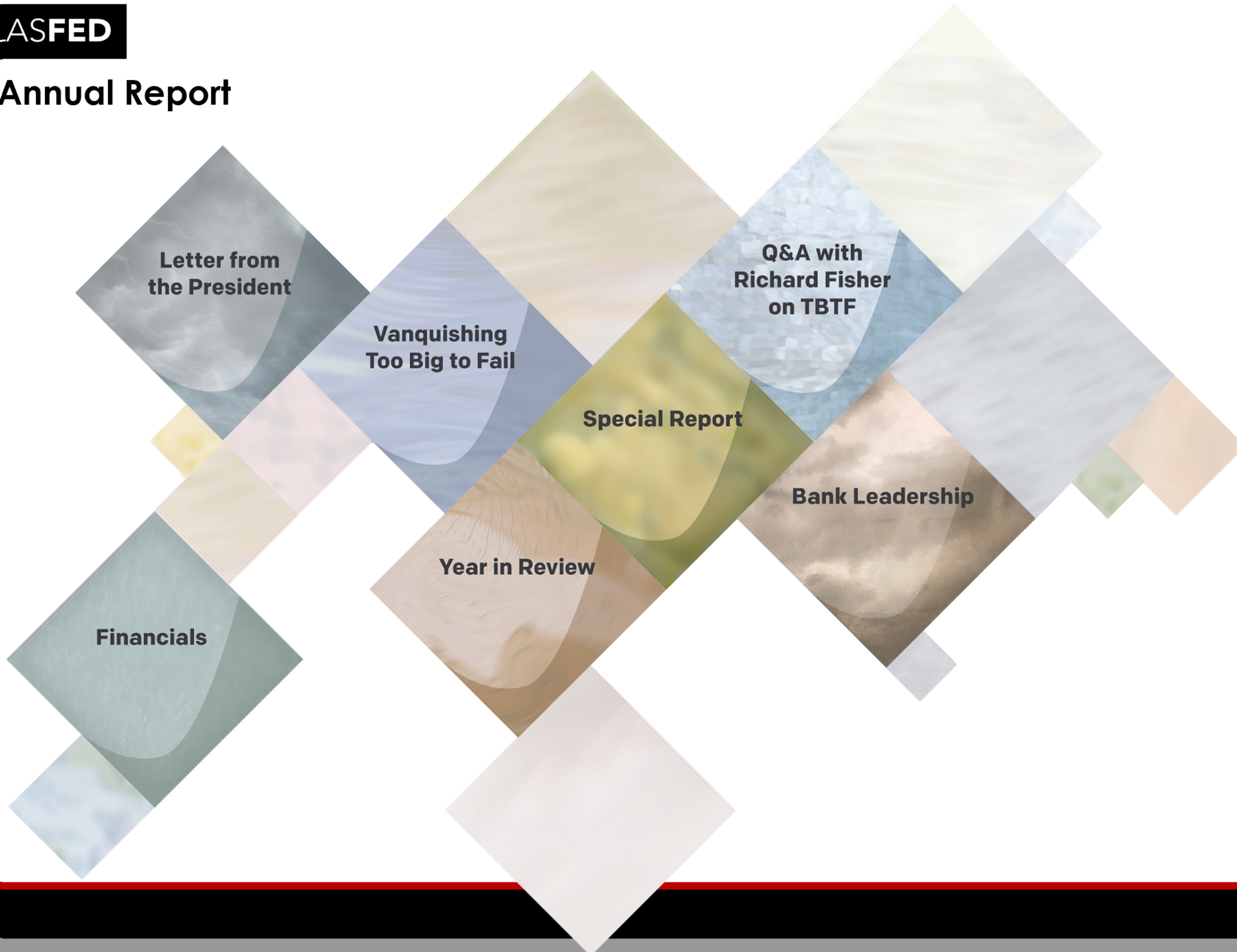
DALLASFED

# 2012 Annual Report

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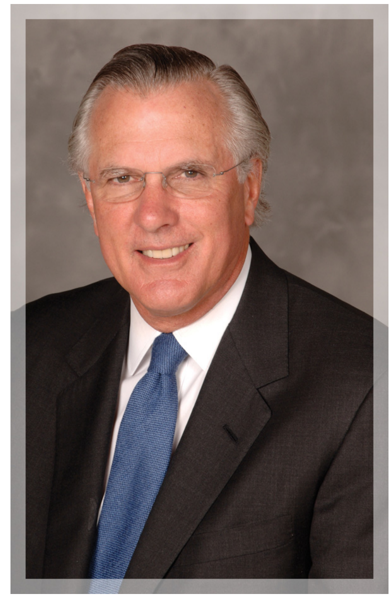
# Letter from the President



Nearly four years ago, the Federal Reserve Bank of Dallas took a public stand against what we called the "pathology of 'too big to fail.'" We have worked tirelessly to advance this important issue and keep it at the top of policymakers' to-do lists, advocating an end to too big to fail (TBTF) in speeches, presentations and reports, including the 2011 annual report.

The fact remains, however, that our economy and financial system are saddled with TBTF institutions. Indeed, our financial sector has become ever-more concentrated, with a dozen of the largest banking institutions controlling some 70 percent of industry assets. Five years after the financial crisis unfolded, these behemoth banks continue adversely affecting monetary policy's transmission mechanism and undermining the process of creative destruction, a hallmark of American capitalism that can't fully function among TBTF entities.

It has become increasingly apparent to financial industry practitioners, public policy experts and politicians on both sides of the aisle that the Dodd–Frank Wall Street Reform and Consumer Protection Act—Congress' attempt to combat TBTF—has codified, rather than eradicated, the large banks' TBTF status. The number of rules, regulations and unintended consequences of this presumably all-encompassing law is mind-numbing.

To press the issue further, the Dallas Fed released a special report in January, "Financial Stability: Traditional Banks Pave the Way." The collection of five essays also forms the centerpiece of this year's annual report. The essays outline the virtues of our nation's community banks, as well as the regulatory burden and cost disadvantage the maintenance of TBTF institutions inflicts upon them. We believe our proposed solution would end taxpayer-funded bailouts and level the competitive playing field. I encourage you to read the report in its entirety and spread its message within your respective communities.

The essays and recommendations—and my speech announcing them—have generated significant attention. Interest was so high that public demand temporarily overwhelmed our website. We have received many thought-provoking questions and suggestions. We have drawn on this response to further refine our approach, and accordingly, have added a sixth essay on the Dallas Fed's prescriptions for TBTF and answers to questions that have arisen about our proposal. Both are included in this annual report.

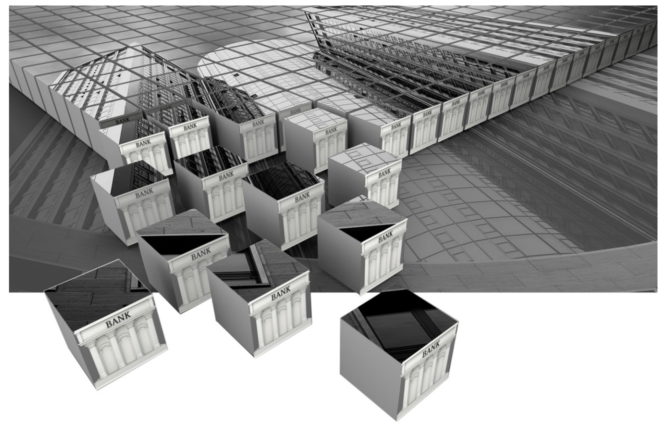
We hope that citizens of the Eleventh District and of this great country can take pride in the Dallas Fed's leadership on this very important issue. We look forward to your thoughts and suggestions as a result of our efforts. We passionately believe that, until we are freed from the stranglehold of TBTF institutions, the American economy cannot reach its highest potential.

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

# Vanquishing Too Big to Fail

By Richard W. Fisher and Harvey Rosenblum

The solution for ending “too big to fail” is not bigger government but smaller, unsubsidized banking institutions governed by the market discipline of creditors at risk of loss.



The United States is burdened by a highly concentrated financial system where the dozen largest banking institutions control almost 70 percent of banking industry assets. This excessive concentration intensified during the 2007–09 financial crisis when several, presumably healthy big banks absorbed some of their failing rivals. Another round of consolidation will likely accompany the next crisis, further reducing competition.

Public policy subsidizes excessive risk taking among the largest financial institutions, whose managements know their banks won’t be allowed to fail if their bets go bad. The banks’ creditors similarly believe the government will backstop their investments, simultaneously undermining the profitability and viability of smaller institutions that enjoy no such implicit guarantee. Economics 101 tells us that if you want more of something, you should subsidize it. The irony is that government policy subsidizes excessive risk taking, the very thing we want to reduce. Increased industry concentration induced by a policy of too-big-to-fail (TBTF) institutions, raises the likelihood and potential damage of another financial meltdown.

## Three Steps to Financial Reform

To address this situation, we have proposed confining access to the federal safety net—the Federal Reserve’s discount window and federal deposit insurance protection—to traditional commercial banks. Further, we advocate that customers and creditors of companies affiliated with commercial banks sign a disclaimer acknowledging their understanding that there is no federal guarantee underpinning their relationship with these nonbank units or with the parent of any banking company. We believe these two steps would reduce the perverse incentives stemming from the implicit—but widely recognized—creditor protection offered to TBTF institutions. These two changes would help realign incentives to better resemble those faced by customers of smaller banks whose unsecured creditors and equity shareholders are exposed to losses. In short, our proposal would revive the inhibited forces of market discipline.

Unfortunately, established customer relationships are slow to change. To accelerate the transition to a more competitive financial system, our proposal has a third element to help level the playing field. Specifically, we recommend that the largest financial institutions be restructured so that every one of their corporate entities is subject to a speedy bankruptcy process, and in the case of banking entities, that each be of a size that is “too small to save.” This last step gets both the incentives and the structure right, neither of which is accomplished by relying on the Dodd–Frank Wall Street Reform and Consumer Protection Act. The aim of our three-step proposal is to underscore to customers and creditors that a credible regime shift has taken place, and the reign of TBTF policies is over.

## Answers to Some Serious Questions

To further clarify our position and address the many questions, comments and suggestions we have received, we offer some additional amplification. Regarding who should drive the financial reform process, we believe that the mandate, guiding principles and deadlines for downsizing are legislative matters for the Congress to determine. However, the design and details of each company’s restructuring should be left to the management and board of directors representing the owner-shareholders. Strong management involvement is necessary to ensure that all spun-off banks and other subsidiaries are viable and profitable companies, able to attract and retain financial capital and management talent. Such restructuring of TBTF financial institutions should be accomplished with minimal statutory modifications and limited government intervention.

Although TBTF financial institutions were not the sole cause of the financial crisis, they were a primary mechanism through which shocks were transmitted throughout the financial and economic systems. Many TBTF banks and their subsidiaries were major players in shadow banking activities dependent on short-term, nondeposit wholesale funding—using financial instruments such as commercial paper and money market funds—that spread systemic risk pervasively at the height of the crisis. Moreover, TBTF status grants these giant institutions a continuing subsidy that facilitates their further growth and ever-greater risk taking, inducing yet more financial system instability.

Some commentators believe that our plan to downsize the largest banks would shrink the financial sector and its overall employment. We believe, however, that our proposal would increase the number of banks, bolstering competition and providing additional services that benefit bank customers. In addition, affiliate companies' ancillary financial services would not disappear; to accommodate market demand, these services will continue, but without subsidies and with a noticeably greater level of due diligence from creditors. Again, increased market discipline, the toughest regulator of all, would mediate credit behavior and improve transparency around riskier activities.

One line of argument suggests the financial system and its health are in stable equilibrium, and Dodd–Frank needs to be given time to prove it will work as intended. We contend that reliance on Dodd–Frank to end TBTF is simply the triumph of hope over experience. We've been down this road before, where bailouts and increased concentration become the only feasible alternatives in a crisis. Our proposal would alter the structure of banking so that bailouts become unnecessary. Under our proposed policy change, the largest banking institutions would pose far less systemic risk.

Additionally, to those who say "just give Dodd–Frank a chance," we note that partial repeal of Dodd–Frank has already occurred through the back door. Megabanks, in the U.S. and abroad, have pushed back to significantly weaken capital and liquidity standards, the statute's purported structural pillars. Moreover, the penance and legal penalties paid to date for egregious errors in mortgage finance, manipulation of the London interbank offered rate (LIBOR) and other legally and ethically questionable activities have been almost immaterial to the large banks (or at least appear insufficient to deter such practices). Under Dodd–Frank, taxpayers remain exposed to similar, possibly larger, losses among giant financial institutions during the next crisis.

Some critics worry that our plan will drive large banks to move their risky activities to other countries that wish to be a haven for giant universal banking institutions. Such havens are already available, but the grass over there may not be greener. Many of these countries have been nearly bankrupted by the failure of their own giant banks, some of which have assets greater than their nations' GDPs. Their taxpayers do not necessarily welcome the prospect of propping up more TBTF banks. And having a large number of very big institutions is no guarantee of economic success in a competitive global economy. Japan had more than half of the world's largest 25 banks in the 1990s (*Table 1*), and for two decades, it has been the caboose of the global economic freight train.

## No Reform Plan Is Perfect

We concede our proposal doesn't have all the answers. It would not eliminate financial crises, but it should reduce their frequency and severity. Nor will it alter the human DNA of those who serve as "first responders" during the next crisis. Our proposal should make the magnitude of the problems regulators face, and the tasks they need to perform, far more manageable. Under our plan, supervisory agencies would confront several thousand community banks, a few hundred moderate-size banks (by today's standards) and **no** megabanks. The nonbank and shadow bank companies would operate without a subsidized safety net and with long-overdue market discipline imposed by at-risk creditors.

There will always be some banks that are larger than the rest, and consequently, there will be temptation for regulators to label the "biggest few" as systemically important. The fluctuating nature of human resolve and political fortitude, as well as the problem of "regulatory capture," has been present in U.S. bank policy at least since the intervention/bailout of Continental Illinois and its creditors in 1984. Our proposal cannot and will not prohibit regulators from intervening to support the unsecured creditors of a failing banking institution. But our proposal reduces the dimensions of the problem—asset size and systemic interconnectedness—by an order of magnitude and thereby should diminish the tendency to intervene out of fear of unknown systemic risks. Our plan would dramatically reduce the costs of non-intervention.

*(Continued from Vanquishing Too Big to Fail)*

A metaphor helps illustrate the point. Question: How do you eat breakfast cereal? Answer: One spoonful at a time. Question: How do you deal with a banking crisis? Answer: One bank failure at a time. The status quo under Dodd–Frank could translate into the complications of rescuing, supporting and resolving various parts of giant financial institutions using taxpayer funds for several years. Under our proposal, historical experience suggests, one bank failure at a time is a manageable proposition because all banks will have been made too small to save. None would be too big to fail. The FDIC would be “in on Friday and out on Monday,” maybe a few days later, perhaps a little longer in the case of bigger and more complex banks. To complete the breakfast cereal metaphor, under our proposal, bank supervisors would deal with the task of eating a cup of cereal, one spoonful at a time. Under the Dodd–Frank status quo, bank supervisors would eventually confront resolving a behemoth bank, a job tantamount to eating a bushel of cereal. This would be an insurmountable task for regulators whose training and natural impulse would irresistibly tempt them into a bailout. Awareness of this pattern of using bailout as the default response reinforces creditors’ tendency to exert no market discipline forever and always. Stated differently, under Dodd–Frank, supervisory action would continue to “put it to the taxpayers.”

## Ultimately, Taxpayers Foot the Bill for Subsidies

Our proposal for financial reform also addresses the growing inability of our financial system’s insurer of last resort—the U.S. taxpayer—to backstop the financial system in future financial crises. In 1990, the four largest banking institutions had assets of $519 billion, about 9 percent of U.S. gross domestic product (GDP). By 2011, the four largest banking organizations held assets exceeding $7.5 trillion, amounting to 50 percent of GDP (*Chart 1*).

This is just their on-balance-sheet assets; if U.S. bank balance sheets were adjusted to international standards (instead of U.S. Generally Accepted Accounting Principles), their asset sizes would reflect significantly more exposure to derivatives and mortgages currently excluded from U.S. regulatory filings. The biggest banks are even bigger than meets the eye. Part of their growth, both absolutely and relative to GDP, has been driven by the subsidized nature of TBTF banking.

Remember the corollary of the Economics 101 lesson: Subsidized activities will grow faster than unsubsidized activities. Taxpayers didn’t approve their exposure to losses in the recent financial crisis or potentially in the next one. Massive taxpayer exposure resulted from the happenstance of TBTF banks responding to the perverse incentives of subsidies implicitly granted to the banking industry’s giants. Such taxpayer exposure is not something that should become embedded into the fabric of our financial system.

We have addressed a few of the most common questions and suggestions. Our response to other points of contention can be found in the accompanying interview with Richard Fisher.

## Protect Taxpayers, Not Megabanks

The potential taxpayer burden of dealing with TBTF institutions could be addressed by a still-growing army of bank supervisory personnel trying to enforce the rigid, complex and probably easy-to-evade rules of Dodd–Frank. It would be oversight without the benefit of supplemental reinforcement from market discipline and increased due diligence.

Under our plan, the solution for ending TBTF is not bigger government, but smaller, unsubsidized banking institutions governed by the market discipline of creditors at risk of loss.

*The views expressed are those of the Federal Reserve Bank of Dallas and not necessarily those of others in the Federal Reserve System. We thank David Luttrell for his excellent assistance throughout this project.*

### About the Authors

Richard Fisher is president and chief executive officer and Harvey Rosenblum is executive vice president and director of research at the Federal Reserve Bank of Dallas.

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# Vanquishing Too Big to Fail

By Richard W. Fisher and Harvey Rosenblum

### Table 1

### World's Largest 25 Banks: Then and Now

| 1990 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|
| Rank | Banking organization | Country | Assets (billions of U.S. dollars) | Rank | Banking organization | Country | Assets (billions of U.S. dollars) |
| 1 | Dai-Ichi Kangyo Bank Ltd. | Japan | 428 | 1 | Deutsche Bank | Germany | 2,800 |
| 2 | Sumitomo Bank Ltd. | Japan | 409 | 2 | HSBC | United Kingdom | 2,556 |
| 3 | Mitsui Taiyo Kobe Bank Ltd. | Japan | 409 | 3 | BNP Paribas | France | 2,543 |
| 4 | Sanwa Bank Ltd. | Japan | 403 | 4 | Industrial and Commercial Bank of China | China | 2,456 |
| 5 | Fuji Bank Ltd. | Japan | 400 | 5 | Mitsubishi UFJ Financial Group | Japan | 2,448 |
| 6 | Mitsubishi Bank Ltd. | Japan | 392 | 6 | Credit Agricole | France | 2,432 |
| 7 | Credit Agricole Mutuel | France | 305 | 7 | Barclays Group | United Kingdom | 2,417 |
| 8 | Banque Nationale de Paris | France | 292 | 8 | Royal Bank of Scotland | United Kingdom | 2,330 |
| 9 | Industrial Bank of Japan Ltd. | Japan | 290 | 9 | **JPMorgan Chase** | United States | 2,266 |
| 10 | Credit Lyonnais | France | 287 | 10 | **Bank of America** | United States | 2,129 |
| 11 | Deutsche Bank | Germany | 266 | 11 | China Construction Bank (CCB) | China | 1,949 |
| 12 | Barclays PLC | United Kingdom | 259 | 12 | Mizuho Financial Group Inc. | Japan | 1,890 |
| 13 | Tokai Bank Ltd. | Japan | 250 | 13 | Bank of China | China | 1,878 |
| 14 | Norinchukin Bank | Japan | 250 | 14 | **Citigroup** | United States | 1,874 |
| 15 | Mitsubishi Trust & Banking Corp. | Japan | 238 | 15 | Agricultural Bank of China | China | 1,853 |
| 16 | National Westminster Bank PLC | United Kingdom | 233 | 16 | ING Group | Netherlands | 1,655 |
| 17 | ABN Amro Holding N.V. | Netherlands | 231 | 17 | Banco Santander | Spain | 1,619 |
| 18 | Bank of Tokyo Ltd. | Japan | 223 | 18 | Sumitomo Mitsui Financial Group | Japan | 1,598 |
| 19 | Societe Generale | France | 220 | 19 | Societe Generale | France | 1,528 |
| 20 | Sumitomo Trust & Banking Co. Ltd. | Japan | 219 | 20 | UBS | Switzerland | 1,508 |
| 21 | **Citicorp** | United States | 215 | 21 | Lloyds Banking Group | United Kingdom | 1,501 |
| 22 | Mitsui Trust & Banking Co. Ltd. | Japan | 211 | 22 | Groupe BPCE | France | 1,473 |
| 23 | Long-Term Credit Bank of Japan Ltd. | Japan | 201 | 23 | **Wells Fargo** | United States | 1,314 |
| 24 | Dresdner Bank | Germany | 187 | 24 | UniCredit | Italy | 1,199 |
| 25 | Compagnie Financiere de Paribas | France | 186 | 25 | Credit Suisse | Switzerland | 1,115 |

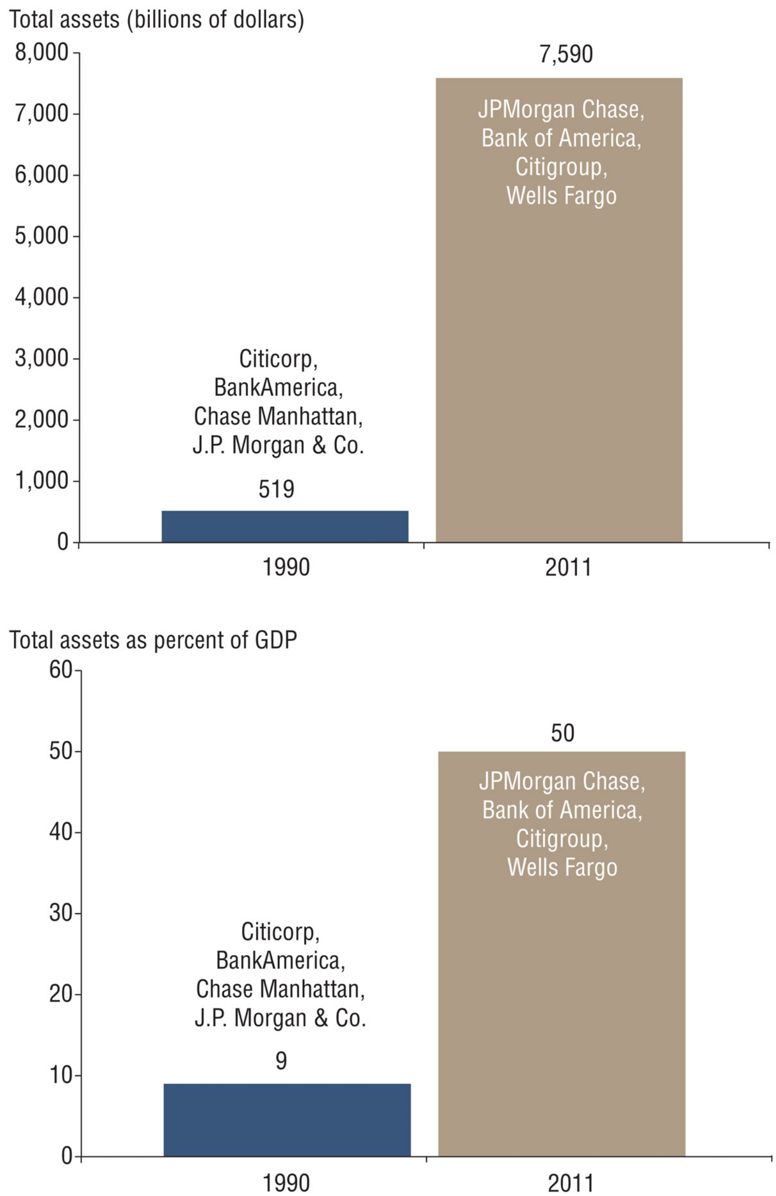
NOTE: Data for banking organizations (holding company, when applicable) as of Dec. 31 (or March 31 fiscal year-end in the case of Japanese banks).

DATA SOURCES: "The Top 100 Banking Companies in the World," Ranking the Banks 1991, *American Banker*; "World's 50 Biggest Banks 2012," *Global Finance*.

# Vanquishing Too Big to Fail

By Richard W. Fisher and Harvey Rosenblum

**Chart 1**
**Explosive Growth of the Big Four Megabanks**




NOTES: Asset size is based on the total assets of the U.S. banking organization (holding company, when applicable). Wells Fargo did not join the ranks of the Big Four until its 2008 acquisition of Wachovia.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# Q&A with Richard Fisher on TBTF

Federal Reserve Bank of Dallas President Richard Fisher answers questions that have arisen about the Dallas Fed's proposal on ending "too big to fail."

### Q. What is the Dallas Fed's proposal on addressing the issue of "too big to fail" (TBTF)?

Ours is a three-step approach: One, roll back the safety net to apply only to commercial banks and not to nonbank affiliates. Two, noncommercial bank customers and counterparties would sign a disclosure acknowledging there is no implied government backstop. Three, TBTF firms may need to be downsized and restructured, using as little public policy intervention as possible, to realign incentives and reestablish a competitive, level playing field.

### Q. Why can't Dodd–Frank solve the TBTF problem?

Rather than resolve TBTF, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) essentially codified these mega-institutions' existence by designating some as "systemically important" and separating them from other banks. Moreover, the act's 849 pages and more than 9,000 pages of proposed regulations all but guarantee that authorities remain two or three steps behind the industry. Even the seemingly straightforward "Volcker Rule"—restricting banks' proprietary trading for their own accounts—gave rise to a nearly 130-page proposed rule with 383 questions for comment. Excessively complicated regulation only adds to the uncertainty that bedevils investors and business.

Dodd–Frank puts smaller institutions, which have fewer resources to devote to the new law, at a competitive disadvantage relative to their largest counterparts. If another crisis occurs, given current regulations, additional industry consolidation would lead to even larger banking behemoths.

### Q. Doesn't Dodd–Frank provide procedures for dealing with big bank failures?

The "orderly liquidation authority" outlined in the act mandates that the Federal Deposit Insurance Corp. (FDIC) wind down large firms "that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." Dodd–Frank also instructs the FDIC, when disposing of assets, to act "to the greatest extent practicable" in a manner that "mitigates the potential for serious adverse effects to the financial system." That leaves significant wiggle room for perpetuating TBTF. To avoid "end-of-the-world" decisionmaking, the bailout paradigm of the last crisis would remain intact.

### Q. Apart from Dodd–Frank, large banks have bolstered capital and liquidity while improving risk controls. Aren't institutions stronger now?

These changes are what we would hope to see develop as best practices. However, they fall short of removing the TBTF subsidy that remains for the largest, most complex banking organizations. Until all financial firms are considered "too small to save," and the playing field is leveled, the big banks will remain comparatively less influenced by regulatory and market discipline.

### Q. Wouldn't breaking up the big banks harm the still-fragile economy?

While there may be *some* economic benefits to size and scope, numerous studies suggest that the benefits of size are limited. In fact, simple logic would dictate that if you are "too big to fail," you're also "too big to manage." If a large multinational corporation needs a huge bridge loan to close a deal or expand services, a group of lenders could share the risk. From lending data, we know that smaller banks serve the smaller businesses that drive job growth. A healthy and competitive banking model that serves the needs of job creators will help get the economy back on the path to stronger growth.

Restructured, refocused and *unsubsidized* financial conglomerates will still provide a full range of financial services. They will operate with a clarified understanding of the boundaries of FDIC protection and access to the Federal Reserve's discount window—only traditional commercial banking operations should benefit from the safety net.

*(Continued from Q&A with Richard Fisher on TBTF)*

### Q. Won't breaking up the TBTF banks be significantly disruptive and/or prohibitively costly?

It could be both disruptive and costly, but *doing nothing* will be even costlier, as we saw during the financial crisis. Do we want to go through that again, this time with an even more concentrated and entrenched banking industry shielded by Dodd–Frank? *That* would be significantly more disruptive and prohibitively costly.

### Q. Why should government interfere in private sector, banking industry decisionmaking?

Government policy permitted banks to become too big and subsidized size at the expense of efficiency, so any new policy needs to correct this blunder by setting the playing field level once again. Public safety nets temper runs on bank deposits and promote the safety and soundness of the payments system. These social benefits come with social costs—the need for regulatory oversight of the banking industry.

### Q. Have you considered other alternatives, such as allowing large banks to operate almost as regulated utilities, with tough new requirements, as Europe is considering?

There is no reason banks should be utilities, with very limited competition and very difficult entry, which is essentially where policy is headed in Europe. While we respect European policymakers in many respects, we don't think we should emulate that trend.

To use an economic term, banks are not a "natural monopoly." Let them be subject to free and fair competition, just like in other industries, with both the freedom to make money and the freedom to fail. U.S. taxpayers have agreed to spend the money needed to ensure the safety and soundness of our collective payments system, but not to backstop the handful of TBTF institutions seeking an exemption from failure.

### Q. How can the community banking model become more vibrant when it is hindered by the Fed's "zero-bound" interest-rate policy and Dodd–Frank?

Fed policy decisions and Dodd–Frank regulations may be challenges, but they are, in part, the product of issues stemming from TBTF that directly threaten the community banking model. Shrinking net interest margin is a consequence of a banking system hijacked by TBTF. If the normal rules of capitalism applied to the financial sector, community banks could gain market share if a TBTF bank failed. The problem is they aren't allowed to fail.

Fiscal transfers, regulatory forbearance and extremely accommodative monetary policy have worked to buttress the behemoth banks at the expense of nearly everyone else. Given the policies in place during the crisis, it has been argued that such intervention was the best effort and option to save the financial system. Now, during the recovery and reform period, it is imperative that we put better policies in place to avoid such a dire outcome in the next crisis.

### Q. The Dallas Fed's favored community bank model resembles the one in place during Texas' banking collapse in the 1980s, when banks were too close to customers. Aren't you exchanging one set of regulatory issues for another?

The '80s collapse, while it cannot be taken lightly, was resolved better than our most recent crisis. Weak Texas banks were allowed to fail, and other banks filled the void—although, admittedly, some of those rescuers were on the path to becoming TBTF. These failures left a mark on the Texas banking industry; avoiding their repetition is one of many reasons why Texas has outperformed the nation during the recovery. We doubt the TBTF banks, not subject to true market discipline, have learned many enduring lessons from the most recent crisis.

### Q. How appropriate is a community bank model in an age of globalization and far-flung financial intermediaries?

"Community bank" isn't the same thing as "tiny bank." There are banks well below TBTF size that operate internationally, and if American corporations require certain global services, the marketplace will provide them.

### Q. Doesn't an economy as large and diverse as ours need financial institutions of all sizes, with diverse business models and strategies?

Yes, the flexible, highly diverse economic engine of growth that is the United States needs a credit intermediation system (taking in short-term deposits and lending longer-term) that supports such vitality. However, our country has become robustly dynamic upon the currents of creative destruction—a "reap what you sow," free-market process of success and failure, innovation and obsolescence. Viable business models should be given the opportunity to compete and prosper on their own merits, while unattractive strategies should be allowed to fail. Subverting the ability to fail, on the taxpayers' dime, is a perversion of American capitalism.

### Q. How do TBTF banks affect monetary policy?

In a September 2009 *Wall Street Journal* article, we called TBTF "the blob that ate monetary policy." When they experience stress, TBTF banks gum up the usual channels of monetary policy, so it must be looser than it would be otherwise to get the same amount of stimulus to the economy. An analogy we like to use involves an automobile engine: If there is sludge on the crankshaft—in the form of losses and bad loans on the balance sheets of the TBTF banks—then the bank-capital linkage that greases the engine of monetary policy does not function properly to drive the real economy. No amount of liquidity provided by the Federal Reserve will help power growth if this transmission mechanism is broken.

### Q. How would the Dallas Fed proposal prevent banks' use of so-called off-balance-sheet vehicles that can conceal institutional health?

Depository institutions should have everything on their balance sheets so investors can appropriately gauge operations. Special-purpose vehicles and off-balance-sheet financing—forms of shadow banking—should occur in a separately funded, collateralized subsidiary without a federal safety net. Nontraditional banking and intermediation should be clearly separated so that there is no implicit subsidy. Any transaction with the holding company or shadow bank affiliates should be at arm's length from the commercial banking institution. Under our proposal, customers and counterparties of nontraditional banks would sign a disclosure acknowledging there is no implied government backstop, notably via the Fed's discount window and federal deposit insurance. Those would only be available for the commercial banking arm. With proper transparency, the equity and debt providers will consider appropriate risks, funding costs will adjust and market discipline will help rein in excesses.

### Q. How should bank regulators deal with nonbank financial firms, such as GE and AIG, who were closely watched during the crisis?

That's a good question to ask the new Financial Stability Oversight Council, established under Dodd–Frank and charged with identifying threats to national financial stability. Dodd–Frank also makes provisions for corporate entities with extraordinary financial system presence, designating them as "systemically important." They will come under the Federal Reserve's supervision. When regulators designate a firm as systemically important, they signal that they are TBTF.

AIG is an interesting case. The company's restructuring and exit from quasi-nationalized status after its rescue have been in the news recently. How did the company experience a turnaround from insolvency to profitability? According to Francesco Guerrera of the *Wall Street Journal* , AIG was *massively downsized* and made a *simpler*, *more manageable* company.

### Q. How do the Basel III international banking requirements governing liquidity, capital ratios and eligible collateral impact TBTF?

The liquidity rules would little affect TBTF. Regulators must achieve a delicate balance between regulation and growth. Too much regulation can stifle growth; so can too little or ineffective regulation, as evidenced by the financial crisis. U.S. banking regulators haven't yet introduced their liquidity proposals and are considering thousands of comments submitted. Besides, the robustness of the new Basel liquidity rules is debatable. In our view, the Basel committee softened the rules initially proposed, although Mervyn King, the governor of the Bank of England, says they are neither weaker nor stronger, just more "realistic."

*(Continued from Q&A with Richard Fisher on TBTF)*

### Q. Capping bank size has been discussed by the Dallas Fed and others. How big is too big?

Ideally, that question would be determined by market forces. As we've noted in this report ("Leveling the Playing Field"), the stock market seems to be penalizing large, complex banking organizations with lower relative valuations. The Dallas Fed wants to impart community bank virtues—relationship-based, conservative lending influenced by regulatory and market discipline—to the core of the banking system as a whole. We could attempt to remove implicit TBTF subsidies through a taxation scheme, or realign incentives through legislation or regulation, and then see where it leads us. But this would replace market forces with increased regulation and politically influenced bureaucracy.

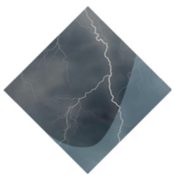
Unfortunately, a subsidy once given is nearly impossible to take away. Overcoming entrenched oligopoly forces, in combination with customer inertia, may require government-sanctioned reorganization and restructuring of the TBTF firms in order to accelerate the imposition of effective market discipline. We advocate using as little government intervention and statutory modification as possible to restructure the largest institutions to a size that is effectively disciplined by both market and regulatory forces—so that every corporate entity is subject to a speedy bankruptcy process, and every banking entity is "too small to save." This would underscore to customers and creditors that a credible regime shift has taken place, and the reign of TBTF policies would end.

# Financial Stability: Traditional Banks Pave the Way

For a prosperous future, the nation must find lasting financial stability…but where? Not in the big financial institutions at the center of the recent crisis. Not in the misplaced hope of restraining these powerful organizations via regulation. Instead, stability is to be found in a surprising place—all around us. America's numerous community banks, small and traditionally oriented, demonstrated stability during the crisis and its aftermath. Imparting their virtues to the financial system as a whole will require the end of financial institutions that are too big to fail.

## Introduction

A stable, well-functioning financial system is a precondition for a healthy economy. In recent years, America has seen what happens when turmoil engulfs the banks and other institutions that handle our money and provide credit to fuel economic expansion. We now confront slow growth, high unemployment and flat incomes. Policymakers appear flustered.



## Community Banks Withstand the Storm

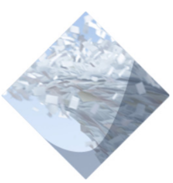
Community banks, which rely on strong customer relationships and disciplined lending practices, weathered the financial crisis better than large, nontraditional banks. This superior performance suggests that a back-to-basics approach to banking could help the nation realize financial stability that lasts.

## A Lender for Tough Times

Community banks are not only a major source of credit, but also a stable one for businesses. During the recent financial crisis and its aftermath, these smaller, traditional lenders provided credit to many firms, especially small businesses, when they needed it most.

## Small Banks Squeezed

With consistent loan quality and resilient lending activity, community banks—and the traditional banking model they represent—can be a much-needed force for financial stability. Unfortunately, they've struggled to maintain market share, partly as a result of unintended consequences of public policy.



## Regulatory Burden Rising

U.S. commercial banks face growing regulatory requirements and complexity, especially with the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, which was intended to rein in excesses of the largest banks. The nation would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks.

## Leveling the Playing Field

Financial reform must be redirected. The government's financial safety net for the biggest banks should cover only their essential banking activities and their role in the payments system. Once that occurs, market discipline can reassert itself, and all institutions—large and small—can compete on a more level playing field.

# Introduction


A stable, well-functioning financial system is a precondition for a healthy economy. In recent years, America has seen what happens when turmoil engulfs the banks and other institutions that handle our money and provide credit to fuel economic expansion. We now confront slow growth, high unemployment and flat incomes. Policymakers appear flustered.

The country won't return to prosperity until the persistent fog surrounding our nation's financial system lifts. This will require not only rebuilding healthy balance sheets, but also addressing the public's diminished confidence in banks as reliable conduits of credit for the practice of American capitalism.

We believe the old and familiar virtues of traditional banking provide the framework. Financial stability rests on a level playing field that rewards sound judgment and integrity and penalizes excessive risk and complexity financed by taxpayer dollars. Government must retain its role as the financial system's watchdog, but it should render no institution immune to market discipline.

In recent years, a small number of globe-spanning behemoths have come to dominate the banking industry. Their size, complexity and risky behavior played a decisive role in the financial crisis and now weigh on the lackluster economic recovery. New laws strive to end "too big to fail" banks but come up short, violating our capitalist principles by interfering with market discipline and perpetuating a threat to the country's financial stability.

When it comes to our financial sector, we've seemingly stumbled into a place where we never wanted to be. Just as disturbing, we don't know how to get out. Do we simply accept that big banks will get bigger? Do we try to rein in their excesses through all-encompassing regulation, even if it risks burdening small and medium-sized banks that had little to do with the financial crisis? Or do we dedicate ourselves to creating a diverse financial system in which no bank is too big to fail?

This report presents five online essays, written by Dallas Fed financial experts, on the theme of rethinking America's banking system:

- "Community Banks Withstand the Storm" examines the inherent stability of smaller, customer-focused institutions.
- "A Lender for Tough Times" shows how smaller institutions support their customers during recessions.
- "Small Banks Squeezed" discusses these institutions' uphill struggle for market share.
- "Regulatory Burden Rising" illustrates the growing burden smaller banks face because of regulations aimed at policing the activities of the big institutions.
- "Leveling the Playing Field" analyzes how market discipline and public policy reform can influence bank size and contain the risk of too big to fail.

The stakes are too high to simply sit back and hope challenges to our system resolve themselves. Only by actively working toward a solution based on market discipline can we expect economic growth to accelerate and the United States to reach its dynamic potential.

Richard Fisher

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

# Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

Community banks, which rely on strong customer relationships and disciplined lending practices, weathered the financial crisis better than large, nontraditional banks. This superior performance suggests that a back-to-basics approach to banking could help the nation realize financial stability that lasts.


Community banks began this century lost in the shadow of the big Wall Street financial institutions. During the 2007–09 recession, however, the merits of the community bank model reemerged. With relatively high loan quality, U.S. community banks weathered the severe operating environment—the worst financial crisis since the Great Depression—better than their largest competitors, many of which required special government support. Community banks' failure rate remained far below the rate at which the government propped up the country's biggest banks.

Community banks are organizations with assets of $10 billion or less. This characterization, although sometimes imperfect, serves as a proxy for institutions following the community bank model, which relies on a strong working knowledge of the local market. A subgroup of smaller community banks—those with assets less than $1 billion—is analyzed here along with the institutions holding $1 billion to $10 billion in assets.

Their performance is compared with two classes of larger banks—those in the over $10 billion to $250 billion range and those with assets exceeding $250 billion.

## Loan Quality

The severity of the 2007–09 downturn—with its extensive real estate component—made business difficult for any bank. Even so, community banks displayed relative stability in key measures of loan quality:

- Noncurrent loans
- Net charge-offs (the loan-loss rate)

Looking at business loans backed by nonfarm, nonresidential real estate as well as commercial and industrial loans, community banks experienced fewer problems (*Chart 1*). They mostly avoided the extreme noncurrent and charge-off rates incurred by other types of banks, especially the largest institutions.

The recent recession's significant real estate component played itself out in historically high noncurrent rates for residential mortgage loans. Closed-end, first-lien, one- to four-family loans, traditionally a low-risk lending category, were hit hard. Some banks had to rebook noncurrent loans that had been securitized—that is, bundled with other, similar obligations and sold to investors as mortgage-backed securities. Even within the beleaguered residential real estate category, however, community banks exhibited performance far superior to the nation's largest financial institutions (*Chart 2*).

The superior loan quality among community banks didn't just emerge during the recent financial crisis. The 2001 economic downturn strained banks' loan portfolios but lacked the outsized real estate-based pressures of the 2007–09 recession. Even so, community banks in this earlier period also avoided severe loan quality problems, while noncurrent and charge-off rates among other types of banks, especially the largest ones, rose to high levels (*Chart 3*).

*(Continued from Financial Stability: Traditional Banks Pave the Way - Community Banks Withstand the Storm)*

## Community Bank Model

The community bank model lies behind this consistently higher loan quality. Locally owned banks establish long-term ties with businesses in their communities. When making lending decisions, community banks tap direct knowledge of customers, going beyond the credit scores, financial statements or other quantitative assessments on which their larger competitors depend. Such lender–borrower relationships become especially important when vital information about borrower creditworthiness is only effectively acquired firsthand.

Of course, we can't expect banks with assets of $10 billion or less to handle by themselves all the credit and financing needs of a sophisticated, globally competitive economy churning out $16 trillion a year in output. However, the community bank model serves a useful purpose by illustrating the financial institution attributes that contribute to economic stability. The country needs a diverse financial system, with bigger institutions alongside the community banks, but these larger banks should deliver the same quality performance as community banks and need not be nearly as large as they are today.

In recent decades—especially in the years leading up to the financial crisis—the community bank model became marginalized. To a limited degree, this was to be expected as an increasingly competitive environment, coupled with the removal of restrictions against geographic expansion, led some small banks to seek greater efficiencies by operating on a somewhat larger scale. However, the perceived advantages of larger scale sometimes proved illusory. Big institutions, amid a wave of banking industry consolidation, began dominating credit markets by using transactional, automated approaches to loan underwriting. In many cases, the new credit-market mechanisms inadequately measured lending risk, proving a poor substitute for the community bank model's firsthand knowledge.

Financial conservatism is also a hallmark of successful community banking. It is grounded in the everyday awareness of the chance of failure and government-mandated closure if too much credit is extended to borrowers with insufficient repayment capacity. It is buttressed by the ownership structure of community banks, where much of managers' or directors' wealth is often on the line.

By comparison, some larger banks' lending became overly aggressive at times, perhaps emboldened by a belief that the likelihood of regulator-ordered shutdown was minimal, even if big segments of their loan portfolios soured. The rising volumes of problem loans and the sometimes fragile means used to fund them—for example, off-balance-sheet vehicles and short-term, volatile wholesale monies—brought credit markets to a virtual collapse in 2007–09. The big banks' size and interconnectedness led to "too big to fail" interventions, which shielded troubled big banks from the full consequences of their decisions.

## Failures and Special Assistance

Community banks as a group exhibited greater financial stability with relatively strong loan quality, while avoiding the hyper-cyclicality of large, nontraditional institutions. In the recent crisis and its aftermath, only about 5 percent of community banks failed. Within the largest group of banks, controlled by only nine organizations in 2007, two required special open-bank assistance, a "prop-up rate" of about 20 percent. Potential failure of these institutions was deemed a risk to the financial system and the economy—so they received guarantees, liquidity access and capital from the U.S. government.

Recent experience suggests that reestablishing a more prominent role for traditional banking, as exemplified by community banks, could help the nation achieve greater financial stability. Policymakers should take note.

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### About the Authors

Jeffery W. Gunther is vice president and Kelly Klemme is a financial industry analyst in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

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2012 Annual Report

Financial Stability: Traditional Banks Pave the Way

# Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

## Community Banks Largely Overcome Regional Differences

What if successful community banks were clustered in just a few states with relatively strong regional economies and healthy housing markets? In that case, the group's superior loan quality might merely reflect a relatively favorable operating environment.

Examining the recent financial crisis and recession at the state level provides insight into whether community banks consistently performed well across regions. The aggregate noncurrent rate relative to total business loans is calculated quarterly for community banks in each state from first quarter 2009 to fourth quarter 2011. Quarterly results are averaged for the three years, then compared with the largest banks' nationwide performance.

By this measure, community banks in 44 states performed better than the large banks in terms of holding down loan problems. The six states in which community banks underperformed faced devastated economies. It took this kind of extreme circumstance to render loan quality problems at community banks as severe as those sustained by the largest banks.

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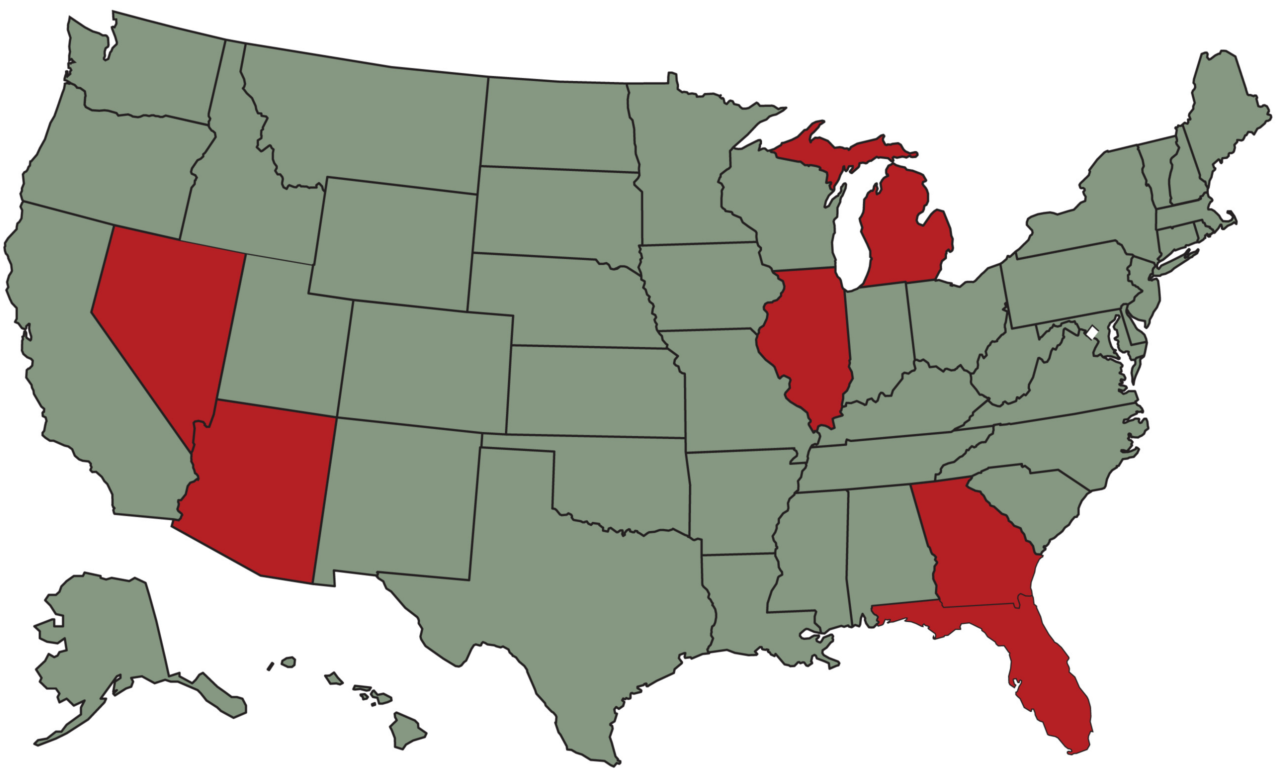
### Community Banks Have Fewer Loan Woes than Big Banks in All but Six States



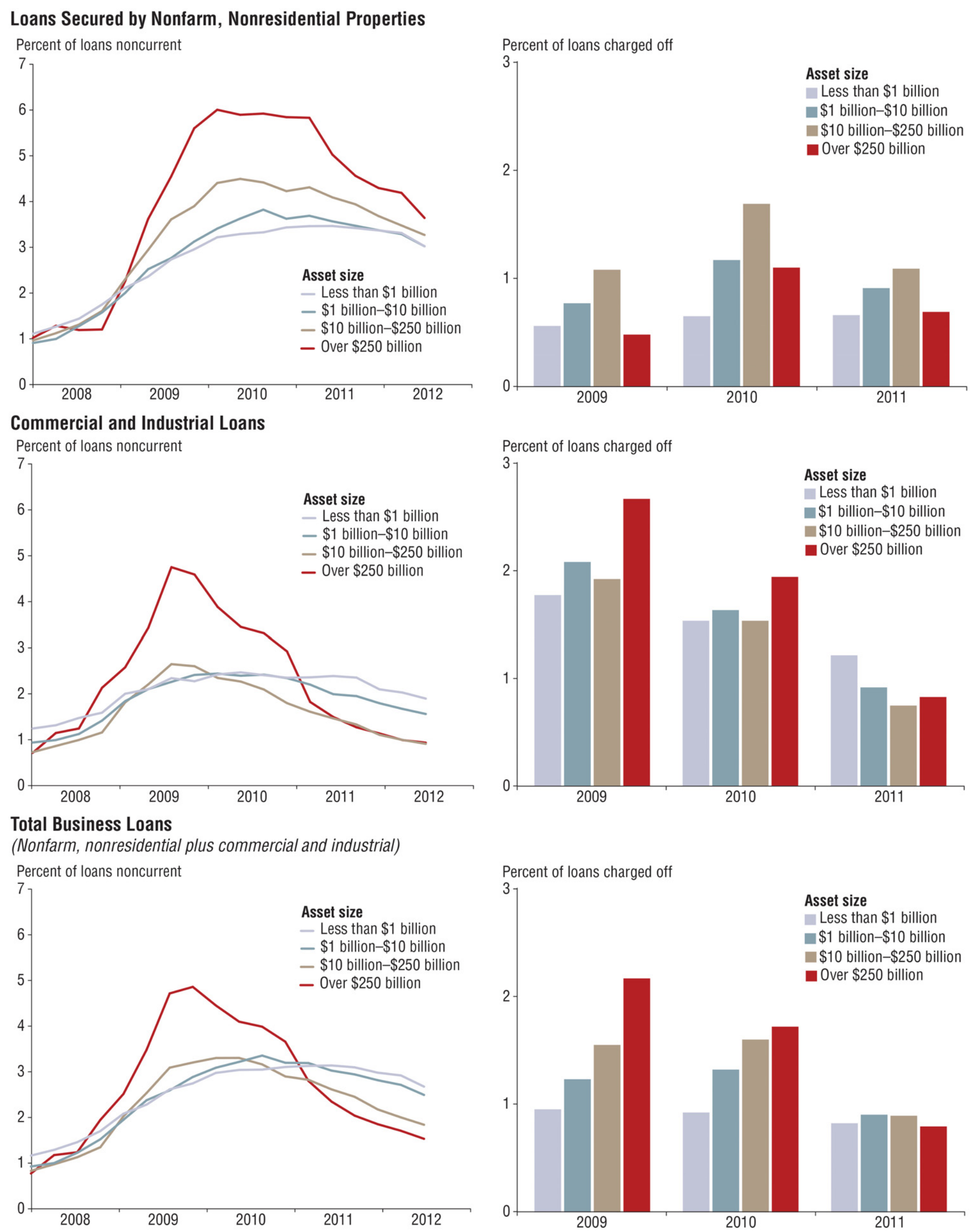
NOTES: Data for commercial banks. Community banks have assets of $10 billion or less. Big banks have assets of $250 billion or more. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). In states shaded red, community banks had an average aggregate noncurrent business loan rate above that of big banks nationwide for 2009:Q1 through 2011:Q4.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

**Chart 1**
**Great Recession: Community Banks Had Fewer Loan Problems than Big Banks**



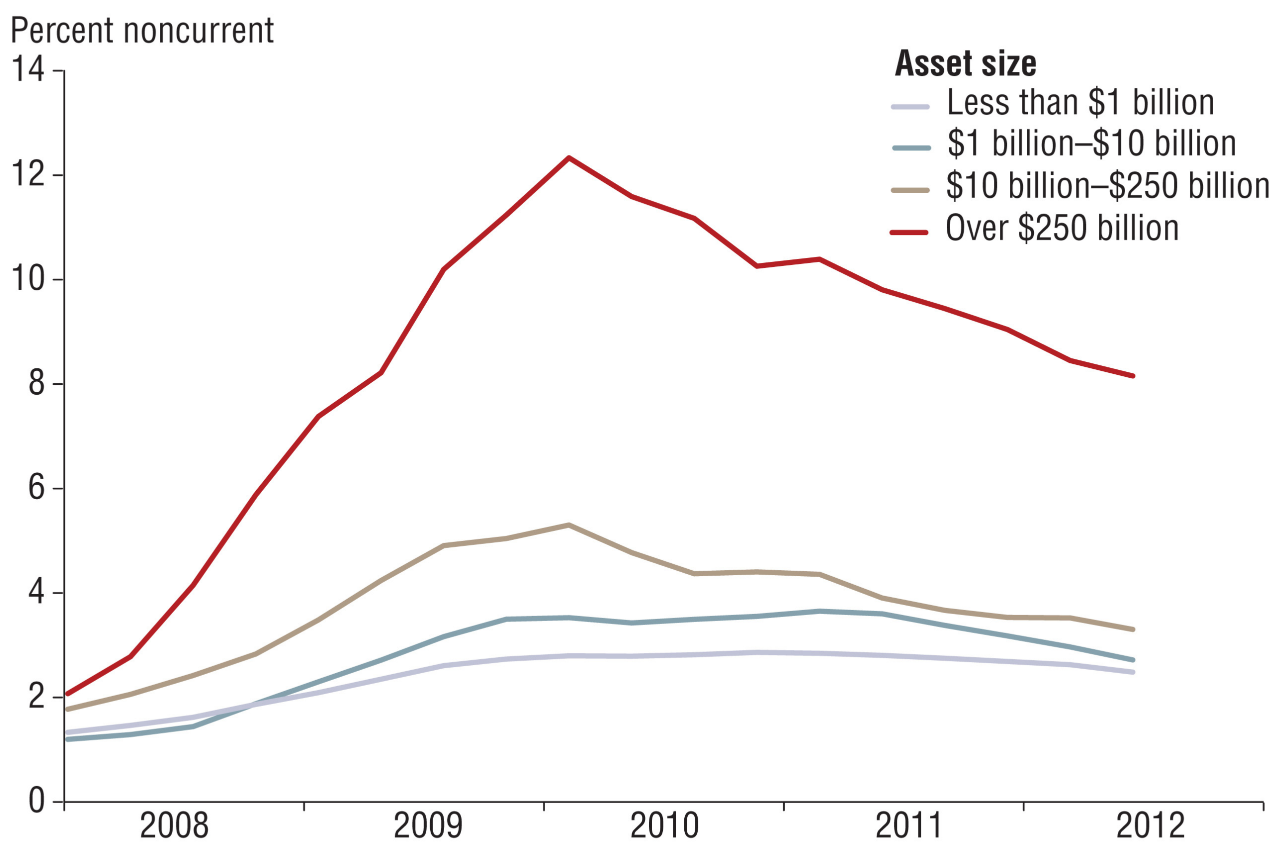

NOTES: Data for commercial banks. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Loans charged off are net of recoveries. (Data revised February 2013.)

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

**Chart 2**
**Community Banks Maintain Residential Real Estate Loan Quality in Great Recession**




NOTES: Data for commercial banks. Residential real estate loans are closed-end, first-lien, one- to four-family mortgages. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable). Noncurrent loans are loans past due 90 days or more and loans no longer accruing interest. Noncurrent loan rates have been adjusted to exclude loans rebooked from Government National Mortgage Association securitizations.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

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## 2012 Annual Report

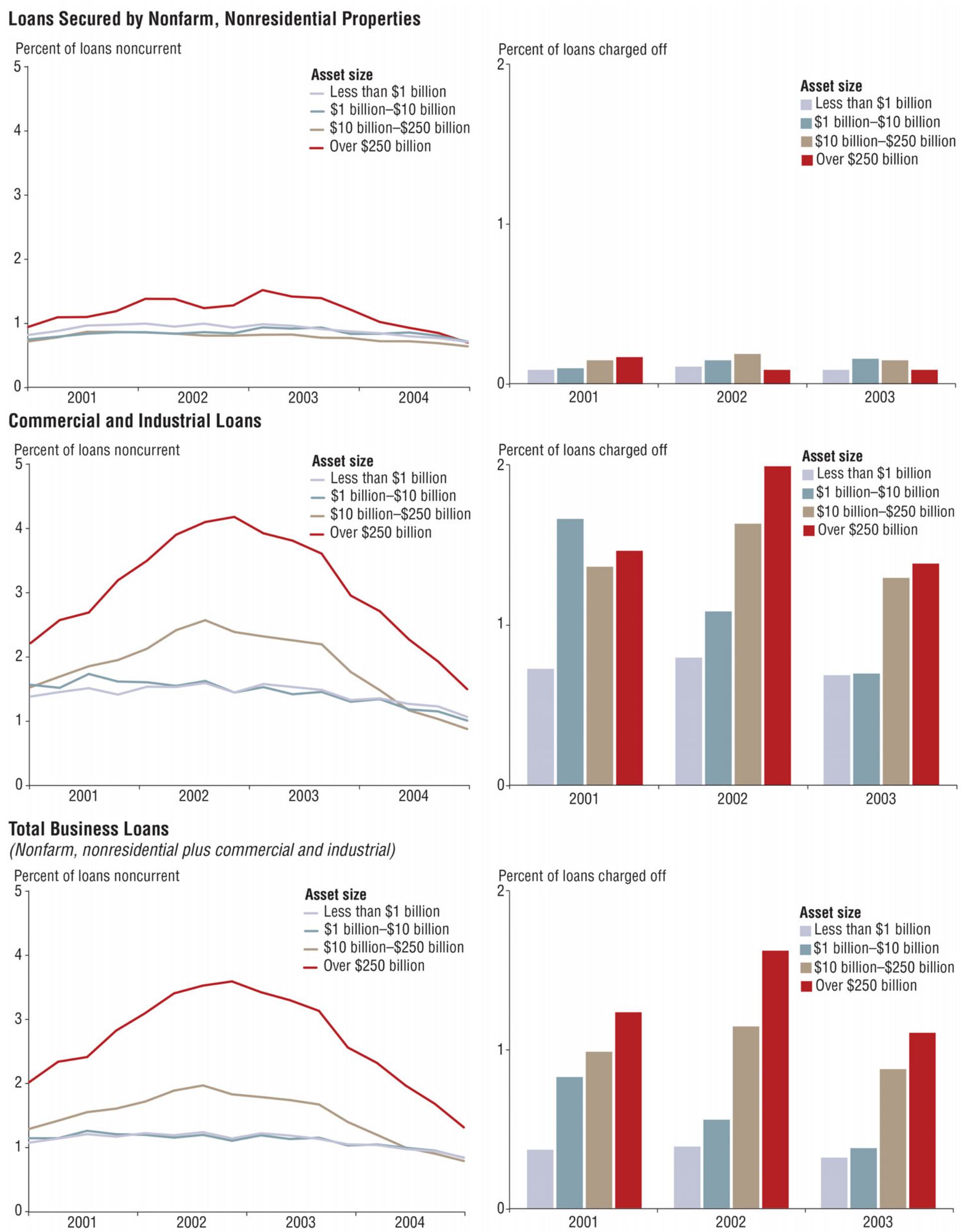
### Financial Stability: Traditional Banks Pave the Way

# Community Banks Withstand the Storm

By Jeffery W. Gunther and Kelly Klemme

**Chart 3**

**2001 Recession: Community Banks Had Fewer Loan Problems than Big Banks**

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DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# A Lender for Tough Times

By Jeffery W. Gunther and Kelly Klemme

Community banks are not only a major source of credit, but also a stable one for businesses. During the recent financial crisis and its aftermath, these smaller, traditional lenders provided credit to many firms, especially small businesses, when they needed it most.


Financial stability is key to economic performance—a proposition made starkly clear when banks became a source of trouble during the recession. Before the downturn's start in December 2007, U.S. banks stoked an epic real estate boom with lax lending, setting the stage for a severe financial crisis. Once the worst was over, these institutions inhibited a recovery by tightening credit standards and limiting loans. Like a broken thermostat, banks and the financial system helped overheat the economy and then helped overcool it.

Some types of banks destabilized the credit cycle and economy more than others. The biggest banks, their focus diverted from traditional balance-sheet activities and toward capital markets and short-term gains, incurred spikes in loan defaults and exhibited significant cyclical declines in business loan volume.

Meanwhile, community banks concentrated on traditional banking, taking deposits and extending loans, relying on long-term relationships and time-tested judgment. These smaller banks not only demonstrated relative strength in business loan quality, but also maintained business loan volume to a much greater degree, providing credit to many small businesses when they needed it most. Such lending is vital to the economy.

Community banks are organizations with assets of $10 billion or less. The smallest community banks are those with assets below $1 billion.

Their activities are compared with the actions of two classes of larger financial institutions—those in the over $10 billion to $250 billion range and others with assets over $250 billion.

## Business Lending Focus

Community banks tend to focus on business lending. Just before the 2007–09 recession, they held overall business loans equal to 30 percent of assets, compared with only 14 percent for the largest banks. This remained true even after the financial crisis. As of June 2012, the subset of smallest community banks held business loans equal to 28 percent of assets, and the group of community banks with assets from $1 billion to $10 billion held business loans equal to 31 percent of assets (*Chart 1*). The largest banks were down to about 12 percent.

Just as important, a significant share of this lending goes to small businesses. Community banks as a group have about 13 percent of assets in small business loans, far above the 2 percent for the largest banks. Among the smallest community banks, small business loans command almost 15 percent of assets.

Community banks held 17 percent of industrywide banking assets as of June 2012—but they accounted for more than half of the amount lent to small businesses (*Chart 2*). This importance to the small-business loan market testifies to community banks' competitive edge based on superior firsthand knowledge of borrowers and their credit needs.

*(Continued from Financial Stability: Traditional Banks Pave the Way - A Lender for Tough Times)*

## Business Lending Durability

Serving the credit needs of small business borrowers in today's challenging times is one thing. But, what happens when the operating environment really turns sour? Who lends to small businesses then?

The housing crisis and recession knocked the financial system off kilter. Small businesses are particularly vulnerable to banking crises because their limited access to broader capital markets increases their dependency on banks. Tightening bank credit will likely curtail small enterprises' activities, jeopardizing the growth and vitality these businesses provide to local communities.

Compared with the big financial institutions, community banks have been more successful in avoiding asset impairment, allowing them to sustain lending activity. At mid-2008, well into the recession, total business lending remained above year-earlier levels for all four bank asset-size categories (*Chart 3*). Over the next two years, however, community bank loan volume held up relative to 2007 levels, while the biggest banks significantly reduced business lending. In 2011 and 2012, business lending tended to recover—but the biggest banks still had not returned to 2008 levels.

A notable pattern also occurred for small business lending: Community banks with assets of less than $1 billion maintained a relatively steady loan volume (*Chart 4*). For other types of banks, small business activity dipped well below precrisis levels. The smallest community banks offer small businesses a relatively stable source of credit—a critical element of the financial landscape worth nurturing.

## Stabilizing Force

Community banks are not only a major source of credit for job-creating businesses but also a stable one. By extending new loans to business customers, renewing existing loans and minimizing loan losses, community banks better maintained loan volume during the downturn. Less-crisis-prone banks help promote a less-crisis-prone economy.

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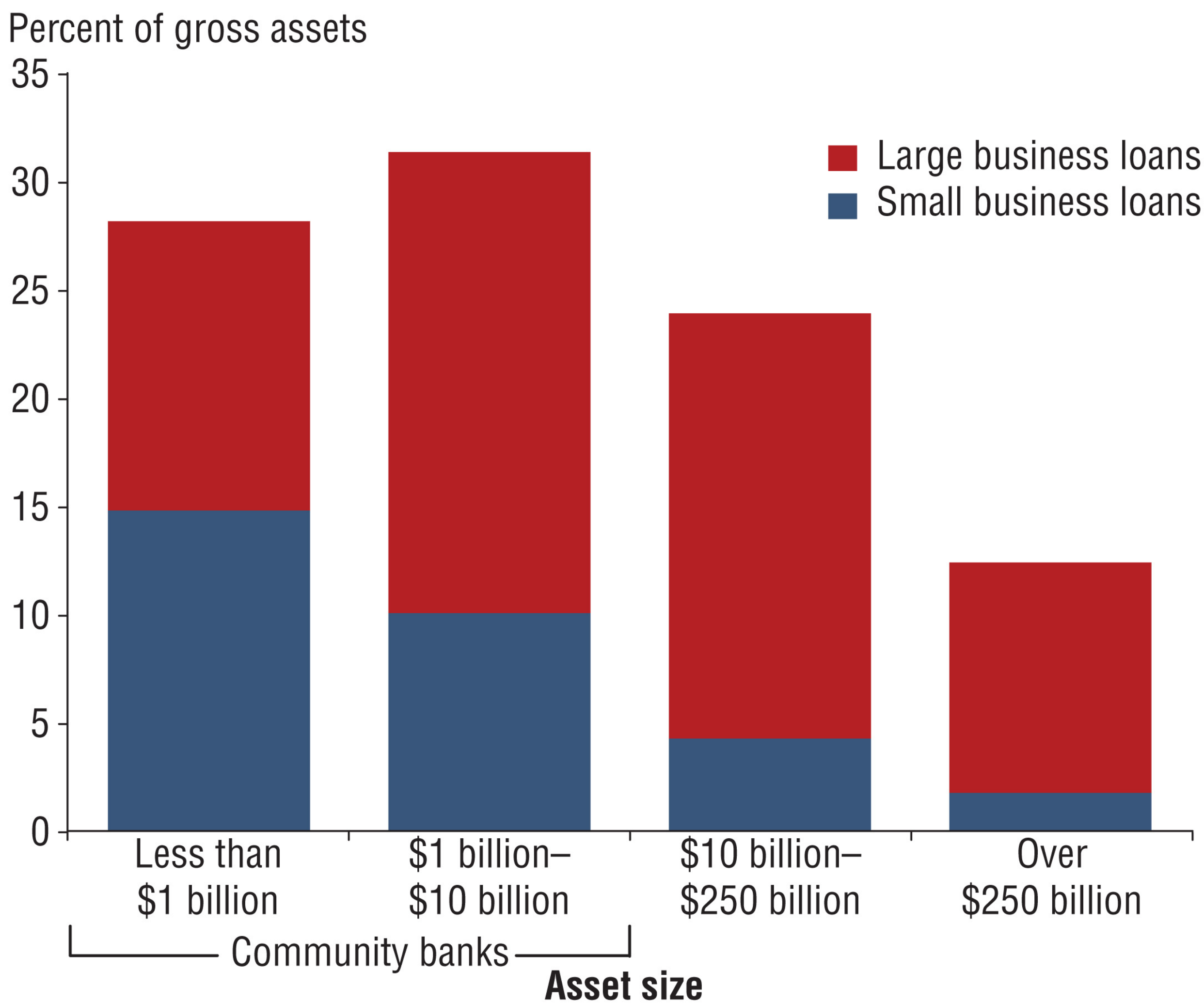
### About the Authors

Jeffery W. Gunther is vice president and Kelly Klemme is a financial industry analyst in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

# A Lender for Tough Times

By Jeffery W. Gunther and Kelly Klemme

**Chart 1**
**Community Banks Focus on Small Business Loans**



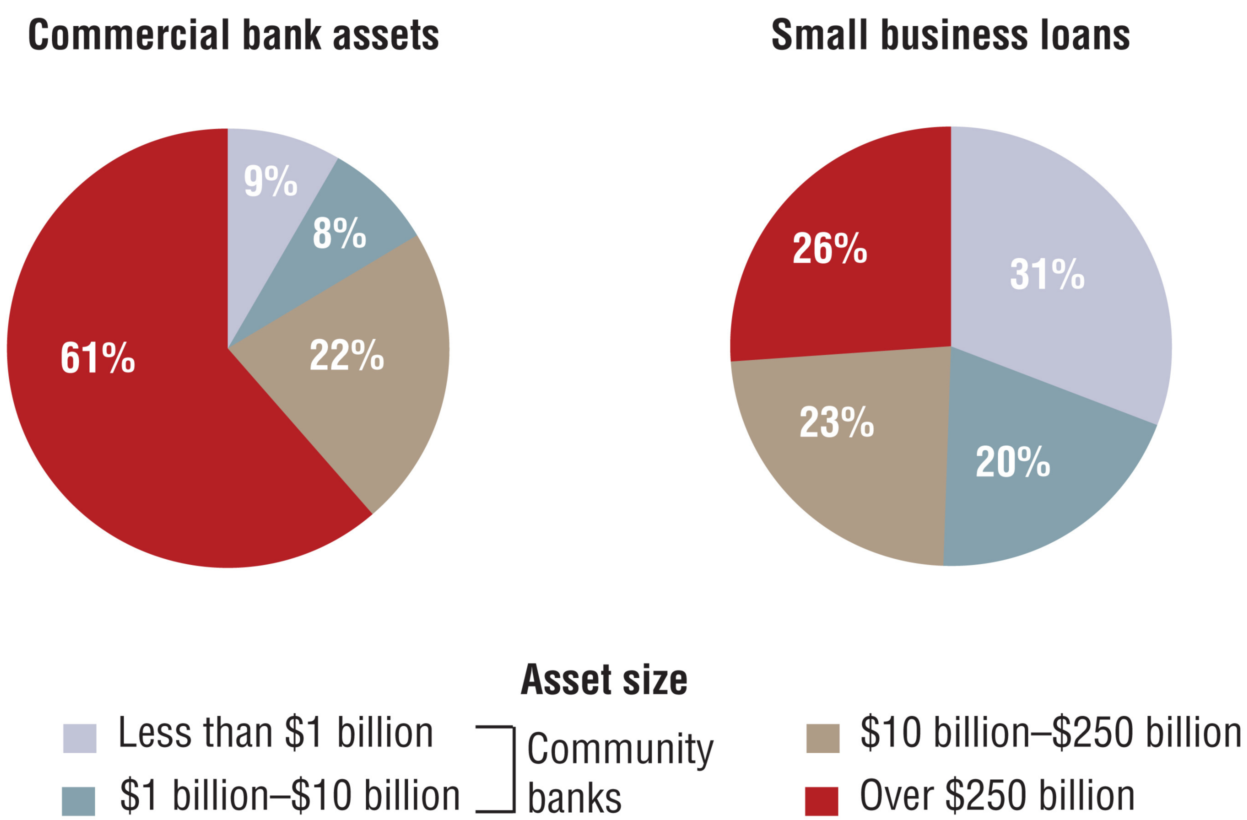

NOTES: Data for commercial banks as of June 30, 2012. Asset size is based on the total assets of a U.S. banking organization (holding company, when applicable). Business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans; small business loans are those with original amounts of $1 million or less.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# A Lender for Tough Times

By Jeffery W. Gunther and Kelly Klemme

**Chart 2**
**Community Banks Hold Less Than One-Fifth of Industrywide Banking Assets but More than Half of Industrywide Small Business Loans**



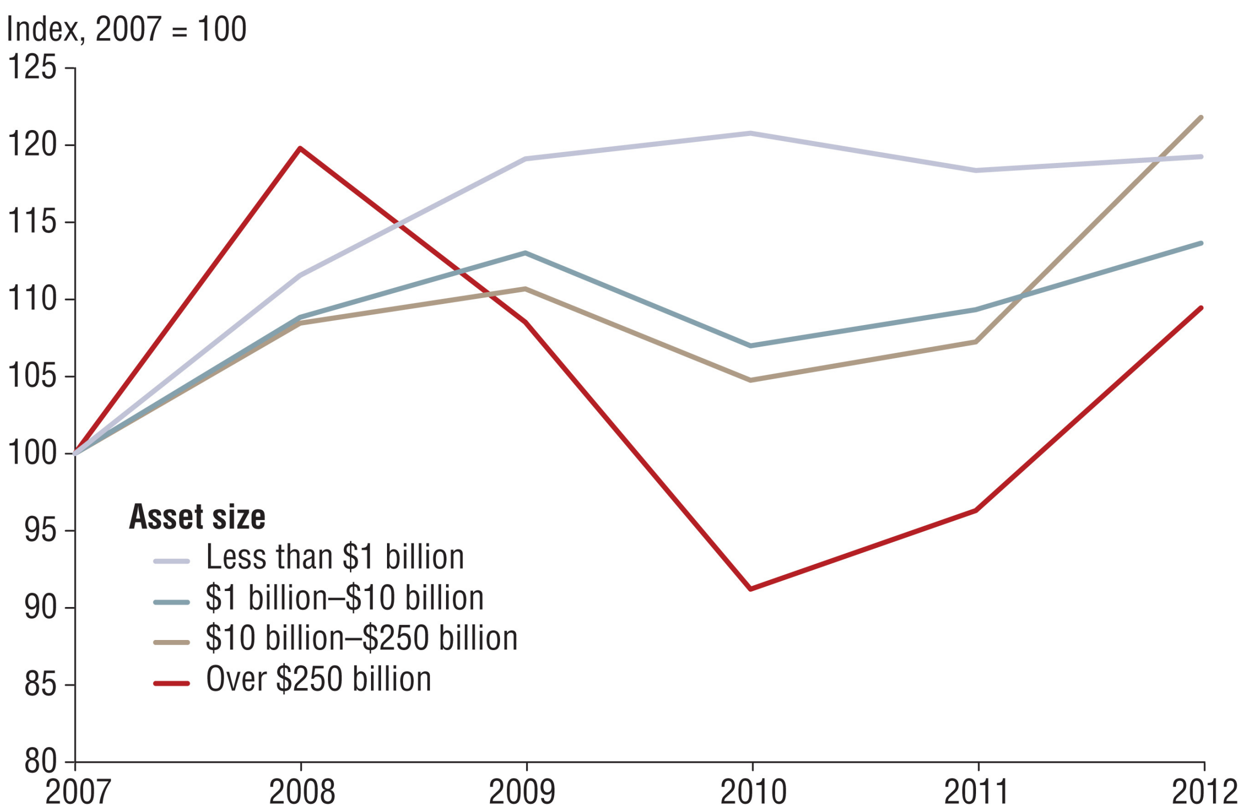

NOTES: Data for commercial banks as of June 30, 2012. Asset size is based on the total assets of a U.S. banking organization (holding company, when applicable). In the assets pie chart, shown are the size groups' shares of industrywide commercial banking operations, excluding nonbank activities. Small business loans are loans secured by nonfarm, nonresidential properties and commercial and industrial loans, with original amounts of $1 million or less.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# A Lender for Tough Times

By Jeffery W. Gunther and Kelly Klemme

**Chart 3**
Business Loan Volume

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# A Lender for Tough Times

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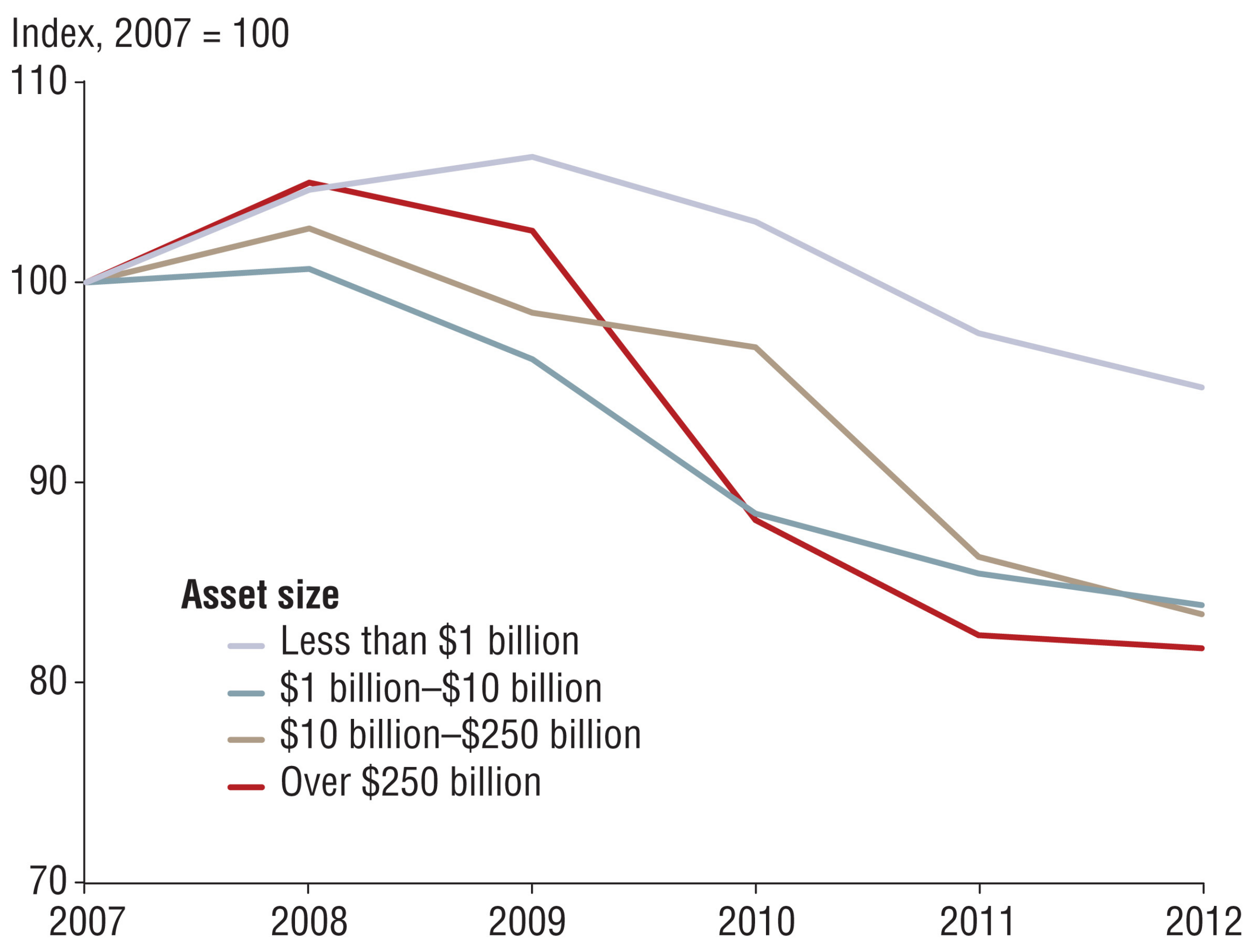
**Chart 4**
**Small Business Loan Volume**

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# Small Banks Squeezed

By Jeffery W. Gunther and Kelly Klemme

With consistent loan quality and resilient lending activity, community banks—and the traditional banking model they represent—can be a much-needed force for financial stability. Unfortunately, they've struggled to maintain market share, partly as a result of unintended consequences of public policy.


The community bank model has a lot going for it—superior loan quality, lower rates of severe difficulty and greater credit stability through which to finance small businesses. With these advantages, community banks can be a much-needed force for financial stability. Unfortunately, their prominence isn't increasing; at best, they've struggled to maintain market presence amid industry consolidation in recent decades.

Community banks are organizations with assets of $10 billion or less. In 2004, such banks accounted for about 21 percent of industrywide banking assets. But as the 2007–09 recession began, community banks' market share had dropped to about 19 percent. Over the next five years, their piece of the marketplace fell further—to under 17 percent. Their market share appeared to slip even after accounting for those community banks that grew and moved into a larger size classification (*Chart 1*).

## Market Share Impediments

What stands in the way of gains for this high-performing class of banks? Historically, a variety of economic factors have contributed to community banks' stagnating market share. For some financial products and services, larger scale might be needed to achieve fully efficient operations. Also at work recently is a more-troubling force: public policies that keep community banks from reaping the rewards of a business model that works for the financial system and the economy. Two examples are particularly striking.

### Too Big to Fail

Especially noteworthy have been financial crisis policies that aided too-big-to-fail (TBTF) banks and resulted in massive public interventions to support and sustain some of the largest institutions. They are the very same banking operations that produced some of the severest losses. Intended or not, these policies worked against community banking and longer-term financial stability.

TBTF policies kept large, deeply troubled banks open, their creditors protected, their shareholders possibly diluted but not wiped out. Propping up large, troubled institutions tended to impede redistribution of market share to smaller, less-trouble-prone banks. The rewards for excessive risk were enhanced; those for prudence were diminished.

A massive rewriting of regulations failed to resolve the TBTF problem. Concentration of deposits among TBTF institutions has increased, not diminished. Funding costs for these institutions have remained less than funding costs for smaller institutions, reflecting persistent TBTF protection of creditors. The regulatory regime still seeks to manage the risk to the financial system that the biggest banking organizations pose. Yet these institutions remain so large and complex—and intertwined with the financial system and economy—that it's doubtful whether regulators would or, indeed, could take decisive action to resolve giant banks if they again encountered serious trouble.

*(Continued from Financial Stability: Traditional Banks Pave the Way - Small Banks Squeezed)*

### Overregulation

Second, a regulatory backlash resulting from the financial crisis presents the risk of an increasingly one-size-fits-all, heavy-handed oversight regime. For some problems, policymakers are continuing to rely on regulatory and supervisory toolkits similar to those used before the crisis but are adding complexity and expanded documentation requirements.

In other areas, they are implementing new and fairly explicit directives that do not credit community banks for their more-intimate customer relationships. Regulators have taken some steps to avoid penalizing community banks with rules aimed at curbing TBTF excess. Still, the cumulative effect of recent policy proposals could ultimately apply regulatory and supervisory approaches befitting large, transaction-oriented banks to small, relationship-oriented ones. The mismatch would unnecessarily boost regulatory costs for community banks.

## Right Course

A more promising alternative exists—using proper incentives to bring discipline to financial markets. If all banking organizations were of manageable size and complexity, with diverse strategies, they could be allowed to stand or fall on their own merits. Prudently managed banks, including the vast majority of community banks, could then reap the rewards of their traditional financial conservatism.

By finding a genuine remedy to TBTF, undue risk taking would be penalized through bank failures, with no banking organization exempt from the threat of aggressive resolution, should it become insolvent. A host of new regulations does not ultimately hold the key to a safe and sound financial system. Rather, there is promise in the basic force behind free markets—the discipline that results from combining the freedom to succeed with the responsibility for losses. If we want the financial system to evolve toward greater stability, we must rely less on boundless regulation and end TBTF by ensuring that no bank is too large, complex or intertwined with the financial system for regulators to close.

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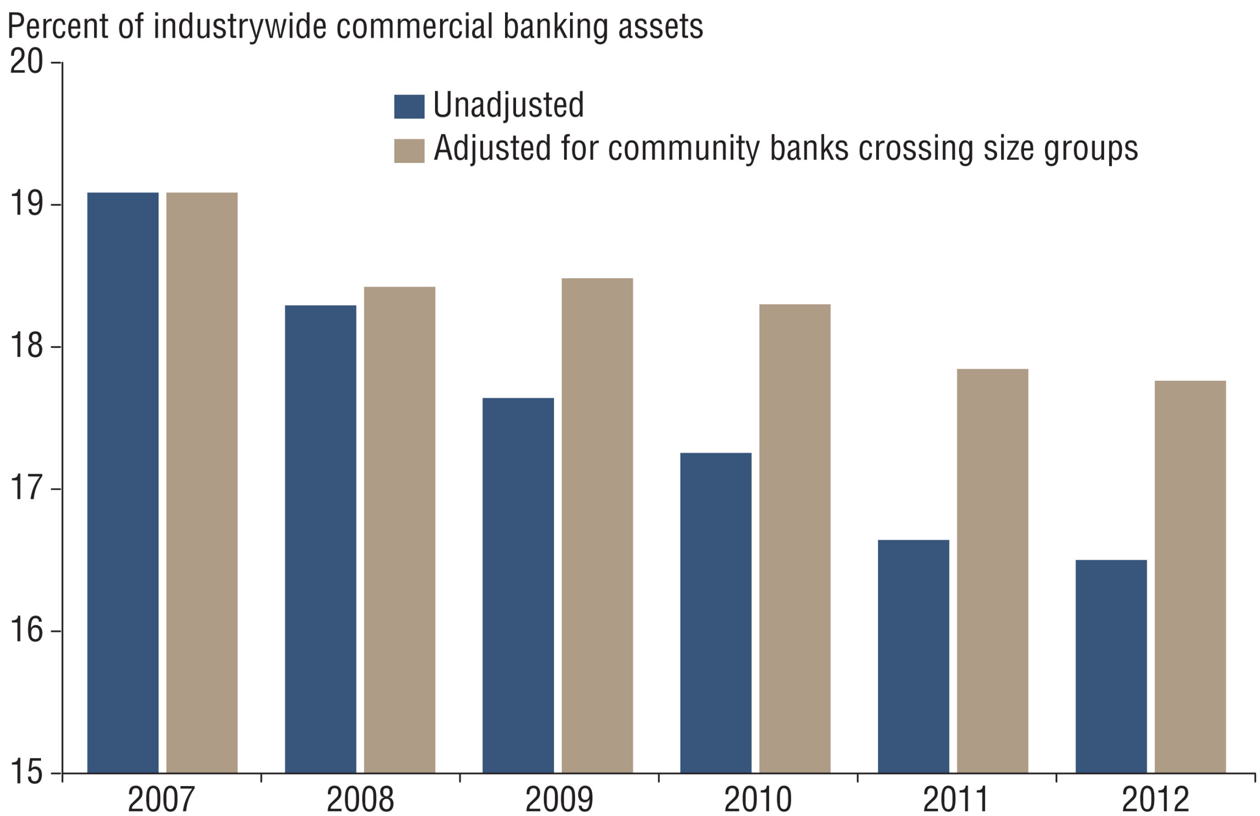
### About the Authors

Jeffery W. Gunther is vice president and Kelly Klemme is a financial industry analyst in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

# Small Banks Squeezed

By Jeffery W. Gunther and Kelly Klemme

**Chart 1**
**Community Banks Struggle to Maintain Market Share**




NOTES: Data for commercial banks as of June 30. Community banks have assets of $10 billion or less. Asset size is based on the total assets (expressed in June 2012 prices) of a U.S. banking organization (holding company, when applicable).

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# Regulatory Burden Rising

By Christoffer Koch

U.S. commercial banks face growing regulatory requirements and complexity, especially with the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, which was intended to rein in excesses of the largest banks. The nation would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks.


The regulatory requirements for U.S. commercial banks have increased over time, most recently with the Dodd–Frank Act, which seeks to curb excesses primarily committed by the largest banks. By comparison, smaller community banks incurred much lower loan-loss rates and posed less of a threat to financial system stability (see “Community Banks Withstand the Storm”). The benefits of increased community bank regulation, it would appear, are limited, especially relative to the added costs.

Tighter regulation and supervision impose heavy burdens on smaller-scale and more-labor-intensive community banks. These institutions to a great extent focus on making and monitoring smaller loans and maintaining individual customer relationships. By undermining their competitiveness, recent regulatory reform may have the unintended consequences of bolstering banking industry concentration while weakening an industry segment posing comparatively little threat to financial stability.

## More Paperwork

Over the past half-century, the level of detail in regulatory filings required from commercial banks has expanded.[1] One telling measure is the number of pages, excluding instructions, needed to complete what is known as the quarterly Report of Condition and Income, or Call Report for short. What began as a four-page filing in the late 1950s grew into a 30- to 40-page document in the 1980s and 1990s, and most recently to a 71-page report (*Chart 1*).

Preparing the Call Report may not be tremendously burdensome, but the document’s increased heft is indicative of regulators’ probing into more areas. The number of potential items to be reported quarterly increased from 241 in 1960 to 1,955 in 2012 (*Chart 2*). Initially, banks reported information taken from basic income statements and balance sheets. Over the past two decades, the reporting has grown more granular and complex, bringing in numerous off-balance-sheet and memoranda items.

The length of financial laws reveals further evidence of mounting regulatory complexity. The Glass–Steagall Act (1933), which governed U.S. financial intermediaries until its partial repeal in 1999, was 37 pages; the Dodd–Frank Act is more than 800 pages (*Chart 3*). Likewise, international agreements on banking supervision have grown in scope and complexity. The number of pages in the third version of the international Basel capital accord has mushroomed to 20 times the length of the first one.

## Expansive Rules

Although long-term regulatory trends reflect a number of evolutionary factors in financial intermediation and practices, rapid acceleration of U.S. reporting requirements over the past four years is partially a response to the recent financial crisis and recession.

Community banks will benefit from some parts of the Dodd–Frank Act—for example, basing deposit insurance premiums on assets rather than deposits. Some of the act’s main features, such as enhanced prudential standards and greater regulatory oversight, will apply only to the largest, systemically important institutions.

*(Continued from Financial Stability: Traditional Banks Pave the Way - Regulatory Burden Rising)*

Nevertheless, other provisions have largely been applied to big and small banks alike, not fully compensating for the differences in these institutions' business models—to the detriment of small banks. A community bank's knowledge of a small business, once sufficient for a loan, now may not satisfy regulation, rendering the lender unable to provide credit. A template-driven definition of qualified residential mortgages might prevent community banks from using their local real-estate market knowledge. Community banks will also be burdened with provisions covering escrow accounts for higher-priced mortgages, even though most subprime problems originated from the largest banks' securitizations—the bundling of such risky notes into mortgage-backed securities—rather than residential loans held on community bank balance sheets.

## Cost Imbalance

Some allowances for community banks have been made in the Dodd–Frank Act, but the cost of implementing the act's regulations on smaller institutions appears high relative to the benefits.[2]

The number of employees per dollar of loans is depicted in *Chart 4* by bank size. Notably higher ratios for smaller banks indicate they are much more labor intensive than larger institutions, reflecting their focus on smaller loans and individualized products and services. The traditional, relationship-based model followed by community banks requires its own regulatory framework, one more streamlined than the increasingly complex and formulaic rules being applied to larger, more transaction-oriented banks. Such a streamlined framework should include flexibility to account for the diversity among community banks, as reflected in their customized approaches to individual customer needs and preferences.

Additionally, smaller banks cannot easily absorb the cost of new regulation. More complicated regulatory compliance will force community banks to increase staff relative to assets to a greater degree than at large banks, further undermining competitiveness. Adjustments to new, complex regulatory requirements represent costs that, spread over fewer assets, are more burdensome for smaller institutions.

Recent changes in bank regulations have focused on curbing excessive risk taking that contributed to a deepening recession and more difficult financial crisis. Associated lending losses were concentrated at larger, and often very large, banks that engaged in highly complex and risky activities. They became "too big to fail." By comparison, community banks were better able to avoid losses, and their practices did not justify greater regulation. They filled an important niche in financial intermediation. As a result, financial reform appears to have imposed high costs on community banks relative to any benefits of curbing micro- and macroprudential risk.

By unduly imposing greater regulations on the smaller institutions, recent regulatory reform will drive additional community bank consolidation. The country would be better served by a regulatory framework that more fully accounts for the operational differences between small and large banks. Some recent proposals call for further efforts to ensure that community banks are overseen differently than are larger and more complex operations.[3] The proposals have merit and deserve serious consideration.

*(Continued from Financial Stability: Traditional Banks Pave the Way - Regulatory Burden Rising)*

## Notes

1. See "The Dog and the Frisbee," by Andrew G. Haldane and Vasileios Madouros, Bank of England, paper presented at "The Changing Policy Landscape" symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 30–Sept. 1, 2012, www.kansascityfed.org/publicat/sympos/2012/ah.pdf.

2. For more details on the merits and risks of individual provisions of the Dodd–Frank Act, see "Community Banks and Credit Unions: Impact of Dodd–Frank Act Depends Largely on Future Rule Makings," Government Accountability Office, September 2012.

3. See "Community Banks and Mortgage Lending," speech by Elizabeth A. Duke, Board of Governors of the Federal Reserve System, at the Community Bankers Symposium, Chicago, Nov. 9, 2012, www.federalreserve.gov/newsevents/speech/duke20121109a.pdf.

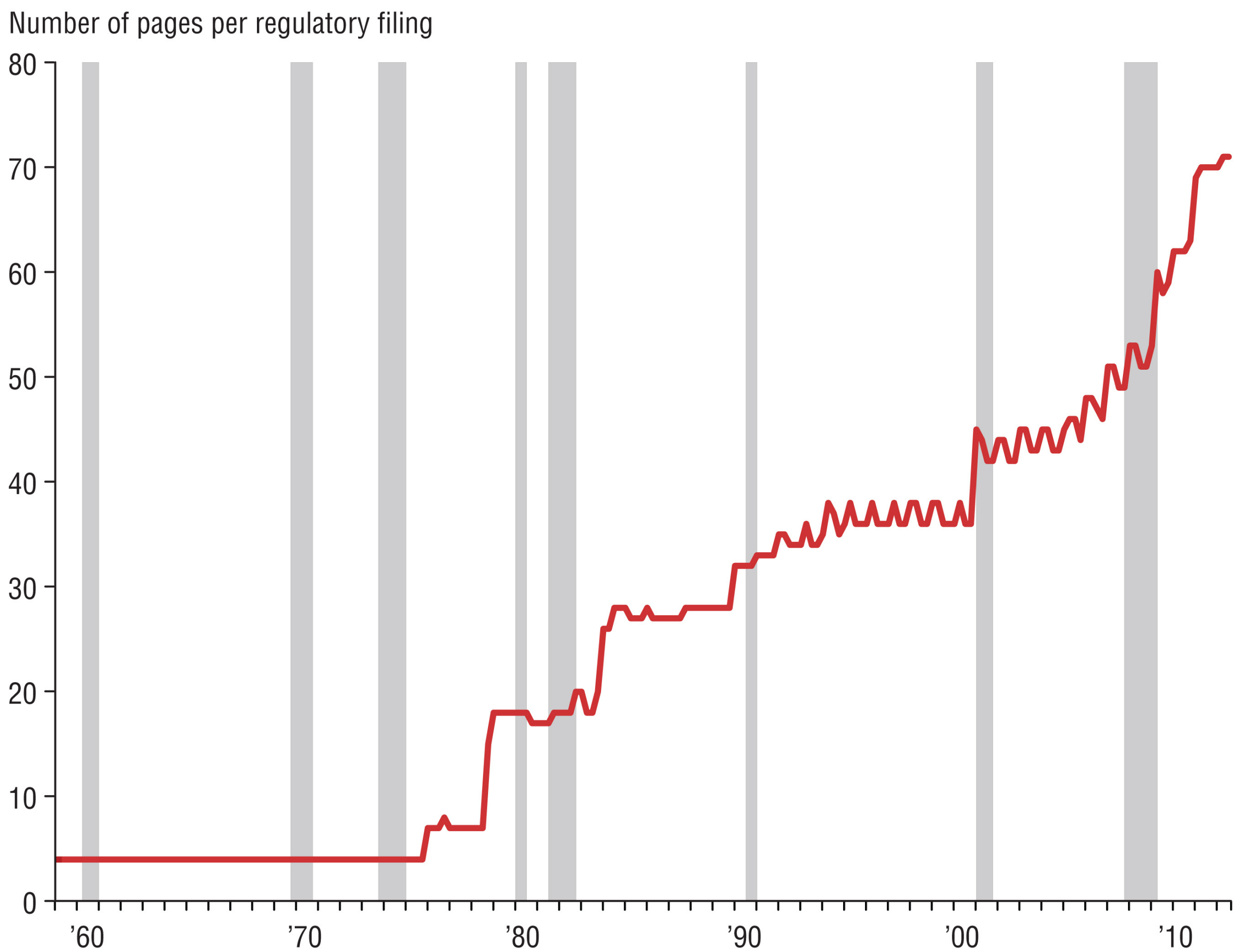
## About the Author

Christoffer Koch is a research economist in the Research Department at the Federal Reserve Bank of Dallas.

# Regulatory Burden Rising

By Christoffer Koch

**Chart 1**
**Pages in U.S. Regulatory Filings Rapidly Increase**



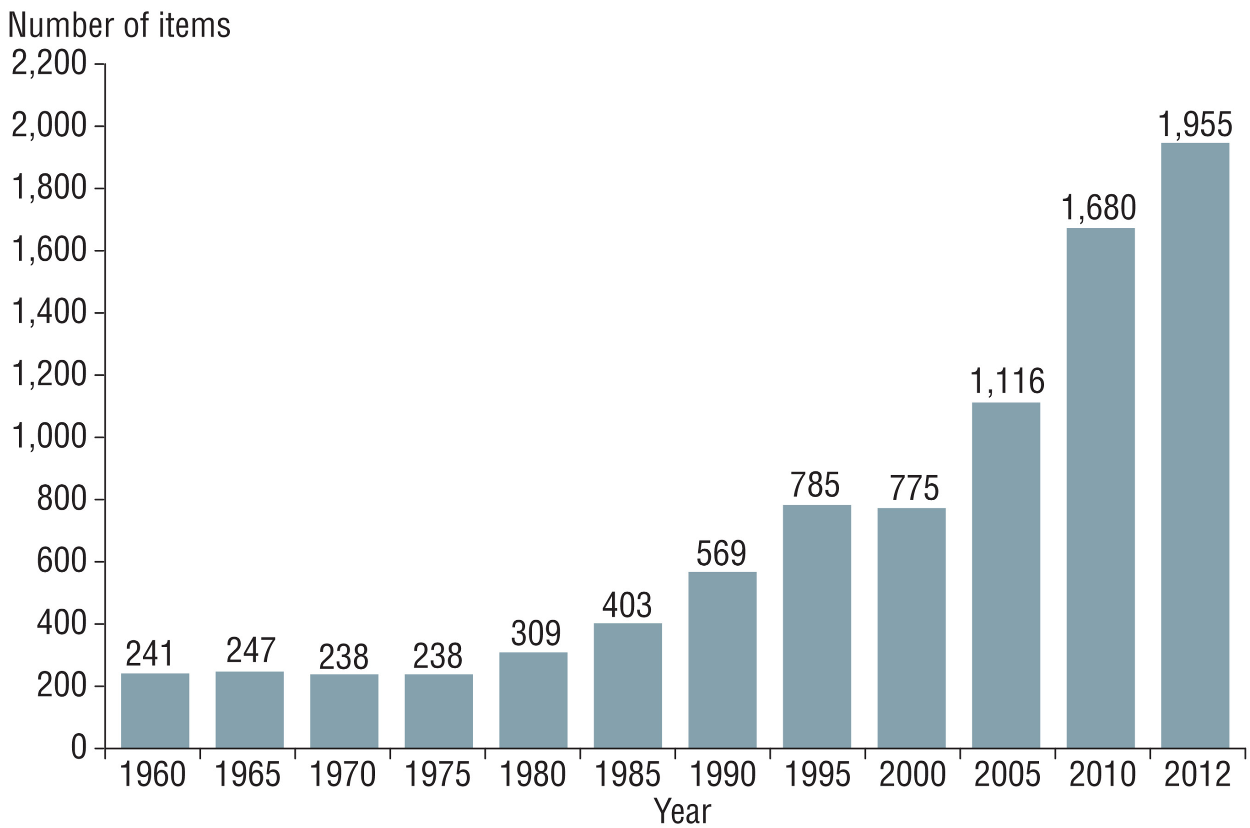

NOTES: Gray bars indicate recessions. Maximum number of report pages for domestic banks only.
1959:Q4–1983:Q4: Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
1984:Q1–2000:Q4: Forms FFIEC 032, FFIEC 033, FFIEC 034.
2001:Q1–present: Form FFIEC 041.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

## Regulatory Burden Rising

By Christoffer Koch

**Chart 2**
**Items per Filing Rise as Complexity Increases**



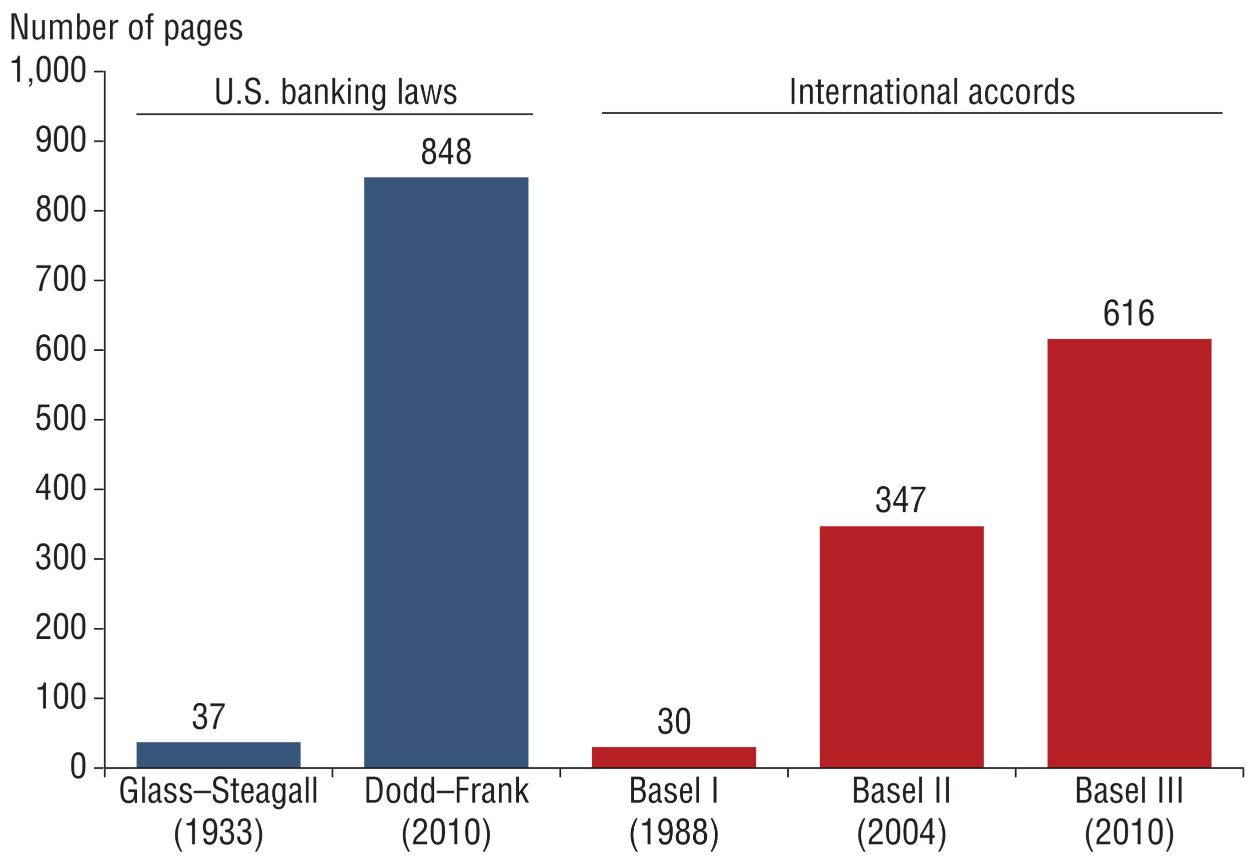

NOTES: Maximum number of reporting items for domestic banks only. Q4 of each year.
1960:Q4–1980:Q4: Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
1985:Q4–2000:Q4: Forms FFIEC 032, FFIEC 033, FFIEC 034.
2005:Q4–present: Form FFIEC 041.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

# Regulatory Burden Rising

By Christoffer Koch

**Chart 3**
**Rising Page Count Mirrors Heightened Oversight**




DATA SOURCE: "The Dog and the Frisbee," by Andrew G. Haldane and Vasileios Madouros, Bank of England, paper presented at "The Changing Policy Landscape" symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., Aug. 30–Sept. 1, 2012.

DALLASFED

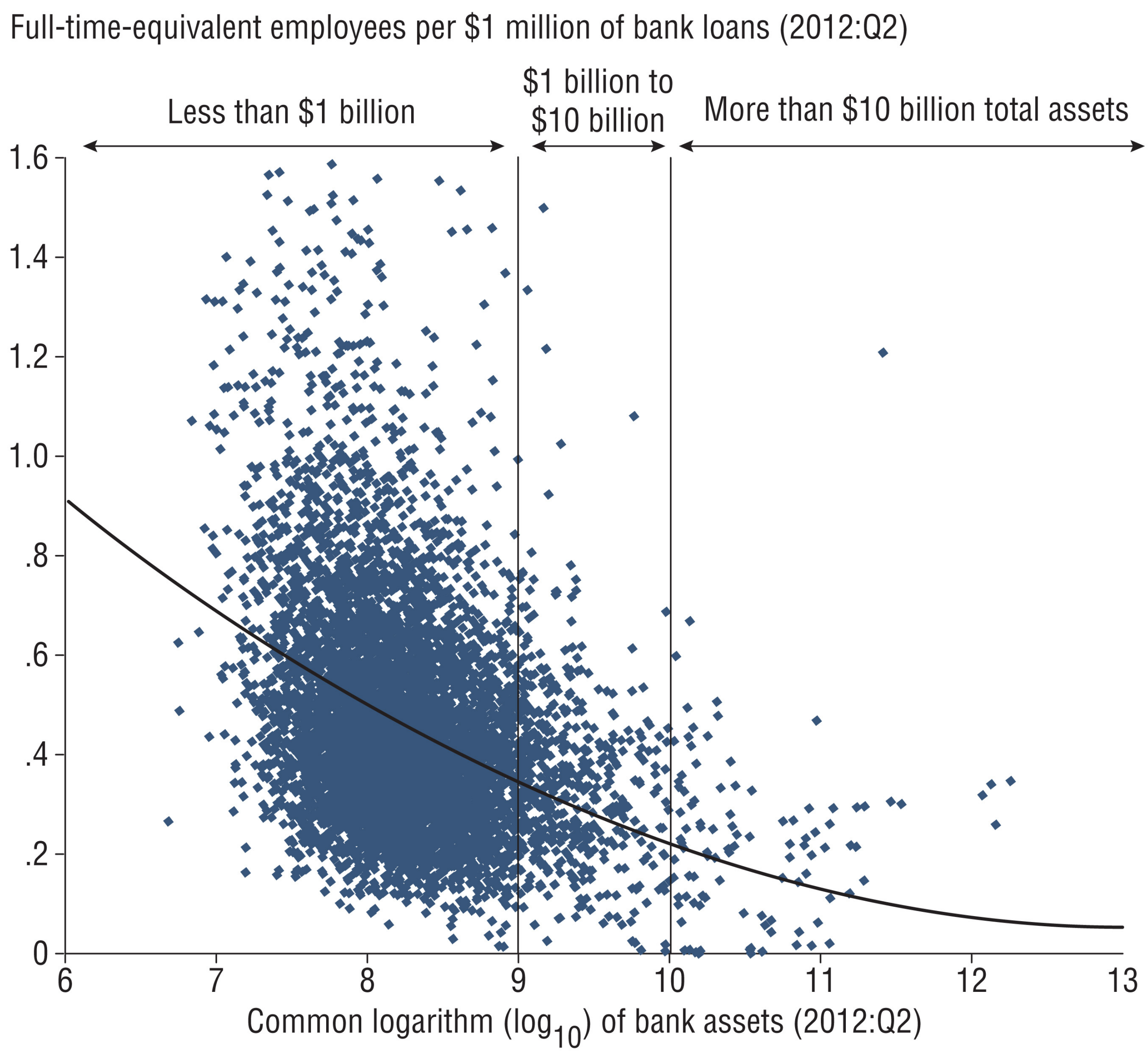
2012 Annual Report

Financial Stability: Traditional Banks Pave the Way

# Regulatory Burden Rising

By Christoffer Koch

**Chart 4**
**Smaller Banks Require Relatively More Personnel**




NOTE: A few outliers with above 1.6 FTE/$1 million loans fall outside plot area.

DATA SOURCE: Call Report, Federal Financial Institutions Examination Council.

# Leveling the Playing Field

By Harvey Rosenblum

Financial reform must be redirected. The government's financial safety net for the biggest banks should cover only their essential banking activities and their role in the payments system. Once that occurs, market discipline can reassert itself, and all institutions —large and small—can compete on a more level playing field.


Market discipline, an essential tenet of capitalism, restrains excessive risk taking. It relies on stockholders, creditors and managers believing they're exposed to losses from ill-advised decisionmaking. Penalties for reckless behavior include lost business, higher borrowing costs and falling stock prices; the ultimate punishment is outright company failure. Fear of adverse consequences provides incentives for prudent actions.

The opposite also holds, of course. Erosion of market discipline could lead to impetuous, short-sighted decisions or strategic decisions that take advantage of the lower funding costs stemming from the implied safety net. In the banking sector, market discipline began to fade with implicit extensions of the federal safety net. The growing perception of a protective umbrella over the nation's biggest banks further weakened market discipline. The big banks became "too big to fail" (TBTF)—insulated from the consequences of ill-advised behavior and bad decisions.

Thus shielded, they could raise funds at lower cost, gaining a distinct and sustainable competitive advantage that has driven the country toward ever greater financial industry consolidation. Left behind were America's small and midsized banks, struggling to maintain market share even though they largely stuck with traditional banking activities and contributed little to the financial markets' near-meltdown in 2008.

For well over a century, the banking industry has been subject to regulatory discipline; that is, a legal code that guides behavior, supplemented by supervisory oversight designed to impose prompt corrective action for rules violations. When such intervention fails, regulators shut down banks, or transfer their ownership, to protect depositors from losses. Today, nearly all banks—with the exception of those few deemed TBTF—are subject to the external forces of market and regulatory discipline. This TBTF exception is untenable and needs to be addressed.

## Risk Assessment

To analyze how market and regulatory discipline limit excessive risk taking, banks have been assigned to one of three groups:

- The roughly 5,500 small community operations that hold about one-eighth of all bank organization assets
- A middle group of roughly 70 midsized, regional institutions with about one-fifth of industry assets
- The 12 largest banking institutions with more than two-thirds of industry assets

### Small Banks: Brutal Efficiency

The smallest group faces varying degrees of pressure from market discipline. The lion's share of deposits is FDIC-insured, so depositors have little incentive to monitor the banks' risk profile. Many of the smaller institutions have few shareholders, some of whom have a significant portion of their wealth invested in the bank's stock. These shareholders have strong incentives to monitor and influence the risk profile. Minority shareholders have the same incentive because of the difficulty of selling their stock; it trades rarely in an illiquid market, especially when bank earnings are squeezed.

*(Continued from Financial Stability: Traditional Banks Pave the Way - Leveling the Playing Field)*

In spite of considerable shareholder-imposed market discipline, small banks can and do encounter problems. For troubled small banks, regulatory discipline works with brutal efficiency—FDIC teams often arrive on Friday and a new bank opens on Monday, with new owners and managers and no losses to insured depositors. In just the past few years, more than 400 such banks have been closed and subjected to ownership transfer, with shareholders essentially suffering total losses.

### Midsized Banks: Restraint Imposed

Midsized regional banks face the industry's greatest market discipline. They often have significant deposits that aren't fully insured and some unsecured debt that would be subject to loss if failure occurred. While their size, geographic reach and product scope make them difficult to close and transfer to new owners over a weekend, many midsized institutions have experienced regulatory discipline in recent decades. So stakeholders—shareholders and uninsured creditors—have enough skin in the game to understand their vulnerability, and they're likely to impose some risk-restraint on bank management. Good executives know this, and it guides their decisions.

### Big Banks: Discipline Diluted

For the 12 biggest banks, the perception of TBTF dilutes market discipline. What little market discipline that may have existed prior to the financial crisis of 2008–09 was undermined by the hundreds of billions of dollars of extraordinary government assistance and depositor and creditor guarantees heaped on these huge institutions. The media's incessant use of the word "bailout," coupled with the fact that these big banking firms never formally failed and still exist under the same names and stock-trading symbols, has likely resulted in a *misplaced perception* that their shareholders were protected from losses.

This has reinforced the view that supervisory agencies are powerless because of an inability to impose regulatory discipline. The sheer size of the biggest banks is daunting. On top of that, these institutions are unimaginably complex, with thousands of subsidiaries spread across the globe and roots sunk deeply into the economies of dozens of countries. Regulators couldn't deal with one of these huge banks in a weekend—or even in a month of weekends. Immense size and geographic reach also provide access to political power, so complaints about regulators will be heard. All told, the biggest banks are little constrained by market discipline or the threat of failure (*Table 1*).

## Restoring Market Discipline

Purging the financial system of these dangers requires reducing the incentives for excessive risk by resurrecting market discipline. The first step involves recognizing the moral hazard inherent in the financial safety net, which should be rolled back to explicitly cover only activities essential to commercial banks and their role in the payments system.

This narrowly defined safety net should include federal deposit insurance and access to the Federal Reserve's lender-of-last-resort facilities, but it shouldn't extend to:

- Bank holding companies
- Broker-dealers
- Insurance subsidiaries
- Finance companies
- Any other nonbank entities

The limits of the safety net should be clearly delineated and credible—put in a one-sentence disclosure statement that's in bold type and capital letters, to be signed by all parties.

With a limited and proper safety net, some of the artificial advantages of size will fade and market discipline will eventually reassert itself.

*(Continued from Financial Stability: Traditional Banks Pave the Way - Leveling the Playing Field)*

Market discipline and its positive incentives could help reduce the size of the biggest banks by penalizing excessive risk taking and mind-numbing complexity. Just as important, small and medium-sized institutions will have a fairer opportunity to compete for market share—if they continue offering less risk and complexity.

Market discipline works elsewhere in the U.S. economy. Facing make-or-break market pressures, industries continually restructure, refocus, streamline and reorganize—such activities are routine and healthy in a capitalist system. If insiders grow complacent, companies end up undervalued, making them tempting targets for investors seeking to unlock shareholder value by breaking up the enterprises into smaller, more economically viable and manageable pieces. Looking at the largest U.S. banking companies, recent stock prices suggest that markets have a gloomy view of bigness (*Chart 1*).

## Clear and Present Danger

Regulatory policy and public policy constrain how much and how rapidly corporate control can change—especially in the biggest institutions. A serious concern, therefore, is that market discipline will take too long to cut the biggest operators down to size—a time during which the economy could face the threat of another financial crisis, this one possibly worse than the last. Policy interventions—for example, a cap on bank size—might be needed to reach the point where any bank, even the largest ones, can fail without endangering the economy.

Defenders of the status quo argue that breaking up big banks would be costly and disruptive. Objections include:

- Inconvenience to customers
- The loss of big banks' size and scope in an era of global business
- A potential shift of business to foreign banks

Moreover, new regulations that address post-financial crisis concerns are scheduled to begin taking effect over the next few years. A case could be made for giving them a chance to work, even if it means tolerating colossal financial institutions.

These arguments ignore a reality: TBTF banks pose a clear and present danger. They've grown large and dominant through favorable government policies. Leveling the playing field will give smaller institutions a fair shake and enhance financial and economic stability.

The 2008 financial crisis cost the U.S. economy $10 trillion to $20 trillion in lost output, reduced wealth, extended unemployment, diminished opportunities and increased costs to taxpayers to fund extraordinary government intervention programs. The crisis left the banking industry more concentrated than ever. The Big Five bank holding companies control over half of industry assets. The next crisis could be more costly and bring further consolidation—a Big Two, perhaps, with 65 percent. What's after that—possibly a single dominant banking institution with market share much greater than we would have ever imagined before the financial crisis?

Big isn't always best. Doing nothing will court disaster. The TBTF problem is neither impossible nor too hard to fix; meanwhile, TBTF banks remain too dangerous to ignore.

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### About the Author

Harvey Rosenblum is executive vice president and director of research at the Federal Reserve Bank of Dallas.

# Leveling the Playing Field

By Harvey Rosenblum

**Table 1**
**Megabanks Face Least External Discipline**

| Bank size and complexity vs. impact of external discipline | | | | | |
|---|---|---|---|---|---|
| | | | | Market discipline from: | |
| | Can fail outright? | Speed of resolution | Regulatory discipline | Shareholders | Unsecured creditors |
| Community banks (5,500) | Yes | Weekend | Often significant | Some, often considerable | Too few to matter |
| Regional/ moderate-sized banks (70) | Yes | Few weeks to 18 months | Significant, but slow | Significant, but lagged | Some, possibly significant |
| Megabanks (12) | No | Never closed | Insufficient, may be ineffective | Limited | Perverse |

NOTE: Numbers shown in parentheses are the approximate (rounded) number of bank organizations in each cohort as of June 30, 2012.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.

# Leveling the Playing Field

By Harvey Rosenblum

**Chart 1**
**Markets Reward Reduced Complexity**


NOTE: The "big, but not as complex" group includes banks larger than $100 billion in assets and predominantly driven by commercial/retail banking activities rather than global banking or investment services and management.

DATA SOURCES: Bloomberg; author's calculations.

# Acknowledgments

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*Executive Vice President and Director of Research*

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**Michael Weiss**
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*Graphic Designers*

**Ellah Piña**
*Chart Producer*

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# Year in Review

The Federal Reserve Bank of Dallas balanced myriad roles in 2012, stepping up outreach efforts, banking supervision responsibilities, research production and educational programs during a challenging period for the economy.

Through speeches, webcasts, conferences, educational events, publications and other communication tools, the Bank sought to reinforce public understanding about the Federal Reserve and the economy and to broaden the conversation about economic policy. Staff reached out to audiences across the Eleventh Federal Reserve District, sharing information and receiving feedback from financial institutions, businesses, nonprofit organizations, educators, civic and community leaders, consumers and many others.

By enhancing communication efforts, implementing financial reform regulations, deepening research and expanding public programs, the Bank rose to meet an extraordinarily complex set of challenges in 2012 and do its part to help the nation recover in the difficult aftermath of the financial collapse and recession of 2007–09.

## Communication Efforts

President Richard Fisher gave a series of speeches and met with community leaders around the district during the year to share his views on issues affecting the regional and national economy—notably the issue of "too big to fail," a reference to those institutions deemed so large, interconnected and/or complex that their failure could substantially damage the financial system. "Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now," the 2011 Annual Report essay by Harvey Rosenblum, executive vice president and director of research, brought nationwide attention to the subject.

As the economy found its footing, the Bank hosted 28 industry-specific roundtables for staff to learn from business leaders "on the ground" about economic conditions in their sectors. These efforts have been increasingly important to the Bank as the regional economy has continued to diversify. The Bank held roundtable events throughout the district that drew more than 400 community bankers and credit union representatives, a key audience in a region dominated by small and mid-sized institutions.

To further strengthen its coverage and access to economic intelligence, the Bank established the Business and Community Advisory Council—a leadership group that meets with Bank officials to discuss issues affecting the economy. Also new in 2012 was the Emerging Leaders Council—a group of young professionals who offer Bank staff their unique perspectives on economic and other matters.

The Community Depository Institution Advisory Council, composed of community bankers and a credit union representative, continued to serve as a valuable source of both information on the state of banking in the region and perspective on the regional economy.

The Financial Institution Relationship Management Department reached out through a series of webcasts on the state of the economy, "Economic Insights: Conversations with the Dallas Fed." The department also launched an electronic publication for the district's financial services providers called *Financial Insights*, which had over 1,800 downloads. With these and other programs, the Bank connected with about 4,000 leaders of district banks and credit unions in 2012.

## Banking Supervision's New Responsibilities

Due to both the greater complexity of financial institutions and new requirements under the Dodd–Frank Wall Street Reform and Consumer Protection Act, the responsibilities of the Dallas Fed's Banking Supervision staff have increased, requiring examiners to have or develop new skills.

The act established new regulatory rules that apply to financial institutions but also restructured some financial regulators. Significantly, the Bank's examination teams took on the task of supervising 23 savings-and-loan holding companies (SLHCs) with a total of $125 billion in assets. These entities operate under different regulations than bank holding companies, and some control securities, real estate and insurance operations.

Beyond the SLHCs, five state-member banks—representing $25 billion in new assets—were added to the Bank's supervision authority.

## Research Reports: Regional and Beyond

Monetary policymakers relied heavily on research in 2012 as the Federal Reserve was asked to react quickly to ever-changing economic developments. The Bank intensified its research focus, both regionally and globally, building on efforts to bring relevant and timely data to policymakers and the public through geographic and industry-specific economic updates, indicators and surveys that are published on the Bank's website.

In particular, the economic outlook surveys on the Texas manufacturing, retail and services sectors were frequently cited in news stories about the expansion of the Texas economy.

Staff of the Bank's Globalization and Monetary Policy Institute circulated 31 working papers, including "IKEA: Product, Pricing and Pass-Through," looking at the Swedish company's catalog prices around the world. The prestigious *Journal of Economic Perspectives* highlighted an essay by one of the Bank's assistant economists on Zimbabwean hyperinflation that was originally published in the institute's 2011 Annual Report .

Five institute papers were accepted for publication during the year by major professional journals. Other Bank research economists had 11 submissions accepted, and one, "Shifting Credit Standards and the Boom and Bust in U.S. House Prices: Time Series Evidence from the Past Three Decades," received a Best Paper Award at the Financial Management Association Asian Conference.

The Bank continued to produce its own in-depth reports that included its working papers series, *Staff Papers*, *Economic Letters* and quarterly *Southwest Economy* publication.

Staff economists contributed to several major research conferences. The institute organized two conferences: "Financial Frictions and Monetary Policy in an Open Economy" and "International Linkages in a Globalized World and Implications for Monetary Policy."

The Bank's continuing relationship with Banco de México included a visit by President Fisher and several research economists to Mexico City in February. Manuel Sánchez, deputy governor of Banco de México, appeared at the Bank's "Mexico: How to Tap Progress" conference. As part of a periodic exchange, the El Paso Branch board of directors met with directors of the Juárez office of Banco de México, and the Houston Branch board met with directors of the Veracruz office of the Mexican central bank to share perspectives on the regional economies. Deputy Governor José Sidaoui and other Banco de México officials participated in the program. The former president of Mexico, Felipe Calderón Hinojosa, participated in a meeting hosted by the Bank and sponsored by the Greater Houston Partnership and consul general of Mexico.

## Educational Initiatives

Many opportunities surfaced in 2012 for the Bank to share its educational resources with the public.

In the fall, the Bank opened *The Economy in Action: An Exhibit on the Federal Reserve, Money and the Regional Economy*. The state-of-the-art exhibit brings the history of central banking in the U.S. to life. The structure, purposes and functions of the contemporary Federal Reserve System are illustrated by video and interactive displays and quizzes. A historical currency exhibit displays actual notes from Colonial times to the present.

The exhibit attracted hundreds of visitors and is open to schools and organizations for scheduled tours.

The Bank's flagship financial literacy program, *Building Wealth*, continued to be a popular guide for educators and community organizations alike. The program was updated for SMART Board technology and had 2,800 downloads. The Bank also introduced the first *Building Wealth* mobile app.

Community Development staff traveled throughout the district, conducting programs on topics such as workforce development, employment for veterans and Texas colonias. The department also launched the Community Outlook Survey to collect timely feedback to assess community and economic development in the district. The survey gathers information about changes in financial well-being for low- and moderate-income populations as well as service providers' ability to serve the needs of these communities.

The Bank's Economic Education program provided in-person training, curriculum guides and publications to over 2,800 educators across the district. The staff developed curriculum for educators and students to use on multiple platforms—print, online and SMART Board. They also developed curriculum for use with *The Economy in Action* exhibit and for "U.S. History Through an Economic Lens" that meets state of Texas requirements for U.S. history in eighth and 11th grades.

In addition, more than 2,000 teachers participated in "Conversation with the Chairman," a videoconference with Fed Chairman Ben Bernanke.

## Other Achievements

In response to the declining use of paper checks and adoption of electronic payment options, the Federal Reserve centralized the infrastructure for check processing operations. The Bank hosted meetings of the Corporate Payments Council, a group it organized in 2012 to exchange information about the changing environment with representatives of businesses that rely heavily on the payments system. Further, the Bank conducted a survey on payments-related fraud in the Eleventh District to gain a better understanding of controls and procedures for mitigating risk.

The Dallas Fed led the System consolidation of the accounts payable function, assuming processing for nine Reserve Banks. The restructuring is expected to save the System several million dollars over the next couple of years.

Also in 2012, activity in the Bank's Go Direct call center accelerated in anticipation of the March 2013 deadline for all federal benefit check recipients to receive payment electronically. The call center, operated on behalf of the U.S. Treasury, processed over 1.2 million enrollments in 2012 and, in October, celebrated the 6 millionth enrollment since the program began. The changeover is expected to save the Treasury $1 billion within 10 years.

## A Dynamic Year

The Federal Reserve Bank of Dallas placed emphasis on outreach in 2012, enhancing its contribution to the nation's monetary policy discussions by sharing and receiving relevant feedback about economic matters. Moreover, the Bank adopted new communications tools to enable quicker, more efficient communication with Eleventh District audiences.

The year also proved to be one of the Bank's most dynamic for its study of the global economy and educational programs and for activities and involvement with major Federal Reserve System technological and operational initiatives.

# Bank Leadership

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# Bank Leadership

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**Helen E. Holcomb**
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Vice President and Senior Economist

# Bank Leadership

*(Continued from Officers/Senior Professionals)*

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**Jay Sudderth**
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Assistant Vice President

# Bank Leadership

*(Continued from Officers/Senior Professionals)*

## Houston Office

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**Randy L. Steinley**
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**Jason K. Ritchie**
Operations Officer

**Donald N. Bowers II**
Assistant Vice President

**Michelle D. Treviño**
Assistant Vice President

## San Antonio Office

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Vice President in Charge

**Keith R. Phillips**
Senior Economic Policy Advisor

## Federal Advisory Council

**Richard W. Evans Jr.**
Chairman and CEO
Cullen/Frost Bankers Inc.
San Antonio

# Resources

## Speeches by Richard W. Fisher

- Ending "Too Big to Fail", March 16, 2013
  http://www.dallasfed.org/news/speeches/fisher/2013/fs130316.cfm

- Ending "Too Big to Fail": A Proposal for Reform Before It's Too Late
  (With Reference to Patrick Henry, Complexity and Reality), Jan. 16, 2013
  http://www.dallasfed.org/news/speeches/fisher/2013/fs130116.cfm

- Taming the Too-Big-to-Fails: Will Dodd–Frank Be the Ticket or Is Lap-Band Surgery Required?
  (With Reference to Vinny Guadagnino, Andrew Haldane, Paul Volcker, John Milton, Tom Hoenig and Churchill's 'Terminological Inexactitude'), Nov. 15, 2011
  http://www.dallasfed.org/news/speeches/fisher/2011/fs111115.cfm

- A Perspective on the U.S. Economy and Monetary Policy, June 6, 2011
  http://www.dallasfed.org/news/speeches/fisher/2011/fs110606.cfm

- "Is America's Decline Exaggerated or Inevitable?" The Role of Monetary and Fiscal Policy
  (With Reference to St. Peter, Calvin Coolidge, Walter Bagehot, Paul Volcker, Winston Churchill and T.R. Fehrenbach), April 8, 2011
  http://www.dallasfed.org/news/speeches/fisher/2011/fs110408.cfm

- Remarks at the SW Graduate School of Banking, June 3, 2010
  http://www.dallasfed.org/news/speeches/fisher/2010/fs100603.cfm

- Remarks before the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, April 14, 2010
  http://www.dallasfed.org/news/speeches/fisher/2010/fs100414.cfm

- Remarks before the Council on Foreign Relations, March 3, 2010
  http://www.dallasfed.org/news/speeches/fisher/2010/fs100303.cfm

- Paradise Lost: Addressing "Too Big to Fail"
  (With Reference to John Milton and Irving Kristol), Nov. 19, 2009
  http://www.dallasfed.org/news/speeches/fisher/2009/fs091119.cfm

- Two Areas of Present Concern: the Economic Outlook and the Pathology of Too-Big-to-Fail
  (With Reference to Errol Flynn, Johnny Mercer, Gary Stern and Voltaire), July 23, 2009
  http://www.dallasfed.org/news/speeches/fisher/2009/fs090723.cfm

## Articles

- How to Shrink the "Too-Big-to-Fail" Banks, by Richard W. Fisher and Harvey Rosenblum, *Wall Street Journal*, March 10, 2013
  http://online.wsj.com/article/SB10001424127887324128504578344652647097278.html

- Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned, by David Luttrell, Harvey Rosenblum and Jackson Thies, Federal Reserve Bank of Dallas *Staff Paper*, no. 18, 2012
  http://www.dallasfed.org/assets/documents/research/staff/staff1203.pdf

- How Huge Banks Threaten the Economy, by Richard W. Fisher and Harvey Rosenblum, *Wall Street Journal*, April 4, 2012
  http://professional.wsj.com/article/SB10001424052702303816504577312110821340648.html?mg=reno64-wsj

- The Blob That Ate Monetary Policy, by Richard W. Fisher and Harvey Rosenblum, *Wall Street Journal*, Sept. 27, 2009
  http://professional.wsj.com/article/SB10001424052748704471504574438650557408142.html?mg=reno64-wsj

*(Continued from Resources)*

## Related Content

- Winter 2012–13 Reading List
  http://www.dallasfed.org/assets/documents/fed/annual/2012winter.pdf
- Break Up the Big Banks: The Key to Economic Prosperity and Improved Financial Stability, Nov. 16, 2012
  http://www.dallasfed.org/assets/documents/news/speeches/121115rosenblum.pdf
- Summer 2012 Reading List on Too Big to Fail
  http://www.dallasfed.org/assets/documents/fed/annual/2012summer.pdf
- Presentation adapted from 2011 Annual Report
  http://www.dallasfed.org/assets/documents/news/speeches/12rosenblum_tbtf.pdf
- Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now, by Harvey Rosenblum, Federal Reserve Bank of Dallas 2011 Annual Report, 2012, pp. 3–23. http://www.dallasfed.org/fed/annual/index.cfm?tab=1##dallastabs

# Glossary

### Asset Impairment
Asset impairment here denotes a condition in which a large portion of a bank's assets stop earning interest and generate losses, thereby depleting the bank's capital and reducing its loan capacity.

### Community Banks
Community banks are typically thought of as smaller-sized institutions engaged in the most traditional form of banking—relying on a stable, retail deposit base to fund loans to consumers and businesses in local communities—with bank owners often assuming a strong oversight role. Yet, in its details, the concept of a community bank can be a matter of opinion. The approach taken here is to proxy for the concept of a community bank by designating a maximum asset size, with the understanding that some organizations exceeding the threshold might still operate as community banks, and some below the threshold might not.

### Moral Hazard
The concept that increased risk taking occurs when risk takers do not bear the full repercussions of their behavior.

### Prompt Corrective Action
The requirement that banks, after experiencing losses, take prompt action to restore their capital ratios to previously acceptable levels. Prompt corrective action by banking supervisors has been in place since 1991 as part of the FDIC Improvement Act.

### Regulatory Capture
A tendency for regulators to foster the narrow interests of the industry rather than those of the public.

### Small Business Loans
Small business loans have original amounts of $1 million or less and are classified as commercial and industrial loans or loans backed by nonfarm, nonresidential properties.

### Too Big To Fail
A euphemism for a financial institution so large, interconnected and/or complex that its demise could substantially damage the financial system and economy if it were allowed to fail.

DALLAS**FED**

2012 Annual Report

# Acknowledgments

## About the Dallas Fed

The Federal Reserve Bank of Dallas is one of 12 regional Federal Reserve Banks in the United States. Together with the Board of Governors in Washington, D.C., these organizations form the Federal Reserve System and function as the nation's central bank. The System's basic purpose is to provide a flow of money and credit that will foster orderly economic growth and a stable dollar. Federal Reserve Banks also supervise banks and bank holding companies and provide certain financial services to the banking industry, the federal government and the public. The Dallas Fed, which has branch offices in El Paso, Houston and San Antonio, has served the financial institutions of the Eleventh Federal Reserve District since 1914. The district encompasses Texas, northern Louisiana and southern New Mexico.


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