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TESTIMONY

REGULATORY BURDENS: THE IMPACT OF DODD-FRANK ON COMMUNITY BANKING

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House Committee on Oversight and Government Reform
Subcommittee on Economic Growth, Job Creation, and Regulatory Affairs

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Chairman Jordan, Ranking Member Cartwright, and members of the Subcommittee, thank you for the opportunity to be part of today's hearing on the effect of Dodd-Frank on community banks. Dodd-Frank was the product of desperation in the face of a deeply painful financial crisis and outrage at the big financial institutions that were at the center of the trouble. Not only does Dodd-Frank fail to effectively address the problems that precipitated the crisis, but it also imposes costly burdens on many businesses that were not central causes of the crisis. Among these are community banks.

Determining how Dodd-Frank affects community banks is not easy given the statute's heft, the lengthy rulemaking process, and the many other factors influencing the number, size, and profitability of community banks. Other challenges faced by community banks include poor economic conditions, declining populations in rural areas, the increasing technological sophistication of banking, low interest rates, and difficult capital markets, as well as non-Dodd-Frank regulatory initiatives. To gain deeper insight into how Dodd-Frank is affecting small banks, the Mercatus Center at George Mason University is currently conducting an online survey of small banks. I hope that these results will assist Congress and regulators as they think about ways to achieve their regulatory objectives without unduly burdening small banks, their customers, the financial system, and the economy.

In the meantime, it is possible to identify certain ways in which Dodd-Frank is likely to affect community banks. The aspects of Dodd-Frank that are of immediate or long-term concern to small banks include extensive new mortgage rules, the Consumer Financial Protection Bureau (CFPB), capital requirements, the new municipal advisor registration regime, data collection requirements, new conditions on the use of swaps for managing interest-rate risk, and a deepening of the too-big-to-fail status of large financial institutions. These concerns can be generalized in the following themes, each of which is discussed in more detail below:

- Increased legal and regulatory compliance burden.
- Further tilting of the regulatory playing field to the disadvantage of small banks.
- Regulatory barriers to community banks' ability to continue providing their bread-and-butter products and services.

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IMPORTANCE OF COMMUNITY BANKS

Community banks are a fixture across the nation.[1] Many have served their communities for decades. They are particularly important in rural areas. The FDIC reported that "more than 1,200 U.S. counties (out of a total of 3,238), encompassing 16.3 million people, who would have limited physical access to mainstream banking services without the presence of community banks."[2] They are also key providers of small business loans. By one measure, "$1 out of every $2 lent to small businesses comes from community banks."[3]

Community banks are known for offering personalized service and meeting the needs of the local residents and businesses in ways that a larger, nonlocal bank, which does not know the unique characteristics of the community, cannot. In the words of Federal Reserve Governor Elizabeth Duke, community banks' "natural advantages" are "deep community ties, daily interaction between senior managers of banks and their customers, and the dexterity to customize financial solutions."[4] Community banks' first-hand knowledge of their customers provides them useful information for sound lending decisions. As a consequence, community banks' loans tend to default at lower rates than loans made by bigger institutions. The rate of loans in default for the first quarter of 2013 on loans secured by one to four family residential properties was 3.47 percent for banks with less than $1 billion and 10.42 percent for banks with more than $1 billion in assets.[5] Community banks that are closest to their borrowers may fare best.[6]

Community banks have declined in numbers and asset share for years. The number of community banks at the end of 2011 was less than half of what it was in 1984.[7] Community banks held only 14 percent of total bank assets in 2011, compared to 20 percent in 1999 and 38 percent in 1984.[8] The number of banks with less than $100 million in assets fell dramatically by more than 80 percent over the time period, but an important part of that change was attributable to small banks' growing bigger rather than failing.[9] The share of assets held by community banks is dwarfed by the top four banking organizations, which collectively held 44 percent of bank assets in 2011.[10]

The downward trend for community banks does not, however, mean that they are a relic of the past. It is not surprising that large banks play an important role in our nation's economy. Nevertheless, community banks remain an essential component of our financial system. Research suggests that well-managed community banks can continue to coexist with their larger rivals.[11] As one study of the rural banking landscape found, "community banks, as

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1. There is not a uniform definition for "community banks." The Office of the Comptroller of the Currency uses a $1 billion threshold. The Federal Deposit Insurance Corporation (FDIC) traditionally considered banks with $1 billion or less to be community banks, but in a recent study, used a multi-factor test that allows for the inclusion of larger entities. *See* Federal Deposit Insurance Corporation, Community Banking Study (2012), at Table 1.1 and accompanying text, *available at* http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf. The Federal Reserve uses a $10 billion threshold. *See* Board of Governors of the Federal Reserve System, *Supervisory Policy and Guidance Topics: Community Banking* (last visited July 15, 2013), *available at* http://www.federalreserve.gov/bankinforeg/topics/community_banking.htm.
2. FDIC Community Banking Study, *supra* note 1, at 3-5.
3. Tanya D. Marsh and Joseph W. Norman, The Impact of Dodd-Frank on Community Banks (American Enterprise Institute), May 2013, at 12.
4. Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System, Speech at the Southeastern Bank Management and Directors Conference (Feb. 5, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/duke20130205a.htm#fn7.
5. *See* FDIC Statistics on Depository Institutions (accessed July 16, 2013), *available at* http://www2.fdic.gov/sdi/main.asp. Loans in default are defined as nonaccrual loans or loans past due 30 or more days.
6. *See, e.g.*, Robert DeYoung, Dennis Glennon, Peter Nigro, and Kenneth Spong, Small Business Lending and Social Capital: Are Rural Relationships Different? (Center for Banking Excellence Research Paper No. 2012-1, 2012), *available at* http://www.business.ku.edu/sites/businessdev.drupal.ku.edu/files/docs/CBE%20WP%202012-1%20DeYoung%20Glennon%20Nigro%20Spong.pdf. The authors found that small business loans originated by rural community banks defaulted at a lower rate than loans originated by their urban counterparts.
7. FDIC Community Banking Study, *supra* note 1, at Table 2.2.
8. *Id*. at Table 2.3
9. *Id*. at 2-3.
10. *Id*. at 2-4.
11. *See, e.g.*, Tim Critchfield, Tyler Davis, Lee Davison, Heather Gratton, George Hanc, and Katherine Samolyk, *The Future of Banking in America; Community Banks: Their Recent Past, Current Performance, and Future Prospects*, 16 FDIC Banking Review 1 (2004), *available at* http://www.fdic.gov/bank/analytical/banking/2005jan/br16n34full.pdf; Robert DeYoung, William C. Hunter, and Gregory F. Udell, *The Past, Present, and Future for Community Banks*, 25 J. of Fin. Services Res. 85 (2004); R. Alton Gilbert, Andrew P. Meyer, and James W. Fuchs, *The Future of*

a group, remain competitive with larger banking organizations, at least in markets where informationally opaque borrowers are most prevalent."[12] One recent study identified the following common characteristics of "thriving banks": (1) "had a strong and localized customer service focus with high community visibility," (2) "operated in a thriving (i.e., growing) community," (3) "practiced forward-looking risk management with an eye toward long-term bank performance," (4) "demonstrated balance between growth objectives and risk level," and (5) "had patient and conservative ownership operating with the belief that returns on investment should be attractive but not necessarily spectacular."[13] As this list of healthy bank characteristics indicates, the manner in which the bank is managed is very important.

When confronted with too many regulations, managers can lose their ability to focus on serving customers in a profitable and sustainable manner. Regulatory burdens and worries divert time and resources away from the bank's day-to-day business. If the distraction is severe enough, there will be an increased likelihood of bank failures, which is a matter of concern to bank shareholders, employees, and customers, and to American taxpayers, who may ultimately be asked to pick up the tab for failed banks. As will be discussed next, Dodd-Frank's regulatory burdens are a significant source of distraction.

INCREASED REGULATORY BURDEN

One of the key ways in which Dodd-Frank affects community banks is increased regulatory burden. Regulatory compliance was already a major cost to all banks before Dodd-Frank. As one community banker recently explained to Congress, "Regulations have accreted steadily over past decades, but are rarely removed or modernized, resulting in a redundant and sometimes conflicting burden."[14] Regulatory costs "tend to be proportionately heavier for small banks."[15] The disproportionate burden on small banks can change the bank landscape. As a Federal Reserve staff study of the costs of bank regulation explains, "Higher average regulatory costs at low levels of output may inhibit the entry of new firms into banking or may stimulate consolidation of the industry into fewer, large banks."[16] A more recent effort by the Federal Reserve Bank of Minneapolis at quantifying the cost of financial regulation demonstrates the disproportionate effect of regulation on small banks by showing how the costs of hiring just two additional compliance personnel could reverse the profitability of one third of the smallest banks.[17]

Chairman Bernanke takes the position that "the vast majority of the provisions of the Dodd-Frank Act do not apply to community banks at all. The Dodd-Frank Act was enacted largely in response to the 'too-big-to-fail' problem, and most of its provisions apply only, or principally, to the largest, most complex, and internationally active banks."[18] Even though small banks were not the focus of Dodd-Frank, many provisions affect them directly

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Community Banks: Lessons from Banks that Thrived During the Recent Financial Crisis, Federal Reserve Bank of St. Louis Review, Mar./Apr. 2013, at 115, *available at* http://research.stlouisfed.org/publications/review/13/02/gilbert.pdf; Ray Brastow, Bob Carpenter, Susan Maxey, and Mike Riddle, *Weathering the Storm: A Case Study of Healthy Fifth District State Member Banks Over the Recent Downturn*, Federal reserve Bank of Richmond Newsletter, Summer 2012, *available at* http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2012/summer/article3.cfm?WT.si_n=Search&WT.si_x=3.

12. R. Alton Gilbert and David C. Wheelock, *Big Banks in Small Places: Are Community Banks Being Driven Out of Rural Markets*, Federal Reserve Bank of St, Louis Review, May/June 2013, at 216, *available at* http://research.stlouisfed.org/publications/review/article/9723.

13. Gilbert et al., *supra* note 12, at 125.

14. William A. Loving, President and CEO, Pendleton Community Bank, Testimony on Behalf of the Independent Community Bankers of America Before the Subcommittee of Financial Institutions and Consumer Credit of the House Committee on Financial Services (Apr. 16, 2013), at 2.

15. Critchfield, et al., *supra* note 11, at 27.

16. Gregory Elliehausen, The Cost of Banking Regulation: A Review of the Evidence (Federal Reserve Board Staff Studies No. 171, 1998), at 29, *available at* http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss171.pdf. Elliehausen provides a helpful overview of research on regulatory costs.

17. Ron Feldman, Ken Heinecke, and Jason Schmidt, Quantifying the Costs of Additional Regulation on Community Banks (Federal Reserve Bank of Minneapolis Economic Policy Paper No. 13-3, 2013), *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=5102. It is important to note, that he authors point out that their "goal is to advance quantification of additional regulatory costs rather than arguing for a specific cost estimate."

18. *The Importance of Community Banking: A Conversation with Chairman Bernanke*, Community Banking Connections (2012), *available at* http://www.communitybankingconnections.org/articles/2012/Q3/conversation-with-Bernanke.cfm.

or indirectly. Among the provisions in Dodd-Frank that directly affect small banks are new mortgage rules, rules governing municipal advisors, changes in capital requirements, new rules from the CFPB, and the transfer of regulatory responsibilities for savings and loans from the now extinct Office of Thrift Supervision to the Office of the Comptroller of the Currency.

The mere task of determining which pieces of Dodd-Frank apply is a daunting one given that the statute is nearly a thousand pages long and many implementing rules are equally long. The complex interactions among the many statutory and regulatory mandates make the analysis even more difficult. Moreover, because only about forty percent of Dodd-Frank rules have been completed,[19] many questions remain about how the statute will change the financial landscape. The uncertainty is particularly pronounced because of the degree to which critical decisions were left to the implementing regulators. Even if the statute includes or regulators create exemptions specifically for small banks, banks may find that determining how to comply with the conditions for exemption is a time-consuming and—because of the legal consequences of getting it wrong—stressful process. Even something like the Volcker Rule, which is aimed at larger, more complex financial institutions, depending on how it is ultimately implemented, could engender compliance costs for small banks trying to avoid running afoul of it.

Banks are citing increased regulatory costs as a concern. As one community banker recently warned, "the business of banking can't just be an exercise in meeting regulatory requirements."[20] In a 2012 survey of Florida community bankers and credit unions, for example, "respondents cited the confusion, complexity, and inconsistencies of the Dodd-Frank Act" as sources of "significant collateral damage on their core operations."[21] The survey found that 56 percent of community banks and credit unions planned to devote an additional one to three full-time employees to compliance over the next three years.[22] In addition to hiring compliance staff, small banks seek compliance advice from outside consultants. Community bankers with whom the FDIC spoke in connection with its recent study explain that "their increasing reliance on consultants is driven by their inability to understand and implement regulatory changes within required timeframes and their concern that their method of compliance may not pass regulatory scrutiny."[23] Compliance costs may already be causing some banks to stop offering certain products and services or to decide to not expand their businesses.[24]

In addition to the costs of hiring new compliance personnel and buying new software, compliance costs include less easily quantifiable costs. These include "psychological costs" and "dynamic changes in the risk-taking of banks" to compensate for "higher fixed costs."[25] They could also include the legal costs associated with regulatory enforcement actions, actions brought by state attorneys general or consumer lawsuits facilitated by Dodd-Frank and its implementing regulations.

With respect to compliance, community banks are at a disadvantage because they do not have their larger competitors' sophisticated legal and compliance staffs to interpret the new rules and regulations and look for effective

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19. Davis-Polk, *Dodd-Frank Progress Report* , July 2013, at 2, *available at* http://www.davispolk.com/files/Publication/093bb6dd-6d24-4efb -a9fb-58b92085e252/Presentation/PublicationAttachment/974c57ea-eac4-4cc6-ae90-5d50991ca308/Jul2013_Dodd.Frank.Progress.Report.pdf.
20. Preston Pinket III, President and CEO, City National Bancshares, Testimony Before the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee (Apr. 16, 2013), at 4, *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba15-wstate-ppreston-20130416.pdf.
21. Florida Chamber Foundation, 2012 Small Business Lending Survey 6 (2012).
22. *Id*. at 10.
23. FDIC Community Bank Study, *supra* note 1, at B-2.
24. *See, e.g.*, Kenneth L. Burgess, Jr., Chairman, FirstCapital Bank of Texas, Testimony on Behalf of the American Bankers Association Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services (Apr. 16, 2003), at 7. Mr. Burgess reported the results of an American Bankers Association survey, which found that 45 percent of banks had stopped "offering loan or deposit accounts" and 43 percent had chosen not to "launch a new product, delivery channel, or enter a geographic market because of the expected compliance cost or risk." *Id*. at 7.
25. *See* Federal Reserve Bank of Minnesota Economic Policy Paper 13-3, *supra* note 17, at 3. The authors also point out that regulations can increase profitability. *Id*. at 3. One way that regulation can do this is to act as a barrier to entry, something that will be discussed below.

ways to comply with those regulations without compromising their ability to serve customers and earn profits. Regulators have made some attempts to ease the burden by, for example, organizing dialogues with community banks and preparing compliance guides for community banks.[26]

Regardless of these efforts, regulatory costs are likely to work against smaller financial institutions as they attempt to compete with larger banks. Many of the community bankers participating in a survey in the early 2000s "voiced strong concerns that the rules of competition worked against them—namely, that state and federal regulation placed them at a disadvantage relative to their large bank and nonbank rivals."[27] As will be discussed next, there are other features of Dodd-Frank that tilt the competitive landscape in favor of larger competitors.

UNBALANCED COMPETITIVE LANDSCAPE

Community banks face competition from many sides. Large interstate banks compete for their customers. In addition, community banks face competition from credit unions, which do not pay taxes. Competition also comes from other financial services providers, such as securities firms, and other investment options, such as money market funds. Community banks also compete with larger rivals that Dodd-Frank deems systemically important—banks with $50 billion or more in assets and other nonbank financial firms designated by the Financial Stability Oversight Council.

The implicit seal of government approval that the systemic designation conveys on large banks gives them a competitive edge. These financial institutions are often not direct competitors of community banks in the capital markets, because community banks tend to fund themselves very differently than larger firms.[28] Nevertheless, when community banks decide to go to the capital markets, not having the government designation will make it harder for them to raise capital. Particularly in a time of crisis, when banks are most likely to need to raise money to survive, the large bank with government backing will find it a lot easier to do so than the community bank that the government has not deemed to be systemic. Large banks with a systemic designation are also likely to find it easier to obtain and retain customers, who will perceive the systemically important status as a guarantee of the financial institution's longevity.

Community banks have not been active users of derivatives to hedge their interest-rate risk.[29] To the extent Dodd-Frank's clearing and execution requirements make the use of derivatives more costly, it is possible that Dodd-Frank will further limit their hedging activity. As a result, small banks could be more vulnerable to interest-rate changes than their larger competitors, who routinely use derivatives to hedge interest-rate risk.

Large banks offer products and services that smaller financial institutions cannot. The system as a whole is better served by a variety of institutions offering a variety of products and services.[30] Dodd-Frank, however, enforces homogeneity.

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26. See, e.g., Board of Governors of the Federal Reserve System, Final Rule on enhanced Regulatory Capital Standards—Implications for Community Banking Organizations (2013), available at http://www.federalreserve.gov/commbankguide20130702.pdf.
27. Robert DeYoung and Denise Duffy, *The Challenges Facing Community Banks: In Their Own Words*, (Federal Reserve Bank of Chicago Economic Perspectives 2002), at 12–13.
28. For a discussion of community bank capital-raising practices, *see* FDIC Community Bank Study, *supra* note 1, at Chapter VI.
29. *See, e.g.*, DeYoung and Duffy, *supra* note 27, at 10.
30. For a discussion of how to achieve a Talebian "antifragile" banking system by letting "a thousand flowers bloom, but [not letting] even one of them be artificially preserved," *see* Lawrence H. White, *Antifragile Banking and Monetary Systems* (paper presented at Cato Institute's 30th Annual Monetary Conference, Nov. 30, 2012).

REGULATORY BARRIERS TO THE PROVISION OF TRADITIONAL COMMUNITY BANK PRODUCTS AND SERVICES

One of Dodd-Frank's main features was the creation of the CFPB, which is charged with protecting consumers. Underlying Dodd-Frank's approach to consumer financial protection is a reliance on regulators to define safe products for consumers. This model works better for large banks than it does for small banks. Wake Forest law professor Tanya Marsh and American Enterprise Institute scholar Joseph Norman explain:

> A recurring theme in Dodd-Frank . . . is that the standardization of financial products and forms will protect consumers. This is implicitly a reaction to the narrative that one of the causes of the financial crisis was the inability of parties to understand and appreciate the risks of innovative financial products. But the focus one standardization of consumer financial products, like home loans and checking accounts, fails to recognize the value to consumers of the community banking model, which emphasizes relationship banking, personalized underwriting, and customization of financial products to meet the specific needs of customers and communities.[31]

The needs of homogenous consumers can be met with homogenous products, but the assumption that consumers are homogenous is wrong. Community banks' practice of getting to know their customers and tailoring products to their needs is at odds with the Dodd-Frank version of customer protection.

Community banks have profited from using "soft information" not available to their larger counterparts. As Marsh and Norman explain, "In contrast to the complex financial modeling large banks use, community bankers' specialized knowledge of the customer and their local market presence allows underwriting decisions to be based on nonstandard soft data like the customer's character and ability to manage in the local economy."[32] Rules adopted by the CFPB under Dodd-Frank do not leave much room for the consideration of such soft information. As George Mason University economics professor Todd Zywicki explains, the CFPB's "one-size-fits-all regulatory approach tends to thus disadvantage those banks that compete on margins such as customer service while favoring those with the lowest costs, big banks that offer economies of scale and lower capital market costs."[33]

As one example, the new qualified mortgage rules specify parameters for mortgages that satisfy Dodd-Frank's ability-to-repay requirement. Nonqualified mortgages can be offered, but the associated legal risk is high. The CFPB defined qualified mortgages so that they could not include features the CFPB believes to be inherently risky. Some of those features are standard in commonly offered community bank loans. Although the CFPB accommodations for certain community bank loans, the qualified mortgage rules will still constrain community banks' ability to lend. The qualified residential mortgage rule, which is now being drafted by regulators, exempts mortgages that fit within its parameters from Dodd-Frank's risk retention requirement. Along with the qualified mortgage rule, the qualified residential mortgage rule will interfere with customer-specific underwriting.

If community banks are unduly constrained in their ability to offer traditional products and services, they may feel pushed to go into business lines with which they are not familiar. This could pose a risk to the viability of the banks and ultimately to the FDIC's Deposit Insurance Fund. The FDIC, in its recent report on community banking, concluded that the banks that stuck to traditional lending strategies fared much better than their counterparts that "abandoned those lending specialties for the small bit of extra yield."[34] Likewise, the Government Accountability Office found that failed small banks "had often pursued aggressive growth strategies using nontraditional, riskier funding sources and exhibited weak underwriting and credit administration practices."[35] It

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31. Tanya D. Marsh and Joseph W. Norman, The Impact of Dodd-Frank on Community Banks 39 (American Enterprise Institute 2013).
32. Tanya D. Marsh and Joseph W. Norman, The Impact of Dodd-Frank on Community Banks 11 (American Enterprise Institute 2013).
33. Todd J. Zywicki, The Consumer Financial Protection Bureau: Savior or Menace (Mercatus Center Working Paper No. 12-25, 2012), at 31-32, *available at* http://mercatus.org/sites/default/files/CFPB_Zywicki_v1-0_0_1.pdf.
34. FDIC Community Banking Study, *supra* note 1, at 5-22.
35. Lawrence L. Evans, Director, Financial Markets and Community Investment, Government Accountability Office, Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, at ii (Mar. 20, 2013).

would be unfortunate if government regulations encouraged community banks to abandon what they are good at in favor of riskier lines of business.

CONCLUSION

It is difficult to understand with precision the degree to which Dodd-Frank affects community banks and their potential to survive and thrive, but it is clear that the regulatory burden is weighing heavily on small banks. Some might argue that regulatory costs could be offset with subsidies for community banks, which could be used, for example, to make loans to small businesses. A better approach is to take steps to relieve the regulatory burden so that community bankers can make loans that will serve their customers and earn profits for bank owners. Certain problematic provisions of Dodd-Frank—such as the risk retention requirement—could simply be eliminated. Others—such as the unaccountable structure of the CFPB—could be reformed. Opportunities for creating new appropriate exemptions for small banks or expanding existing ones should be explored and implementation deadlines could be extended. More generally, a requirement that all rulemaking by the financial regulators be informed by economic analysis could assist the regulators in designing better regulations and identifying instances in which additional regulation is not necessary.

As mentioned above, the Mercatus Center is conducting a survey of small bankers to better understand the nature of the challenges they are facing and opportunities they are seeing as Dodd-Frank implementation progresses. I encourage community bankers to take the survey. The results will help policymakers to better understand how they can ensure that the American banking sector remains vibrant, competitive, efficient, and customer-focused.

Thank you again for inviting me here today. I would be happy to answer any questions.

ABOUT THE AUTHOR

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