Acting Comptroller of the Currency Michael J. Hsu

"What Should the U.S. Banking System Look Like? Diverse, Dynamic, and Balanced"

University of Michigan School of Business

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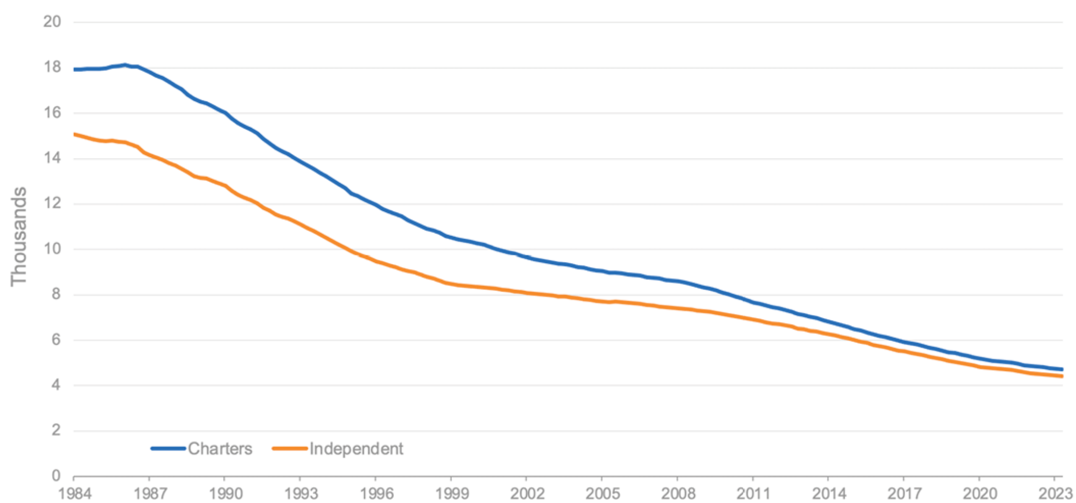
Thank you for hosting me today at the University of Michigan Stephen M. Ross School of Business. It is an honor and pleasure to be here.

I would like to start today's discussion with a question: What should the U.S. banking system look like? Is the system we have today optimal? Or should we go back to a system with many more and smaller banks? Or should we follow other countries and have a banking system served by just a handful of large banks?

Typically, this question is asked indirectly. "How many banks should there be?" is the most common formulation, sometimes accompanied by a table or graph showing the decline from roughly 15,000 banks in the U.S. in 1985 to 4,500 banks today.

Charters and Independent Banks

Total number of charters and independent banks

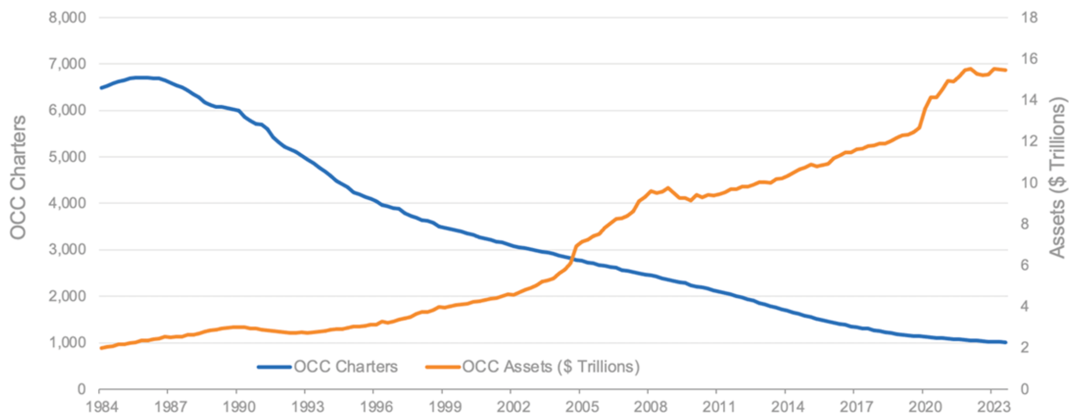


Source: FDIC Research Information System (RIS) Data

At the OCC, I have sometimes used a similar graph showing the decline in the number of OCC-chartered institutions, while overlaying their total assets, which have grown considerably. In 1984 the OCC supervised nearly 6,500 institutions, which had around $2 trillion in assets. Today, we supervise roughly 1,000 institutions with over $15 trillion in assets.

OCC Regulated Institution Counts and Assets

OCC Regulated Banks, Thrifts, and Trusts*



Source: FDIC Research Information System (RIS) Data

*All OTS federal thrifts were absorbed by the OCC in 2011 after the 2008 financial crisis. Federal thrifts are included here with the OCC.

These visuals and datapoints, while striking, lack context. Without context—i.e., without a broader view of what the banking system should look like—it is difficult to determine what levels or trends are good or bad from a policy perspective. Some see the decline in the number of banks as a loss or hollowing out, while others see it as a natural and inevitable consequence of healthy competition. Some see the rise in total assets as positive, while others see it as a threat to financial stability. These views are not trivial. They influence debates about banking and bank mergers.

I believe we can elevate those debates if we consider the context and try to develop a macro view by answering the question "What should the banking system look like?" more directly and rigorously.

My remarks today will start with a discussion of *why* we should develop a macro view of the banking system and suggest that evaluating imbalances between the economy and banking system may provide a useful framework for doing so. I will then walk through three key attributes of today's U.S. economy—its diversity, dynamism, and size—against which the U.S. banking system can be evaluated and potential imbalances identified.

With that backdrop, I will then describe actions the OCC is taking to improve transparency and trust in our bank merger processes.

<u>The case for developing a macro view</u>

By law and as a matter of long-standing practice, regulators like the OCC consider bank merger applications on a case-by-case basis.[1]

Currently, there is no framework for assessing whether this case-by-case approach cumulatively leads to a good or bad banking system overall.

Commentary regarding the banking system tends to focus on one cohort of banks at a time—for instance, criticizing the dominance and financial instability risks of the largest banks, or questioning why there are thousands of small community banks, or assessing the uncertain future of midsize and regional banks.

[1] See 12 USC 1828(c), 12 CFR 5.33, and the "Business Combinations" booklet of the *Comptroller's Licensing Manual*.

Studies analyzing the pros and cons of bank mergers also tend to focus on particular products and services or demographic groups. Some of these are cited to support bank mergers, while others are cited to criticize them. Absent a consensus view, policymakers can be accused of seeing what they want to see, leading to a perception that bank merger policy is fickle.

The development of a macro view—i.e., thinking holistically about the banking system—can provide discipline to these analyses and studies. Developing a sense of what good looks like regarding the overall structure of the U.S. banking system could allow for more effective and stable bank merger policy.

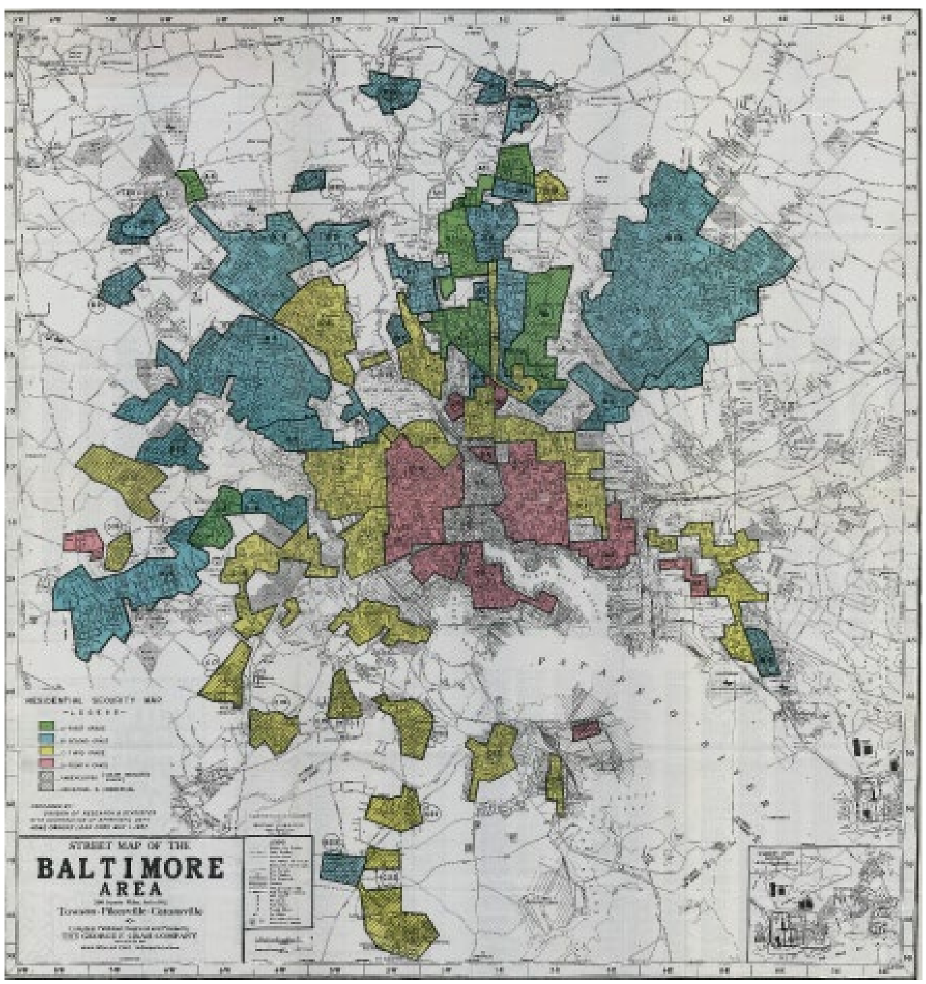
As noted in my opening, the banking structure question typically gets posed as "How many banks should the U.S. have?" which is much too simplistic. If we are going to adopt a rigorous macro view of the banking system, we need to take a more thoughtful and principled approach.

<u>The case for balance</u>

The banking system supports the economy and the businesses, communities, and individuals that comprise it. This point bears reemphasizing when thinking about what the banking system should look like. Put simply, we don't exist to serve banks; banks exist to serve us. Therefore, in order to have a view on what the banking system should look like, we need to be clear about what to measure it against.

Economies and banking systems coevolve. They change together and interact in complex ways. One size does not fit all, however. There is a wide range of relationships and coevolutionary patterns.

Consider two extremes. In one scenario, the banking system is woefully underdeveloped relative to the economy. The demand for banking services greatly exceeds the supply, the economy is not able to grow to its full potential, and bouts of financial instability occur too frequently. Internationally, one might see this in certain developing countries—for instance, in Latin America leading up to the debt crises of the 1980s. Domestically, U.S. neighborhoods that were redlined might also be said to fit this scenario, such as when the government-sponsored Home Owners' Loan Corporation created maps like below in the 1930s, starving entire communities of banking services and creating imbalance as a matter of policy.



Note: This scan of the Home Owners' Loan Corporation map of Baltimore shows the boundaries that set redlining in that city. Scan courtesy of [“Mapping Inequality,”] from the Digital Scholarship Lab at the University of Richmond.

In another scenario, the banking system is much larger than the economy. The oversupply of banking services leads to excessive leverage, risk-taking, and financial instability. We saw examples of this in the lead up to the 2008 financial crisis. For instance, in 2007 Iceland's banking system was roughly nine times larger than its gross domestic product (GDP), and Switzerland's banking system was over eight times the size of Swiss annual GDP.[2] Domestically, this was reflected in the rise and fall of subprime mortgages and derivatives.

The optimal scenario is between these extremes, where the economy and banking system are *balanced*.

The history of U.S. banking can be seen through this lens, as vacillating between periods of imbalance and balance. For instance, the instability of the state-centric "free banking" period before the Civil War was balanced by the establishment of a federal banking system and the OCC in 1863, which enabled the Union to fund the war and support national initiatives, such as building infrastructure and railroads.[3] A similar pattern emerged in the 1920s, after excessive leverage and financial speculation led to the 1929 crash and Great Depression. That was followed by a rebalancing of the banking system through the passage of the 1933 Glass–Steagall Act, which effectively separated commercial banking from investment banking, and through the creation of federal deposit insurance. The lead up to and aftermath of the 2008 financial crisis followed a similar pattern.

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[2] Benediktsdottir, Sigridur, Gauti Bergthoruson Eggertsson, and Eggert Thorarinsson, *The Rise, Fall, and Resurrection of Iceland: A Postmortem Analysis of the 2008 Financial Crisis*, Brookings Institution, September 2017.

[3] Lowenstein, Roger, *Ways and Means: Lincoln and His Cabinet and the Financing of the Civil War* (New York: Penguin Press, 2022).

An interesting period that has particular salience to bank mergers and today is the 1990s. Before the ’90s, banks were restricted from opening branches across state lines. This, in part, explains why the United States had 15,000 banks in 1985. Branching restrictions in both federal and state laws gradually liberalized, culminating in the 1994 Riegle–Neal Act, which broadly legalized interstate banking. Some observers note that much of the consolidation that took place in the 1990s and early 2000s was due to this legal change.

That period also coincided, though, with profound changes in the economy, including globalization and the rise of multinational corporations, the rapid growth of information technology, and significant corporate consolidation. That economic context is critical to understanding bank consolidation and growth during that period.

Today, while there has not been a legal or statutory change like the Riegle–Neal Act, there have been similarly profound changes in the economic context. In order to understand whether or not there is balance between the economy and banking system requires taking a closer look at the economy and its constituent parts—the individuals, communities, and sectors that comprise it—and then looking to the banking system to see where and how it matches up.

The U.S. economy and banking system today

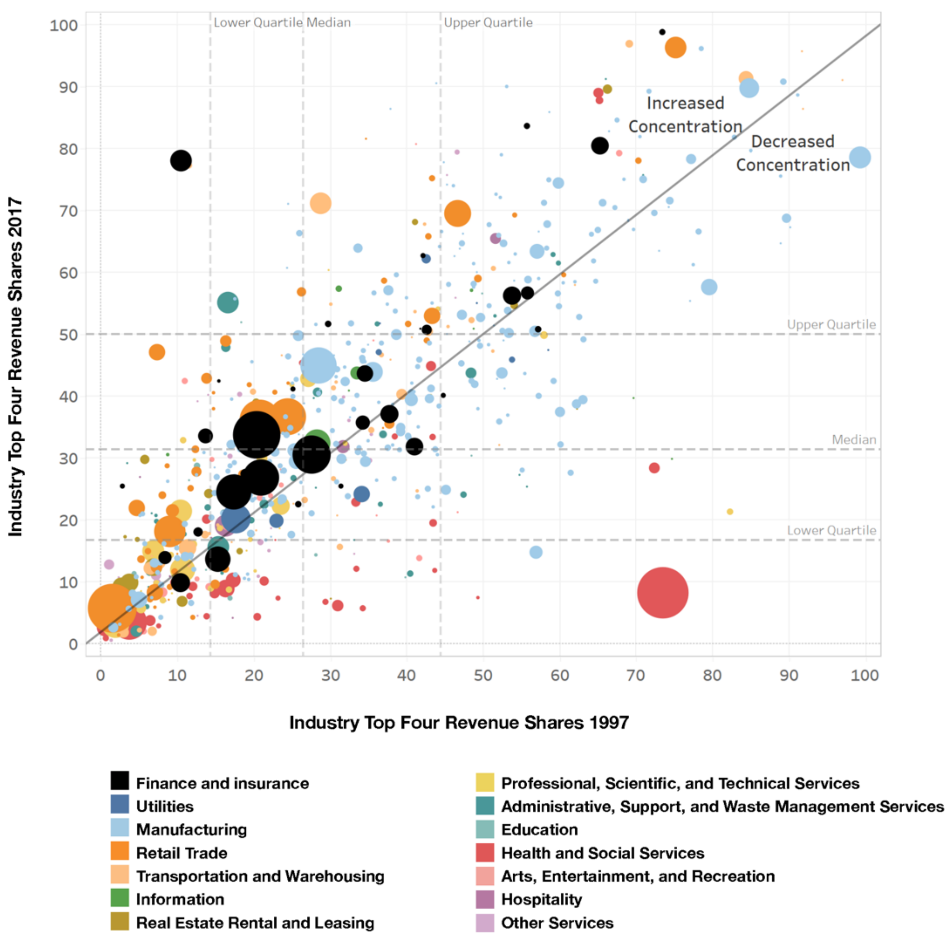
The U.S. economy is uniquely diverse, dynamic, and large. These attributes distinguish the economy and banking system of the U.S. from those of other countries. To understand why the U.S. banking system should not, for instance, look like Canada’s or the UK’s, which are dominated by a small handful of large banks, it helps to unpack each of these attributes.

Diverse

The U.S. economy is extraordinarily diverse across multiple dimensions.

Consider the U.S. business landscape. It includes an extremely broad array of enterprises, ranging from one-person sole proprietorships to the world's largest corporations, providing a wide range of products and services across an even wider range of fields. This interactive graphic captures some of this diversity through a scatterplot of about 700 industries (each dot) across 14 sectors (each color) by revenue (dot size) and concentration (placement along each axis).

Top Four Firm Revenue Shares by Six-Digit North American Industry Classification System Industry and Year



Source: Census Bureau—Economic Census Data, 1997 and 2017

While large, publicly traded corporations tend to get the most attention, small businesses comprise a substantial part of the U.S. economy and are highly varied. They employ nearly half of the American workforce and generate over 40 percent of U.S. GDP.[4]

The U.S. also has an extremely diverse population. Based on the 2020 census, 58 percent of the U.S. population is non-Hispanic White, 19 percent Hispanic, 12 percent Black, and 6 percent Asian. Four percent of the population consider themselves multiracial,[5] 14 percent of the nation's residents are foreign-born,[6] and over 350 languages are spoken.[7] By 2044 the U.S. is projected to not have any one single majority racial/ethnic group. The U.S. population is also geographically dispersed with 46 million Americans living in the nation's rural counties, 175 million in its suburbs and small metropolitan areas, and 98 million in its urban core counties.[8]

American states and municipalities are also incredibly diverse with a wide range of sizes, characteristics, and complexities. For instance, there are over 90,000 local governments, including 20,000 municipalities.[9] State government annual budgets range from Delaware's at $5.6 billion to California's at $311 billion.[10]

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[4] U.S. Chamber of Commerce, "The State of Small Business Now," April 10, 2023.

[5] Johnson, Kenneth, "New Census Reflects Growing U.S. Population Diversity, With Children in the Forefront," October 6, 2021, University of New Hampshire, Carsey School of Public Policy.

[6] U.S. Census Bureau, "Foreign-Born: 2020 Current Population Survey Detailed Tables."

[7] "Official Language of the United States," USAGov.com.

[8] Parker, Kim, Juliana Horowitz, Anna Brown, Richard Fry, D'Vera Cohn, and Ruth Igielnik, *What Unites and Divides Urban, Suburban, and Rural Communities*, Pew Research Center, May 22, 2018.

[9] U.S. Census Bureau, "U.S. Local Governments by State: 1942–2022," August 24, 2023.

[10] California Department of Finance, "2023–24 State Budget"; Owens, Jacob, "Legislature Passes $5.6B FY 2024 Budget," *Delaware Business Times*, June 27, 2023.

The U.S. economy has an extremely diverse not-for-profit sector, which spans healthcare, higher education, environmental stewardship, religious, arts, and cultural services, and other services for communities. In 2022 nonprofits employed approximately 11 million Americans and contributed $1.4 trillion to the economy, exceeding the GDP of Saudi Arabia.[11]

Dynamic

In addition to being diverse, the U.S. economy is highly dynamic. The agricultural foundations of the economy during the founding of the nation shifted in the 1800s to factories with the onset of the industrial revolution. Later, manufacturing gave way to services and the digital economy. For instance, in 1917 the largest companies by sector were in steel, oil and gas, mining, food, and telecom. By 1967 that had shifted to oil and gas, tech, telecom, film, and autos. By 2017 it had shifted again to tech, financial services, medical, conglomerate, and telecom.[12] In 2021 the digital economy alone accounted for 10 percent of U.S. GDP, $1.2 trillion of compensation, and eight million jobs.[13] In most other countries, such change occurs more narrowly and more slowly if at all.

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[11] "Health of the U.S. Nonprofit Sector Annual Review," Independent Sector, November 13, 2023. The GDP of Saudi Arabia in 2022 was $1.1 trillion. "GDP (Current US$) - Saudi Arabia," World Bank Open Data. Accessed January 25, 2024.

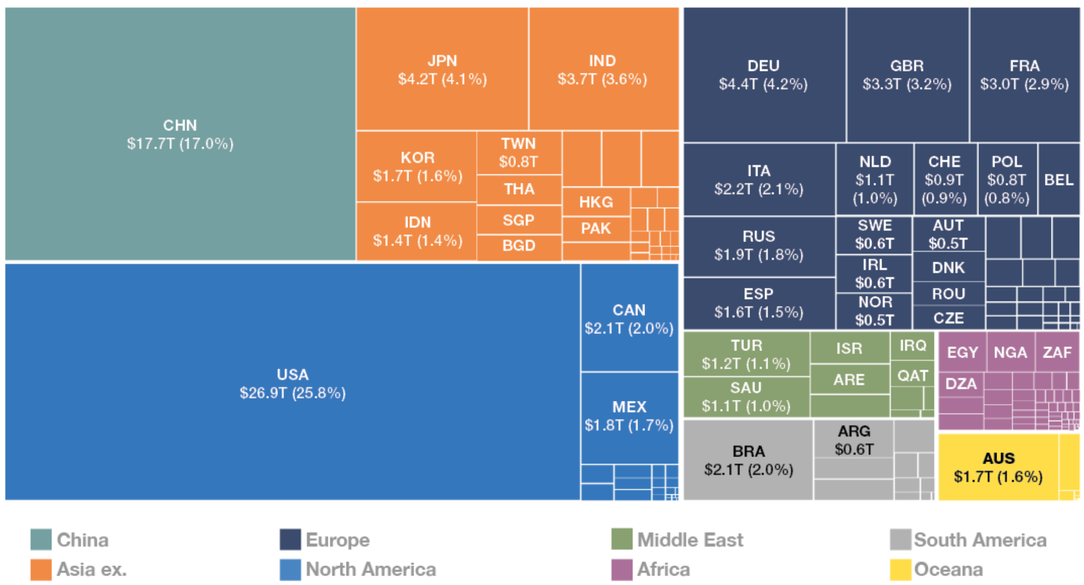
[12] Noer, Michael, and Jeff Kauflin, "America's Top 50 Companies 1917–2017," *Forbes*, September 27, 2017. This dynamism has not been limited to large publicly traded companies. Small businesses have also shifted over time. For instance, in 2002 the healthcare industry was the largest employer, followed by retail trade and manufacturing. By 2021 the landscape had changed again, and healthcare, food services, construction, and professional/technical services were the leading industries for small businesses. (Source: U.S. Census Bureau, "Statistics of U.S. Businesses [SUSB] Tables.")

[13] Highfill, Tina, and Christopher Surfield, *New and Revised Statistics of the U.S. Digital Economy, 2005–2021.* U.S. Department of Commerce, Bureau of Economic Analysis, November 2022. The authors state, "Digital economy activities are organized by infrastructure (software and hardware), e-commerce (business-to-business and business-to-consumer), priced digital services (cloud services; telecommunications services; internet and data services; and all other priced digital services); and federal nondefense digital services, a new activity introduced with this report."

Large

Finally, there is the matter of size. The U.S. economy is the largest in the world, with a GDP of nearly $27 trillion.[14] As the graphic below shows, this dwarfs nearly all other countries.

United States is roughly 26 percent of the $104 trillion world economy based on 2023 global GDP.



Source: International Monetary Fund

The U.S. equities market tells a similar story. There are roughly 750 large-cap stocks trading on U.S. exchanges with a total market capitalization of over $30 trillion, as well as over 1,000 mid-cap stocks and 1,400 small cap stocks.[15] Sixty-two of the 100 largest companies in the world are headquartered in the United States, while just 11 are based in China and five in France.[16]

[14] "GDP, Current Prices," International Monetary Fund, 2023.

[15] "Large-Cap Stocks," Stock Analysis. Accessed January 26, 2024; "Mid-Cap Stocks," Stock Analysis. Accessed January 26, 2024; " Small-Cap Stocks," Stock Analysis. Accessed January 26, 2024.

[16] Neufeld, Dorothy, "Ranked: The 100 Biggest Public Companies in the World," *Visual Capitalist*, December 26, 2022.

Aggregate statistics across a wide range of areas—from mortgage lending and consumer credit to employment and payroll to payments and custody—do the same, reflecting the sheer size of the U.S. economy.

The banking system

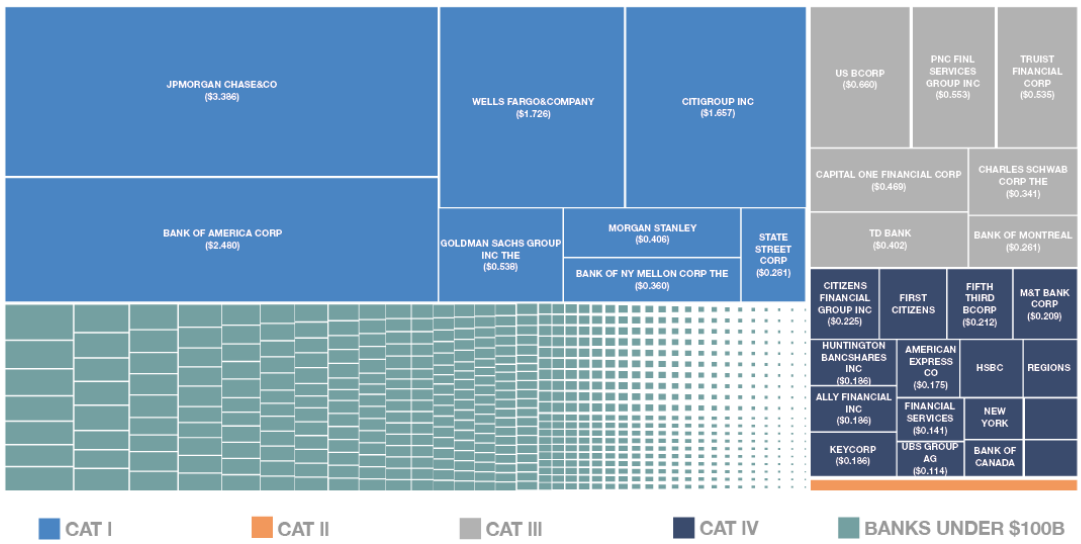
When asking ourselves what the banking system should look like, statistics like those shared above can begin to provide a sense of the extraordinary diversity, dynamism, and size of the U.S. economy. That context sheds light on *why* it is so important to promote a diverse and dynamic U.S. banking system—a proposition that is often asserted, but not explained.

To answer the question, I believe we should focus on whether the U.S. economy and banking system are in balance and whether and where material imbalances may exist. While we cannot fully answer that here—the stats I have highlighted merely provide a sketch—I think it is possible to pose some preliminary questions to guide future research and debate.

For instance, as Professor Jeremy Kress and others have noted, the U.S. banking system is highly concentrated.[17] The eight global systemically important banks, otherwise known as the Category I banks, dwarf the next largest banks (Categories II through IV) and have total assets rivaling the aggregate assets of the 4,000-plus banks smaller than $100 billion, as shown in the following graphic.

[17] Kress, Jeremy C., "Reviving Bank Antitrust," *Duke Law Journal*, December 2022.

Bank Total Assets by Large Bank Categories (I-IV) and All Other Banks ($ trillion)



Source: FDIC Research Information System (RIS) Data

To the extent that such concentration of the largest banks (in blue) is a concern, the right policy question to ask is: How can that concentration be addressed *while also supporting and balancing the diversity, dynamism, and size of the U.S. economy*? The second part of this question is critical. If we focus only on addressing concentration, one could argue that the largest Category I banks (in blue) should be capped and broken up *or* that the Category II, III, and IV banks (in amber, gray, and dark blue) and smaller banks (in teal) should be encouraged to grow, including through mergers. Mathematically, both paths would reduce concentration (i.e., shrink the blue area). But each path would result in a very different-looking banking system with different abilities to support the diversity, dynamism, and size of the economy, and with different impacts on balance.

At the other end of the spectrum (within the teal shaded area), there are over 680 community banks with less than $100 million in assets, 2,700 with assets between $100 million and $1 billion, and 820 with assets between $1 billion and $10 billion. Given the size and diversity of the economy discussed earlier and the many different communities comprising it, are there too many or too few community banks?[18] At what level of consolidation would there be a clear imbalance and impairment in support for the diversity of small businesses, rural communities, and individuals?

These and other critical questions about the composition and shape of the banking system warrant deeper study and analysis. It is my hope that researchers, academics, and astute observers of the banking system engage on these to help policymakers and other stakeholders develop well-informed macro views of the banking system.

OCC actions

Macro views notwithstanding, the OCC must consider and decide on all merger applications involving a federally chartered acquirer on a micro, case-by-case basis.

As I have noted before, the OCC is committed to working with our interagency peers to update our bank merger analytical frameworks, including collaboration with the Department of Justice (DOJ) on the competition prong of the Bank Merger Act. That work is ongoing.

In the meantime, the OCC is taking action to improve our bank merger applications processes and transparency in order to help promote a diverse and dynamic banking system.

First, we believe in the power of data, transparency, and research and will be taking steps to promote all three. Later this year, we plan to post data on bank mergers subject to OCC review in a research-friendly, publicly accessible format on OCC.gov. The data will be downloadable

[18] For instance, an internal OCC staff analysis shows that 66 percent of majority-minority census tracts lack a physical bank branch.

and include applicant information, asset size, Community Reinvestment Act (CRA) rating, target bank information, and the OCC action on the filing. Along with this, we will be issuing a report that provides a comprehensive review of the literature related to bank mergers and consolidation and identifies key outstanding questions.

Second, we believe in the need for clearer guidelines. Today the OCC will publicly release a notice of proposed rulemaking (NPR) that eliminates the possibility that merger applications will be deemed approved solely by the passage of time. Under a rule adopted by the OCC in 1996, certain merger applications are deemed approved by the OCC on the 15th day after the close of the comment period unless the OCC takes action to remove the filing from expedited processing.[19] The forthcoming NPR proposes to remove that, reflecting our view that bank mergers are significant corporate transactions that require the OCC to make a decision.

Included in the NPR release, the OCC will also propose a policy statement that clearly sets forth the features of applications or indicators that are generally consistent with OCC approval under the Bank Merger Act, as well as the features and indicators that raise supervisory or regulatory concerns and may be inconsistent with OCC approval. The proposed policy statement will also clarify the OCC's decision process for extending the public comment period or holding a public meeting.

Merger applications exist along a spectrum. Some have significant deficiencies. Others are straightforward because the acquiring bank is a model of safety and soundness and has earned the trust of the community and its supervisors. The majority lie somewhere in between and require varying degrees of scrutiny and multiple rounds of inquiry. The transparency

[19] 12 CFR 5.33(i).

provided in our proposed policy statement effectively proposes chalk lines demarcating these three groups. For example, the proposed policy statement notes that applications where the acquiring bank has satisfactory supervisory ratings, no open enforcement actions, and no fair lending, CRA, Bank Secrecy Act (BSA), or consumer compliance concerns, along with other features, are consistent with timely approval. On the other hand, applications where the acquirer has unsatisfactory supervisory ratings, open or pending BSA enforcement actions, poor CRA ratings, or other supervisory concerns are highly unlikely to receive approval unless and until such concerns are resolved. We expect most applications are likely to fall between these. We look forward to getting comments on the policy statement including the appropriateness and effectiveness of where these lines are set.

Third, we need to develop modes of analysis for banking competition that go beyond retail deposits as a proxy for market power. As Assistant Attorney General Jonathan Kanter has noted, the banking system is radically different than it was in 1995,[20] and it is appropriate for us to assess whether the factual and economic assumptions underlying the 1995 guidelines[21] are adequate to measure and assess the many different dimensions of competition that exist today. I agree with Mr. Kanter's sentiment that it is imperative that we work together to formulate a new framework for assessing competition that reflects the current state of the banking industry.

[20] U.S. Department of Justice, "Assistant Attorney General Jonathan Kanter Delivers Keynote Address at the Brookings Institution's Center on Regulation and Markets Event 'Promoting Competition in Banking'," June 20, 2023.

[21] U.S. Department of Justice, "Bank Merger Competitive Review – Introduction and Overview (1995)."

Conclusion

In conclusion, I believe we can improve outcomes for the economy and the communities and individuals that comprise it by developing a macro view of the banking system. Such a view could help ensure that our banking system remains diverse, dynamic, and balanced with the economy, as well as inform bank merger policy and decisions. Deeper research is needed, and the OCC looks forward to working with the academic community on that.

In addition, as the OCC continues to work with the Federal Reserve, Federal Deposit Insurance Corporation, and DOJ on updating our analytical frameworks related to bank mergers, we are taking steps to improve the transparency and processes by which we, the OCC, consider merger applications. We look forward to receiving comments on our proposals to eliminate automatic expedited approvals and to clarify the features of merger applications and indicators that are consistent with and inconsistent with approval. Those proposals will be made publicly available later today.