# Reviving Main Street and Strengthening Community Banks

Part I The Original Story, Framework Proposed, The 16 Point Plan

A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to

**"Bring Money Back to Main Street"**

*(First published in 2012)*

# Reviving Main Street and Strengthening Community Banks:

## A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to Bring Money Back to Main Street

### The Background Perspective

Having been a banker in small town Ohio for almost 40 years I've been able to look at our economy from a very different perspective. Main Street towns the size I am familiar with have been financially decimated by our own legislators and regulators who have not understood, been mislead by interest groups or just ignored basic economic and banking truths. First, a short story for you to better understand the underlying passion to craft the framework provided in this paper.

#### The Gentleman Banker

My father was 1 year old when the family moved from Ireland to the northern part of Marion County, Ohio to set up a farm and homestead. My grandmother did the business of negotiating and grandpa was the farm labor along with the seven kids.

Gentleman banker, Cy Sears, was the President of Harpster Bank, a very small community bank located 7 miles from the family farm. Cy had much respect for Grandma and loaned her money to start the farm, asking her to sign a cashier's check for the money (today's equivalent would be about 100 pages of legal size paper).

As I grew up years later, Cy remained as the bank President and always greeted young Master Steen (as he called me) and encouraged me to put money in my passbook that I proudly displayed for him to see.

My college years led me toward part-time teller work at a local bank with 10 offices in nearby Marion. I worked hard and moved up quickly, really enjoying serving people.

When it was time to decide on a full-time career I couldn't forget Cy Sears as a person to ask about banking and finance. But on an even deeper level, I needed to thank him. I went to Cy's home as he was feeble and ailing and pulled a stool up beside his chair and told him that I wanted to thank him for putting my family in business, taking care of our community, as well as inspiring me to go into banking full-time. I asked him "Mr. Sears do you think I can be a good banker?" and he replied "You came to see me didn't you? You'll do just fine."

## There Goes the Dough

About 8 years later I had been promoted several times and at age 26 became Senior Vice President and Cashier of the local $180 million, 10 office bank in 1994. Our successful local bank fell into some greedy shareholders grip and was sold to National City Bank of Cleveland. As Cashier, I wrote a semiannual check for our net profit to the parent bank in Cleveland. Upon writing the second semiannual check, I asked myself "what the hell am I doing?" "This is just the profit I'm sending out of town, what happens when the parent bank taps into our local deposit base and sucks it to Cleveland or to make loans somewhere else and creates a massive economic hole in our market."

That's the moment I knew a local bank was needed (and continues to be needed in every Main Street town). So I quit, and found a vacant bank building directly across the street in downtown Marion in which to open a new local bank. Seeing over 1,000 people in a year to offer stock in the new bank, we opened with 330 local shareholders committed to promoting and preserving the local community. Ironically, in the end, National City Corporation needed to be sold due to the fact that it used Ohio deposits to fund loans backed by real estate located outside of Ohio.

## Then Along Comes Mary

Another negative that happened in my neck of the woods was the "brilliant" idea of hometown gal, Mary Ellen Withrow, County Treasurer, who became Treasurer of the State of Ohio (eventually U.S. Treasurer) to consolidate public funds into the Star Ohio Program. That program further pillaged counties/villages by sending money to the state which reinvested it on Wall Street vs. leaving it in the communities. This was done to gain a pittance of additional interest income, but in reality it left a void of lendable deposits. The irony is that these communities would have been much better served if the deposits had been kept and used to support local small businesses. The increase in tax receipts would have far exceeded the small gain in interest income.

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*The accepted "economic velocity" of money in a town like ours (population 50,000-100,000) is 7 times. For example, each $1,000,000 in deposits sent to a big bank headquarters somewhere else equates to a $7,000,000 economic loss to that town, since the flow of money is interrupted.*

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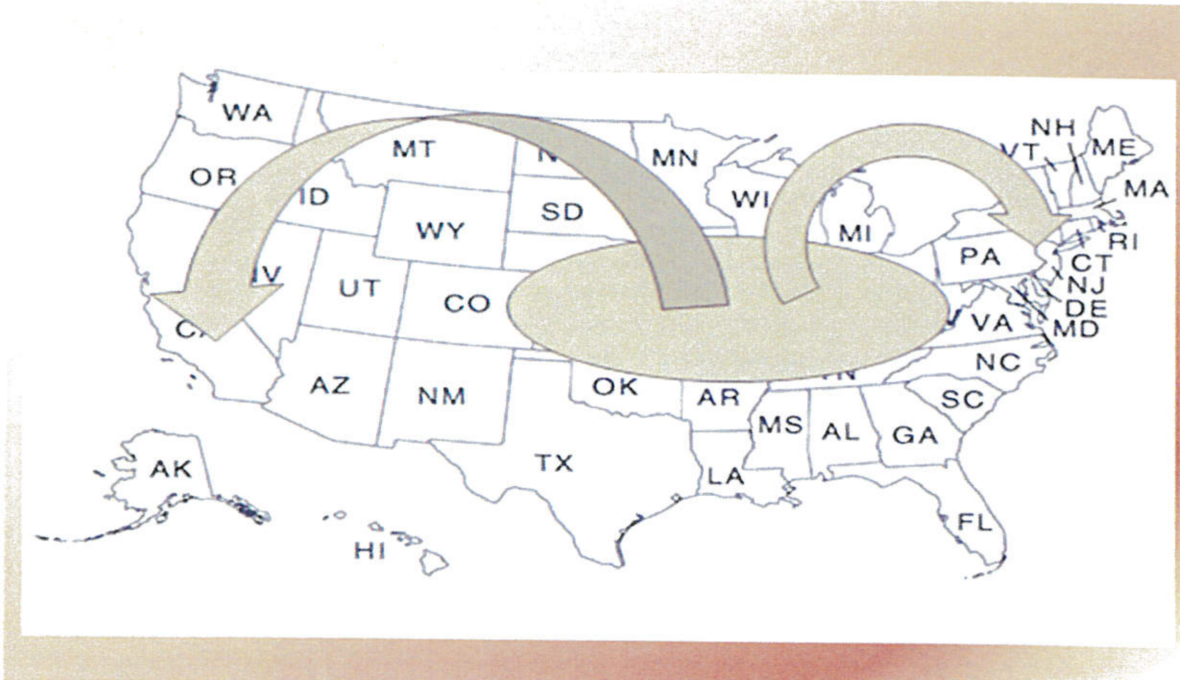
## Are small local banks facing extinction?

This question may seem facetious but is quite serious. What I spent my career supporting is now in peril. Approximately a dozen U.S. banks now dominate market share and have become increasingly large, complex, and difficult to regulate. Small banks have been mowed over by the attempt to regulate and limit risk exposures that have greatly contributed to the recent boom/bust economic cycles. A number of these cycles were actually created, albeit unknowingly, by regulators hidden in investment portfolios of unsuspecting big bankers in the case of the 2008 mortgage crisis. Approximately 10,000 small banks have been forced to merge with larger institutions or close their doors over the last 30 years. Consumers and small businesses in these communities are left with fewer options and watch helplessly as their deposits are redeployed in larger cities, many times to support investment banking activities rather than loans. Community banks are crucial to the economic stability of many non-metro areas but they are becoming an endangered species. I personally believe that this has had a negative effect on the current national economic recovery considering that small business is such an important driver of economic activity. How? According to the ICBA, small banks control approximately 22% of the U.S. banking assets but are responsible for 58% of lending activity to small businesses.

## Deposit Flow 1990-2010




*"Entrepreneurs and their small enterprises are responsible for almost all of the economic growth in the United States."*
*Ronald Reagan*

Profit margins have been squeezed by lower rates in this national economic downturn as well as by the massive pursuit of increasing deposit and loan market shares by the largest banks. <u>The importance of the customer relationship has fallen victim to this "grow at all costs because bigger is better mentality".</u> Tragically, this big bank mentality has spread from Wall Street to Washington D.C. with a constantly revolving door of large financial institution executives who miraculously now serve in key positions in the

Federal government or as lobbyists. Policy and regulation have followed their philosophy and favored large institutions at the taxpayers' expense. An example is the unprecedented access to loans from the Federal Reserve itself during the financial crisis. Bloomberg reported the amount of these Federal Reserve loans to the six largest institutions was a staggering $7.7 trillion of taxpayer money. (Ivry, 2011) None of these Non-TARP bailout benefits were equally offered to Main Street banks or communities and were not reported in the mainstream media. This amount dwarfs the exposure to the taxpayer from the TARP program ($700 billion authorized, reduced to $475 billion under Dodd-Frank) and offers a huge advantage in funding costs for these large banks.

## "Those Who Ignore History are Doomed to Repeat It"

This is a famous quote from George Santayana. History has been clear that regulation has not been successful in controlling the risk of the largest banks. Basel I, II and now III are examples of capital framework that have been created in an attempt to control the risk activities of the largest international banks. The first two versions were not successful in averting the recent financial crisis and the latest version will likely face the same fate. "The Basel I agreement on global banking regulation, adopted in 1988, was 30 pages long and relied on simple arithmetic. The latest update, known as Basel III runs to 509 pages and includes 78 calculus equations." (Onaran, 2013) A troubling difference with Basel III is that the Federal Reserve has decided that it will apply to every bank regardless of size. This places an even larger regulatory burden on small banks that clearly played a minimal role in the recent crisis. Basel III, on the heels of the Dodd-

Frank Bill continues to stack the deck in favor of the largest banks. Large bank capital requirements continue to be much lower compared to community bank capital requirements resulting in excessive leverage and inflated ROE's which draw investors to their stock. The resulting effect makes it much more difficult for small banks to raise necessary capital. Over the long term, the ability to raise capital at small banks is critical for success. During bad national economic times, smaller banks are painted with the same negative brush as the big banks and suffer by association due to media misrepresentation and consequences of additional regulation.

There have been some positive steps attempting to curtail the excessive risk-taking of the largest institutions. A greater understanding of the importance of community banking by legislators, regulators and consumers will illustrate the need for these small banks to survive. A common theme among those who believe that Basel III should apply to every institution, regardless of size, is that 400 community banks failed during the crisis so they must be placed under the same regulations. This number of failures is misleading. A significant portion of community bank failures were de novo start-ups. They were not operated as traditional community banks and they suffered from the lack of customer "relationship" and growth of community roots essential to community banks. Bank regulators noted the risks but did not understand the underlying motive. This motive was, in many cases, to create and sell these banks for a quick profit rather than fostering the relationships and community involvement that continue to make traditional community banks successful.

Since the barriers between investment banking and traditional banking were removed by repeal of the Glass-Steagall Act in 1999, the allure of large profits shifted resources away from Main Street and toward Wall Street. Securitization, proprietary trading and the creation of exotic derivative instruments moved to the forefront, the risk of which was not understood by customers, by regulators and by many of the executives managing the big banks. The lack of regulatory and supervisory integration of all investment, insurance and banking activities in the financial system allowed risk to be transformed, with derivatives passed out to the less regulated and capitalized industries outside of banking, such as insurance and re-insurance. As a result, similar obligations in the financial industry were not treated equally and the overall risk to the system actually increased with less capital required. (Atkinson, 2010) Basic lending functions by big banks have focused on extremely large commercial loans where qualifying grids and boxes can be the decision maker, or conversely on consumer lending instruments such as mortgages, auto finance and credit cards, where quantitative tools such as Beacon scores are used as the basis for decision making. The use of this impersonal scoring protocol contributed greatly to the current mortgage and housing crisis. Borrowers with more opaque profiles, such as small businesses, experienced a large reduction in the opportunity to obtain credit as big banks moved further away from this "document cumbersome" yet "more deserving" business segment. *The effects on the economy as a whole continue to be felt as the engine of job creation has stalled.* When liquidity was reduced in the money markets in 2008, the U.S. government took unprecedented steps to provide "too big to fail" companies access to working capital. Unfortunately, many

small and medium sized businesses were not provided this same access creating a massive imbalance in working capital. With deposits (sources of funding for banks) siphoned out, and the belief that "bigger is better", Main Street, small business, and community banks have been pillaged. *Community banks are the fuel for the U.S. economic engine.*

## Reviving Main Street and Community Banks: The 16 Point Plan to Bring Money Back to Main Street.

We recommend that the following steps be taken to create and support an ongoing economic recovery on Main Street:

Since interstate banking was approved in the mid 1990's the flow of cash and resources has moved away from most communities and into large financial centers such as New York. Coupled with the repeal of the Glass-Steagall Act, this monetary capital was used to fund higher risk activities such as investment and international banking. These funds must return to the states/communities as rapidly as possible in order to stimulate business activity, revive the sluggish economy and increase low-risk relationship banking. *The proposed capital framework offered later in this paper will assist with and literally drive this transition.*

1. **Exempt community banks from the Basel III capital regulations.** Basel III will add considerable costs with negligible benefits. Community banks do not pose a material risk to the financial system and should not be penalized by regulation designed to restrict activities of the large, international banks.

2. **Leverage ratio limitations prescribed by Basel III should be implemented much sooner than suggested for large banks. In that same context, banks should be prohibited from leveraging non-core transactional deposits such as tax deposits of government agencies.** A system should be implemented immediately where capital and leverage requirements vary with the risk level of the activity. For example, the use of derivative instruments requires higher capital than traditional banking services and leverage is limited to a pre-defined ceiling.
3. **To provide liquidity and credit to small businesses, the focus of legislators needs to be on the demand side (small businesses) rather than supply issues (financial institutions) such as reserve and capital requirements.** A major concern for the small business owner is that the availability of credit will disappear as the costs of regulation and capital increase for community banks that are beyond their control. This concern acts as a disincentive to invest in long-term growth such as hiring new employees or purchasing capital assets.
4. **Eliminate third party mortgage servicers (many are owned by the large institutions) that provide little value but extract a significant share of the profit.** As much as 50% of the net profit for these activities is captured by large financial institutions. Internal procedures need to be studied at the GSEs to provide a more traditional review, approval and collection of consumer loans. A lesson in history from the 1930's showed a very successful Home Owners Loan Corporation and an ongoing conservatively managed Veteran's Loan Administration. They operated as community oriented, relationship based organizations. This is potentially a role for the restructured GSE's.

5. **Include community banks in the process of reorganizing the Government Sponsored Enterprises (FNMA, GNMA, FHLMC, FHLB, FAMC, FCS. SLMA) as they emerge from the conservatorship process.** *Community banks have a successful history of managing mortgage relationships that will be critical to the process of re-defining the financing of the housing industry in a more prudent fashion.*
6. **The FDIC finally recognized the importance of the community bank model and has created an advisory committee to give the smaller banks a voice in the regulatory process.** *However, we need more community bankers involved in decision making at the inception of studies.* Community Bank associations need to be vigilant in keeping that voice strong and actively involved in the entire process, given the opportunity to do so.
7. **Eliminate unnecessary regulatory burden and stop the over taxing of job producers in banks and small business.** This fosters long term investment and hiring to provide service to their customers that are the engines of economic growth. *Access to capital, both working and long-term is vital to small business and community banks' survival.*
8. **The Dodd-Frank Financial Reform Act requires a "living will" plan for orderly liquidation if insolvency occurs.** This is designed to end the practice of taxpayer funded bailouts for financial institutions. Every effort should be made to follow this element of the Dodd-Frank Act. All businesses, including financial institutions should follow normal bankruptcy and reorganization procedures. *Taxpayer funds should not be used to save banks that have taken excessive risks and are on the brink of collapse.*
9. **Provide a disincentive to stop the urge to nationalize banks.** *We recommend not authorizing the future use of taxpayer funds to nationalize a Systematically Important*

*Financial Institution (SIFI).* The term itself is an oxymoron. Expanding the definition of a SIFI to non-banks such as insurance companies (and possibly hedge funds) increases the potential to continue or increase risky activities with the belief that the government will act as a backstop in the event of another collapse. This is the textbook definition of "moral hazard" and we do not believe it is a prudent policy for legislators and regulators to follow. *It allows these institutions to privatize gains in good times and socialize losses in the event of a crisis.*

10. **The public and the media need to be further aware of the risks and potential taxpayer liability associated with a "too big to fail" financial mentality. This practice must be eliminated.**

The implicit government guarantee of "too big to fail" provides a competitive advantage in funding costs as well as increasing market share vis a vis competition. This protection is not equally available to community banks that also pay an FDIC premium. The result is an unlevel playing field on which larger banks are rewarded at the expense of the community banks.

These "too big to fail" institutions have "failed" our economy in many ways. Excessive risk taking, taxpayer funded infusions of capital (TARP) and the transfer of assets from Main Street to major metropolitan areas (and Wall Street) have dealt a huge blow to the rest of the U.S. economy for many years. **For example, 50% of domestic U.S. deposits are now concentrated on the East Coast. In 1985 the average "big" banks ($1B +) were 12 times larger than the average community banks. By 2010 this difference had grown to 64 times larger.** (FDIC, 2012) The prevailing theory that a few big banks allow the United States to

better compete in a global marketplace has yet to be proven. The current crisis in Europe and previously in Japan has confirmed that bigger is not better, yet we blindly follow history to the cliff of insolvency. In fact, I believe that the consolidation of banks has been detrimental to our economy and especially to small business, the provider of the majority of U.S. job growth. During the 1970's-1990's, the reduction of concentration risk in certain regions of the country and the increased diversification of risk were pillars of the platform to create national institutions. Economies of scale and technological advances were also hailed as advantages for industry consolidation. However, decades later, subsequent legislative and regulatory changes have resulted in limited success to control economic risks and the creation of unforeseen issues has resulted in devastating effects on the economy. Economies of scale no longer exist as technology has put all banks in a position to offer a suite of products such as online banking, bill pay, etc. *"Too Big to Fail" must be totally eliminated from our system.*

11. **Apply the monopoly theory to banks and limit the percentage of total assets any institution can hold to a defined level (5%-10%) of total industry assets.** This is commonly done in a variety of industries to promote competition and protect the consumer. The original Trust Buster, President Theodore Roosevelt said "Uncontrolled competition, like unregulated liberty, is not really free." Camden Fine, President of the ICBA paraphrases in a recent Investor's Business Daily editorial when he stated, "Uncontrolled asset concentration (which was why Roosevelt sued Northern Securities in the first place) is not conducive to a free market." This should apply equally to the banking industry. (Fine, 2012)

*"Let the watchwords of all our people be the old familiar watchwords of honesty, decency, fair-dealing and common sense."*
*Theodore Roosevelt*

12. **Require state governments to invest short term funds only in banks headquartered in their respective states**. The framework recommended in this paper will also make rates more competitive between small and large banks.

13. **Allow and enhance the community banks to conduct the business of traditional banking that they have done successfully for many decades.** In addition to providing competitive deposit and lending products, community banks invest substantial amounts through donations and sponsorships directly into the communities where they do business. Strong customer relationships result in more prudent loan decisions. A conference hosted by the FDIC discussing the Future of Community Banking in February 2012 reports that community banks have higher risk-adjusted returns on commercial loans than their larger counterparts. This result occurs due to the more *"hands on" approach by small banks and the perceived value of that approach by small business owners.*

14. **Returning to the broad theory of the Glass-Steagall Act separating traditional and investment banking (at least within the holding company umbrella) should be implemented immediately.** Each line of business should, by regulation, hold sufficient capital to operate independently. An investment banking subsidiary would need to rely on its own capital (and the capital of the holding company) in the event of a shortfall but could not rely on capital from the sister bank subsidiary. The same is true for

international deposit operations. This would alleviate the risk of the failure of a European operation, for example, from adversely affecting the capital of a U.S. bank. Why should U.S. deposits be used to make international loans? Shouldn't these deposits be loaned within the U.S.? International lending should be funded by deposits from the country of origin. Unforeseen circumstances are currently evident in Europe as banks were encouraged to open branches and merge across borders. Very recently the European monetary authorities are ordering banks not to move capital from branches in one nation to another. (Low, 2012)

15. **Focus regulatory resources on ensuring the flow of capital to the community banks to assist them in furthering their mission by use of the Simplified Framework for Calculating Bank Capital.** It is very difficult for small banks to raise capital (both for growth and to meet regulatory requirements). The recent JOBS Act increased the allowable number of shareholders prior to reaching SEC filing requirements. This is a positive step but further improvements can be made that help the community banks gain the capital to add crucial technology and attract talented personnel.
16. **Current nationwide banking should be controlled by a tracking of deposits and their eventual placement in loans and investments by census tract.** *If deposits are removed from other states, the required capital should increase.* The A Simplified Framework for Calculating Bank Capital should be immediately implemented with a base capital for all commercial banks of 7.00%. Existing criteria can be used by regulators to "score" each bank using positive or negative adjustments to a base level of capital. These adjustments

will increase the cost of deposits from other states and translates to increased capital and less willingness to “bid up” deposit prices.

Simple Summary, Simple Solution:

*"Too Big to Fail" must be stopped now or the condition of the U.S. financial system will remain unstable.* Investors, not taxpayers, should bear the risk of the activities of private companies, including banks. As it stands, the process of analyzing risk in banks and regulating them reminds me of the complexity and enforcement of the U.S. tax code. Regulations on the books and government intervention has created unintended consequences and in some cases directly caused the Great Recession of 2008. The capital framework methodology presented, along with the suggested Simplification Plan, will allow a vast reduction of useless, time and resources dealing with regulatory compliance. *It's time to return to a common sense approach and reinvest in our communities and to stop re-regulating regulations.* Do not assume that since this approach is simple, that it is easy to attain or not "tight" enough. Banks of all sizes will need to exercise prudent risk management to reach their respective capital requirements. The base level of 7.0% is similar to that prescribed in Basel III but doesn't require a twenty page calculation of capital.

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*"The true sustained economic recovery of this nation will come from Mid America."*

*Gordon Gee, President of The Ohio State University*

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## Solutions Accomplished by Using the Simplified Framework for Calculating Bank Capital (see page 19):

- Billions of dollars will flow away from Wall Street and Big Bank control due to the increased capital required to gather interstate deposits, participate in derivatives, etc. *Rates will naturally be reduced to competitive, common sense levels across the country as the Big Banks reduce more expensive deposit gathering activities.*
- Capital levels will be established using calculations already in place. All banks currently submit call report data to regulators so there will be *no new documentation burden on either party.*
- The framework rewards banks that conduct banking in the traditional, common sense manner. Additionally, it requires more capital if the bank chooses to engage in more risky banking and non-banking activities. In effect, *"You Play, You Pay".*
- The CAMELS system has worked well with built in safeguards to identify higher risk activities within each institution. If the regulators and bankers have fully adopted the CAMELS system, why isn't it being used verses creating an entire new method to arrive at the same conclusion? *Why re-regulate existing tried and true regulations if we can simply apply existing regulations to the proposed Framework? Simple!*

## A Simplified Framework for Calculating Bank Capital

### (Applies to ALL banks)

| | |
|---|---|
| Swaps, Derivatives on balance sheet | +___% |
| Out of State Deposits (Census Tract) | +___% |
| Liquidity Rating (3,4,5) | +___% |
| Asset Quality Rating (3,4,5) | +___% |
| Overall CAMELs Rating (3,4,5) | +___% |
| No Lending in CRA defined Mkt (census tract) | +___% |
| **BASE CAPITAL-- ALL BANKS** | **7.00%** |
| Asset Quality Rating (1,2) | -___% |
| Overall CAMELs Rating (1,2) | -___% |
| Lending in CRA Defined Mkt | -___% |

**REQUIRED CAPITAL (TOTAL OF ABOVE)** ______%

Note: The above formula will typically result in required capital of 6.25% for community banks and 8.50% for large banks. The data used in the formula is already tracked for regulators so gathering of additional data is not necessary.

# Reviving Main Street and Strengthening Community Banks:

## A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to Bring Money Back to Main Street

1. Exempt community banks from the Basel III capital regulations.
2. Leverage ratio limitations prescribed by Basel III should be implemented much sooner than suggested for large banks. In that same context, banks should be prohibited from leveraging non-core transactional deposits such as tax deposits of government agencies.
3. The focus of legislators needs to be on the demand side (small businesses) rather than supply issues (financial institutions) such as reserve and capital requirements.
4. Eliminate third party mortgage servicers (many are owned by the large institutions) that provide little value but extract a significant share of the profit.
5. Include community banks in the process of reorganizing the Government Sponsored Enterprises.
6. However, we need more community bankers involved in decision making at the inception of studies.
7. Eliminate unnecessary regulatory burden and stop the over taxing of job producers in banks and small business.
8. The Dodd-Frank Financial Reform Act requires a "living will" plan for orderly liquidation if insolvency occurs. Every effort should be made to follow this element of the Dodd-Frank Act.
9. Not authorizing the future use of taxpayer funds to nationalize a Systematically Important Financial Institution (SIFI). It allows these institutions to privatize gains in good times and socialize losses in the event of a crisis.
10. "Too big to fail" financial mentality. This practice must be eliminated.
11. Apply the monopoly theory to banks and limit the percentage of total assets any institution can hold to a defined level (5%-10%) of total industry assets.
12. Require state governments to invest short term funds only in banks headquartered in their respective states.
13. Allow and enhance the community banks to conduct the business of traditional banking that they have done successfully for many decades.
14. Returning to the broad theory of the Glass-Steagall Act immediately.
15. Focus regulatory resources on ensuring the flow of capital to the community banks to assist them in furthering their mission by use of the Simplified Framework for Calculating Bank Capital.
16. Current nationwide banking should be controlled by a tracking of deposits and their eventual placement in loans.

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# Reviving Main Street and Strengthening Community Banks

## Part II A 2015 Update & Addendum to

A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to

**"Bring Money Back to Main Street"**

*(First published in 2012)*

# Reviving Main Street and Strengthening Community Banks Part II: A 2015 Update & Addendum to:

## A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to Bring Money Back to Main Street (First published in 2012)

### WHERE WE ARE NOW

We need take a look to see what has occurred over the last three years (2012-2015). But first let's summarize again how the financial industry and the nation got to this point.

A. Nationwide banking was allowed in the 1990's with no capital increase requirements, large banks grew larger and become more leveraged.

B. The Glass Stegall Act (separation of banking, investments & insurance) was eliminated in 1999 with no capital increase requirements for large banks to experiment in handling all three at one time.

C. A push for Banks to make home loans in the 1990's for Community Reinvestment Act (CRA) purposes. The loan to home value percentages kept moving up to the point of 120% loans being made, with the approval of Freddie Mac or Fannie Mae (government funders). No capital increase requirements for any banks were put in place.

D. Dodd Frank has accomplished next to nothing except to add more layers of regulatory compliance. Although someone must have somewhat thought it through since at least larger capital requirements were put in place, probably to allow compliance with the

"bunch of do nothing" new regulations.

*The Outcome*

*A concentration of assets, once spread across the United States, and the use of those assets to create extreme leveraging by a chosen few. TBTF banks having government funding or backstops to be able to leverage risk to the point of crisis.*

## FAILING ATTEMPTS TO FIX THINGS

### Basel III

Basel III is now law. For the TBTF banks dealing with the international banks world it remains to be seen if competitive leveling will occur. However, it will add no competitive leveling in the US and just more complexity in reporting for all banks.

Basel III will result in greater opportunity for larger banks and will not be effective in solving TBTF at all.

*The only benefit is for the TBTF banks to be on equal analysis (yet to be seen) with global banks.*

## ENDING TOO BIG TO FAIL

*Since the financial crisis began in 2008, the TBTF banks have become larger. With no substantive new controls on risk or size.*

Brown Vitter TBTF ACT – A Quick Review/Opinion (A Good Attempt, A Good Start, But…)

A. Brown Vitter does not force downsizing… it only requires a higher level of capital be held.

B. The Brown Vitter TBTF Act will help in the long term and bankers should be positive towards the Act but it is not solving the problem.

C. The new equity target for TBTF banks will cause them little pain and effort since they have 5 years to get to the 15% capital target.

D. The new equity target gives them no incentive to downsize. *TBTF banks have no reason to divest alternative risky balance sheet items because they remain TBTF. They don't mind risk and tolerate higher risk investments. They remain too big to manage as illustrated at JP Morgan in the recent London Whale trading incident.*

Other Solutions to TBTF Offered

Another proposed solution to the TBTF dilemma is a two-tiered approach, community and regional banks "relationship model" and a megabank model. *Once again, this "solution" using analysis of data to determine outcomes is way too burdensome and complex.*

The Basic Truth Overlooked

The basic truth that has been forgotten with the important but not the albeit studies of leverage… which is further looked at as overall asset size. As far as the risk that should

be studied it is *the mix on the Balance Sheet that creates high or poor performance, in any type of financial institutions, it is not the overall size.*

## THE RESULT OF REGULATORY OVERBURDEN

Four years after the crisis, the assets controlled by the TBTF banks have grown by more than $1 trillion. The growth of these institutions is the gravest threat to the safety and soundness of our financial system today. This tremendous concentration of banking assets into so few institutions distorts the markets and contravenes the public interest. These firms are "too big to fail"- so big and interconnected that the government would not allow them to fail because it would cause too much damage to our financial system and push our economy into a severe recession or worse. A more diverse financial system would reduce risk and promote competition, innovation and the availability of credit to consumers of various means and businesses of all sizes.

Too-big-to-fail distorts free markets, incentivizes risky behavior, leaves taxpayers on the hook for bailouts, and creates unfair competitive advantages for the largest banks. But there is perhaps no greater reminder of the too-big-to-fail impact than the constant, oppressive regulatory burdens that community banks face on a daily basis.

The sheer amount of regulation certainly adds expense with more employees, more training, more reporting but a very large outcome that is normally not factored in is the true effect... It is less time to do banking (to make loans)... Therefore, there is less income potential for individual banks due to extra work and less loans made resulting in less working capital back to local economies and therefore economic slowdown.

*Regulatory overburden creates consolidation in the industry and therefore compounds the problem of too big to fail.*

Post Dodd-Frank & Proposed Fixes That Come Up Short

Reduction of systemic risk is needed now. The Dodd Frank fixes and the Brown-Vitter preventions will be more effective if the risk is stripped off the TBTF banks first. Please note, three years have passed since the passage of Dodd Frank with no true regulatory resolutions yet in sight.

TBTF institutions will definitely feel the effects on ROE when they must play by the same rules as all other banks using the Brown Vitter TBTF Act. The proposal that follows will make them feel it to a much bigger extent.

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*FDIC Vice Chairman Thomas Hoening recently stated that since the 2008 crisis TBTF institutions have increased in asset size to over 71% of GDP, compared to 25% of GDP in 1997.*

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Due to increased regulatory burden, community banks net income is down roughly (25%) twenty five percent. The share of total deposits in the US economy held by community banks is down 19%, double the rate before Dodd Frank. Community banks have lost market share in small business lending due to the focus being compliance versus lending.

In addition, government bailout money continues to be pushed in the TBTF banks. *The Dodd Frank ACT has done nothing to increase lending, in fact, it has reduced lending.*

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*Recently, Candace Franks, Commissioner of the Arkansas State Banking Commission agreed that there must be a capital differentiation or carve out for community banks use very significantly.*

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In a March 2013 survey of US adults, the results are strongly in favor of breaking up the big banks (50%), while only 23%, opposed breaking them up. The time has never been better to fix the disease.

According to the GAO, homeowners lost more than $9 trillion in equity and the lost US economic output could run up to $10 trillion. The large banks continue to grow with their collective ability to be protected by taxpayers under TBTF.

Also as a side thought, have the Ally Banks of the new internet world been accounted for in analysis of TBTF? (GMC owned Bank)

## DRILL DOWN TO THE DISEASE

Get Past Fixing Symptoms – **Let's Fix the Disease**

While I agree with the Independent Community Bankers Association (ICBA) regarding fighting the TBTF regulatory burden, once again it is only a symptom. They fall short on identifying the disease.

*The disease at the very core of the regulatory burden, is the trillions of $'s that have been sucked from Main Street USA for over 35 years and sent packing to be used by the greed barons of Wall Street and TBTF banks. This must only stop but the money gone must be returned.*

## THE FIX

The resulting pool of money/wealth from Main Street USA has been pulled to the East Coast, concentrated for redistribution, then poorly managed. The same thing is occurring by Internet Banks that are pulling deposits to a central point. This all started in the 1990's, as the legislators and financial gurus did the bulk of the damage to Mid-America by allowing: 1.) The nationwide branching of banks 2.) Repeal of the Glass Stegall Act,(keeping banking, insurance, brokerage separate) 3.) No changes in capital level requirements.

Big bank mistakes, and poor service levels, and major-risk activities have the door wide open to fix the major part of the original disease, being the concentration of assets.

The CAMEL System Works – Use It

*Use and enforce the " Simplified Framework" to measure all banks inherent risk.*

At a threshold of assets (same as Basel III low range) the CAMELS based proposal within will apply to all banks or fail safe-second look use for big banks. All banks under $50 billion should only use the CAMELS based formula program discussed below.

## "USE THE SIMPLIFIED FRAMEWORK"

(as presented below on page 11)

Since Part 1 of this position paper was written in 2012, Basel III has been approved, which is truly an unnecessary burden on small banks. But, this "Simplified Framework" below can be implemented across the board to all U.S. Banks as the "Fail Safe" test. There is no additional reporting burden on banks since the information is currently reported at least quarterly to the FDIC. Not only will the TBTF begin to downsize, this framework will fix the problem. Monies will begin to flow back to Main Street, USA. The American economy will not be corrected and we will remain stagnant until monies return to where they are properly and conservatively to grow local economies. Use of this Simplified Framework will finally fix the problem.

# Reviving Main Street and Strengthening Community Banks:

## A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to Bring Money Back to Main Street

| 2012 PLAN | UPDATES 2015 |
|---|---|
| 1. Exempt community banks from the Basel III capital regulations. | DID NOT HAPPEN |
| 2. Leverage ratio limitations prescribed by Basel III should be implemented much sooner than suggested for large banks. In that same context, banks should be prohibited from leveraging non-core transactional deposits such as tax deposits of government agencies. | VERY SLOW |
| 3. The focus of legislators needs to be on the demand side (small businesses) rather than supply issues (financial institutions) such as reserve and capital requirements. | HAS NOT HAPPENED |
| 4. Eliminate third party mortgage servicers (many are owned by the large institutions) that provide little value but extract a significant share of the profit. | HAS NOT HAPPENED |
| 5. Include community banks in the process of reorganizing the Government Sponsored Enterprises. | HAS NOT HAPPENED |
| 6. However, we need more community bankers involved in decision making at the inception of studies. | WE ARE LISTEND TO AND ASKED MORE OFTEN |
| 7. Eliminate unnecessary regulatory burden and stop the over taxing of job producers in banks and small businesses. | WORSE THAN EVER |
| 8. The Dodd-Frank Financial Reform Act requires a "living will" plan for orderly liquidation if insolvency occurs. Every effort should be made to follow this element of the Dodd-Frank Act. | THE EFFECTIVENESS OF THIS PLAN IS YET TO BE SEEN |
| 9. Not authorizing the future use of taxpayer funds to nationalize a Systemically Important Financial Institution (SIFI). It allows these Institutions to privatize gains in good times and socialize losses in the event of a crisis. | STILL IN PLACE<br>HAS BEEN USED ON LIMITED BASIS-MUST STOP |
| 10. Apply the monopoly theory to banks and limit the percentage of total assets any institution can hold to a defined level (5%-10%) of total industry assets. | NO EFFORT HERE |
| 11. Require state governments to invest short term funds only in banks headquartered in their respective states. | NO EFFORT HERE |
| 12. Allow and enhance the community banks to conduct the business of traditional banking that they have done successfully for many decades. | MORE REGS, LESS TIME |

| | |
|---|---|
| 13. "Too Big to Fail" financial mentality. This practice must be eliminated. | SOME EFFORTS, BUT NO FIX |
| 14. Returning the broad theory of the Glass-Steagal Act immediately. | SOME RECENT LEGISLATIVE ACTION ON IT |
| 15. Current nationwide banking should be controlled by a tracking of deposits and their eventual placement in loans. | NOTHING YET |
| 16. Focus regulatory resources on ensuring the flow of deposits to the community banks to assist them in furthering their mission by use of the Simplified Framework for Calculation Bank Capital. | NOTHING YET |

## The "Simplified Framework" for Calculating Bank Capital

### (Applies to ALL banks)

| | |
|---|---|
| Swaps, Derivatives on balance sheet | +___% |
| Out of State Deposits (Census Tract) | +___% |
| Liquidity Rating (3,4,5) | +___% |
| Asset Quality Rating (3,4,5) | +___% |
| Overall CAMELs Rating (3,4,5) | +___% |
| No Lending in CRA defined Mkt (census tract) | +___% |
| **BASE CAPITAL-- ALL BANKS** | **8.00%** |
| Asset Quality Rating (1,2) | -___% |
| Overall CAMELs Rating (1,2) | -___% |
| Lending in CRA Defined Mkt | -___% |

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**REQUIRED CAPITAL (TOTAL OF ABOVE)** ______%

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Note: The above formula will typically result in required capital of 7.25% for community banks and 9.50% for large banks. The data used in the formula is already tracked for regulators so gathering of additional data is not necessary. All adjustments are equally applied at 0.25%.

## Summary

## Solutions Accomplished by Using the "Simplified Framework" for Calculating Bank Capital:

- Billions of dollars will flow away from Wall Street and Big Bank control due to the increased capital required to gather interstate deposits, participate in derivatives, etc.

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*Rates will naturally be reduced to competitive, common sense levels across the country as the TBTF Banks reduce more expensive deposit gathering activities. Now the community banks can compete.*

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- Capital levels will be established using calculations already in place. All banks currently submit call report data to regulators so there will be *no new documentation burden on either party.*
- The framework rewards banks that conduct banking in the traditional, common sense manner. Additionally, it requires more capital if the bank chooses to engage in more risky banking and non-banking activities. In effect, *"You Play, You Pay".*
- The CAMELS system has worked well with built in safeguards to identify higher risk activities within each institution. If the regulators and bankers have fully adopted the CAMELS system, why isn't it being used verses creating an entire new method to arrive at the same conclusion? *Why re-regulate existing tried and true regulations if we can simply apply existing regulations to the proposed Framework? Simple!*

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# Reviving Main Street and Strengthening Community Banks

## Part III: Too Big To Fail Grows:

A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to

**"Bring Money Back to Main Street"**

*(First published in 2012)*

# Reviving Main Street and Strengthening Community Banks
# Part III: Too Big To Fail Grows:

## A Simplified Framework for Calculating Bank Capital and a 16 Point Plan to Bring Money Back to Main Street
(First published in 2012)

## DODD FRANK RESULTS

At least, the Dodd Frank (DF) Act has severely limited Too Big To Fail (TBTF) bank trading for their own account. As a result, corporate bond market liquidity (particularly for high yield bonds) has largely vanished.

Most mortgage loans that got us into the 2008 crisis were not made by banks. If only Fannie and Freddie qualified loaned had been made there would not have been a mortgage crisis and there would not have been a need for the DF Act. The problem arose when Fannie and Freddie needed to lower their standards to compete with the AAA rated non-agency Mortgage Backed Securities (MBS) juggernaut. Today (because of Dodd Frank) there are no more off the books mortgage tranches, parked in TBTF sponsored companies, funded by commercial paper.

## BAN "TOO BIG TO FAIL" BANKS BUT FOCUS ALSO ON STATES & PENSION FUNDS

We really need to worry about TBTF banks, but we need to worry about excessive levels of debt sucking life out of the economy. Many states are in trouble. Pension funds are deplorably underfunded. Are states and pensions TBTF? Inflation is nearly zero. The velocity of money, which continues to decline and is at a six decade low. If velocity doesn't pick up we will

continue to limp along at 2% GDP growth, interest rates won't rise and community banks will struggle even more from NIM compression.

## IMPLEMENT NOW

**We must get money BACK to mid-America from the TBTF banks. Use of the Simplified Framework for Bank Capital mentioned in Part 1 & in Part 2 along with repeal of the Nationwide Banking Act and reinstatement of part of the Glass Stegall Act will change everything.**

The TBTF war must be fought but it's not the only problem we need to solve. Forget credit unions. They aren't going away. Forget regulations. Comply with them. Instead let's lobby the Fed to normalize interest rates so Bank Net Margins have a chance to rise and community bank employees can keep their jobs and shareholders will be rewarded for holding community bank shares.

At banks, get costs down. Money is being wasted in most non-interest expense categories of every community bank income statement.

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