Research Briefs
IN ECONOMIC POLICY

CATO INSTITUTE

February 2015 | Number 20

How Are Small Banks Faring Under Dodd-Frank?

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Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) four and a half years ago in response to the financial crisis of 2007–2008. Since the law's enactment, federal regulators have steadily issued subsequent rules to govern the practices of U.S. financial institutions. The legislative text of Dodd-Frank alone totaled approximately 850 pages. As of mid-November 2013, its new rulemakings had created nearly 19,000 pages of regulatory text, with approximately 60 percent of the rules still outstanding.

Although new regulations associated with Dodd-Frank affect many types of financial institutions and other companies, the effect on small banks has emerged as a matter of considerable concern. As Federal Reserve Chairman Ben Bernanke (2013) noted,

> As battle-scarred survivors of a financial crisis and deep recession, community bankers today confront a frustratingly slow recovery, stiff competition from larger banks and other financial institutions, and the responsibility of complying with new and existing regulations. Some observers have worried that these obstacles—particularly complying with regulations—may prove insurmountable.

In making these comments, Chairman Bernanke likely was reacting to sentiments such as those expressed by one of the small bank respondents in our survey that "more compliance expense is killing the small community banks, who actually serve, work, volunteer in the communities they serve. The new rules are going to make it nearly impossible to continue helping our community." In response to such concerns, some regulators have stepped up efforts to reach out to small banks—while simultaneously continuing to promulgate rules.

Small banks were not a principal regulatory target of Dodd-Frank. Proponents of the law described it as a targeted response to Wall Street's large financial institutions and their potential to cause downstream harm in the broader economy. In their view, Dodd-Frank was intended to ensure that "no longer again will recklessness on Wall Street cause joblessness on Main Street" (Pelosi 2010). One of the statute's primary architects, Sen. Christopher Dodd (2010), opined that "we have put an end to too-big-to-fail bailouts and to an era in which executives on Wall Street felt free to gamble with other people's money in the belief that American taxpayers would be there for them if they lost."

The law's advocates explained that small banks were not responsible for the crisis and should not pay for larger

Editor, Jeffrey Miron, Harvard University and Cato Institute

financial institutions' missteps. Senator Dodd (2011) challenged the "myth" that "Dodd-Frank hurts small businesses and community banks" and explained that "the law is squarely aimed at better regulating the largest and most complex Wall Street firms—the ones that were most responsible for the crisis and still present the most risk. Small community banks were victims of the crisis, with hundreds failing as a result of the big banks' risky gambles." Neal Wolin (2011), deputy secretary of the Treasury, likewise explained

> that the authors of the Dodd-Frank Act understood the important role of community banks and that they were not the cause of the crisis. That is why Dodd-Frank is focused on constraining risk at the largest institutions and on closing gaps in regulation for activities, like derivatives trading, that are not central to the business of community banks.

Dodd-Frank did make certain accommodations for small banks. For example, changes deemed favorable to small banks were made to the way that deposit insurance premiums are calculated. Small banks were also exempted from the so-called Durbin Amendment, which limits debit interchange fees. Perhaps most significantly, small banks are not subject to direct supervision by the Bureau of Consumer Financial Protection (the agency also known as the Consumer Financial Protection Bureau). Instead, a small bank's federal prudential regulator—the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, or the Office of the Comptroller of the Currency—is primarily responsible for enforcing the Bureau's rules. Dodd-Frank also directed the Bureau to consider as part of its rulemaking "the impact of the proposed rules" on small financial institutions. Other accommodations include items such as exemption from the stress-testing requirements imposed on large financial institutions and exemption from employee incentive compensation provisions for banks with under $1 billion in assets.

Despite the intentions of Dodd-Frank's proponents and the attempts made to moderate its effect on small banks, as regulators have filled in the details of the new regulatory regime there has been a growing realization of the law's profound effects on financial institutions of all sizes. Bankers, politicians, regulators, and commentators have noted the potential harm that Dodd-Frank is causing small banks and the communities they serve. Most of these concerns are based on an increasing body of compelling anecdotes rather than on broad-based survey data.

This paper adds to the discussion about the effects of Dodd-Frank on small banks by describing and analyzing the results of a 2013 survey of approximately 200 small banks (defined as banks with less than $10 billion in assets) conducted by the Mercatus Center at George Mason University. The purpose of the survey was to understand with more granularity how Dodd-Frank is affecting small banks and the communities they serve.

Our findings suggest that Dodd-Frank has deeply affected small banks. A large majority of small banks view Dodd-Frank as more burdensome than the Bank Secrecy Act, a regulatory regime that banks widely regard as very burdensome. The participating banks noted their substantially increased compliance costs in the wake of Dodd-Frank. These costs include new compliance-personnel hires, increased reliance on outside compliance experts, additional resources allocated to compliance, and more time spent by noncompliance employees on compliance.

Contrary to the hopes of Dodd-Frank's framers, an important driver of compliance expenditures is the Consumer Financial Protection Bureau (CFPB). Small banks' experience with the mortgage rules—where the CFPB has concentrated much of its rulemaking activity to date—seems to have generated a broader concern about the effect that the Bureau will have in the future on small banks across other products and services. One respondent expressed the realization that "small banks were supposed to be exempt from CFPB—well, we definitely are not." Another comment similarly observed that "while [small banks are] not examined by CFPB, their initiatives will definitely flow to the prudential regulators and affect all banks."

More generally, Dodd-Frank's exemptions do not appear to effectively shield small banks from new burdens. The Durbin Amendment, for example, is affecting small banks, despite the statutory exemption they enjoy. As one commenter noted, "any regulations applied to larger [systemically important financial institutions] always roll downhill, regardless of what congressional leaders say." Because large and small banks compete against one another, the effect of regulatory changes—such as price caps under the Durbin Amendment—are not easily limited to large banks.

Increased regulatory burdens have led small banks to reconsider their product and service offerings. In general, Dodd-Frank's regulatory approach does not work well with the nonstandardized lending based on local knowledge that small banks often specialize in. Based on the survey responses, we expect that the small bank share of the residential mortgage business will shrink considerably. Small banks also have begun to cut back on overdraft protection. These changes in product offerings will affect small bank consumers, who may have difficulty locating convenient alternatives.

The long-term ramifications of Dodd-Frank on bank customers are unclear. Respondents expressed frustration that many of the new compliance burdens are not beneficial to the customers that these new regulations are supposed to help. Of particular concern was the extent to which regulations distracted banks from focusing on customer needs.

Small banks report mixed results on profitability. Some banks' return on equity has increased, while it has decreased for others. The widespread belief that industry consolidation will happen suggests, however, that banks are concerned about profitability. Because the vast majority of respondents' compliance expenditures have risen, many may be looking for ways to spread increased compliance costs over a larger asset base. Regulation is not the only issue driving worries about profitability. Small banks also are concerned about the low–interest-rate environment and the prospect that interest rates will rise quickly.

NOTE

This research brief is based on Hester Peirce, Ian Robinson, and Thomas Stratmann, "How Are Small Banks Faring Under Dodd-Frank?" http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2435206##; all references are provided therein.