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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To:	Members, Subcommittee on Investigations, Oversight and Regulations
From:	Committee Staff
Date:	November 27, 2013
Re:	Hearing: Regulatory Landscape: Burdens on Small Financial Institutions

On Thursday December 3, 2013 at 10:00 a.m., the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building to receive testimony on the impact of regulations on small banks and credit unions. The reforms enacted after the 2008 financial crisis impose potentially significant impacts on small financial institutions.

I. Introduction

Banks and credit unions[1] operate by accepting deposits (paying interest on those deposits[2]) and then lending funds at interest rates higher than they pay to obtain deposits. While most people think of lending institutions as large multi-state or even international businesses, most banks and credit unions can be classified as small businesses. According to the Federal Deposit Insurance Corporation (FDIC) almost 5,100 of the approximately 7,600 banks with deposit insurance (or 68 percent) have assets of less than $250 million.[3] According to the National Credit Union

[1] Credit unions are tax-exempt not-for-profit organizations, 12 U.S.C. § 1768, whose depositors actually own the credit union and are called members. There are three types of credit unions: 1) single-bond unions in which all the members have a common bond through organization or occupation; 2) community unions in which people live in a well-defined geographic area; and 3) multiple-bond unions where the union is not limited to a single occupation or association. *Id.* at § 1769.

[2] Technically, the interest paid on credit union member deposits are actually dividends since their deposits represent a share of ownership. *Id.* at § 1763. However, this memorandum will not adopt that technical distinction.

[3] FDIC, COMMUNITY BANKING BY THE NUMBERS 3 (2012), *available at* http://www.fdic.gov/news/conferences/communitybanking/community_banking_by_the_numbers_clean.pdf. Given the fact that the Small Business Administration (SBA) defines a small bank as one with less than $500 million in assets, *see* Small Business Size Standards: Finance and Insurance and Management of Companies and Enterprises, Final Rule, 78 Fed. Reg. 37,409, 37,411 (June 20, 2013), the FDIC actually undercounts the total number of small banks in the United States.

Administration (NCUA) the nearly 6,700 credit unions have average assets of about $150 million.[4]

Since the Great Depression, banks and credit unions have been subject to significant federal regulation in order to protect depositors. However, these regulations, as supplemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[5] may hinder their ability to lend money.[6]

II. Types of Lending Institution, Regulation and Dodd-Frank

Regulation of lending institutions is split among a variety of federal agencies. Banks that receive their charter (the power to operate) from states and choose to be members of the Federal Reserve System are regulated by the Board of the Governors of the Federal Reserve (the Fed). Banks that receive a charter from the Office of the Comptroller of the Currency (a division of the Department of Treasury) are called national banks and are regulated, not surprisingly, by the Comptroller of the Currency (OCC) and must be members of the Federal Reserve System. Banks that have state charters but are not members of the Federal Reserve are regulated by the FDIC. Banks that are controlled by another bank are called bank holding companies and are regulated by the Fed. All of these banking institutions carry federal deposit insurance issued by the FDIC.[7] Finally, credit unions are regulated by the NCUA which also oversees a separate deposit insurance program.[8] The primary purpose of all these regulators is to ensure that banks and credit unions are financially sound and capable of providing funds to depositors when they seek to withdraw them.[9]

Dodd-Frank did not significantly alter the longstanding responsibilities among various federal agencies in addressing the financial soundness of lending institutions. However, Dodd-Frank did make a significant modification to the regulation of lending activities by banks and credit unions

[4] http://www.ncua.gov/Legal/Documents/Reports/IAG201306.pdf. The SBA also categorizes a small credit union as one with less than $500 million in assets. *See* Small Business Size Standards: Finance and Insurance and Management of Companies and Enterprises, Final Rule, 78 Fed. Reg. at 37, 411. Therefore, the overwhelming majority of credit unions are small businesses.
[5] Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[6] Ultimately, these restrictions on lending may have deleterious effects on the economy as individuals and businesses find it difficult to obtain needed debt capital. These indirect effects on the United States economy are not the subject of this hearing but those consequences should not be underestimated.
[7] BOARD OF THE GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 60 (9th ed. 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf. [hereinafter "The Federal Reserve System"]. There are lending institutions denoted as savings and loans who were overseen by the Office of Thrift Supervision. *Id.* Those functions were transferred to the Fed by § 312 of Dodd-Frank. Given that transfer, this memorandum makes no distinction between savings and loans and other for-profit lending institutions subject to federal regulation.
[8] FEDERAL REGULATORY DIRECTORY 373 (Congressional Quarterly Press ed., 2012).
[9] The Federal Reserve System, *supra* note 7, at 62.

with the establishment of the Consumer Financial Protection Bureau or CFPB.[10] Congress, in Dodd-Frank, transferred the regulation of loans and other consumer financial products (including residential mortgages) from various bank regulators to the CFPB.[11]

[10] Dodd-Frank, § 1011, 124 Stat. at 1964 (codified at 12 U.S.C. § 5491).
[11] *Id.* at § 1061, 124 Stat. 2035-39 (codified at 12 U.S.C. § 5581).

III. New Capital Requirements

The primary mission of various bank regulators is to ensure the financial soundness of deposit-taking institutions. This ensures that banks will have sufficient funds to meet depositors' requests for withdrawals. One critical mechanism for doing so is through the maintenance of adequate capital reserves.

a. Purpose of Capital Requirements

Banks make money by lending out deposits. For depositors wanting access to their funds, this is not problematic as long as the borrowers repay the loans. However, if the loans are not repaid, the bank may have difficulty paying its depositors (who essentially are creditors of the bank since the deposit actually is a loan from the depositor to the bank).[12] By having adequate capital reserves to cover potential losses, banks avoid the possibility that their depositor/creditors calls on the bank will not be met. A key aspect of financial soundness regulation is to ensure that banks have sufficient capital reserves to absorb losses should the banks loans not be repaid.[13]

b. Basel III

Prior to 1989, the various banking regulators adopted diverse standards for measuring the adequacy of capital reserves.[14] In 1989, federal regulators adopted a common definition and methodology for measuring the adequacy of capital reserves for banks.[15] Essentially, the standards require that banks hold more capital if they have a higher percentage of riskier loans.

These standards were based on a multinational agreement the "International Convergence of Capital Measurement and Capital Standards" (the Basel Accord) developed by an arm of the Bank of International Settlements – the Basel Committee on Banking Supervision.[16] By imposing similar standards on banks in all countries participating in the Basel Accord, it prevents one country from enticing relocation of banks by reducing the capital reserves needed to operate.

The latest capital requirements, known as Basel III,[17] were developed in response to the 2008 financial crisis. In addition to the Basel Committee standards, the Dodd-Frank Act requires that

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[12] PAUL CALEM & MICHAEL LACOUR-LITTLE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, RISK-BASED CAPITAL REQUIREMENTS FOR MORTGAGE LOANS 4 n.8 (2001), *available at* http://federalreserve.gov/PUBS/feds/2001/200160/200160pap.pdf.
[13] The Federal Reserve System, *supra* note 7, at 73.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] Basel II standards were developed in 2004. *Id.* at 74.

federal banking regulators establish minimum risk-based capital requirements for financial institutions accepting deposits.[18]

The Basel III capital requirements were adopted in the United States by the Federal Reserve and the Office of the Comptroller of the Currency in a joint rulemaking[19] and in a separate rulemaking by the FDIC.[20] The Basel III final rule applies to all banks and bank holding companies domiciled in the United States, with some exceptions not relevant for this memorandum. Given the requirements of Dodd-Frank, adoption of the Basel III standards also satisfies that statutory mandate.

For the purposes of this hearing, the key component of Basel III is the calculation of Tier 1 capital. Tier 1 capital constitutes the most readily available asset of the bank to cover potential losses from loans.[21] Under the Basel III standards as adopted by the Fed, the OCC, and the FDIC, Tier 1 capital is the sum of Tier 1 common equity capital (generally common stock and retained earnings from operations) and additional Tier 1 capital (other instruments that have characteristics of common stock but are not common stock).[22] The rules require that banks have a common equity tier 1 capital ratio of 4.5 percent and total tier 1 capital of 6 percent.[23] These ratios are calculated by dividing the capital by the total risk-weighted assets (loans and other instruments for which the bank provided funds and might not be repaid such as derivatives like credit default swaps).[24] The rules explicate in excruciating detail how to calculate the risk-weights for various types of assets.[25]

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[18] Dodd-Frank, § 171(b)(2), 124 Stat. at 1436 (codified at 12 U.S.C. § 5371(b)(2)).

[19] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013) [hereinafter "Basel III Rules"].

[20] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Interim Final Rule, 78 Fed. Reg. 55,340 (Sept. 10, 2013). Other than the fact that the FDIC adopted the capital requirements as an interim final rule, the FDIC rule is identical to that adopted by the Fed and OCC. *Id.* at 55,340. The Fed and OCC acted earlier than the FDIC but the FDIC's rule was published first into the Federal Register.

[21] *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, DODD-FRANK ACT: HYBRID CAPITAL INSTRUMENTS AND SMALL INSTITUTION ACCESS TO CAPITAL 1 n.1 (2012) (GAO-12-237), *available at* http://www.gao.gov/assets/590/587759.pdf.

[22] The detailed criteria for determining additional Tier 1 capital can be boiled down to whether the bank can rely on the funds without a prior call on that capital by some other party. *See* Basel III Rules, 78 Fed. Reg. at 62,173.

[23] *Id.* at 62,170.

[24] *Id.*

[25] *Id.* at 62,179-269. The calculations use a variety of complicated mathematical formulae. To some extent, small banks will not have to suffer through these complex calculations since they address assets, such as derivatives, that generally are not held by small community banks.

On a quarterly basis, community banks will need to track 13 categories of deductions and adjustments to capital and changes to risk-weighted assets.[26] Because of the complexity of these requirements, most community banks will be forced to hire additional compliance staff or outside consultants.[27] The additional cost could cause problems for community banks since hiring of additional staff has a direct impact on bank profitability.[28] According to the Independent Community Bankers of America, "[m]any community banks will be forced to merge, consolidate, or significantly curtail lending to improve their capital positions or to comply with the additional regulatory burden."[29]

IV. The Dodd-Frank Act

The new capital requirements mandated by Dodd-Frank and implemented through the adoption of Basel III will impose substantial regulatory burdens on small banks. Additional regulatory requirements emanating from the implementation of Dodd-Frank will add to the burdens of Basel III, particularly the regulation of lending activities of small banks and credit unions by the CFPB.

a. Overall Regulatory Burden

The Dodd-Frank Act is designed to fix perceived gaps in the regulatory framework for banks that led to the near collapse of the financial system. While many of the reforms are designed to apply to large, complex financial institution, smaller financial institutions will be affected by higher costs imposed by regulations.[30] The full impact is difficult to determine because small financial institutions cannot be certain which provisions will apply to them[31] as regulators have wide discretion in implementing Dodd-Frank. Further, costs are difficult to predict because institutions cannot anticipate how the new regulatory environment will affect the financial

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[26] TANYA D. MARSH & JOSEPH W. NORMAN, AMERICAN ENTERPRISE INST., THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 31 (2013), *available at* http://www.aei.org/files/2013/05/06/-the-impact-of-doddfrank-on-community-banks_164334553537.pdf [hereinafter "Community Banks"].

[27] *Id. See Examining Community Bank Regulatory Burdens: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 113th Cong. (statement of Ken L. Burgess, Chairman, First Bancshares of Texas, Inc.), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba15-wstate-kburgess-20130416.pdf.

[28] RON J. FELDMAN, KEN HEINECKE AND JASON SCHMIDT, FEDERAL RESERVE BANK OF MINNEAPOLIS, QUANTIFYING THE COSTS OF ADDITIONAL REGULATION ON COMMUNITY BANKS 5 (May 20, 2013), *available at* http://www.minneapolisfed.org/pubs/eppapers/13-3/epp_13-3_community_banks.pdf.

[29] Letter from James Kendrick, Vice President, Accounting & Capital Policy, Independent Community Bankers Association to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Thomas J. Curry, Comptroller, Office of the Comptroller of the Currency and Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation 7 (Oct. 22, 2012), *available at* http://www.icba.org/files/ICBASites/PDFs/cl102212.pdf.

[30] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, COMMUNITY BANKS AND CREDIT UNIONS: IMPACT OF DODD-FRANK DEPENDS LARGELY ON FUTURE RULEMAKINGS 13-14 (2012), *available at* http://www.gao.gov/assets/650/648210.pdf [hereinafter "Dodd-Frank Rulemakings"].

[31] *Id.*

services industry as a whole.[32] In response to anticipated higher costs, small institutions may: lower returns to shareholders; reduce funding costs by paying less to depositors; reduce expenses which may negatively affect customers; ration credit by cutting back on lending to higher-risk customers; raise prices for credit by charging higher interest rates for loans; and eliminate lines of business that, given the increased regulatory costs, are no longer profitable.[33] Adding to the uncertainty for small financial institutions is the cost of compliance with new regulations emanating from the CFPB.

b. Consumer Financial Protection Bureau

Created by Dodd-Frank, the CFPB is responsible for regulating the offering and provision of consumer financial products or services so that markets are fair, transparent and competitive.[34] Within its mandate, the CFPB has broad rule-making authority to achieve its mission.[35] Small financial institutions are concerned that the new CFPB rulemaking will impose additional compliance costs, which include both time and resources.[36]

Of particular concern to small institutions are the CFPB's rules related to the mortgage industry.[37] The new rules establish standardized disclosures and prohibit institutions from charging certain fees.[38] Not only will these new rules limit a small institution's ability to serve customers with unique needs,[39] it may also result in some smaller institutions exiting the residential lending business if they can no longer afford to compete.[40]

IV. Conclusion

The past several years have been difficult for small financial institutions. Many institutions have been forced to close their doors, or have merged with other, and much larger, financial institutions. For those institutions that have survived, the regulatory burden has required staff to

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[32] Community Banks, *supra* note 26, at 28-29.
[33] DOUGLAS ELLIOTT, SUZANNE SALLOY AND ANDRÉ OLIVEIRA SANTOS, INTERNATIONAL MONETARY FUND, ASSESSING THE COST OF FINANCIAL REGULATION 22-24 (2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp12233.pdf.
[34] Dodd-Frank, § 1021, 124 Stat. at 1979 (codified at 12 U.S.C. § 5511).
[35] Dodd-Frank Rulemakings, *supra* note 30, at 33.
[36] *Id.* at 35.
[37] *Id.* at 30. *See* Letter from Camden R. Fine, President and CEO, Independent Community Bankers Association to Richard Cordray, Director, Consumer Financial Protection Bureau 2 (Oct. 9, 2013), *available at* http://www.icba.org/files/ICBASites/PDFs/ICBA%20Letter%20Regarding%20Mortgage%20Rules%20Implementation.pdf.
[38] Jonathan Macey, *The Feds' New Mortgage Disclosures are a Bust*, WALL. ST. J., July 17, 2012, *available at* http://online.wsj.com/news/articles/SB10001424052702303740704577527192635240670.
[39] Community Banks, *supra*, note 26 at 32-33.
[40] Letter from James Kendrick, Vice President, Accounting & Capital Policy, Independent Community Bankers Association to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Thomas J. Curry, Comptroller, Office of the Comptroller of the Currency and Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation, 15 (Oct. 22, 2012), *available at* http://www.icba.org/files/ICBASites/PDFs/c1102212.pdf.

spend more time on compliance than on helping customers. This hearing will examine the regulatory compliance burden on small financial institutions and how regulatory compliance is affecting their ability to serve their customers.