



## Big Ideas for a New America

# To Save America's Finances, Bring Back Community Banking

By [Ellen Seidman](#), [Phil Longman](#), New America Foundation

November 20, 2008

In the fall of 2007, Countrywide Financial, then the nation's largest mortgage lender, had a curious new idea -- or, more precisely, an old one. It would no longer import foreign capital through Wall Street to make subprime loans. Instead, it would depend entirely on deposits from savers, who would finance each other's mortgages -- kind of like that humble thrift institution run by George Bailey in the movie "It's a Wonderful Life."

Sadly, Countrywide waited too long to go back to basics and became the first major bank of 2008 to require an urgent rescue. But it is not too late for other financial institutions. Indeed, with the world's system of anonymous high finance in crisis, and pressures -- including from the government -- building for even greater consolidation, there is a strong case for fostering many more small-scale, traditional depository institutions like George Bailey's.<sup>[1]</sup>

So far this year, the failure rate among big banks is seven times greater than among small banks. The latest available FDIC data show that banks with less than \$1 billion in assets are outperforming their larger peers with respect to the critical metrics of return on assets, net interest margin, and the all-important net charge-offs to loans and leases. While banks with between \$100 million and \$1 billion in assets charged off 0.37 percent of loans and leases, those with over \$1 billion in assets charged off 1.35 percent.

Once regarded as at best niche, and at worst vestigial, players in a new world of global consumer finance, small-scale community banks, thrifts, and credit unions have the potential, if favored with appropriate public policy, to ameliorate many of the country's deepest problems. These include a dangerously high level of concentration within the financial services industry -- a problem made especially acute as the Treasury rescue package allows big banks to get bigger. The promotion of small-scale banking can also help to improve the nonexistent savings rate, high consumer debt levels, and dwindling supplies of social capital in many areas. Finally, increasing the number and health of small-scale financial institutions can also help to overcome the lack of mutual interest between borrowers and lenders that is at the heart of the current global financial crisis.

Community banks and credit unions don't need a bailout, but they could use some help to deal with two major issues: the high fixed costs of some business essentials (such as information technology and meeting regulatory compliance costs) and access to capital, especially patient capital that will support them as they serve communities that now, more than ever, need both a place to save and access to responsible credit. We propose a Community Banking Trust Fund to respond to these needs.

The proposed fund would make equity investments in small-scale depository institutions that need patient capital to serve their communities effectively. For credit unions and mutually owned banks that do not issue stock, the fund



*A long dominant theory has held that when it comes to finance, bigger is always better. The facts, however, say otherwise.*

### Related Programs:

[The Bernard L. Schwartz Fellows Program](#), [Asset Building Program](#)

would provide net worth certificates, which would count as equity, but pay a set interest rate.[2] In addition, the fund would make technical assistance grants to cover critical investments in areas such as information technology and disaster recovery.

The fund would encourage these institutions to offer financial services that are limited in many communities, such as lending to local businesses and homeowners, safe and convenient mechanisms for savings, and transactional, cash management, and investment services. Eligibility would be limited to banks, thrifts, and credit unions with a record of service to their communities as measured by high loan-to-deposit ratios, a high level of local lending, local deposits, local boards of directors, and high ratings under the Community Reinvestment Act.

We propose to start the fund with a one-time infusion of \$30 billion from the \$700 Treasury rescue package -- an amount proportional to that which the Treasury has announced it will invest in the biggest banks.[3] On an ongoing basis, the fund would be paid for through a tax of no more than 0.5 percent of the amount of newly issued asset-backed securities -- the very type of derivatives that have been at the core of the current financial crisis.

## Why Size Matters

A long dominant theory has held that when it comes to finance bigger is better. According to the theory, large financial institutions are more efficient due to their economies of scale and, more importantly, because of their ability to match lenders and borrowers wherever they might be around the world. Banks with global reach can take capital from wherever it is in oversupply (say, China or the United Arab Emirates ) and direct it to places where it is in undersupply, no matter how distant (say, Stockton, California, or East Cleveland, Ohio).

This has been the central argument for financial deregulation over the last generation. In the late 1970s and 1980s, small banks and thrifts lost many of the regulatory protections that prevented other financial institutions from competing for their business. In 1994, large bank holding companies secured the freedom to set up branch networks outside their home states, thereby extending the typical distance between borrowers and lenders to first, regional, and then, national, scale. At the urging of the then Federal Reserve chairman Alan Greenspan, Congress, and the Clinton administration repealed the Depression-era Glass-Steagall Act in 1999. As the barriers between commercial banks, investment houses, and insurance companies subsequently came down, complex hybrid institutions emerged that put a global-scale distance between borrowers and lenders.

Under the new financial order, anonymous global-scale "transactional banking" replaced small-scale "relationship banking." Small-scale banks could not compete on price. Some lacked the capital to invest in information technology, and meeting regulatory challenges took proportionately more effort: it could take as long as 40 minutes to get through the paperwork simply to open an account. Big banks, taking advantage of deregulation and their economies of scale, continued buying up community banks or shooting out new branches and ATM networks across state lines. Internet mortgage originators, like Lending Tree, ran television commercials mocking the idea that a consumer would show personal loyalty to any one bank or banker. "When Banks Compete, You Win" was Lending Tree's slogan; relationship banking was for chumps, transactional banking was for the savvy.

As transactional banking expanded, the number and market share of small-scale financial institutions shrank dramatically. In 1985, there were 14,000 community banks with inflation-adjusted assets of less than \$1 billion. Today, their number has been cut in half. Credit unions have also experienced a decline in numbers. Because of that decline, many communities, and especially many neighborhoods in urban America, have lost most or all of their local depositories. Not only has this left people in many communities with no place to open a savings account or take out a small loan (aside from payday lenders), it has also dried up a critical source of lending to small businesses since, according to the Federal Reserve, community banks make nearly three times as many small business loans on a dollar-for-dollar basis as do large banks.

With the benefit of hindsight, however, we can see two clear facts that call into question whether global-scale finance really is more efficient than small-scale banking. First, the new system invested the world's savings in a spectacularly irrational manner. The money that poured into underwriting mortgages on McMansions and tract houses in automobile-dependent, jobless suburbs, it is now obvious, could have been more profitably invested in just about anything else -- in, for example, rebuilding America's crumbling infrastructure, converting to sustainable energy sources, or constructing affordable rental housing near good jobs and schools.

In contrast, small-scale financial institutions generally avoided subprime lending and related derivatives, concentrated on traditional mortgage and small business loans, and today are in comparatively good shape. Though vulnerable to a downturn in the economy, with few exceptions they appear to be resistant to the financial contagion striking down larger institutions. So is bigger really better?

The second clear fact that emerges with hindsight is that it was the lack of a relationship of mutual interest between lender and borrower that was at the heart of the breakdown in global finance. All the different players in the system, from mortgage brokers to investment banks peddling "asset"-backed securities had little interest in whether consumers could actually afford their debt.

Unlike a traditional community bank, for example, few lenders held on to even some of the mortgages they wrote. Nor did they depend on deposits from the same people to whom they made loans. Instead, most of their money was made on fees. When faraway funding sources without any understanding of who or what they're funding substitute for local depositors, when loans can be sold without effective recourse, when borrowers are told not to worry about repayment because never-ending refinancing will be available, everyone loses.

In traditional small-scale banking, by contrast, there is a mutuality of interest between borrower and lender. This mutuality has both a soft and a hard side. On the soft side, small-scale banking means that savers, borrowers, and lenders all have a heightened ability to judge each other's character and to hold each other accountable. They are all members of a community and, as such, subject to social pressures to act responsibly. George Bailey didn't write loans containing improvised explosive devices in part because he saw his customers regularly around Bedford Falls and knew his thrift's business depended on his good reputation. His customers, in turn, would face the opprobrium of their neighbors if they walked away from their loans.

In small-scale banking, borrowers and lenders also know each other's prospects better than borrowers and lenders on opposite sides of globe. Put another way, small-scale banks are rich with what Federal Reserve Chairman Ben Bernanke calls "informational capital," which they develop through "gathering relevant information, as well as by maintaining ongoing relationships with customers."<sup>[4]</sup>

Or as the Federal Reserve Bank of Dallas put it with more prescience than it probably realized in a 2004 report: "While lending decisions have increasingly relied on data-rich statistical analyses, in many cases the most relevant indicators regarding the creditworthiness of individual small businesses still take the form of firsthand information gained through close lender-borrower relationships."<sup>[5]</sup>

George Bailey put it even better in his clinching argument to his panicked depositors in "It's a Wonderful Life." The residents of Bedford Falls could rest assured that their money was safe, he said, because they knew each other: "Well, your money's in Joe's house. That's right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can."

High levels of informational capital also mean that default rates are lower than they otherwise would be, as proven by the ability of faith-based and other tight-knit credit unions to offer payday loans at nonusurious rates. Large stocks of informational capital also mean that lending based on character becomes possible, so the bright young man or woman with a strong business plan doesn't get turned down just because his or her proposed business doesn't have exactly the debt service coverage expected.

As the Federal Reserve notes, "Locally focused community banks have a clear advantage at assessing the creditworthiness, and monitoring the ongoing condition, of small and medium-sized businesses. These loans are customized to reflect the idiosyncrasies of these borrowers, and cannot be 'put in a box' for credit-scoring and securitization."<sup>[6]</sup>

There is also a harder side to the mutuality we are proposing to restore between borrower and lender by encouraging small-scale banking. Institutions that largely depend on depositors to whom they also make loans have strong financial incentives to avoid predatory lending and to inculcate thrift in its broad, full meaning. Such institutions need their customers to strike the right balance between saving and borrowing, because otherwise the institution either falls short on deposits or gets stuck with too many defaults.

This is why, in the past, banks put so much effort into promotions such as "Thrift Week," a national institution which, older readers will remember, started each year on Benjamin Franklin's birthday until it petered out in the 1960s. It is why even into the 1970s, banks and thrifts would offer you a toaster if you opened a savings account, and why they tried to inculcate thrift in youngsters through school banking programs. Banks, to a much larger extent than today, only thrived if their customers did as well because they needed customers who both saved sufficiently and were not ruined by debt.

Small-scale financial institutions also have a much deeper mutuality of interest with the communities they serve than do distant bank holding companies, much less national payday lender chains and mortgage originators. If the local economy goes down, so most likely does the local community bank because it does no business elsewhere. This relationship makes small-scale banking more vulnerable to local downturns, to be sure, but historically it has also created a virtuous spiral in most communities. Local bankers have long played a self-interested role in bringing their town's business community and civic groups together to solve common problems, thereby helping to preserve and build the social capital needed to bring prosperity.

In a Grant Thornton survey of community bank chief executive officers conducted in 2001, almost all reported participating in civic groups (94 percent) or their local chamber of commerce (92 percent). More than half reported that their banks supported local relief efforts and gave special help to low-income segments of the community.<sup>[7]</sup> The absence of civically engaged local bankers is a growing problem in the many parts of the country where sweeping bank consolidations have put most banking business in the hands of a few giant institutions headquartered far away, and where responsible community banks and credit unions have been further weakened by payday lender franchises that have become more common than Starbucks or McDonald's.

None of this is to say that small-scale banking is virtuous in every respect. In the past, if you couldn't form a good relationship with your community's bankers -- perhaps because you were from the wrong ethnic group, or just unpopular -- you were often out of luck. Community banks have frequently been clannish in choosing their customers. They have also been known to take in deposits from customers in poorer neighborhoods while reserving their loans for customers in richer neighborhoods.

However, public policy has ensured that community banks are investing in their own communities. For three decades before the current financial crisis, for example, the Community Reinvestment Act nudged banks large and small into lending in areas that were previously "redlined" -- that is, avoided by banks. (Although some conservatives have recently been eager to tar the Community Reinvestment Act as being responsible for the current crisis, numerous studies have shown that the overwhelming number of bad subprime loans were made by financial institutions not covered by the act.)

Moreover, even without federal regulation, small-scale banking has always offered an opportunity for excluded groups to help themselves in the face of discrimination. In 1913, for example, there were more than 200 "immigrant banks" -- including 55 for Italians, 22 for Germans, 16 for Poles, and 6 for Jews -- in Chicago alone.<sup>[8]</sup> Many such immigrant banks survive today and have since shed their exclusivity. Suburban Baltimore's Madison Bohemian Savings Bank, for example, no longer limits its loans to the Bohemian farmers of Hereford county -- or even to Bohemians.

## Policy Levers

What policy levers are available to encourage the growth of responsible, small-scale financial institutions? One, obviously, is continued regulatory crackdown on predatory lenders. Close the predators down, and more space will be created for traditional financial institutions dedicated to thrift and mutuality of interest. When Washington, D.C. finally shut down payday lending, local credit unions saw an upsurge in business.<sup>[9]</sup>

The creation of national standards for mortgages, credit card contracts, and other loan products would also help level the playing field between responsible and irresponsible lenders. Columbia Law School's Ronald Mann has suggested that credit card contract terms be standardized so as to limit competitive differences to a small set of clearly identified and relatively easy-to-comprehend terms (the interest rate and various fees).<sup>[10]</sup> The behavioral economists Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir have suggested that all mortgage borrowers be first offered a 30-year fixed rate mortgage or similarly safe adjustable rate product. Turning down one of these

products in favor of a more complex loan would require especially clear and explicit disclosures. If such disclosures were not made, the borrower could use the failure as a defense against foreclosure if an alternative loan turned bad. They have made similar suggestions regarding credit cards, like a default payment plan that would pay off the debt in a reasonable period of time.[11]

These are important steps toward restoring responsibility in the consumer credit markets. However, they do not directly address the breakdown of mutuality between borrower and lender, which is the ultimate source of the financial system's breakdown and the problem that the small-scale banks and credit unions can best fix.

To increase the number of small-scale financial institutions, we have to address their biggest challenge, which is access to patient capital. They need funds that can be leveraged eight or ten times over to make good loans in the community -- at rates and terms that generate a reasonable, if not a spectacular, rate of return. Badly burned by losses on Wall Street and their experience with exploding mortgages, many Americans are already redirecting their savings to insured deposits and seeking as well to forge a personal relationship with their bankers -- trends that bode well for community banking. Still, a robust community banking sector requires funding beyond local deposits.

Even purely mutual institutions, which are owned by their customers -- like the traditional mutual savings bank or a credit union -- need access to funding sources beyond their deposits in order to maintain even a modest return. This is primarily because of imbalances between the geography and timing of deposits and the demand for loans. Institutions in lower-income and smaller markets find it particularly difficult to fund themselves exclusively with local deposits.

There are essentially five ways a bank or credit union can expand its ability to lend funds beyond those provided by local customer deposits: raising deposits outside the local area, borrowing against assets (using the loans it holds as collateral), selling loans, earning income from other sources such as fees, and raising more equity capital from investors. A major challenge facing community banks is whether they can access these sources while retaining their community connection.

**Raising nonlocal deposits.** Raising deposits beyond the local area has always been difficult and expensive for community banks. This has been mitigated to some extent by the advent of the Internet and, perhaps more importantly, by the Certificate of Deposit Account Registry Service. The CDARS interbank network allows some 2,500 banks, many of them small, to attract insured deposits of up to \$50 million while retaining a relationship with the depositor, rather than sharing it with other banks and a broker, as is the case with traditional brokered deposits. [12] Although some banks have been successful at raising long-term, relatively cheap deposits this way, others have found out-of-area deposits to be short term, more expensive than those raised at home, and not available to institutions that are under financial stress. [13]

**Borrowing against assets.** Community banks and credit unions have access to the Federal Home Loan Bank system, as well as to other sources of secured wholesale funding, which enable them to borrow against high-quality assets. Because of the Home Loan Bank system's status as a government-sponsored enterprise, the cooperative nature of the system, and economies of scale, Home Loan Bank advances are cheaper than other forms of borrowing, although generally more expensive than deposits gathered from local customers. However, while this borrowing resource has held up relatively well through the current credit problems, there are limits on its use, including cost, availability of acceptable collateral, and regulatory pressure to restrain it (in part because Home Loan Bank advances reduce assets available to the FDIC in the event of a bank failure).[14]

**Selling loans.** Loan sales, meanwhile, have become substantially more difficult in this environment. This is especially the case with sales of home loans made to any but the most conservatively defined perfect customers. The private secondary market has largely shut down, and Fannie Mae and Freddie Mac, even in conservatorship, have put in place restrictions that make sales of the moderate-size mortgages needed by the bulk of the population difficult. It is particularly hard for a community bank to make a loan sale to Fannie and Freddie if it wishes to retain the payment, or servicing, relationship with its local customers, as many do and more should.[15]

**Fee income.** Fee income is an area where community banks have consistently lagged larger institutions. In part, this is a function of the "originate and hold" -- or at least the "originate and service" -- strategy that builds the mutuality of interest between lenders and borrowers. But it is also due to the laudable fact that community banks have been



significantly smaller players in the credit card market, where frequently abusive fees can account for much of the revenue.

**Equity.** The biggest problem facing small banks today, however, is attracting long-term equity capital from stockholders. Most small banks are privately held, and even for those that are not, interesting the public in banks stocks is not easy.[16] This problem could get worse for small banks if, after all the bailouts, just a few giant financial institutions control most banking. This outcome now seems more likely, especially since it has become government policy, under the Treasury's Troubled Asset Relief Program (TARP), to favor large institutions with the lion's share of equity infusions.

Small banks have always needed a proportionately higher level of equity because of their higher cost structure, their lack of diversification, and (for the majority that are either mutually owned or closely held) their lack of easy access to the capital markets. In the current market environment, particularly with reduced access to loan sales, community banks and credit unions that want to step up their lending need sources of additional capital. Equity is important both as a risk cushion and as the basis for leverage. Even conservative small banks leverage each dollar of equity into about \$7 of loans. For communities banks serving low-income areas, accessing additional capital can be particularly difficult, but the additional opportunity to lend generated by the equity is especially important.

## **The Community Banking Trust Fund**

To solve these obstacles to greater mutuality of interest between borrowers and lenders, we propose the establishment of a Community Banking Trust Fund. As previously stated, the fund would make equity investments in small-scale depository institutions that need patient equity capital to serve their communities effectively. In addition, the fund would make nontaxable technical assistance grants to cover critical investments in such areas as information technology and disaster recovery.

Currently, some small-scale banks and credit unions deeply involved in community building have access to equity capital and grants through the Community Development Financial Institutions Fund, which provides a useful model. Unfortunately, its resources are subject to the whims of the congressional appropriations process and cumbersome to access. Moreover, the CDFI Fund has never had an appropriation in excess of \$120 million, making it far too modestly funded to make much of a difference.[17]

By contrast, the Community Banking Trust Fund would be of a size commensurate with the sector's needs and have a stable, dedicated source of funds. Although qualified institutions would not have to compete with each other to obtain these funds (dividend payouts and other forms of return on investment, for example, would be standardized) equity infusions would flow only to those that demonstrated their need for additional support to enable them to continue to serve their communities effectively.

These equity infusions would be structured to take into account the corporate form of the receiving institution, whether a credit union, a mutually owned bank, a Subchapter S corporation, a regular corporation that is privately held, or a publicly traded entity. For example, banks in corporate form might sell the government nonvoting common stock (with the requirement that no dividend be paid to other shareholders unless the government were paid a dividend at the same rate). For Subchapter S banks, the dividend payout to the government would be modified to take into account the lack of a tax at the corporate level. Mutuals and credit unions could receive net worth certificates, which would count as equity but pay a set interest rate.[18]

Only banks and credit unions that won formal designation as community banks or credit unions would be eligible to participate in the Community Banking Trust Fund. Currently, "community bank" is an industry term that has no specific legal definition.[19] Generally, it refers to smaller, local banks that concentrate on personal service. Some cater principally to upscale citizens and small business owners who demand personal attention. Others, typically known as community development banks, have social missions and are deeply involved in local community building efforts. But there are also banks with as much as several billion dollars in assets and far-flung branch networks that call themselves community banks. Some of these, especially those made up of formerly independent banks that retain their identity, still are. Others use the moniker mainly because they once were community banks and the phrase has a nice ring to it.

Under our proposal, to become a federally designated community bank or credit union, and therefore eligible for

equity investment from the Community Banking Trust Fund, an institution would have to remain small. We define small as holding assets of no more than \$5 billion. Participating institutions would also be required to seek out local deposits, and concentrate the vast bulk of their lending (say, 70 percent) on home mortgages, multi-family mortgages, and consumer, business (including nonprofit), and local government loans within a limited geographic area.

They would also have to show demonstrable investment in their local community through high loan-to-deposit ratios, coupled with a high market share of local depositors (taking into account the ability of the community to provide deposits). That means service to the entire community, including minorities, immigrants, and those of modest means. No country club banks need apply. Other criteria would include having board members who are of the community and the performance of community service by officers and employees of the bank.

Criteria such as an outstanding rating under the Community Reinvestment Act<sup>[20]</sup> or the "Development Lending Intensity" and "Development Deposit Intensity" metrics created by the National Community Investment Fund could also be used.<sup>[21]</sup> We expect that as the system evolved additional metrics would be developed, including in particular measures specifically appropriate to credit unions.

## Funding

How much money are we talking about? The Treasury Department has announced that it will invest up to \$250 billion in preferred stock in banks and thrifts, at the rate of between 1 percent and 3 percent of an institution's risk-weighted assets. (This is the dollar amount of assets such as loans, increased or decreased according to regulatory standards to reflect their riskiness.)<sup>[22]</sup>

As of June 30, 2008, total risk-weighted assets of banks and thrifts with under \$1 billion in assets were about \$1.1 trillion. Thus, banks and thrifts of this size could conceivably receive between \$11 billion and \$33 billion from the Treasury's program. As of June 30, 2008, the assets of all credit unions totaled \$740 billion, with \$328 billion of that in credit unions under \$500 million in assets. Using the same analysis, if credit unions were eligible for the Treasury program, their share would be between \$7 billion and \$21 billion. In comparison, each of several large banks got infusions of \$25 billion.

Another way to estimate the initial cost of supporting small institutions in a manner commensurate with their larger brethren, while taking into account their need for higher equity ratios, is to look at what it would take to bring the relevant group to a capital ratio of 13. This is in line with traditional levels for healthy, smaller institutions. Based on the June 30 data, it would take a total of \$73 billion to bring the aggregate capital of all banks with less than \$5 billion in assets and all credit unions to this level.<sup>[23]</sup>

However, this is a huge overestimate of the amount that would actually be needed to support true community banking effectively. First, not all banks and thrifts with under \$5 billion in assets, and not all credit unions, will qualify for public investment under the standards set out above. Second, of the group that qualifies, not all institutions will need the money or will apply for it. Many may feel comfortable with a lower equity ratio, or uncomfortable with any sort of government equity ownership. And some institutions (including some of those that ceased being real community banks and invested in speculative real estate far from home) may be so troubled that a government investment would be unwise.

To get a more realistic (though still high-end) estimate, we assume a take-up rate of 50 percent for banks and thrifts of under \$1 billion in assets and for all credit unions. We also assume a take-up rate of 20 percent for banks and thrifts in the \$1 billion to \$5 billion category, a greater proportion of which would have difficulty qualifying as community banks. On this basis, the Community Banking Trust Fund would need a one-time infusion of about \$30 billion.

How much would this cost on an ongoing basis? The needed level of support can only be approximated. As discussed above, most small institutions are doing well. But let's assume that each year the group in the aggregate would need about one-half of 1 percent of assets to ensure its continued ability to meet community needs. Assuming take-up rates remain constant, that works out to a total annual cost of about \$7 billion.<sup>[24]</sup>

Where would this funding (as well a much smaller amount for grants for technology upgrades and similar needs)

come from? We propose that on an ongoing basis, the funding for both equity and grants come from a tax on securitized loan transactions, which are the type of transactions that have the least mutuality between borrower and funder, the lack of which led to the current crisis.

Issuance of asset-backed securities peaked at about \$3.2 trillion (\$2 trillion of mortgage debt and \$1.2 trillion of other such securities) in 2006. This market has declined substantially since, and will probably be depressed for some time. Looking back to the beginning of the recent bubble, in 2001 issuance of asset-backed securities totaled about \$2 trillion (\$1.6 trillion of mortgage debt and about \$400 billion of other such securities). A tax of about one-half of 1 percent (0.005) of the dollar amount of asset-backed securities issued annually would be more than sufficient to finance the Community Banking Trust Fund to a level that would meaningfully check the financial service sector's overall tendency toward consolidation and lack of mutuality.

The notion that big market players with government backing should support those that are more community-oriented is hardly unprecedented. The Federal Home Loan Banks have long been required to set aside 10 percent of their annual net income to support the Affordable Housing Program.<sup>[25]</sup> Moreover, since the summer of 2008, Fannie Mae and Freddie Mac have been required to contribute an amount equal to 4.2 basis points (0.042 percent) of the principal amount of mortgages purchased to support affordable housing, including housing produced by community development financial institutions.<sup>[26]</sup>

Collecting such a tax should not be difficult. The Securities and Exchange Commission collects fees on securities registration (as well as on sales on exchanges and in the over-the-counter market), and the system could be adapted for these purposes also.

The cost of administering the Community Banking Trust Fund will likely be modest. The administrative budget for the Community Development Financial Institutions Fund is only about \$14.7 million. The National Credit Union Administration, with oversight of about 8,000 credit unions, gets by on about \$150 million. We assume the Community Banking Trust Fund could be effectively administered for well under \$100 million annually.

## **The Virtues of Small-Scale Banks**

As we foster small-scale banking we must avoid past regulatory errors, such as the infamous Regulation Q that prevented thrifts and commercial banks from paying market rates for deposits and led to the savings and loan crisis. Too much coddling and protection for small-scale bankers could also erode their competitiveness and spirit of enterprise, which became a big problem in the 1960s and 1970s, and remains so to a lesser extent today. More community bankers need to learn to apply information technology, which fortunately is becoming more affordable, to lower the cost of their operations and transactions.

At the end of the day, it is also clear that small-scale banking won't work unless Americans regain the savings habit. Such a change in behavior will have to happen in any event, as rapid population aging in creditor nations, unsustainable trade imbalances, and other factors reduce the amount of foreign capital Americans can cheaply import. Moreover, small-scale banks can help to foster a return to the thrift ethos. They can do this by bringing back banking and credit union services to areas where residents are currently "unbanked" and by promoting financial education and thrift.

A final argument for encouraging small-scale banking looks to the near future. The ongoing credit crisis had its roots in the destruction of the mutuality of interest between borrowers and lenders. That mutuality is now becoming further eroded by the even greater consolidation of financial services institutions that is emerging from the crisis itself. By the fall of 2008, just three institutions, Citigroup, Bank of America, and J.P. Morgan Chase, held more than 30 percent of the nation's deposits, while also holding 40 percent of bank loans to corporations.<sup>[27]</sup> We should not be surprised if large banks wind up using much of the public money they are now receiving to buy up smaller banks. When the credit crisis is past, just a handful of "banks," for want of a better term for these hydra-headed goliaths, will control most of the market.

Our proposal for a Community Banking Trust Fund will cost money. But funding will come by taxing, and therefore discouraging, those forms of transactional, securitized borrowing that led to the current crisis. Moreover, making the Community Banking Trust Fund part of our new regulatory architecture will help redress the long-term distortions



caused by the massive federal investments now flowing from the Treasury to big banks -- some of them the very institutions responsible for our current troubles.

Since the Progressive Era and before, community banks, thrifts, and credit unions have served customers in a manner that promoted mutuality while also serving as a check against monopoly finance in the hands of a few money-center banks. Before the conflagration of the global financial system brought on by predatory subprime mortgage lending practices and other irrational uses of the world's savings, singing the virtues of small-scale banks might have seemed nostalgic and romantic. After the painful bursting of three financial bubbles in a decade, however, paying attention to those virtues is both essential and hardheaded.

In *It's a Wonderful Life*, George Bailey got to see how much poorer his world would be if he hadn't existed. Today, a world that has passed him by looks ugly indeed.

## Notes

[1] Mark Landler, "U.S. Is Said to Be Urging New Mergers in Banking," *New York Times*, October 21, 2008.

[2] Net worth certificates were used to a limited extent in the 1980s and early 1990s. See <http://www.fdic.gov/bank/historical/reshandbook/ch6altvs.pdf>.

[3] The Treasury has announced that it will invest an amount equal to between 1 percent and 3 percent of risk-weighted assets—the assets on a bank's balance sheet weighted to reflect the assets' riskiness under regulatory capital rules—but no more than \$25 billion in individual banks. The first investments, including three at the \$25 billion level, went to nine very large banks. The Treasury Department has also urged small banks to apply for Treasury preferred stock investments, and on November 17, 2008, Treasury announced a special program for banks that are not publicly traded. The application deadline for this program is December 8. <http://www.treas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf>. There is also a special program for banks serving low-income communities that are certified as Community Development Financial Institutions, who will not be required to issue warrants. <http://www.treas.gov/press/releases/reports/faq%20111708%20%20private.pdf>. It is unclear how many smaller banks will choose to apply. The new program does not apply to Subchapter S corporations, for whom the program's restriction on dividends (which are taxed at the shareholder, rather than the corporate, level as in a standard corporation) may make participation undesirable (see Bonnie McGeer, "Mutuals, Sub S Banks to Treasury: What About Us?" *American Banker*, October 22, 2008, 1), nor to banks in mutual ownership form. Making sure small banks are not disadvantaged with respect to deposit insurance is also critical. The recent actions to both temporarily increase the deposit insurance level to \$250,000 for all banks and credit unions, and to remove the cap for non-interest-bearing (mainly business) accounts in banks until December 31, 2009, are important steps in this regard.

[4] Ben S. Bernanke, "The Financial Accelerator and the Credit Channel," speech given at the Credit Channel of Monetary Policy in the Twenty-first Century Conference, Federal Reserve Bank of Atlanta, Atlanta, Georgia, June 15, 2007, <http://www.federalreserve.gov/newsevents/speech/Bernanke20070615a.htm>.

[5] "Small Banks' Competitors Loom Large," *Southwest Economy*, Federal Reserve Bank of Dallas, January/February 2004, <http://www.dallasfed.org/research/swe/2004/swe0401b.html>.

[6] Robert DeYoung, *Community Banks at Their Best: Serving Local Financial Needs*, 2004 Annual Report (Chicago: Federal Reserve Bank of Chicago 2004).

[7] *Ninth Annual Survey of Senior Community Bank Executives* (Grant Thornton, 2002).

[8] Grace Abbott, *The Immigrant and the Community* (New York: Century Company, 1917), 84.

[9] Jordan Weissmann, "Credit Unions Slowly Fill Void as Payday Lenders Leave D.C.," *Washington Post*, July 26, 2008.

[10] Ronald Mann, "'Contracting' for Credit," *Michigan Law Review* 104:899 (March 2006): 927-28.

[11] Michal S. Barr, Sendhil Mullainathan, and Eldar Shafir, "A One-Size-Fits-All Solution," *New York Times*,

December 26, 2007, <http://www.nytimes.com/2007/12/26/opinion/26barr.html?scp=1&sq=michael20barr20mortgage&st=cse>; see also Barr, Mullainathan, and Shafir, *Behaviorally Informed Financial Services Regulation* (Washington, DC: New America Foundation, 2008), [http://www.newamerica.net/files/naf\\_behavioral\\_v5.pdf](http://www.newamerica.net/files/naf_behavioral_v5.pdf).

[12] See <http://www.cdars.com/index.php>.

[13] For example, ShoreBank in Chicago has raised over \$20 million in deposits in about a year through its high yield savings account, an Internet account that funds its Rescue Loan program to refinance Chicago borrowers out of bad mortgages. ShoreBank has been able to hold and grow these deposits even while lowering the interest rate paid from an initial 5 percent to the current 3.5 percent (<http://shorebankdirect.sbk.com/>).

[14] The FDIC has proposed raising insurance premiums for institutions that have high levels of secured liabilities, including Federal Home Loan Bank advances. See *Federal Register* 73, no. 201, October 16, 2008, 61570.

[15] This difficulty in selling loans is critically important, as no community bank funded primarily with deposits can take the interest rate risk of making the 15-year or longer fixed-rate loans that Americans are once again learning to value. While in time this situation will probably relax some, long-term support of community banking requires a continuous and reliable secondary market for these loans. That includes loans made specifically to new homeowners, those in neighborhoods that have been the focus of government support, and loans made to a broad swath of Americans of moderate income across the country.

Whatever their ultimate fate, Fannie Mae and Freddie Mac must, during this period of crisis, enhance their essential core function of buying well-designed, consumer-friendly loans from community banks and credit unions. As in the past, Fannie and Freddie must set the standards for high loan quality, while being creative in helping banks make prudent loans for both rental and owned housing. In contrast to current practice, in which a premium is paid when the servicing relationship is transferred out of the bank making the loan, banks should be strongly encouraged to retain the servicing relationship. In the short term, the Federal Housing Finance Administration, which regulates Fannie and Freddie, could immediately direct Fannie and Freddie to accelerate their purchases and improve their pricing.

[16] Others are in mutual form, which, as with credit unions, means they do not have stock to sell, but rather obtain their capital by holding on to retained earnings, a very slow way to build a capital base.

[17] Although we present it here as a separate entity, the Community Banking Trust Fund could be also structured as a program within the CDFI Fund. This has the advantage of building on a structure already in place that has extensive experience with financial institutions of all sizes and types.

[18] Net worth certificates were used to a limited extent in the 1980s and early 1990s. See <http://www.fdic.gov/bank/historical/reshandbook/ch6altvs.pdf>.

[19] "Community credit union" is, in contrast, a designation conferred by the National Credit Union Administration. Whether it is being conferred too broadly is a matter of debate that should be incorporated into the discussion about the community bank designation.

[20] Contrary to assertions by a group of conservative critics, the Community Reinvestment Act was not the cause of the ongoing financial crisis. See Michael S. Barr and Gene Sperling, "Poor Homeowners, Good Loans," *New York Times*, October 17, 2008; and Robert Gordon, "Did Liberals Cause the Sub-Prime Crisis?" *The American Prospect* online, April 7, 2008, [http://www.prospect.org/cs/articles?article=did\\_liberals\\_cause\\_the\\_subprime\\_crisis](http://www.prospect.org/cs/articles?article=did_liberals_cause_the_subprime_crisis). A recent study finds that default rates on subprime mortgages made by traditional banks, often in response to the Community Reinvestment Act, have performed far better than those made through brokers. See Lei Ding, Roberto G. Quercia, and Janneke Ratcliffe, "Risky Borrowers or Risky Mortgages," Center for Community Capital, University of North Carolina, October 2008, [http://www.ccc.unc.edu/documents/RiskyBorrowers\\_RiskyMortgages\\_1008.pdf](http://www.ccc.unc.edu/documents/RiskyBorrowers_RiskyMortgages_1008.pdf).

[22] Treasury investments are, however, limited to a maximum of \$25 billion per institution.

[23] In the aggregate, bringing the 7,777 banks and thrifts with under \$1 billion in assets to a 13 percent capital ratio would require approximately \$35 billion; the 481 between \$1 billion and \$5 billion would require approximately \$21 billion; the 7,972 credit unions would require about \$17 billion. Because these are aggregate numbers, they do not

reflect the fact that a limited number of primarily small entities already have more than 13 percent equity; in practice the equity in those entities will not cross-subsidize the entities with less equity.

[24] This consists of about \$4 billion for the smaller banks, \$1 billion for the banks with between \$1 billion and \$5 billion in assets, and \$2 billion for the credit unions.

[25] See <http://www.fhlbanks.com/html/programs.html>.

[26] Section 1331 of the Housing and Economic Recovery Act of 2008, Pub. L. 110-289. Initially, the funds will be used to support the Hope for Homeowners program, but starting in 2010 they will be available to Community Development Financial Institutions and others for affordable housing. The Housing Trust Fund and Capital Magnet Fund will also get a portion of profits on the sale of assets under the bailout legislation.

[27] Binyamin Appelbaum, "Wachovia Is Sold As Depositors Flee," Washington Post, September 29, 2008.

---

The New America Foundation, 1630 Connecticut Avenue, N.W., 7th Floor, Washington, DC 20009  
<http://www.newamerica.net>

---

New America content carries a Creative Commons license, which permits non-commercial re-use when proper attribution is provided. For additional information, please visit <http://www.newamerica.net/about/copyright>

