).

¹⁵¹ *Id.* at 724, 726-29, 732-34; *see also supra* note 149 (discussing business credit card loans made by large banks to small businesses).

community banks were more likely to provide credit to small businesses through commercial real estate loans (because community banks could evaluate “soft” information about local property values) or through lines of credit that were based on existing relationships between the borrowers and the lending banks. Community banks therefore preferred to provide lines of credit to small businesses that maintained checking accounts or had longer relationships with them.¹⁵² Berger and Black concluded that relationship factors were more important than the size of the borrower in determining whether small businesses obtained credit from community banks instead of large banks.¹⁵³

In keeping with their business strategy of building strong relationships, community banks were more reliable sources of credit for small businesses during the last two banking crises, compared with larger banks.¹⁵⁴ During the most recent crisis, larger banks cut back sharply on their small business lending. A study by Rebel Cole determined that banks receiving TARP capital assistance – which were primarily larger banks – reduced their small business lending by a significantly higher percentage between 2008 and 2011, compared with banks (mainly smaller institutions) that did not receive TARP assistance.¹⁵⁵ Similarly, the Small Business Administration reported that large banks substantially reduced the amount of credit they provided to small firms through business credit cards after 2008.¹⁵⁶

¹⁵² Berger & Black, *supra* note 150, at 728-29, 733-34.

¹⁵³ *Id.* at 733-34.

¹⁵⁴ Gunther & Klemme, *supra* note 141, at 10 (stating that, between mid-2008 and mid-2010, “community bank loan volume held up relative to 2007 levels, while the biggest banks significantly reduced business lending”); Wilmarth, Transformation, *supra* note 13, at 262 (citing a study finding that “small business lending declined by a greater percentage at banks larger than \$10 billion [during the banking crisis of the late 1980s and early 1990s] compared to banks smaller than \$1 billion”).

¹⁵⁵ Cole, *supra* note 139, at 25-26, 31, 41, 43-44. See also *supra* notes 24-25 and accompanying text (explaining that most TARP capital assistance was given to the largest banks, while relatively little TARP assistance was provided to community banks).

¹⁵⁶ Small Business Economy Report, *supra* note 137, at 86-87, 94-95.

Community banks slightly increased their share of the small business lending market between mid-2008 and mid-2012, even though their share of banking industry assets declined during that period.¹⁵⁷ Moreover, small business lending grew at a much faster rate at community banks between mid-2013 and mid-2014, compared with the rest of the banking industry.¹⁵⁸ The lending performance of community banks during the recent crisis is particularly impressive when one considers that (i) the federal government provided relatively little help to community banks during the crisis while providing enormous amounts of assistance to big banks, and (ii) as a result of the generosity shown by the federal government toward large banks, only nine banks larger than \$10 billion failed while more than 450 smaller banks failed.¹⁵⁹

B. Recent Failures of Community Banks Have Inflicted Serious Harm on Small Businesses and Communities

Notwithstanding the commendable performance of the more than 6,000 community banks that survived the financial crisis,¹⁶⁰ the failures of hundreds of community banks seriously damaged the small business sector as well as local communities. As Mark Gertler observed, “[t]he demise of local lenders has inflicted a disproportionate blow on small enterprises.”¹⁶¹ Mark Zandi similarly explained, “Small bank failures matter a lot to the communities in which

¹⁵⁷ U.S. Small Bus. Admin., Off. of Advocacy, *Small Business Economy 2012* [hereinafter 2012 SBA Report]. Table B.9 (“Share of Business Loans and Total Assets by Size of All U.S. Depository Institutions”) (showing that, between June 2008 and June 2012, the share of small business loans held by banks with assets under \$10 billion increased from 51.73% to 51.79%, even though the share of total banking industry assets held by those banks declined from 23.46% to 22.19%), available at <http://www.sba.gov/advocacy/small-business-economy> (providing links to summary report for 2012 and tables).

¹⁵⁸ *FDIC Quarterly Banking Profile*, 2d Qtr. 2014, at 14-15 (reporting that small business loans by community banks grew by 3.1% from June 2013 to June 2014, compared with a growth rate of only 1.1% for the entire banking industry), available at <https://www2.fdic.gov/qbp/2014jun/qbp.pdf>; see also Chris Cumming, “Smaller Banks Generating Solid Loan Growth as Others Ease Up,” *American Banker*, April 25, 2014, 2014 WLNR 11028680 (reporting that loans at banks with assets under \$40 billion had grown by 12% since the first quarter of 2013, while loans at banks larger than \$50 billion had grown by less than 2% during that period).

¹⁵⁹ See *supra* Part 1.

¹⁶⁰ See Backup, *supra* note 48, at 29 (tbl.1), 34-37 (reporting that 6,141 community banks remained in operation at the end of 2012, and their performance improved during 2012).

¹⁶¹ Matthews, *supra* note 101 (quoting Prof. Gertler).

they operate, especially in non-urban areas. Small banks are key to small businesses.”¹⁶² A prominent Atlanta lawyer pointed out that the failures of many community banks in Georgia “sidelined the important mission of allocating capital to borrowers with legitimate needs [and] had a very damaging impact on the state.”¹⁶³

A recent study by John Kandrac determined that bank failures between 2008 and 2010 had significantly adverse impacts on income, employment, compensation growth and poverty in the counties where failures occurred.¹⁶⁴ Similarly, news reports indicate that many small businesses could not find any type of external funding, or were forced to rely on much more expensive credit from nonbank lenders, when local banks failed or were unable to continue providing loans to their established small firm customers.¹⁶⁵ Financing for small businesses from angel investors, venture capital firms and public stock offerings declined precipitously after 2008, and those sources of funding have recovered very slowly in the past few years.¹⁶⁶

¹⁶² *Id.* (quoting Mr. Zandi, chief economist at Moody’s Analytics, Inc.).

¹⁶³ *Id.* (quoting Brian Olasov).

¹⁶⁴ John Kandrac, *Bank Failure, Relationship Lending, and Local Economic Performance* (Oct. 1, 2013), at 3, 10-11, 19-20, available at <http://ssrn.com/abstract=2353687>. Kandrac found that the effects of bank failures on local economies were less severe in cases where the FDIC entered into loss-sharing agreements with acquiring banks. As Kandrac pointed out, those loss-sharing agreements obligated the acquiring banks to maintain relationships with the failed banks’ borrowers for a specified period of time. *Id.* at 12-15. The results of his study “support the view that bank failures can have important effects on local economies, and that the disruption of banking relationships is a likely channel through which these effects are transmitted.” *Id.* at 16; *see also* Adam B. Ashcraft, “Are Banks Really Special? New Evidence from the FDIC-Induced Failure of Healthy Banks,” *95 American Economic Review* 1712 (2005) (finding, based on a study of 56 solvent bank subsidiaries of two large Texas bank holding companies that failed after the FDIC triggered cross-guarantee obligations in 1988 and 1992, that those bank failures led to sharp declines in bank lending and significant reductions in personal incomes in the counties where the failed banks were located).

¹⁶⁵ Matthews, *supra* note 101 (describing the inability of small firms to find alternative financing after their local banks failed); Zeke Faux & Max Abelson, “A Nasty Neighborhood’s Mr. Rogers,” *Bloomberg BusinessWeek*, July 14-20, 2014, at 36 (reporting on Kalamata Capital, a nonbank lender that was charging annual interest rates to small firms ranging from 53 to 72 percent); Andrew Martin, “The Places They Go When Banks Say No,” *New York Times*, Jan. 31, 2010, § BU, at 1, 2010 WLNR 2021142 (describing Harsko Financial Services, another nonbank lender that was charging annual interest rates of more than 40 percent to small and mid-sized firms).

¹⁶⁶ Small Business Economy Report, *supra* note 137, at 98-103; SBA FAQ, *supra* note 136, at 2.

Similarly, total business lending by finance companies fell at a significantly faster rate between 2008 and 2012, compared with the decline in small business lending by banks.¹⁶⁷

In view of the close relationships that community banks build with entrepreneurs and the significant injuries that the community banking sector suffered during the financial crisis, it is not surprising that small businesses also experienced severe losses during and after the financial crisis. For example, nearly 60 percent of the net job losses recorded by all U.S. employers occurred at small businesses during the first three quarters of 2009.¹⁶⁸ The share of net U.S. job losses incurred by the smallest firms (those with fewer than 50 employees) “was nearly double their 30% share of total employment” between 2007 and 2012.¹⁶⁹ During the same five-year period, rates for new business formation and small business expansion fell sharply below their established trend lines between 1992 and 2006.¹⁷⁰ An important reason for the financial crisis’ disproportionate impact on smaller firms was that small businesses have long relied on banks for external credit and had very few alternative sources for financing when bank lending declined.¹⁷¹

Two Citigroup economists, Nathan Sheets and Robert Sockin, recently documented the harm suffered by the small business sector as a consequence of the financial crisis and the resulting drop in bank credit.¹⁷² Sheets and Sockin found that bank credit to both large companies and small firms declined sharply between 2008 and 2010. However, bank loans to

¹⁶⁷ 2012 SBA Report, *supra* note 157, Tables B.9. & B.10 (showing that, between 2008 and 2012, small business lending by banks declined from \$711.5 billion to \$587.8 billion, a decrease of 17.4%, while total business lending by finance companies fell from \$607.6 billion to \$467.4 billion, a reduction of 23.1%).

¹⁶⁸ Small Business Economy Report, *supra* note 137, at 28-29.

¹⁶⁹ Elizabeth Laderman, “Small Businesses Hit Hard by Weak Job Gains,” *FRBSF Economic Letter*, No. 2013-26 (Sept. 9, 2013), at 1, available at <http://www.frbsf.org/economic-research/publications/economic-letter/2013/september/small-business-job-growth-employment-rate/el2013-26.pdf>.

¹⁷⁰ *Id.* at 3-4; François Gourio et al., “What is the economic impact of the slowdown in new business formation,” *Chicago Fed Letter* No. 326 (Sept. 2014), at 1-2, available at http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2014/cflseptember2014_326.pdf.

¹⁷¹ Laderman, *supra* note 169, at 1-2; Gourio et al., *supra* note 170, at 1.

¹⁷² Nathan Sheets & Robert A Sockin, “Empirical & Thematic Perspectives: Does Size Really Matter? The Evolving Role of Small Firms in the U.S. Economy,” *Citi Research: Economics* (Dec. 10, 2012) (copy on file with the author, available at file:///C:/Users/awilmarth/Downloads/CITI++Empirical+&+Thematic+Perspectives%20(1).pdf).

large companies increased after 2010 and “returned to their previous peak” by 2012, while bank loans to small firms remained “15 percent off their peak” in 2012. Sheets and Sockin also calculated that bank lending to large companies increased by \$400 billion, or 75 percent, between 2004 and 2012, but bank lending did not show any substantial increase for small firms.

As Sheets and Sockin pointed out, “This is a remarkable shift in the distribution of credit over an eight-year period and may, if anything, understate the actual difference in credit allocation, given that large firms have greater access to corporate debt markets.”¹⁷³ As they also observed, a Boston Fed staff study found that small firms with a high degree of dependence on external financing were “more likely to lay off workers” during the financial crisis because those small firms “absorbed a significant credit-supply shock.”¹⁷⁴

Beyond the curtailment of credit for small businesses, failures of community banks have inflicted broader injuries on their local communities. As noted above, (i) community banks and their managers and staff play leading roles in supporting local charitable and civic groups through financial contributions and volunteer work,¹⁷⁵ and (ii) community banks are the only banks operating physical offices in many rural counties and some metropolitan areas.¹⁷⁶ Consequently, failures of community banks have caused significant funding and staffing challenges for many local charities and public service organizations.¹⁷⁷ Large, out-of-town

¹⁷³ *Id.* at 13.

¹⁷⁴ *Id.* at 15 (citing Burcu Duygan-Bump et al., “Financing Constraints and Unemployment: Evidence from the Great Recession,” Fed. Res. Bank of Boston, Working Paper No. QAU10-6 (Dec. 6, 2011), available at <http://www.bostonfed.org/bankinfo/qau/wp/2010/qau1006.pdf>). The Boston Fed staff study determined that “reduction in bank lending to small and financially constrained firms during the Great Recession is associated with increased layoffs of workers.” Duygan-Bump et al., *supra*, at 23.

¹⁷⁵ See *supra* note 144 and accompanying text.

¹⁷⁶ See *supra* note 145 and accompanying text.

¹⁷⁷ GAO Bank Failure Report, *supra* note 68, at 53 (describing views of state bank regulators and community banking associations); Tammy Joyner, “Failed bank honored in Henry County,” *Atlanta Journal-Constitution*, May 4, 2012, 2012 WLNR 28602023 (reporting on the extensive charitable contributions and community involvement of a failed community bank, and describing concerns among local citizens about the availability of future support for community organizations); Laura McVicker, “Bank’s collapse puts local charities in limbo,” *Columbian* (Vancouver, WA), Jan. 22, 2009, 2009 WLNR 1359469 (same).

banks that acquire failed community banks are less likely to provide comparable support to local nonprofits, because those banks tend to give most of their backing either to nonprofits located in their headquarters cities or larger statewide and national organizations.¹⁷⁸ Thus, community bank failures have ripple effects that reach far beyond the banks themselves.

C. A Further Decline in the Significance of the Community Banking Sector Would Seriously Harm Small Businesses, Consumers and Local Communities

Domestic and international evidence confirms that small firms, consumers and local communities suffer when community banks are unable to maintain a significant competitive presence in local markets. After reviewing the striking contrast between the rapid growth in bank credit for large firms between 1995 and 2012 and the much slower rate of growth in bank lending to small firms, Sheets and Sockin emphasized the importance of the shrinking presence of community banks.¹⁷⁹ As they pointed out:

Well-established results in the empirical literature have shown a special link between small firms and small banks. As such, this sustained and sizable decline in the role of small banks as providers of credit – reflecting the ongoing consolidation of the U.S. banking system – is very likely a factor contributing to the downtrend in the share of credit provided to small firms.¹⁸⁰

¹⁷⁸ GAO Bank Failure Report, *supra* note 68, at 53; *see also* Brunell, *supra* note 144, at 151-55, 214-15 (discussing the tendency of larger, nonlocal banks to reduce contributions to local charities after acquiring local banks and to give greater support to nonlocal charities); Carstensen, *supra* note 144, at 1425 (same).

¹⁷⁹ Sheets & Sockin, *supra* note 171, at 13-14 (noting that bank lending to large firms expanded from \$350 billion in 1995 to \$900 billion in 2012, an increase of more than 150 percent, while bank lending to small firms rose from \$175 billion to \$280 billion during the same period, a rise of only 60 percent).

¹⁸⁰ *Id.* at 14 (footnote omitted); *see also id.* at 15 (stating that “the ongoing consolidation of the U.S. banking system, particularly the declining role of small banks, also appears to have been an important factor weighing on the supply of credit to small firms in recent years”).

A study by Steven Craig and Pauline Hardee concluded that small businesses were less likely to obtain access to bank credit, and also were likely to receive lower amounts of credit, in U.S. markets that were dominated by the largest banks.¹⁸¹ Craig and Hardee determined that nonbank lenders offset some, but not all, of the reduction in availability of small business credit in markets dominated by big banks.¹⁸² Similarly, a study by Allen Berger and others found that small firms were more “credit constrained” and more likely to be late in paying off their trade credit if they borrowed from larger banks.¹⁸³ Berger’s study concluded that larger banks “are not as effective at alleviating credit constraints” for small businesses and, consequently, “bank consolidation may raise meaningful concerns for small firms.”¹⁸⁴

A continued decline in the competitive presence of community banks would harm consumers and local communities as well as entrepreneurs. Numerous studies have concluded that large banks charge substantially higher fees for deposit account services, including automated teller machine (ATM) fees, account maintenance fees, overdraft fees and non-sufficient funds (NSF) fees, compared with small banks.¹⁸⁵ Surveys of bank customers also show that small banks maintain customer satisfaction rates that are much higher than those for

¹⁸¹ Steven G. Craig & Pauline Hardee, “The impact of bank consolidation on small business credit availability,” 31 *Journal of Banking & Finance* 1237, 1239-40, 1248-49, 1258-59 (2007).

¹⁸² *Id.*

¹⁸³ Berger et al., *supra* note 143, at 241, 245-46, 260.

¹⁸⁴ *Id.* at 266.

¹⁸⁵ See, e.g., Consumer Financial Protection Bureau, *CFPB Study of Overdraft Programs: A white paper of initial data findings* 52 (June 2013) (stating that, in 2012, the median NSF fee and median overdraft fee among 33 large banks were both \$34, while the median NSF fee and median overdraft fee among 800 smaller banks and credit unions were both \$30), available at http://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf; U.S. Pub. Interest Res. Group, *Big Banks, Bigger Fees 2012: A National Survey of Fees and Disclosure Compliance* 1-2, 9-11 (2012) (reporting results of survey showing that “small banks had lower average checking account fees, overdraft fees and foreign or off-us ATM fees, as well as lower balance requirements to avoid checking fees, than big banks,” *id.* at 1), available at http://www.uspirg.org/sites/pirg/files/reports/USPIRG_Big_Banks_Bigger_Fees_0.pdf; U.S. Gov’t Accountability Off., *Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts*, GAO-08-281 (Jan. 2008), at 16 (“Large institutions on average charged between \$4.00 and \$5.00 more for insufficient funds and overdraft fees than smaller institutions”); Wilmarth, *Transformation*, *supra* note 13, at 295 (citing earlier studies finding that “large, multistate banks charge fees on deposit accounts that are significantly higher than the fees assessed by small community banks”).

big banks.¹⁸⁶ In addition, as indicated above, many rural counties and some counties in metropolitan areas will be left without any banking offices (or with very few) if large numbers of community banks are forced to close.¹⁸⁷

Studies of foreign banking markets have similarly found that small businesses and consumers receive better service in markets where community banks maintain a significant presence, compared with markets dominated by large banks. A study of banking markets in twenty European nations between 2005 and 2008 concluded that small and medium-sized enterprises (SMEs) made substantially lower investments if they were dependent on bank financing and operated in markets where banks exercised significant market power.¹⁸⁸ Another study of twenty-one developed nations and twenty-eight developing nations found that countries with stronger community bank sectors (i.e., countries where community banks had a larger total market share and a higher average efficiency ranking) reaped significant benefits in the form of faster growth in GDP, higher employment by SMEs, and increased availability of bank credit.¹⁸⁹

Recent studies by the U.K. Financial Conduct Authority (FCA) and Competition & Markets Authority (MCA) show that the U.K.'s highly concentrated banking system provides inferior service and imposes high costs on SMEs and consumers. The four largest U.K. banks hold over 80 percent of domestic "business current accounts" (BCAs) maintained by SMEs, and

¹⁸⁶ Kate Berry, "Small Banks Still Rule in Customer Satisfaction," *American Banker*, April 18, 2013; see also Tom Bengtson, "Community banks have edge in small business lending," *Northwestern Financial Review*, Dec. 15, 2008, at 19, 2008 WLNR 24955810 (reporting that "[s]mall banks have historically enjoyed the highest level of customer satisfaction, although medium-size banks are making gains, narrowing the gap with smaller banks. . . . [S]urveys show 72 percent of small business customers who bank at small banks are very satisfied with their banking relationship; 64 percent who bank at medium-size banks are very satisfied, and 51 percent of people who bank at large banks are very satisfied.").

¹⁸⁷ See *supra* note 145 and accompanying text.

¹⁸⁸ Robert Ryan et al., "Does bank market power affect SME financing constraints?," *Journal of Banking & Finance* (2014) (forthcoming) (preliminary version available on journal website).

¹⁸⁹ Allen Berger et al., "Further Evidence on the Link between Finance and Growth: An International Analysis of Community Banking and Economic Performance," 25 *Journal of Financial Services Research* 169, 186-92, 197-98 (2004).

those banks also provide 90 percent or more of business loans to SMEs.¹⁹⁰ A joint study by the FCA and MCA determined that (i) only 13 percent of SMEs in the U.K. “trust their bank to act in their best interests,” (ii) only 25 percent of SMEs in the U.K. “consider that their bank supports their business,” and (iii) “more SMEs would be *unwilling* to recommend their bank to a friend than would be *willing* to do so.”¹⁹¹ The joint study also found that BCAs offered by smaller U.K. banks were less expensive than those provided by the four biggest banks, and that “satisfaction levels of SME customers at the smaller banks tend to be higher than those at the largest banks.”¹⁹² The joint study concluded that “competition is less effective in delivering good outcomes for SMEs . . . than would be the case in a market where banks are under more competitive pressure. . . . [O]verall we believe the evidence indicates that [U.K.] banks are underperforming in satisfying SME customers.”¹⁹³

A separate study by the CMA reached similar results with regard to “personal current accounts” (PCAs) that U.K. banks provide to consumers. The four biggest U.K. banks control more than three-quarters of the consumer PCA market.¹⁹⁴ The CMA’s study found that “larger [banks] have lower customer satisfaction scores and attract more complaints” and also “pay lower interest on credit balances,” compared with smaller banks.¹⁹⁵ In addition, banks “with the lowest customer satisfaction rating have the highest market shares, while [smaller banks] with

¹⁹⁰ U.K. Financial Conduct Auth. & U.K. Competition & Markets Auth., *Banking services to small and medium-sized enterprises: A CMA and FCA market study* (18 July 2014), at 44-51, available at https://assets.digital.cabinet-office.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf.

¹⁹¹ *Id.* at 153, 168 (emphasis added).

¹⁹² *Id.* at 161, 168.

¹⁹³ *Id.* at 5, 172.

¹⁹⁴ U.K. Competition & Markets Auth., *Personal current accounts: Market study update* (18 July 2014), at 9, 26 (fig. 2.2), available at https://assets.digital.cabinet-office.gov.uk/media/53c834c640f0b610aa000009/140717_-_PCA_Review_Full_Report.pdf.

¹⁹⁵ *Id.* at 36.

high customer satisfaction struggle to expand as market shares remain stable. This [evidence] suggests that there are limited competitive incentives to improve customer service.”¹⁹⁶

Much like the U.S. government, the U.K. government responded to the financial crisis by encouraging mergers among troubled institutions and by treating megabanks as TBTF, thereby promoting even greater consolidation within the U.K. banking system. For example, the U.K. government arranged for Lloyds TSB to make an emergency takeover of HBOS, and the government subsequently bailed out the resulting Lloyds Banking Group as well as RBS to prevent both megabanks from failing.¹⁹⁷ As Chancellor of the Exchequer George Osborne observed, “One of the prices we’re paying for the financial crisis is that our banking sector is now dominated by a few big banks.”¹⁹⁸ The Parliamentary Commission on Banking Standards pointed out that the TBTF status of the largest U.K. banks gives them “access to cheaper credit than would otherwise be available” and thereby “distorts competition and raises barriers to entry. Success does not depend simply on being prudently run or on serving customers effectively, but on the implicit [TBTF] guarantee.”¹⁹⁹

In view of the U.K.’s experience, the U.S. should take immediate steps to preserve the vitality of its community banking sector and to eliminate the perverse incentives created by TBTF treatment of megabanks. A similar warning flag appears when one considers the plainly inadequate services that SMEs receive from big banks in the highly concentrated Canadian banking system. The Canadian Federation of Independent Business (CFIB) has issued a series of survey reports over the past decade, which show that Canadian SMEs are deeply dissatisfied

¹⁹⁶ *Id.* at 119.

¹⁹⁷ Parliamentary Commission on Banking Standards, *Changing banking for good*, First Report of Session 2013-14 (June 2013), at 233-34, 247-48, 270-71 [hereinafter U.K. PCBS Report], available at

¹⁹⁸ *Id.* at 233 (quoting speech by Mr. Osborne on Feb. 4, 2013).

¹⁹⁹ *Id.* at 113.

with the performance of the five largest Canadian banks. The “Big Five” banks control more than 70 percent of the SME lending market in Canada, and there is no meaningful community bank sector in Canada.²⁰⁰

In the absence of community banks, Canadian credit unions have consistently outperformed the “Big Five” banks since 2000 in terms of satisfying SME customers.²⁰¹ As the CFIB observed in 2003, the superior performance of Canadian credit unions “provides further evidence that these locally based and managed institutions have an edge servicing their small business clientele.”²⁰² In contrast, when evaluating the performance of the big Canadian banks, the CFIB declared that “there is not a single Big Five bank that seems to be taking a leadership role in serving the SME sector. . . . Efforts must be made to encourage the development of competitive alternatives to the major chartered banks.”²⁰³ Thus, surveys and other evidence from the highly consolidated U.K. and Canadian banking systems confirm that markets dominated by big banks are unlikely to provide good service and adequate credit to SMEs.²⁰⁴

²⁰⁰ Canadian Federation of Indep. Bus., *Research: Battle of the Banks: How SMEs Rate Their Banks* (May 2013), at 9, 29 (Tbl. C1) (providing market shares of the “Big Five” Canadian banks for loans to SMEs between 2000 and 2012) [hereinafter 2012 CFIB Report], available at <http://www.cfib-fcei.ca/cfib-documents/rr3292.pdf>; Renee Haltom, “Why Was Canada Exempt from the Financial Crisis?,” *Econ Focus*, Fed. Res. Bank of Richmond, 4th Qtr. 2013, at 22, 22 (stating that “Canada has just 80 banks, six of which hold 93 percent of the market share”), http://www.richmondfed.org/publications/research/econ_focus/2013/q4/pdf/feature2.pdf.

²⁰¹ 2012 CFIB Report, *supra* note 200, at 3 (“In 2012, credit unions dominated among all the banks in serving the SME market, similar to findings in 2009”); Canadian Fed. of Indep. Bus., *CFIB Research: Banking on Competition: Results of CFIB Banking Survey* (Oct. 2003), at 2 (reporting that “[c]redit unions rank first in terms of overall satisfaction among business clients” in 2003, and noting that “credit unions ranked first in CFIB’s 2000 survey”) [hereinafter 2003 CFIB Report], available at <http://www.cfib-fcei.ca/cfib-documents/Banking.pdf>.

²⁰² *Id.*

²⁰³ *Id.* at 3, 18.

²⁰⁴ See Haltom, *supra* note 200, at 25 (“Critics claim that Canada’s tightly regulated [banking] system is slower to innovate and fund entrepreneurs.”); Arthur E. Wilmarth, Jr., “Too Big to Fail, Too Few to Serve: The Potential Risks of Nationwide Banks,” 77 *Iowa Law Review* 957, 1054-55 (1992) (explaining that national surveys of bank lending to SMEs in 1987 showed that “the decentralized U.S. banking system [was] more competitive and responsive than the highly concentrated British and Canadian systems in providing credit to small businesses,” apparently because “most British and Canadian small businesses [were] served by large nationwide banks, while small firms in the United States [were] served primarily by local independent banks.”).

U.S. policymakers and regulators should therefore take all possible measures to preserve a vibrant community bank sector in this country.

IV. Dodd-Frank Has Not Ended TBTF Treatment for Megabanks

[To be inserted]

V. A Tiered System of Regulation Is Needed to Maintain a Healthy Community Banking Sector and to Eliminate TBTF Treatment for Megabanks

A. Congress and Federal Regulators Should Reduce Compliance Burdens for Community Banks

As shown above, Dodd-Frank imposes a number of costly new compliance burdens on community banks. The CFPB's new mortgage lending rules – especially the QM regulation and the mortgage servicing regulation – and the federal banking agencies' new capital regulation create difficult challenges that impair the ability of community banks to provide customized home mortgage loans to entrepreneurs and farmers.²⁰⁵ Unless those compliance burdens are significantly reduced, many community banks are likely to abandon the residential mortgage business.²⁰⁶

Accordingly, the CFPB should expand the small creditor exception in its QM regulation and the small servicer exception in its mortgage servicing regulation so that both exceptions apply to all banks with assets under \$10 billion. As noted above, both exceptions require qualifying smaller banks to satisfy a series of safeguards to ensure that mortgage borrowers will be treated fairly by smaller mortgage originators and servicers.²⁰⁷ Similarly, the federal banking agencies should revise their new capital regulation to provide less punitive treatment for MSAs

²⁰⁵ See *supra* notes 111-132 and accompanying text.

²⁰⁶ See *supra* notes 133-134 and accompanying text.

²⁰⁷ See *supra* notes 122, 127 and accompanying text.

retained by banks with assets under \$10 billion.²⁰⁸ Community banks have established a record of sound home mortgage lending that is far superior to the performance of big banks.²⁰⁹ There is no good reason to require community banks to deal with the same regulatory burden that Congress imposed on megabanks after determining that those banks bore primary responsibility for the irresponsible lending and securitization practices that created the subprime lending bubble.²¹⁰

While Dodd-Frank does not go nearly far enough, it does reflect a growing recognition by policymakers that compliance burdens should be reduced across the board for community banks.²¹¹ In recent congressional testimony, Fed Governor Daniel Tarullo supported a number of steps to reduce examination, reporting and other regulatory costs for community banks. He also recommended that Congress should consider excluding community banks “from the scope of the Volcker rule and from the incentive compensation requirements of section 956 of the Dodd-Frank Act,” because those provisions are directed at concerns that primarily relate to the largest financial institutions.²¹²

Congress and federal regulators should promptly undertake a comprehensive review of federal banking statutes and regulations to identify compliance requirements that can be eliminated, simplified or made more flexible for community banks without endangering the safety and soundness of our banking system or creating substantial concerns about consumer protection. In addition, Congress should index to inflation the \$10 billion statutory ceiling for community bank status. An inflation-adjusted maximum will help to ensure that the statutory

²⁰⁸ See *supra* notes 130-132 and accompanying text.

²⁰⁹ See *supra* notes 87-92, 100 and accompanying text.

²¹⁰ See S. Rep. No. 111-176, at 4-6, 11-17 (2010).

²¹¹ See *supra* note 107 and accompanying text.

²¹² Testimony of Fed Governor Daniel K. Tarullo on “Dodd-Frank Implementation” before the Senate Comm. on Banking, Housing, and Urban Affairs, Sept. 9, 2014, available at <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm>.

ceiling continues to provide a reliable standard for identifying community banks that should qualify for a simplified and more flexible compliance regime.

B. A Two-Tiered Regulatory System Is Needed to Preserve Traditional Intermediation Activities by Community Banks and to Control the Risks of Capital Markets Activities by Megabanks

As shown above, Dodd-Frank does not end TBTF treatment for megabanks.²¹³ A far more effective way to attack the TBTF problem would be to prevent the spread of federal safety net subsidies from megabanks to their nonbank affiliates that engage in risky capital markets activities. At the same time, our regulatory system should continue to encourage and support traditional deposit-taking and lending activities by banking organizations that do not engage in capital markets activities.

To accomplish these goals, I have proposed a two-tiered structure of bank regulation and deposit insurance.²¹⁴ As explained below, the first tier of “traditional” banking organizations would be permitted to offer a relatively broad range of banking-related services, but those organizations would not be allowed to engage, or affiliate with firms engaged, in securities underwriting or dealing, insurance underwriting, or derivatives dealing or trading. In contrast, the second tier of “narrow banks” could affiliate with “nontraditional” financial conglomerates engaged in capital markets operations (except for commodities trading, merchant banking and private equity investments). Narrow banks, however, would be prohibited from making any extensions of credit or other transfers of funds to their nonbank affiliates, except for lawful dividends paid to their parent holding companies. The narrow bank approach provides the most

²¹³ See *supra* Part IV.

²¹⁴ For a more detailed description of my proposal (from which this Part V is adapted), see Wilmarth, Dodd-Frank, *supra* note 15, at 1034-52.

politically feasible approach for ensuring that megabanks cannot transfer their safety net subsidies to affiliated companies engaged in speculative transactions in the capital markets.²¹⁵ To further reduce the systemic risk of large financial conglomerates, those institutions should be required to (i) pay risk-based premiums to pre-fund the Orderly Liquidation Fund in order to reduce the likelihood of taxpayer-funded rescues of SIFIs, and (ii) structure their compensation plans for key employees so that at least half of that compensation is paid in the form of long-term contingent convertible bonds (CoCos).

1. The First Tier of Traditional Banking Organizations

Under my proposal, the first tier of regulated banking firms would be “traditional” banking organizations that limit their activities (including the activities of their holding company affiliates) to lines of business that satisfy the “closely related to banking” test under Section 4(c)(8) of the Bank Holding Company Act (BHC Act).²¹⁶ To provide a reasonable degree of flexibility to first-tier banking organizations, Congress should amend Section 4(c)(8) to enable the Fed to expand the list of “closely related” activities that are currently allowed for holding company affiliates of traditional banks.²¹⁷

The first tier of traditional banks could take deposits, make loans, offer fiduciary services, and act as agents in selling securities, mutual funds and insurance products underwritten by non-

²¹⁵ For discussions of similar “narrow bank” proposals, *see, e.g.*, Robert E. Litan, *What Should Banks Do?* 164–89 (1987); Ronnie J. Phillips & Alessandro Roselli, *How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal* (Networks Fin. Instit. Pol’y Brief 2009-PB-05, 2009), available at http://ssrn.com/abstract_id=1459065.

²¹⁶ *See* 12 U.S.C. § 1843(c)(8); Richard Scott Carnell, Jonathan R. Macey & Geoffrey P. Miller, *The Law of Financial Institutions* 416-18 (5 ed. 2013) (describing activities that are “closely related to banking” and are permissible for nonbank subsidiaries of BHCs under Section 4(c)(8)).

²¹⁷ The Gramm-Leach-Bliley Act (GLBA) prohibits the Fed from approving any “closely related” activities for bank holding companies under Section 4(c)(8) of the BHC Act beyond those that were permitted on November 11, 1999. Carnell, Macey & Miller, *supra* note 216, at 417-18. Congress should amend Section 4(c)(8) to authorize the Fed to approve a limited range of new activities that are “closely related” to the traditional banking functions of accepting deposits, extending credit, discounting negotiable instruments and providing fiduciary services. Wilmarth, Dodd-Frank, *supra* note 15, at 1036-37 n.375.

affiliated firms. Additionally, they could underwrite and deal in “bank-eligible” securities that national banks are permitted to underwrite and deal in directly.²¹⁸ First-tier banking organizations could also purchase, as end-users, derivatives transactions that (i) hedge against their own firm-specific risks, and (ii) qualify for hedging treatment under Financial Accounting Standard (“FAS”) Statement No. 133.²¹⁹ However, first-tier banks would not be allowed to engage, either directly or through affiliates, in underwriting or dealing in “bank-ineligible” securities,²²⁰ insurance underwriting, derivatives dealing or trading, or commodities trading, merchant banking or private equity investing.

First-tier banking firms would include community banks as well as midsized regional banks that choose to follow a traditional, intermediation-based business model. In the past, those banks have not engaged to any substantial extent in capital markets activities, and it therefore should not be difficult for first-tier banks to comply with the prohibition against any affiliation with capital markets businesses. My proposal would encourage first-tier banks to maintain and strengthen their current focus on attracting core deposits, providing “high touch,” relationship-based loans to consumers and small businesses, and offering wealth management and other fiduciary services to local customers. Traditional, first-tier banks and their holding companies should continue to operate under their current supervisory arrangements, and all deposits of first-tier banks (up to the current statutory maximum of \$250,000) should be covered by deposit insurance.

²¹⁸ See Wilmarth, Transformation, *supra* note 13, at 225, 225–26 n.30 (discussing “bank-eligible” securities that national banks are authorized to underwrite or purchase or sell for their own account); Carnell, Macey & Miller, *supra* note 216, at 132–34 (same).

²¹⁹ Wilmarth, “Dodd-Frank,” *supra* note 15, at 1036 (explaining the importance of limiting derivatives for first-tier “traditional” banking organizations to those that qualify for hedging treatment under FAS 133).

²²⁰ See Wilmarth, “Transformation,” *supra* note 13, at 219–20, 225–26 n.30, 318–20 (discussing the distinction between (i) “bank-eligible” securities, which banks may underwrite and deal in directly, and (ii) “bank-ineligible” securities, which affiliates of banks may underwrite and deal in under GLBA, but banks may not).

2. The Second Tier of Nontraditional Banking Organizations

Unlike first-tier banking firms, the second tier of “nontraditional” banking organizations – which would include all of today’s megabanks – would be allowed to engage in a broader range of “financial in nature” activities through nonbank affiliates.²²¹ The permitted activities for nonbank affiliates of second-tier banks would include underwriting and dealing in bank-eligible securities, underwriting all types of insurance, and dealing and trading in derivatives.²²² Second-tier banking organizations would include (i) financial holding companies (FHCs) registered under Sections 4(k) and 4(l) of the BHC Act,²²³ (ii) holding companies owning grandfathered “nonbank banks,” and (iii) grandfathered “unitary thrift” holding companies.²²⁴ In addition, firms controlling industrial banks should be required either to register as FHCs or to divest their ownership of such banks if they cannot comply with the BHC Act’s prohibition against commercial activities.²²⁵ Second-tier holding companies would thus encompass all of the largest banking organizations, most of which are heavily engaged in capital

²²¹ See Carnell, Macey & Miller, *supra* note 216 (discussing “financial in nature” activities that are permitted for FHCs under GLBA).

²²² Wilmarth, Dodd-Frank, *supra* note 15, at 1037.

²²³ 12 U.S.C. § 1843(k), (l). See Carnell, Macey & Miller, *supra* note 216, at 420-21 467-70 (describing the requirements for FHC status under the BHC Act, as amended by GLBA).

²²⁴ See Arthur E. Wilmarth, Jr., “Wal-Mart and the Separation of Banking and Commerce,” 39 *Connecticut Law Review* 1539, 1569-71, 1584-86 (2007) (explaining that (i) during the 1980’s and 1990’s, many securities firms, life insurers and industrial firms used the “nonbank bank” loophole or the “unitary thrift” loophole to acquire FDIC-insured institutions, and (ii) those loopholes were closed to new acquisitions by a 1987 statute and by GLBA, respectively), available at <http://ssrn.com/abstract=984103> [hereinafter Wilmarth, Wal-Mart].

²²⁵ Industrial banks are exempted from treatment as “banks” under the BHC Act. See 12 U.S.C. § 1841(c)(2)(H). As a result, the BHC Act allows commercial (i.e., nonfinancial) firms to retain their existing ownership of industrial banks. Section 603 of Dodd-Frank imposed a three-year moratorium on the authority of federal regulators to approve any new acquisitions of industrial banks by commercial firms, but that moratorium expired in July 2013. See Wilmarth, “Wal-Mart,” *supra* note 224, at 1543-44, 1554–1620 (arguing that Congress should prohibit commercial firms from owning industrial banks because such ownership (i) undermines the long-established U.S. policy of separating banking and commerce, (ii) threatens to spread federal safety net subsidies to the commercial sector of the U.S. economy, (iii) threatens the solvency of the deposit insurance fund, (iv) creates competitive inequities between commercial firms that own industrial banks and other commercial firms, and (v) increases the likelihood of federal bailouts of commercial companies).

markets activities, as well as other financial conglomerates that control FDIC-insured depository institutions.

Under my proposal, FDIC-insured banks that are subsidiaries of second-tier holding companies would be required to operate as “narrow banks.” The purpose of the narrow bank structure would be to prevent a “nontraditional,” second-tier holding company from transferring the bank’s federal safety net subsidies to its nonbank affiliates. Narrow banks could offer FDIC-insured deposit accounts, including checking and savings accounts and certificates of deposit. Narrow banks would be required to hold all of their assets in the form of cash and marketable, short-term debt obligations, including qualifying government securities, high-quality commercial paper and other liquid, short-term debt instruments that are eligible for investment by money market mutual funds (MMMFs) under the SEC’s rules.²²⁶

Narrow banks could not hold any other types of loans or investments, nor could they accept any uninsured deposits. Narrow banks themselves would present a very small risk to the FDIC’s Deposit Insurance Fund (DIF), because (i) each narrow bank’s non-cash assets would consist solely of short-term securities that could be “marked to market” on a daily basis, and the FDIC could therefore readily determine whether a narrow bank was threatened with insolvency, and (ii) the FDIC could promptly convert a narrow bank’s assets into cash if the FDIC decided to liquidate the bank and pay off the claims of its insured depositors.²²⁷ My proposed limitations on narrow bank investments would protect the DIF from any significant loss if a narrow bank failed.

²²⁶ Wilmarth, Dodd-Frank, *supra* note 15, at 1038.

²²⁷ *Id.*; Kenneth E. Scott, “Deposit Insurance and Bank Regulation: The Policy Choices,” 44 *Business Lawyer* 907, 921-22, 928-29 (1989).

Restricting the permissible investments of second-tier narrow banks should not have a significant impact on bank lending to small businesses. As shown above, megabanks – unlike community banks – do not generally make relationship loans to small firms. Instead, big banks provide credit to small businesses primarily through standardized, “cookie cutter” loan programs, including business credit cards and equipment leases, which rely on impersonal credit-scoring techniques and other automated technologies and are designed to allow many of the resulting loans to be securitized.²²⁸ Similarly, major banks typically provide loans to large businesses through a syndication process that is closely tied to the capital markets and is very similar to an underwriting of debt securities. As a result, the lead banks in loan syndications sell many of the resulting loans to institutional investors.²²⁹

Under my proposal, second-tier holding companies would be able to conduct their current business lending programs through nonbank subsidiaries that are funded by the capital markets through securitization and loan sales. The main difference – and an important one – from current practice is that second-tier holding companies would not be able to use low-cost, FDIC-insured deposits to fund their lending activities. Since megabanks have already largely abandoned the relationship lending model and have instead adopted a lending strategy tied to the capital markets, those banks should not be permitted to continue relying on safety net subsidies (rather than capital markets funding) to conduct their lending activities.²³⁰

²²⁸ See *supra* notes 148-51 and accompanying text; see also Wilmarth, Transformation, *supra* note 13, at 262-67 (describing how big banks provide credit to SMEs primarily through impersonal, highly automated methods).

²²⁹ Wilmarth, Dark Side, *supra* note 13, at 980-84, 1039-42 (describing the loan syndication process employed by big banks and the selling of the resulting loans to institutional investors, including insurance companies, pension funds, mutual funds, and collateralized loan obligations); Wilmarth, Transformation, *supra* note 13, at 378-80 (same).

²³⁰ Wilmarth, Dodd-Frank, *supra* note 15, at 1048-49 (noting that Congress, if it wished, could allow narrow banks that are subsidiaries of second-tier holding companies to make a limited amount of relationship loans to bank-dependent firms, up to a specified maximum percentage (e.g., 10%) of their assets, as long as such loans were retained on the banks’ balance sheets and were fully protected against loss by their capital).

3. Five Additional Rules Would Prevent Narrow Banks from Transferring Safety Net Subsidies to Their Affiliates

Congress should enact four supplemental rules to prevent second-tier holding companies from exploiting the safety net subsidies available to FDIC-insured banks. First, narrow banks should be absolutely prohibited – without any possibility of a regulatory waiver – from making extensions of credit or other transfers of funds to their affiliates, except for the payment of lawful dividends out of profits to their parent holding companies.²³¹ Currently, transactions between FDIC-insured banks and their affiliates are restricted by Sections 23A and 23B of the Federal Reserve Act.²³² However, the Fed repeatedly waived those limitations during recent financial crises. The Fed’s waivers allowed bank subsidiaries of FHCs to provide extensive support to affiliated securities broker-dealers and MMMFs. By granting those waivers, the Fed enabled FHC-owned banks to transfer the safety net subsidy provided by their low-cost, FDIC-insured deposits to their nonbank affiliates.²³³

Dodd-Frank limits but does not remove the authority of the Fed to grant future waivers or exemptions under Sections 23A and 23B. Dodd-Frank requires the Fed to obtain the concurrence of either the OCC (with respect to waivers granted by orders for national banks) or the FDIC (with respect to waivers granted by orders for state banks or general exemptions granted by regulation).²³⁴ However, it is unlikely that the OCC or the FDIC would refuse to concur with the Fed’s proposal for a waiver under conditions of severe financial stress.

²³¹ Scott, *supra* note 227, at 929; Wilmarth, Dodd-Frank, *supra* note 15, at 1041.

²³² 12 U.S.C. §§ 371c, 371c-1.

²³³ Wilmarth, Dodd-Frank, *supra* note 15, at 1041-42. For a comprehensive analysis of the Fed’s repeated waivers of Section 23A during the most recent financial crisis, see Saule T. Omarova, “From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act,” 89 *North Carolina Law Review* 1683, 1729-63 (2011).

²³⁴ Dodd-Frank, § 608(a)(4) (amending 12 U.S.C. § 371c(f)); *id.* § 608(b)(6) (amending 12 U.S.C. § 371c-1(e)(2)).

Accordingly, Dodd-Frank does not ensure that the restrictions on affiliate transactions in Sections 23A and 23B will be adhered to in a crisis situation.²³⁵

For example, the Fed permitted BofA in 2011 to evade the restrictions of Section 23A by transferring an undisclosed amount of derivatives contracts from its Merrill broker-dealer subsidiary to its subsidiary bank. That transaction increased the potential risk that the DIF and taxpayers might ultimately have to cover losses incurred by BofA on the transferred derivatives. The derivatives transfer reportedly allowed BofA – which was then struggling with a host of problems – to avoid contractual requirements to post \$3.3 billion in additional collateral with counterparties, due to the fact that BofA’s subsidiary bank held a significantly higher credit rating than Merrill.²³⁶ One commentator noted that “the Fed’s priorities seem to lie with protecting [BofA] from losses at Merrill, even if that means greater risks for the FDIC’s insurance fund.”²³⁷

My proposal for second-tier narrow banks would replace Sections 23A and 23B with an ironclad rule. That rule would absolutely prohibit any extensions of credit or other transfers of funds by second-tier narrow banks to their nonbank affiliates (except for lawful dividends paid to parent holding companies). My proposal would thereby prevent federal regulators from approving any transfers of safety net subsidies from narrow banks to their affiliates. An absolute bar on affiliate transactions is necessary to prevent narrow banks (and the DIF) from being used as backdoor bailout devices for nonbank affiliates of second-tier banking organizations.

²³⁵ Wilmarth, Dodd-Frank, *supra* note 15, at 1042.

²³⁶ Kate Davidson, “Democrats Raise Red Flag on BofA Derivatives Transfer,” *American Banker*, Oct. 28, 2011; Simon Johnson, “Bank of America Is Too Much of a Behemoth to Fail,” *Bloomberg.com*, Oct. 23, 2011; Jonathan Weil, “Bank of America Bosses Find Friend in the Fed,” *Bloomberg.com*, Oct. 19, 2011.

²³⁷ Weil, *supra* note 236.

Second, Congress should repeal the “systemic risk exception” (SRE) that is currently included in the FDI Act.²³⁸ By repealing the SRE, Congress would require the FDIC to follow the least costly resolution procedure for every failed bank, and the FDIC could no longer rely on the TBTF policy as a justification for protecting uninsured creditors of a failed megabank or its nonbank affiliates. Repealing the SRE would make clear to the financial markets that the DIF only protects bank depositors. Uninsured creditors of megabanks and their nonbank affiliates would therefore have stronger incentives to monitor the financial operations and condition of such entities.²³⁹

Additionally, a repeal of the SRE would mean that smaller banks would no longer have to share in the cost of protecting uninsured creditors of megabanks. Under current law, all FDIC-insured banks must pay a special assessment (allocated in proportion to their total assets) to reimburse the FDIC for the cost of protecting uninsured claimants of a TBTF bank under the SRE.²⁴⁰ A 2000 FDIC report noted the unfairness of expecting smaller banks to help pay for “systemic risk” bailouts when “it is virtually inconceivable that they would receive similar treatment if distressed.”²⁴¹ The FDIC report suggested that the way to correct this inequity is “to remove the [SRE],”²⁴² as my proposal would do.

Third, second-tier narrow banks should be barred from acting as dealers in derivatives or from purchasing derivatives as end-users except in transactions that qualify for position-specific hedging treatment under FAS 133. My proposal would require all derivatives dealing and trading activities of second-tier banking organizations to be conducted through separate nonbank

²³⁸ See *supra* notes ___ and accompanying text (discussing the SRE).

²³⁹ Wilmarth, *Dodd-Frank*, *supra* note 15, at 1042-43.

²⁴⁰ 12 U.S.C. § 1823(c)(4)(G)(ii).

²⁴¹ Federal Deposit Ins. Corp., Options Paper, Aug. 2000, at 33, *available at* http://www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf.

²⁴² *Id.*

affiliates, in the same manner that GLBA currently requires all underwriting and dealing in bank-ineligible securities to be conducted through nonbank affiliates of FHCs.²⁴³ Prohibiting second-tier banks from dealing and trading in derivatives would accomplish an essential goal of the Lincoln Amendment (Section 716 of Dodd-Frank), because such a prohibition would prevent FHCs from continuing to exploit federal safety net subsidies by conducting speculative trading activities within their FDIC-insured bank subsidiaries.²⁴⁴

The OCC has noted that FHCs generate higher profits when they conduct derivatives activities within their subsidiary banks, in part because the “favorable [funding] rate enjoyed by the banks” is lower than “the borrowing rate of their holding companies.”²⁴⁵ Such an outcome may be favorable to FHCs, but it is certainly *not* beneficial to the DIF and taxpayers. The DIF and taxpayers are exposed to a significantly higher risk of losses when derivatives dealing and trading activities are conducted directly within banks. My proposal would terminate this artificial, federally-subsidized advantage for megabanks by forcing second-tier banking organizations to conduct such activities within nonbank affiliates.²⁴⁶

Fourth, Congress should prohibit all merchant banking and private equity investments by second-tier banks and their holding company affiliates. To accomplish this reform, Congress should repeal Sections 4(k)(4)(H) and (I) of the BHC Act,²⁴⁷ which allow FHCs to make

²⁴³ See Carnell, Macey & Miller, *supra* note 216, at 25-26, 420-23 (explaining that, under GLBA, all underwriting and dealing of bank-ineligible securities by FHCs must be conducted through nonbank holding company subsidiaries or through nonbank financial subsidiaries of banks); Wilmarth, “Transformation,” *supra* note 13, at 219-20, 225-26 n.30, 318-20 (same).

²⁴⁴ See Wilmarth, Dodd-Frank, *supra* note 15, at 1030-34 (discussing the Lincoln Amendment and its objectives).

²⁴⁵ Office of the Comptroller of the Currency, OCC Interpretive Letter No. 892, at 3 (2000) (from Comptroller of the Currency John D. Hawke, Jr., to Rep. James A. Leach, Chairman of House Committee on Banking & Financial Services), available at <http://www.occ.treas.gov/interp/sep00/int892.pdf>.

²⁴⁶ Wilmarth, “Dodd-Frank,” *supra* note 4, at 1044-45.

²⁴⁷ 12 U.S.C. § 1843(k)(4)(H), (I).

merchant banking investments and insurance company portfolio investments.²⁴⁸ Merchant banking and private equity investments involve a high degree of risk and have inflicted significant losses on FHCs in the past.²⁴⁹ In addition, such investments threaten to “weaken the separation of banking and commerce” by allowing FHCs “to maintain long-term control over entities that conduct commercial (i.e., nonfinancial) businesses.”²⁵⁰ Such affiliations between banks and commercial firms are undesirable because they are likely to create serious competitive and economic distortions, including the spread of federal safety net benefits to the commercial sector of our economy.²⁵¹

[Insert discussion of fifth supplemental rule that would prohibit commodity trading by second-tier banking organizations, including Goldman Sachs and Morgan Stanley, despite their claim of “grandfathered” powers under 12 U.S.C. § 1843(o).]

In combination, the five supplemental rules described above would ensure that narrow banks cannot transfer their federal safety net subsidies to their nonbank affiliates and also cannot use those subsidies to break down the traditional separation between financial and commercial activities. Restricting the scope of safety net subsidies is of utmost importance in order to restore a more level playing field between small and large banks and also between banking and commercial firms. Safety net subsidies have increasingly distorted our regulatory and economic policies over the past three decades. As shown above, my proposal would establish strong

²⁴⁸ See Carnell, Macey & Miller, *supra* note 216, at 483–85 (explaining that “through the merchant banking and insurance company investment provisions, [GLBA] allows significant nonfinancial affiliations” with banks).

²⁴⁹ Wilmarth, Transformation, *supra* note 13, at 330-32, 375-78 (discussing losses incurred by financial conglomerates on risky equity investments during the late 1990s and early 2000s); see also Donal Griffin, “Pandit Pay Climbs as Citigroup Revenue Slumps,” *Bloomberg.com*, Mar. 12, 2012 (reporting that Citigroup recorded an investment loss of \$200 million after it acquired a large hedge fund, Old Lane Partners, for \$800 million in 2007 and later had to shut down that fund).

²⁵⁰ Wilmarth, Wal-Mart, *supra* note 224, at 1581-82.

²⁵¹ For further discussion of this argument, see *id.* at 1588-1613.

safeguards to prevent megabanks from using safety net subsidies to support their speculative capital markets activities.

My proposal's ultimate purpose is to force large financial conglomerates to prove that they can produce superior risk-related returns for investors *without* relying on explicit and implicit government subsidies. Most studies have failed to confirm the existence of favorable economies of scale or scope in giant financial conglomerates, and those conglomerates have not been able to generate consistently positive returns, even under the current regulatory system that allows them to capture extensive federal subsidies.²⁵²

In late 2009, a prominent bank analyst suggested that if Congress prevented nonbank subsidiaries of FHCs from relying on low-cost deposit funding provided by their affiliated banks, large FHCs would not be economically viable and would be forced to break up voluntarily.²⁵³ Many of the largest commercial and industrial conglomerates in the U.S. and Europe were broken up during the past three decades by hostile takeovers and voluntary divestitures after they proved to be “less efficient and less profitable than companies pursuing more focused business strategies.”²⁵⁴ It is long past time for financial conglomerates to be stripped of their safety net subsidies and their presumptive access to TBTF bailouts so that they will become subject to the same type of scrutiny and discipline that the capital markets have already applied to commercial and industrial conglomerates. My proposal provides a workable plan to impose such scrutiny

²⁵² Wilmarth, *Blind Eye*, *supra* note 61, at 1427; Wilmarth, *Reforming Financial Regulation*, *supra* note 23, at 748-49; Johnson & Kwak, *supra* note 85, at 212-13.

²⁵³ Karen Shaw Petrou, the managing partner of Federal Financial Analytics, explained that “[i]nteraffiliate restrictions would limit the use of bank deposits on nonbanking activities,” and “[y]ou don’t own a bank because you like branches, you own a bank because you want cheap core funding.” Ms. Petrou therefore concluded that an imposition of stringent limits on affiliate transactions, “really strikes at the heart of a diversified banking organization” and “I think you would see most of the very large banking organizations pull themselves apart” if Congress passed such legislation. Stacy Kaper, “Big Banks Face Most Pain under House Bill,” *American Banker*, Dec. 2, 2009, at 1 (quoting Ms. Petrou).

²⁵⁴ Wilmarth, *Dodd-Frank*, *supra* note 15, at 1047.

and discipline on financial behemoths, which currently exercise far too much power within our financial and political systems. Alternative plans have also been advanced that would more directly and explicitly mandate a breakup of the largest banking companies.²⁵⁵

4. Second-Tier Banking Organizations and Other SIFIs Should Pay Risk-Based Premiums to Pre-Fund the OLF

[To be inserted.]

5. Second-Tier Banking Organizations Should Pay at Least Half of Key Employee Compensation in the Form of CoCos

[To be inserted]

Conclusion

[To be inserted]

²⁵⁵ Wilmarth, *Blind Eye*, *supra* note 61, at 1437-46 (discussing my proposal and alternative plans to limit the financial and political power of megabanks).