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## **REGULATORY LANDSCAPE: BURDENS ON SMALL FINANCIAL INSTITUTIONS**

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House Committee on Small Business  
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Chairman Schweikert, Ranking Member Clarke, and members of the Subcommittee, thank you for the opportunity to be part of today's hearing on regulatory burdens on small financial institutions.<sup>1</sup>

In financial services, as in every other sector, the United States is not a one-size-fits-all nation. Financial institutions of all different sizes coexist, and customers choose among them based upon their needs. A regulatory environment that is increasingly unwelcoming to small financial institutions may curtail customer choice.

Increasingly burdensome regulation is not the only challenge facing small banks and credit unions. They are also confronting slow economic growth, declining populations in rural areas, the increasing technological sophistication of banking, the sustained low-interest-rate environment, competition from new types of financial services providers, and difficult capital markets. Small financial institutions can adapt and excel in the face of such challenges, but not if regulation stands in the way and absorbs resources and managerial attention that would otherwise be devoted to dealing with them.

Today I will briefly discuss the importance of small financial institutions and then talk about three ways in which regulation or regulators are threatening their future prospects. First, the regulatory framework accommodates

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1. The definition of "small financial institution" is open to debate. I favor a cutoff of \$10 billion in assets, which is also used by others, such as the Federal Reserve Board of Governors, in defining community banks. See, for example, "Supervisory Policy and Guidance Topics: Community Banks," Board of Governors of the Federal Reserve System, last modified August 2, 2013 (noting that "in general, community banks can be defined as those owned by organizations with less than \$10 billion in assets"), [http://www.federalreserve.gov/bankinforeg/topics/community\\_banking.htm](http://www.federalreserve.gov/bankinforeg/topics/community_banking.htm). The \$10 billion threshold is also used in Dodd-Frank to demarcate banks and credit unions over which the Bureau of Consumer Financial Protection has primary consumer protection-related examination and enforcement authority from those over which it does not. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, §§1025 & 1026 (2010). Although using such a high threshold aggregates financial institutions with very different profiles, it also recognizes that even financial institutions with billions of dollars in assets are experiencing substantial regulatory overload. It is important to acknowledge, however, that the smallest financial institutions feel these strains far more intensely than the banks and credit unions at the top end of the range. As of December 2012, the median asset size was \$21 million for credit unions and \$168 million for banks. Mike Schenk, Economics and Statistics Department, Credit Union National Association, "Commercial Banks and Credit Unions: Facts, Fallacies, and Recent Trends Year-End 2012," 3, accessed November 21, 2013, <http://www.cuna.org/Research-And-Strategy/Credit-Union-Data-And-Statistics/> (scroll to bottom for link to pdf).

large financial institutions better than it does small ones. Second, the increased regulatory and compliance burden is felt most heavily by the smallest financial institutions. Finally, regulators' lackluster commitment to fundamental administrative process protections takes a particular toll on small financial institutions.

## THE IMPORTANCE OF SMALL FINANCIAL INSTITUTIONS

With one-fifth of one percent of the banking industry controlling two-thirds of its assets,<sup>2</sup> it is easy to forget the important role that the remaining financial institutions—most of which are small—play. Many have served their communities for decades and continue to serve the financial needs of millions of retail customers and small businesses. Community banks are particularly important in rural areas. The FDIC reported that community banks serve “more than 1,200 US 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.”<sup>3</sup> 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.”<sup>4</sup> Federal Reserve Governor Jerome Powell has noted that “as auto, mortgage, and credit card loans have become increasingly standardized, community banks have had to focus to a greater extent on small business and commercial real estate lending—products where community banks’ advantages in forming relationships with local borrowers are still important.”<sup>5</sup> Credit unions are also an increasingly important source of small business loans.<sup>6</sup> More generally, credit-union lending expanded by thirteen percent between the end of 2007 and the end of 2012.<sup>7</sup>

Community-based financial institutions are able to distinguish themselves from larger competitors by developing firsthand knowledge about their customers. This enables them to provide personalized service and meet 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. The Government Accountability Office explained:

Despite the decline in their number, community banks and credit unions have maintained their relationship-banking model, relying on their relationships with customers and local knowledge to make loans. Such institutions can use their relationship-based information to make loans to small businesses and other borrowers that larger banks may not make because of their general reliance on more automated processes.<sup>8</sup>

Federal Reserve Governor Elizabeth Duke likewise cited the following “natural advantages” of community banks: “deep community ties, daily interaction between senior managers of banks and their customers, and the dexterity to customize financial solutions.”<sup>9</sup>

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2. Hearing on “Examining How the Dodd–Frank Act Could Result in More Taxpayer-Funded Bailouts,” Before the Committee on Financial Services, 113th Cong. (2013) (statement of Richard W. Fisher, president and CEO, Federal Reserve Bank of Dallas), 3, <http://www.dallasfed.org/assets/documents/news/speeches/fisher/2013/fs130626.pdf>.

3. See Federal Deposit Insurance Corporation, *FDIC Community Banking Study* (December 2012), 3–5, <http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf>. See also *Nominations Hearing, Before the Senate Committee on Banking, Housing, and Urban Affairs*, 113th Cong., 1st Sess. 39 (2013) (statement of Richard T. Metsger, Nominee for Board Member, National Credit Union Administration) (“A large portion of our Nation is dominated by small communities that rely on the services of equally small credit unions and community banks as their economic lifeblood.”).

4. Tanya D. Marsh and Joseph W. Norman, *The Impact of Dodd-Frank on Community Banks*, 12 (Washington, DC: American Enterprise Institute, 2013).

5. Jerome Powell, Governor, Board of Governors of the Federal Reserve System, “Community Banking: Connecting Research and Policy” (speech at the Federal Reserve/Conference of State Bank Supervisors, Community Banking Research Conference, St. Louis, MO, October 3, 2013), <http://www.federalreserve.gov/newsevents/speech/powell20131003a.htm>.

6. James A. Wilcox, *The Increasing Importance of Credit Unions in Small Bank Lending* (Sept. 2011), <http://www.sba.gov/sites/default/files/files/rs387tot.pdf>. The study was prepared for the Small Business Administration.

7. Schenk, “Commercial Banks and Credit Unions,” 9–10.

8. Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule-makings* (Sept. 2012), i, <http://www.gao.gov/assets/650/648210.pdf>. See also “Community Banks and Credit Unions,” Consumer Financial Protection Bureau, accessed November 18, 2013, <http://www.consumerfinance.gov/small-financial-services-providers/> (“Community banks and credit unions . . . generally base their businesses on building personal, long-term customer relationships.”).

9. Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System, “The Future of Community Banking” (speech at the Southe-

Firsthand knowledge of customers provides useful information for making sound lending decisions. Credit unions report that delinquent loans peaked in 2009 at 1.82 percent of credit unions' loan portfolios and were down to 1.15 percent at the end of 2012.<sup>10</sup> 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 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.<sup>11</sup> Community banks that are closest to their borrowers may fare best.<sup>12</sup> As one study of the rural banking landscape found, "community banks, as a group, remain competitive with larger banking organizations, at least in markets where informationally opaque borrowers are most prevalent."<sup>13</sup> Small financial institutions thrive when they use what they know about retail and small business borrowers to make well-tailored, sound loans.

## REGULATORY FRAMEWORK IS DESIGNED FOR LARGE FINANCIAL INSTITUTIONS

The regulatory framework is not well suited to the kind of lending that distinguishes small financial institutions from their large bank counterparts.<sup>14</sup> A recent survey of community bankers found that "many bankers felt that the move toward standardized products and a 'one-size-fits-all' supervisory approach were taking away one of the strongest advantages of community banks: the ability to tailor products to fit individualized needs."<sup>15</sup>

A prime example of this is Dodd-Frank's approach to consumer financial protection that allows the new Bureau of Consumer Financial Protection ("CFPB") effectively to delineate the products that are safe for consumers. This model works better for large institutions than it does for small ones. Marsh and 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 on 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.<sup>16</sup>

While the needs of homogenous consumers can be met with homogenous products, the fundamental assumption that consumers are homogenous is wrong. Community-based financial institutions' practice of getting to know their customers and tailoring products to their needs is at odds with the Dodd-Frank version of one-size-fits-all consumer protection.

Rules adopted by the CFPB under Dodd-Frank leave insufficient room for the consideration of the "soft infor-

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astern Bank Management and Directors Conference, Duluth, GA, February 5, 2013), <http://www.federalreserve.gov/newsevents/speech/duke20130205a.htm>.

10. Schenk, "Commercial Banks and Credit Unions," 11.

11. See *FDIC Statistics on Depository Institutions*, accessed July 16, 2013, <http://www2.fdic.gov/sdi/main.asp>. Loans in default are defined as nonaccrual loans or loans past due 30 or more days. These data include one to four family residential properties.

12. 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), <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.

13. 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* 95, no. 3 (May/June 2013): 216, <http://research.stlouisfed.org/publications/review/article/9723>.

14. Even some well-intentioned regulatory changes may have the effect of decreasing small financial institutions' reliance on soft information. See, e.g., John R. Walter, "Not Your Father's Credit Union," *Federal Reserve Bank of Richmond Economic Quarterly* 92, no. 4 (2006): 369–70 (noting the role that such factors as the introduction of deposit insurance and the loosening of the common bond mandate have played in lessening credit unions' focus on relationship lending). Nonregulatory trends are also relevant. See, e.g., David C. Wheelock and Paul W. Wilson, "Are Credit Unions Too Small?," *Review of Economics and Statistics* 93, no. 4 (2011): 1343 ("recent advances in information processing and communications technology have lowered the cost of acquiring hard information about potential borrowers, and thereby have eroded some of the advantages of small scale and common bond that traditionally enabled credit unions to provide financial services at low cost to their members").

15. Conference of State Bank Supervisors, *Community Banking in the 21st Century: Opportunities, Challenges and Perspectives* (2013), 15, <http://www.stlouisfed.org/CBRC2013/town-hall.pdf>.

16. Marsh and Norman, *Impact of Dodd-Frank*, 39.

mation” that community banks and credit unions have profited from using in the past. Credit unions, which are limited-membership organizations, have their origins in relationship lending, although the intensely personal nature of credit union lending has diminished over time.<sup>17</sup> Likewise, 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.”<sup>18</sup> 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.”<sup>19</sup>

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. Mortgages that fall outside the CFPB’s parameters may work well for certain borrowers identifiable by using non-standardized eligibility criteria. The CFPB made some helpful accommodations for small lenders, but the qualified mortgage rules will still operate as a constraint on small financial institutions’ participation in the mortgage market. As the Independent Community Bankers of America has pointed out:

many community banks do not have the bandwidth to constantly learn and absorb frequent changes and update their business practices to comply. Recent feedback from our members indicates that approximately one third will not be able to comply with all of the new mortgage rules by January 2014 for various reasons such as not having enough time to change policies and procedures or train their staff, or their vendors and suppliers will not be ready in time to complete preparations.<sup>20</sup>

A recent survey of credit unions found that sixty percent will “discontinue, delay or reduce their mortgage loan product offerings” because of CFPB mortgage regulations.<sup>21</sup> Preliminary results of a survey of small banks that I and my colleagues at the Mercatus Center conducted found that approximately ten percent of banks with less than \$200 million in assets have discontinued offering residential mortgages and another fourteen percent anticipate doing so.

If community banks and credit unions are unduly constrained in their ability to offer traditional products and services, they may feel pushed to go into lines of business with which they are not familiar. This could pose a risk to the viability of the banks, credit unions, and ultimately to the government deposit insurance funds that back them. 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.”<sup>22</sup> 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.”<sup>23</sup> It would be unfortunate if government regulations encouraged small financial institutions to abandon what they are good at in favor of lines of business with which they are less familiar.

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17. Walter, “Not Your Father’s Credit Union,” 92 (discussing how credit union “members knew one another, and failure to repay a loan harmed fellow members and damaged the defaulting member’s reputation in the group, there was social pressure to repay, thus reducing the likelihood of default, and consequently providing another explanation for low interest rates on loans from credit unions”).

18. Marsh and Norman, “Impact of Dodd-Frank,” 11.

19. Todd J. Zywicki, “The Consumer Financial Protection Bureau: Savior or Menace?” (Working Paper No. 12-25, Mercatus Center at George Mason University, Arlington, VA, October 2012), 31–2, [http://mercatus.org/sites/default/files/CFPB\\_Zywicki\\_v1-0\\_0\\_1.pdf](http://mercatus.org/sites/default/files/CFPB_Zywicki_v1-0_0_1.pdf).

20. Camden R. Fine, President and CEO, Independent Community Bankers of America, to Richard Cordray, Director, CFPB, 9 October 2013, 2.

21. Credit Union National Association, “Many Credit Unions Will Reduce or Discontinue Mortgage Loans as a Result of CFPB Regulations,” news release, October 21, 2013, <http://www.cuna.org/Stay-Informed/Press-Room/Press-Releases/2013-Press-Releases/Survey-Reveals-Mortgage-Lending-Regulations-May-Hurt-Consumers/>.

22. FDIC, *Community Banking Study*, 5-22.

23. *Hearing on the State of Community Banking in the Current Regulatory Environment, Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services*, 113th Cong. ii (March 20, 2013) (statement of Lawrence L. Evans, Director, Financial Markets and Community Investment, Government Accountability Office).

Regulations are often written with big financial institutions in mind. The Basel III capital rules are one such example. As the American Bankers Association notes, “even though Basel standards are held out to be designed and intended for large, internationally active banks, US regulators are increasingly applying them to even the smallest banks.”<sup>24</sup> American regulators worked with their international counterparts to develop a framework designed for big banks. The proposed rules, which clearly targeted larger institutions, generated considerable push-back from community banks.<sup>25</sup> The final rules better accommodate community banks, but fundamental questions about the utility of a risk-based approach for these institutions remain.<sup>26</sup> The complexity of the capital rules and the implications for investors, regulators, and banks also have raised cost and efficacy concerns.<sup>27</sup>

Regulations explicitly crafted to preserve large financial institutions—such as systemic designations under Title I of Dodd-Frank—can have a deleterious effect on small financial institutions. These kinds of regulations lead to market perceptions that regulators will not let large financial firms fail. Institutions that are perceived to be too big to fail enjoy a subsidy,<sup>28</sup> the size of which and degree to which it is offset by increased regulatory costs are hotly debated.<sup>29</sup> Although not typically competing directly with designated financial companies in the capital markets,<sup>30</sup> small banks are at a funding disadvantage, particularly in a time of widespread crisis, when banks are most likely to need to raise money to survive. Large banks that enjoy explicit or implicit government backing will find it a lot easier to attract private capital than community banks. Large banks with a systemic designation are also likely to find it easier than other financial institutions to obtain and retain customers, for whom the government’s designation functions as a perceived guarantee of the financial institution’s longevity.

#### INCREASED REGULATORY BURDEN FALLS MOST HEAVILY ON SMALL FINANCIAL INSTITUTIONS

Contrary to a popular misconception, the financial services industry is not lightly regulated and was not prior to the crisis, either.<sup>31</sup> Regulatory costs imposed on financial institutions are passed on, in whole or in part, to the customers that rely on these institutions. The increasing burden of regulations is a reality across the entire financial

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24. High C. Carney, Senior Counsel, American Bankers Association, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, 12 November 2013, 2, <http://www.aba.com/Advocacy/commentletters/Documents/11-12-13CommentLettertoFDICreBaseIII.pdf>.

25. For a discussion of comments related to community banks, see *Revised Memorandum from Staff to Board of Governors of the Federal Reserve System re Draft Final Regulatory Capital Rule and Market Risk Notice of Proposed Rulemaking* (July 1, 2013), [http://www.federalreserve.gov/aboutthefed/boardmeetings/20130702\\_\\_Basel\\_\\_III\\_\\_Board\\_\\_Memo.pdf](http://www.federalreserve.gov/aboutthefed/boardmeetings/20130702__Basel__III__Board__Memo.pdf).

26. See Thomas L. Hogan, Neil Meredith, and Xuhao Phan, “Evaluating Risk-Based Capital Regulation” (Working Paper No. 13-02, Mercatus Center at George Mason University, January 2013), [http://mercatus.org/sites/default/files/Hogan\\_EvaluatingRBC\\_v2\\_1.pdf](http://mercatus.org/sites/default/files/Hogan_EvaluatingRBC_v2_1.pdf).

27. See, e.g., Eric S. Rosengren, President & CEO, Federal Reserve Bank of Boston, “Simplicity and Complexity in Regulation” (speech before the Financial Stability Institute of the Bank for International Settlements: Program for Financial Sector Supervisors, Abu Dhabi, United Arab Emirates, November 18, 2013), <http://www.bostonfed.org/news/speeches/rosengren/2013/111813/111813text.pdf>; Basel Committee on Banking Supervision, “The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability” (Bank for International Settlements Discussion Paper 2013), <http://www.bis.org/publ/bcbs258.pdf>.

28. See, e.g., William C. Dudley, President, Federal Reserve Bank of New York, “Ending Too Big to Fail,” (speech at the Global Economics Forum, New York, NY, November 7, 2013) (“The market’s belief that a too big to fail firm is more likely to be rescued in the event of distress than other firms weakens the degree of market discipline exerted by capital providers and counterparties. Since the government does not charge for this implicit guarantee, this reduces the firm’s cost of funds and incents the firm to take more risk than would be the case if there were no prospect of rescue and funding costs were higher. The fact that firms deemed by the market to be too big to fail enjoy an artificial subsidy in the form of lower funding costs distorts competition to the detriment of smaller, less complex firms. This advantage, in turn, creates an unfortunate incentive for firms to get even larger and more complex. As a result, the funding benefit of being seen to be too big to fail causes the financial system to become skewed toward larger and more complex firms in ways that are unrelated to true economies of scale and scope.”).

29. For a spirited sample of that debate, compare Abby McCloskey, “Why Big Banks May Be at a Funding Disadvantage,” *American Banker*, October 24, 2013, <http://www.americanbanker.com/bankthink/why-big-banks-may-be-at-an-annual-fourteen-billion-dollar-disadvantage-1063111-1.html>, with Camden R. Fine, “Wall Street Funding Advantage Is All Too Real,” *American Banker*, October 30, 2013, <http://www.americanbanker.com/bankthink/wall-street-funding-advantage-is-all-too-real-1063257-1.html>.

30. For a discussion of community bank capital-raising practices, see FDIC, *Community Banking Study*, Chapter VI.

31. See, e.g., Patrick McLaughlin and Robert Greene, “Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank” (Chart, Mercatus Center at George Mason University, Arlington, VA, July 19, 2013), <http://mercatus.org/publication/did-deregulation-cause-financial-crisis-examining-common-justification-dodd-frank>.

industry.<sup>32</sup> It falls disproportionately on small financial institutions.<sup>33</sup> Indeed, regulatory burdens have been and are likely to be the death-knell of many of the smallest financial institutions.

With respect to regulatory compliance, small financial institutions are at a clear disadvantage. They cannot spread costs over a large portfolio of loans. They do not have their larger competitors' sophisticated legal and compliance staffs to interpret the new rules and regulations and look for effective 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.<sup>34</sup> Nevertheless, regulation ends up giving larger financial institutions a competitive advantage over smaller ones.<sup>35</sup>

Regulations have built up over time, and it is difficult to pare them back.<sup>36</sup> 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."<sup>37</sup> Professor Tanya Marsh, who recently conducted a study of community banks, explained that "we just react to crises and add new laws. And what we need to do is take a step back and fundamentally re-imagine what is the appropriate way to regulate a bank that is located in rural Wyoming and most of its business is farm lending."<sup>38</sup>

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."<sup>39</sup> 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.<sup>40</sup> Small credit unions also feel regulatory burdens very keenly.<sup>41</sup>

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32. JPMorgan has 5,000 or more compliance staffers. Dawn Kopecki, "Dimon Tells JPMorgan to Brace for More Regulatory Woes," *Bloomberg*, September 17, 2013.

33. 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," *FDIC Banking Review* 16, no. 3 (2004): 27, <http://www.fdic.gov/bank/analytical/banking/2005jan/br16n34full.pdf>.

34. See, e.g., Board of Governors of the Federal Reserve System, *Final Rule on Enhanced Regulatory Capital Standards—Implications for Community Banking Organizations* (2013), <http://www.federalreserve.gov/newsevents/press/bcreg/commbankguide20130702.pdf>; Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies Release a Regulatory Capital Estimation Tool for Community Banks," joint press release, November 19, 2013, <http://www.federalreserve.gov/newsevents/press/bcreg/20131119a.htm>.

35. 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." Robert DeYoung and Denise Duffy, "The Challenges Facing Community Banks: In Their Own Words," (Federal Reserve Bank of Chicago Economic Perspectives 2002), 12-13.

36. This problem is not limited to the banking industry. See, e.g., Tyler Cowen, "More Freedom on the Airplane, If Nowhere Else," *New York Times*, November 16, 2013 (discussing regulatory accretion and, given existing bureaucratic incentives, the difficulty of doing anything about it), [http://www.nytimes.com/2013/11/17/business/more-freedom-on-the-airplane-if-nowhere-else.html?\\_r=1&](http://www.nytimes.com/2013/11/17/business/more-freedom-on-the-airplane-if-nowhere-else.html?_r=1&).

37. *Hearing on "Examining Community Bank Regulatory Burdens," Before the Subcommittee of Financial Institutions and Consumer Credit of the House Committee on Financial Services*, 113th Cong. 2 (Apr. 16, 2013) (statement of William A. Loving, President and CEO, Pendleton Community Bank, Testimony on Behalf of the Independent Community Bankers of America), <http://www.icba.org/files/ICBASites/PDFs/test041613.pdf>.

38. *Regulatory Burdens: The Impact of Dodd-Frank on Community Banking*, *Hearing before the Subcommittee on Economic Growth, Job Creation and Regulatory Affairs of the House Committee on Oversight and Gov't Reform*, 113th Cong., 1st. Sess. 57 (2013) [hereinafter *Community Banking Hearing*] (testimony of Tanya Marsh, Assistant Professor of Law, Wake Forest University School of Law), <http://www.gpo.gov/fdsys/pkg/CHRG-113hhrg82337/pdf/CHRG-113hhrg82337.pdf>.

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

40. 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), [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=5102](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=5102). The authors point out that their "goal is to advance quantification of additional regulatory costs rather than arguing for a specific cost estimate."

41. *Community Banking Hearing*, 67 (letter of Bill Cheney, President & CEO, Credit Union National Assoc.) ("If a smaller credit union offers a ser-

Small banks often supplement internal compliance staff with compliance advice from outside consultants and software providers. 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.”<sup>42</sup>

In addition to the costs of hiring new compliance personnel and buying new software, there are less easily quantifiable compliance costs, including “psychological costs” and “dynamic changes in the risk-taking of banks” to compensate for “higher fixed costs.”<sup>43</sup> 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 day-to-day business. If the distraction is severe enough, there will be an increased likelihood of financial institution 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 and credit unions.

Even when Congress or regulators create exemptions, it can be costly and time-consuming for small financial institutions to determine how to comply with the conditions for the exemption. The legal consequences of non-compliance can be very high, so small financial institutions may instead avoid certain activities altogether. A recent study found that community banks can benefit from using derivatives to hedge their business risks.<sup>44</sup> The authors noted, however, that, as a consequence of the Volcker Rule—which will impose disproportionately high costs on small banks—“community banks may have to reduce and even stop using derivatives for risk management due to the increased regulatory costs.”<sup>45</sup>

New rules under Dodd-Frank aggravated the already heavy regulatory burden. 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.”<sup>46</sup> The survey found that fifty-six 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.<sup>47</sup> To gain deeper insight into how Dodd-Frank is affecting small banks, the Mercatus Center conducted an online survey of small banks and is currently in the process of compiling the results. Approximately two hundred banks participated. The average asset size of respondents was \$500 million, and most serve rural or small metro markets. More than eighty percent responded that since the passage of Dodd-Frank, their costs of regulatory compliance have increased by more than five percent. Sixty-five percent responded that they expect requirements of Dodd-Frank to be “substantially more burdensome than the Bank Secrecy Act.” I hope that our final 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.

## INADEQUATE REGULATORY PROCEDURES

Regulators have not given sufficient consideration to the costs that regulations impose on small financial institutions. Small financial institutions are less likely than bigger institutions to have policy-related interactions with

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vice, it has to be concerned about complying with most of the same rules as a larger institution, but only can spread those costs over a much smaller volume of business. Not surprisingly, smaller credit unions consistently say that their number one concern is regulatory burden.”).

42. FDIC, *Community Banking Study*, B-2.

43. See Feldman et al., “Quantifying the Costs,” 3. The authors also point out that regulations can increase profitability. One way that regulation can do this is to act as a barrier to entry.

44. TXuan (Shelly) Shen and Valentina Hartarska, “Financial Derivatives at Community Banks,” 20 (Paper Prepared for Presentation at Community Banking in the 21st Century, St. Louis Federal Reserve Bank, October 2013), [http://www.stlouisfed.org/banking/community-banking-conference/PDF/Financial\\_Derivatives\\_Community\\_Banks\\_%20XS\\_and\\_VH.pdf](http://www.stlouisfed.org/banking/community-banking-conference/PDF/Financial_Derivatives_Community_Banks_%20XS_and_VH.pdf).

45. *Ibid.*, 2.

46. Florida Chamber Foundation, *2012 Small Business Lending Survey* (2012), 6.

47. *Ibid.*, 10.

their regulators.<sup>48</sup> Regulators are making some efforts to learn about issues that affect small banks and credit unions,<sup>49</sup> but they can do more.

Agencies have been faulted for not adequately fulfilling their responsibilities under the Small Business Regulatory Enforcement and Fairness Act of 1996 (SBREFA). The Federal Reserve's Inspector General issued a report several months ago that found that the Federal Reserve was not providing consistent, clear, and useful small entity compliance guides and that it could "considerably improve its approach to ensure that its compliance guides consistently (1) explain the actions a small entity should take to comply with the corresponding final rules and (2) enable a small entity to know when such requirements have been satisfied."<sup>50</sup> The Federal Reserve's inspector general currently is conducting an evaluation of the CFPB's compliance with its obligations to take small entities' concerns into account.<sup>51</sup> The CFPB, one of the few agencies required to convene SBREFA panels to hear the views of small entities, has been faulted for not taking this SBREFA obligation seriously.<sup>52</sup>

Regulators have thus far resisted taking a more fundamental step towards understanding the implications of their regulations. Because the federal financial regulators are independent regulatory agencies, they are not subject to executive orders that require executive agencies to conduct economic analysis.<sup>53</sup> Even absent a requirement, however, the federal financial regulators should perform economic analysis of their own volition. It is a tool that would help them identify both the problems they are trying to solve and effective solutions that do not unduly burden financial institutions and the consumers they serve. Yet the regulators have consistently failed to conduct the kind of economic analysis that would help to elucidate unintended consequences *before* a new regulatory burden is imposed.<sup>54</sup> A National Credit Union Administration board member went so far as to reject cost-benefit analysis as too much trouble:

I also do not believe we should write a report on the cost-benefit analysis of every regulation NCUA proposes. Doing so would be too burdensome, or necessitate hiring additional employees. In any event, the intended benefits are generally obvious in the regulations we propose, and, indeed, many comments point out potential costs—we need not duplicate those efforts. Like credit unions themselves, we at NCUA need to run as tight and as focused an agency as we can.<sup>55</sup>

While performing rigorous economic analysis is not easy, it is preferable to regulating without a complete analysis of the costs and benefits. A statutory requirement that all rulemaking by the financial regulators be informed by

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48. Nearly thirty-five percent of the respondents in our survey had been contacted by a regulator regarding the feasibility of Dodd-Frank implementation, but most of the contacts came from state regulators.

49. The Board of Governors of the Federal Reserve System, for example, has a Community Depository Institutions Advisory Council, made up of representative banks, thrifts, and credit unions. The FDIC has an Advisory Committee on Community Banking and has looked in depth at community banks. See FDIC, *Community Banking Study*. The Federal Reserve Bank of St. Louis recently held an event on community banking. See Federal Reserve Bank of St. Louis, "Community Banking in the 21st Century," accessed November 19, 2013, <http://www.stlouisfed.org/banking/community-banking-conference/>.

50. Office of Inspector General, Board Of Governors of the Federal Reserve System, *Evaluation Report: Board Should Enhance Compliance with Small Entity Guide Requirements Contained in the Small Business Regulatory Enforcement Fairness Act of 1996* (2013), 4, [http://www.federalreserve.gov/oig/files/FRB\\_SBREFA\\_compliance\\_full\\_Jul2013.pdf](http://www.federalreserve.gov/oig/files/FRB_SBREFA_compliance_full_Jul2013.pdf).

51. Office of Inspector General, Board Of Governors of the Federal Reserve System, *Work Plan*, (November 25, 2013), 9.

52. See, e.g., Letter from Various Small Business Organizations to Sam Graves, Chairman, and Nydia Velázquez, Ranking Member, House Committee on Small Business (August 1, 2012), 1 ("we are concerned that the CFPB views SBREFA as a burden rather than as a means of improving their regulations. In some cases, CFPB chooses to skip the process altogether, and in other cases they choose to convene panels on compressed timelines, making it difficult for small companies to prepare and gather industry information.").

53. The Office of the Comptroller of the Currency used to be subject to regulatory analysis requirements, but Dodd-Frank reclassified the agency as an independent regulatory agency. See Dodd-Frank Act § 315 (amending the definition of "independent regulatory agency" in 44 U.S.C. § 3502(5) (2006) to include the OCC).

54. For a more in-depth discussion of this topic, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *Journal of Law, Economics & Policy* 9, no. 4 (2013): 569–613.

55. Michael E. Fryzel, Board Member, National Credit Union Administration, Remarks before the NASCUS State System Summit (Sept. 16, 2011), <http://www.ncua.gov/News/Pages/SP20100916FryzelNASCUS.aspx>.



economic analysis could assist the regulators in designing better regulations and identifying instances in which additional regulation is not necessary. This, in turn, would help to stop unnecessary regulatory burdens from being placed on small financial institutions.

## CONCLUSION

Small banks and credit unions face a growing list of regulatory obligations. The discouraging reality is that many of these regulations are not working to make banks safer or to protect consumers. They are absorbing more and more of small financial institutions' time, talent, and other resources. They are preventing small financial institutions from effectively and safely playing their essential role in the financial system. Once the Mercatus Center has finalized the results of our small bank survey, we expect to have a better understanding of the nature of the challenges small financial institutions are facing and the opportunities they are seeing in the current environment. These results should help policymakers to better understand how they can ensure that the American banks and credit unions remain vibrant, competitive, efficient, and customer-focused.

Thank you again for including me in today's discussion. I would be happy to take any questions.

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## ABOUT THE AUTHOR

Hester Peirce is a senior research fellow at the Mercatus Center at George Mason University and coauthor of *Dodd-Frank: What It Does and Why It's Flawed* (Mercatus Center at George Mason University, 2013). She was on the staff of the Senate Banking Committee during the drafting of the Dodd-Frank Act. Prior to that, she spent eight years at the Securities and Exchange Commission.

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