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BANKING REFORM: BUILDING A FINANCIAL SYSTEM FOR THE FUTURE

By Ellen Seidman

Two of the most potentially devastating concerns during the financial meltdown in the fall of 2008 were the near total collapse of both the residential and commercial real estate sectors and the evaporation of capital for lending to consumers, businesses and even state and local governments. Our road to restored prosperity must address how to keep open access to credit while cracking down on risky lending practices.[1]

Urgent Issues

First, let's look at some of the issues we are facing: Making the system work fairly and equitably for consumers—and sustainably for banks and credit unions; getting credit to small businesses; taking on different challenges of the largest institutions and of the smaller ones; and keeping all communities, including those with limited resources, economically strong.

"Under" Banking: Why Do So Many People Avoid Financial Institutions

According to the Federal Deposit Insurance Corporation (FDIC), 9 million households nationwide are "unbanked" (i.e. they have no bank accounts), and another 21 million are "under banked" (i.e. they have a checking or savings account at a bank, thrift or credit union, but use non-bank providers, such as check cashers, for a portion of their financial needs). Such products are often expensive and in some cases can trap people into a cycle of debt.

Maine does better than the country as a whole. Nevertheless, according to the FDIC, approximately 3 out of every 100 Maine households are unbanked and 1 in 5 households is under banked. The unbanked and the under

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banked are disproportionately people with lower incomes. Still, more than half are homeowners and a substantial number earn at least $75,000 a year and have some college education. Since the survey was completed a year ago, the situation has probably deteriorated.

The challenge for Maine's banks and credit unions will be not only to make sure they are on top of the needs of their current customers, but also to understand what is missing in their outreach, products or services that keeps good potential customers out of the system.

The Perils of Bank Concentration

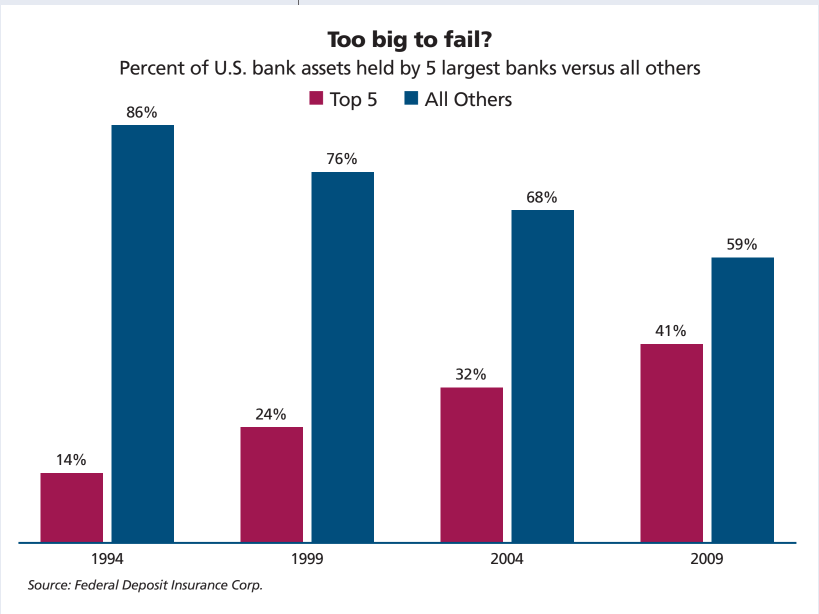
Maine is blessed with a relatively large number of healthy community banks and credit unions. Many still enjoy the close relationship with their customers and their neighborhoods that all banks had decades ago. But the banking environment has changed drastically. Maine's dominant bank, TD Bank, is owned by a Canadian bank, and three other banks with major market shares—Bank of America, Key Bank and Peoples—are based outside the state. In 1994, there were 51 banks active in Maine, all based here; by June of last year, there were 33. Much of mortgage and credit card finance, including those that finance small businesses, also comes from banks and other financial institutions with no deposit presence in Maine. This means that loan repayments from these lenders do not revolve in the Maine economy in the same way as those from Maine-based banks.

Nationally, while the size of the industry has mushroomed, the number of banks declined sharply and the concentration of control among the shrinking number of institutions has become extreme. In 1992, bank assets totaled $4.5 trillion and the top 5 held 12%; by the end of 2005, the total was $10.8 trillion, and the top 5 had a 34% market share. The current financial crisis has only exacerbated the situation. As of last September, the top 5 banks had 41% of the market. These "too big to fail" institutions have funding advantages over everyone else, and their perceived safety makes it harder for community banks to compete for deposits.

Institutions too big to fail may also be too big to manage well or to regulate effectively. If allowed to retain their size and complexity, we must insist on at least three precautions to reduce future risk: far greater transparency, financial disincentives to excessive size and risk, and better trained and less conflicted supervision.[2] Meanwhile, the public should expect these institutions to devote a portion of the benefit they gain from their status to support the communities they serve.

Financial Strains in Maine

The bad news is that the subprime foreclosure crisis has hit certain Maine communities particularly hard. Recent state legislation, together with the Obama Administration's Home Affordable Mortgage Program and the actions of individual lenders, will definitely provide some relief. However, the underlying problems of bad loans, the decline in real estate prices, and rising unemployment will continue to take their toll. As reported by Mortgage Bankers Association of America, in the third quarter of 2009, prime mortgage delinquencies topped 6% in Maine—up from 3% as recently as the first quarter of 2008—and subprime delinquencies topped 25%.



Small businesses are also suffering. Nationally, notwithstanding significant enhancements in SBA programs, championed by both Senator Olympia Snowe and SBA Administrator Karen Mills, small business lending is down by 2% over the last year. On the state level, this is likely to put additional pressure on job creation and retention. Community banks, like so many Maine institutions, are doing a disproportionately large share of small business lending.

Finally, many Community Development Financial Institutions (CDFI) that serve lower income, minority and rural communities find themselves squeezed between more demand for their services, slower loan repayments, higher delinquencies, fewer bank funding sources, and tighter foundation and government budgets.

Reforms for the Future

The proliferation of over-priced, poorly-structured, badly-underwritten mortgages, as well as a general willingness to allow consumers (and some businesses) to overextend themselves with credit, played a significant role in the current economic crisis. In addition, real incomes for most Americans have been stagnant over the last decade while the costs of housing, education and health care have soared.

Protect Consumers from Manipulation, Over Extension and Abuse

The remedies fall in three categories: better underwriting, better products, and better understanding.

1. Better underwriting is the essence of bank regulation: stopping institutions from practices so systematically stupid that they put the institution at risk. Regulators have to focus more fully on consumer protection as well as on an institution's financial health.[3]

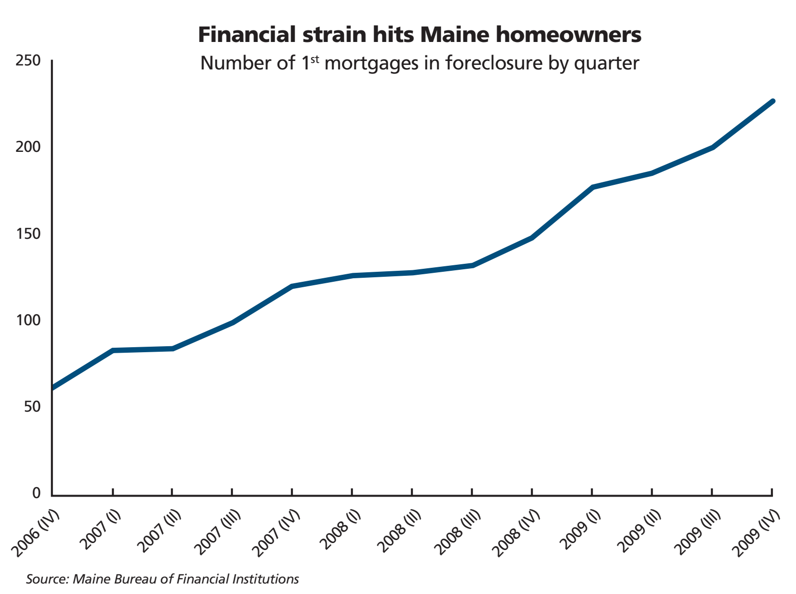
2. Products that are toxic in inception (like up-front fees that reduce borrower's equity) or nefarious in presentation and implication (i.e. double cycle billing, cascading overdraft fees, perpetual penalties) should simply be banned nationally. And the ban must be binding and effectively enforced on all institutions, banks and non-banks alike.

3. An alternative to outright banning is "default products." The initial product offered consumers should be easily understood and unlikely to create problems. Most consumers take the terms of financial products as they are offered rather than shop for the terms that best meet their needs. The products are inherently difficult to understand and consumers routinely underestimate future spending and overestimate future income. Therefore, we need to define the default products and give them preferential treatment.

We also need a separate financial services regulator dedicated to both protecting consumers and helping all parts of the industry develop better products, better consumer understanding of those products, and better disclosures.[4]

Improve Access to Credit for Small Businesses

Small businesses have traditionally been a major source of growth and jobs, especially in Maine. For example, from 2005 to 2006, Maine added over 9,300 net new jobs; almost half came from firms with 1-4 employees. But between the 3rd quarter of 2008 and that of 2009, every employment category in Maine other than education and health services showed a substantial decline. Maine's unemployment rate has remained high at 8.3% as of February this year, far higher than 5.3% in 2008 and 4.7% in 2007. Unemployment in many Maine communities has reached double digits.



Source: Maine Bureau of Financial Institutions

We are starting to see some positive signs spurred in part by funds from the American Recovery and Reinvestment Act (ARRA) and program modifications from the SBA. For example, there has been a slight decrease in the percentage of small business loans overdue 180 days or more and the SBA's flagship 7(a) program backed 36% more loans in the last quarter of 2009 than the year before.

Nevertheless, we need to use all tools available—and press for more—to enable small businesses to both survive this recession and restore growth and prosperity. The Administration has proposed to enhance SBA's ability to help refinance real-estate based loans, as well as extending ARRA programs that eliminate fees and raise guarantees, and increasing the maximum loan size that SBA can guarantee.

Because of various factors, such as business scale, structure and risk, not all small businesses are bankable. That is where CDFIs come into play. They can take a business from initial counseling through sophisticated real estate deals. Many CDFIs serve low-income or minority communities. In partnership with banks, they frequently help finance "on the cusp" small businesses, those ready to make a major leap into long-term sustainability and growth.

Strengthen the Community Reinvestment Act

The latest financial crisis has erased any argument that banks and other financial institutions exist in a pure free market.

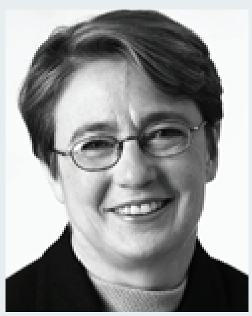
They operate in a market defined and supported by the government. It is not asking too much to expect them to serve all communities within their market area, "consistent with safe and sound operation."

Over the 15 years since the last revision of CRA regulations for large banks, we have witnessed spectacular concentration in the banking industry, the emergence of both virtual banks and banks with nationwide presence and the rise (and collapse) of a non-bank financial services industry that took substantial market share from those subject to CRA. This, coupled with weak CRA enforcement, particularly in relation to large banks, has resulted in fewer assets available for community development and community investment. The exception to this trend is community banks, where the connection to community development has grown stronger.

Regulators must elevate CRA to the status it had in the 1990s. This is fundamental to recovery. We also need a new mechanism to encourage greater community investment, which focuses on meeting the actual needs of the community, not just counting dollars invested. We must hold banks with huge footprints accountable to serve all communities within which they operate. And we need to broaden the statute's reach to "nonbank" lenders.

We need to build a new financial system that is more sustainable not only for financial institutions, but more importantly, for consumers, businesses and communities. Maine's community banks, credit unions and CDFIs are showing the way. Our nation's policymakers can learn from them.

About the Author



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Endnotes

1 This is an edited transcription of Ellen Seidman's remarks at the annual meeting of Coastal Enterprises, Inc. on February 23, 2010. © 2009 New America Foundation. www.newamerica.net.

2 "Ending Too Big to Fail" and "Addressing Systemic Risks: The Agency for Financial Stability" are proposed in Senator Chris Dodd's Financial Reform Bill (Draft).

3 "Independent Consumer Financial Protection Agency," *ibid*.

4 "Creating a Single Federal Bank Regulator," *ibid*.

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