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Hearing on Regulatory Burdens: The Impact of Dodd Frank on Community Banking

Regulatory Burdens: The Impact of Dodd Frank on Community Banking

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of Wake Forest University or the American Enterprise Institute.

Chairman Jordan, Ranking Member Cartwright, and members of the Subcommittee, thank you for convening this hearing today to examine the regulatory burden on community banks, and for inviting me to testify. My name is Tanya Marsh and I am an Associate Professor at the Wake Forest University School of Law in Winston-Salem, North Carolina, and an Adjunct Scholar with the American Enterprise Institute. In May 2013 I co-authored a research paper for the American Enterprise Institute entitled "The Impact of Dodd Frank on Community Banks." A copy of that paper is attached and included in my written testimony.

Any discussion of regulatory burden is incomplete without examining both the costs and the benefits of the specific regulation. It is my position that the regulatory framework for financial institutions in the United States, including many provisions of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), impose significant costs on community banks without providing benefits to consumers or the economy that justify those costs. The stated purpose of the Dodd-Frank Act was to prevent another financial crisis by enhancing consumer protection and ending the era of "too big to fail." However, the application of Dodd-Frank to community banks is misplaced. Community banks did not cause the financial crisis. The relationship-banking business model and market forces protect the customers of community banks without the need for additional regulation. Dodd-Frank builds on decades of "one size fits all" regulation of financial institutions, an ill-conceived regulatory framework that puts community banks at a competitive disadvantage to their larger, more complex competitors. The imposition of regulatory burdens on community banks without attendant benefits ultimately harms both consumers and the economy by: (1) forcing community banks to consolidate or go out of business, furthering the concentration of assets in a small number of mega-financial institutions; and (2) encouraging standardization of financial products, leaving millions of vulnerable borrowers without meaningful access to credit.

Who are the Community Banks?

Before turning to the impact of Dodd-Frank on community banks, it is useful to understand the general landscape of American banking. There are roughly 7,000 banks in the United States, of which 92.4 percent are classified as community banks. Although numerically dominant, community banks hold only 14.2 percent of all banking institution assets. The 5,000 members of the Independent Community Bankers of America collectively hold $1.2 trillion in assets. That's about half of the assets held by a single financial institution – JP Morgan Chase. The median American bank has $165 million in assets and 39 employees. Nearly 3,000 banks have fewer than 30 employees. Most community banks are small businesses.

Generally speaking, community banks offer traditional depository, loan, and trust services, operate in limited geographic areas, and are often located in rural areas. For example, 82 percent of community banks operated within three or fewer counties. Community banks make up more than 70 percent of banking offices in rural areas. In fact, community banks operate in 1,200 U.S. counties that have no other bank, fully one-third of American counties.

Community banks are different from larger banks, which must treat the average American as a commodity in order to maintain a profitable relationship. Because their banking activities are directed toward small businesses, farmers, and consumers, community banks are considered "relationship" banks. Community banks use personal knowledge of a customer's financial situation and local business conditions to make lending decisions.

In contrast to the complex financial modeling used by large banks, 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. For example, the president of a $250 million bank in the upper Midwest explained to me that his customers face challenges that larger banks unfamiliar with the area would not understand. The community served by his bank relies on timber and mining, both seasonal activities. As a result, cash flows for consumer and business customers vary throughout the year. He described a pattern of successful loans where the borrower had uneven income or other characteristics that would lead a person from outside the community to conclude that person was a poor credit risk. But, the banker continued, he knew those loans would be repaid. He knew the borrower's family. He saw the borrower every Sunday at church, in the grocery store, at Little League. Because of the community banker's individual confidence an individual borrower, that borrower had access to valuable credit. Large banks simply can't think that way – they are unable to profitably underwrite and structure loans for borrowers who don't fit the standard mold. But through relationship banking, through community banks, access to credit is more broadly available.

The other main characteristic of relationship banking is that it is based on *relationships*. Community banks operate in small geographic areas. They cannot afford to alienate their consumer base through predatory lending or poor customer service. They depend upon the good will of the community and repeat customers to continue in business. In other words, market forces are a powerful means of ensuring good behavior from smaller banks. Regulation that intends to do the same thing is duplicative and unnecessary.

Community banks hold approximately 14 percent of banking assets. But they play an outsized role in most categories of financial services that matter to individual consumers. Community banks provide 48.1 percent of small-business loans issued by U.S. banks, 15.7 percent of residential mortgage lending, 43.8 percent of lending secured by farmland, 42.8 percent of farm operations lending, and 34.7 percent of commercial real estate loans. In addition, they hold 20 percent of all retail deposits at U.S. banks.

Before I joined the faculty at Wake Forest, I practiced commercial real estate in Indianapolis for ten years. I know from the experience of representing my clients that when they had a smaller project, or a project outside of the heart of a highly dense metropolitan area, their main financial option was to go to a community bank. They simply would not be able to finance that project through an insurance company, a large financial institution, or the commercial mortgage backed securities (CMBS) market.

A "One Size Fits All" Regulatory Approach

The American system of banking regulation is a system of regulation by accretion – it is the result of legislative responses to particular crises, from the need to create a market for U.S. national bonds to help finance the Civil War, which led to the creation of national bank charters, the creation of the Federal Reserve after the monetary panic of 1907, the creation of the FDIC following the stock market crash of 1929, and Dodd-Frank after the 2007 financial crisis.

Each of these legislative efforts was a well-meaning attempt to deal with the perceived problems that led to each crisis. But the net effect of these policies is a federal regulatory system for banking that is fundamentally flawed and imposes unintended negative consequences on community banks, consumers, and the economy.

The major flaw of the federal banking regulatory system is that it treats a community bank with $165 million in assets, the median-sized American bank, as the same essential creature as JP Morgan Chase or Bank of America. A bank with $165 million in assets and a bank with $2 trillion in assets may both take deposits and make loans, but the similarities end there. Since the 1999 Gramm-Leach-Bliley Act, which reduced barriers between depository banks and investment banks, the gap between community banks and large, complex financial institutions has grown. It simply is not a principled policy choice to regulate them both under a "one size fits all" approach. It is an accident of history that we do so. Dodd-Frank continues the historical trend of regulating small, traditional banks and large, complex financial institutions under the same rubric and will have an impact on shaping the market in ways that I believe are counterproductive to the stated purposes of Dodd-Frank and which are against our common interests.

The Impact of Dodd-Frank

The narrative that emerged immediately after the 2007 financial crisis was that the regulatory framework for American banking was broken and that government intervention must fix it. Dodd-Frank is a massive and complicated piece of legislation with two main goals – (1) end the era of "too big to fail" without actually breaking up the largest financial institutions; and (2) strengthen consumer protection. It is my contention that the net effect of federal regulation on community banks undermines both key goals.

More fundamentally, the application of Dodd-Frank to community banks is misguided because community banks did not participate in the perceived sins that led to the financial crisis. They did not engage in subprime lending that was sold into residential mortgage backed securities (RMBS) – they originate loans and generally hold them on their books until repayment, which leads to much more conservative underwriting and an alignment of incentives. They did not participate in securitization activity. They do not participate in the derivatives market. Nonetheless, seven of the 16 titles of Dodd-Frank are anticipated to impact community banks. Two years after Dodd-Frank, it is remains unclear to what extent these provisions will impact community banks because of the Act's heavy reliance on agency rulemaking. As of July 1, 2013, one-third of the 398 rulemaking requirements in Dodd-Frank had been satisfied with finalized rules. Rules have been proposed to meet an additional one-third, and the remaining third have not been addressed.

The attached paper details the seven titles of Dodd-Frank that are expected to have an impact on community banks and the anticipated effect. There will be two meta-outcomes. First, the regulatory burdens of Dodd-Frank will further the recent trends of consolidation and merger in the American banking sector, leading to a higher concentration of assets in the mega-financial institutions that were the original target of Dodd-Frank. Second, the focus on standardization as a means of consumer protection will undermine the relationship banking model of community banks and make it more difficult for millions of Americans and small businesses to access credit. Neither of these outcomes will fulfill the purposes of Dodd-Frank or advance our common interests.

Compliance Costs and Consolidation

As a result of Dodd-Frank, community banks will incur significant compliance costs that will place them at a further competitive disadvantage to large banks. This is a cumulative cost that has arisen over time, with the accretion of federal regulation. The number of community banks will continue to shrink, through failure and merger, leading to increased consolidation and continued growth of the "too big to fail" institutions.

Community bankers have repeatedly expressed concern that Dodd-Frank will impose new and costly regulatory compliance burdens on community banks. Both the GAO and FDIC, in reports released in September 2012 and December 2012, respectively, concluded that it is impossible at this time to quantify the costs that community banks will incur as a result of Dodd-Frank. Anecdotal information, however, suggests that compliance costs at small banks have already significantly increased in recent years.

Although they are largely unable to quantify the expected costs, community banks are focused on the rules contemplated by Dodd-Frank, particularly with respect to the Basel III capital rules, data gathering and reporting mandated by the CFPB, and the qualified mortgage provisions. All of these provisions are complex, and the stakes for understanding and following them are high. The chief executive of a small North Carolina institution summarized the impact: "For a little bank like ours with 19 people, [it] could be a full-time job for somebody to make sure we comply with the provisions of [Dodd-Frank]."

The Bureau of Labor Statistics expects that Dodd-Frank will significantly increase the regulatory burden on banks. The "financial examiners" job category, which includes compliance officers, is projected to grow 27 percent from 2010 to 2020, faster than average for all occupations. But community banks, particularly small institutions located in rural areas, may have difficulty recruiting and retaining qualified personnel.

Although the regulatory costs associated with Dodd-Frank will annoy the large banks, they will constitute a blip on their balance sheets. These costs will have a far greater impact on community banks. Basic economic theory supports the presumption that smaller banks are disproportionately affected by the costs of regulatory compliance. Research on this point was conducted by Federal Reserve staff in 1998. That study found evidence that smaller banks are at a cost disadvantage compared to larger banks. That cost disadvantage will intensify with further investments in compliance staff, technology, lawyers, and consultants.

For some community banks, the regulatory burdens imposed by Dodd-Frank will be the straw that breaks the camel's back, forcing them out of business. This will further the trend toward "too big to fail" because it will lead to greater asset concentration in a smaller number of financial institutions. Over the past several decades, bank consolidation and asset concentration has increased dramatically in the American banking sector. Between 1982 and 2013, the number of commercial banks in the United States decreased by more than 57 percent. Both mergers and bank failures account for this decrease. Except in the years following the savings and loan crisis of the late 1980s and early 1990s, and the years since the financial crisis, bank failures have been relatively rare.

Failures and mergers both disproportionately impact smaller banks. The number of banks with assets of less than $100 million decreased by more than 80 percent from 1985 to 2010, while the number of banks with assets greater than $10 billion nearly tripled over the same period. Meanwhile, the concentration of capital in those large banks increased. A mere 7.6 percent of banks currently hold about 86 percent of all banking assets in the United States. There is anecdotal evidence that the cumulative regulatory burden imposed by Dodd-Frank is already exacerbating this problem by pushing community banks to pursue mergers.

Increased Standardization

The second impact of Dodd-Frank is on consumers. A recurring theme in Dodd-Frank, particularly with respect to the Consumer Financial Protection Bureau (CFPB), 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. One of the chief advantages of community banks is their ability to successfully lend to borrowers who do not have the deep credit history or documentation necessary for the model-based lending used by large financial institutions. The self-employed, seasonal workers, farmers, and people transitioning to work will be particularly at risk.

Financial institutions with assets of more than $100 billion constitute 0.3 percent of all U.S. financial institutions. Banks in this category are behemoths, employing thousands of workers in their complex organizational and operational structures. JPMorgan Chase alone has more than $2 trillion in assets under supervision. Large financial institutions play a valuable role in the American economy – through their size and influence, they can help facilitate economic activity on a large scale. But they don't do everything well. Financial activities that are fundamental to the average American, such as taking deposits, and making residential mortgages, small business loans, and farm loans, are only worth the time of a mega financial institution if they involve a completely standardized product and if the borrower is a completely standardized borrower. There is no negotiation of terms, there is little room for explanation for why a particular borrower has a unique profile. You either fit in the box or you don't. As a result, millions of Americans are left out of that box altogether. One in four American households are either "unbanked," meaning they lack a checking or savings account, or "underbanked," meaning they rely on alternative financial services like payday loans in addition to a traditional bank account. The unbanked and underbanked typically bear far higher costs than those fully served by banks and find it much more challenging to meaningfully participate in the economy.

If regulators push the entire financial services industry in lockstep towards standardization—of underwriting, financial products, and applications—then many small businesses and individuals currently served by the community bank model may be denied credit, joining the ranks of the unbanked or underbanked. In addition, because of their higher operating costs relative to larger banks based on economies of scale, if community banks become forced through standardization into small versions of large financial institutions, they will be at a severe competitive disadvantage. As a result, credit and banking services will be eliminated or become more expensive for small businesses, those living in rural communities, and millions of American consumers and businesses that are challenging or less profitable for large banks to serve.

Conclusion

The purpose of Dodd-Frank was to protect consumers and the stability of the financial system. Community banks provide vital services to millions of Americans, many of whom would be underserved if the community bank model were broken or if community banks abandon lines of service. If community banks are forced to merge, consolidate, or go out of business as a result of Dodd-Frank, one result will be an even greater concentration of assets on the books of the "too big to fail" banks. Another result will be that small businesses and individuals who do not fit neatly into standardized financial modeling or who live outside of metropolitan areas served by larger banks will find it more difficult to obtain credit. Neither of these outcomes will protect consumers, the financial system, or the recovery of the American economy.

More broadly, Dodd-Frank exacerbates the broken model of American financial regulation that fails to differentiate between small banks engaged in traditional relationship banking and modern, complex financial services firms. Meaningful reform of the financial regulatory system, reform that would actually reduce systemic risk and protect consumers, would establish a two-tiered regulatory framework. Community banks operating on the traditional model would be subject to less stringent regulation and examination. This is appropriate because the success of their business model depends on the quality of their underwriting and their long-term relationships with repeat customers. Freed of unnecessary regulatory burden, and allowed by examiners to engage in true relationship banking without fear of criticism, community banks would strengthen their ability to serve their customers. The largest financial institutions would be subject to regulations and examinations appropriate to their size, complexity, and role in the American economy. Staff of existing regulatory agencies could more appropriately and efficiently address the unique challenges that these large banks pose to the stability of the financial system if they could focus less on community banks.

As an intermediate step, key provisions of Dodd-Frank could be modified or repealed with respect to community banks. For example, loans originated and held in portfolio by community banks should be given safe harbor status under the "qualified mortgage" rules. The qualified mortgage regulations adopted by the CFPB are a perfect example of the kind of "check the box" standardization that will degrade the relationship banking model. The qualified mortgage rules are designed to prevent the reckless subprime lending that took place before the financial crisis by aligning underwriting and default risk. But again, community banks did not participate in that activity in the first place. If a community bank originates a loan and holds it in portfolio for the life of the loan, its underwriting and incentives are already aligned. Additional regulations are not only unnecessary, they will reduce the availability of credit to non-traditional, creditworthy borrowers who do not fit in the CFPB's box by penalizing the community banks which lend to them.

Two-thirds of the regulations contemplated by Dodd-Frank have not been finalized. That means that much remains to be settled, and there is still opportunity to reassert the value of community banks and to work to maintain the viability of the community banking model within the Dodd-Frank framework. But more meaningful reform consistent with the goals of Dodd-Frank and the best interests of the American consumer and American economy would ultimately require the implementation of a two-tiered regulatory system.

The Impact of Dodd-Frank on Community Banks

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Key Findings

- The purpose of the Dodd-Frank Act was to protect consumers and the stability of the financial system. Community banks provide vital services to millions of Americans, many of whom would be underserved if the community bank model were broken or if community banks were to abandon lines of service. If community banks are forced to merge, consolidate, or go out of business as a result of Dodd-Frank, one result will be an even greater concentration of assets on the books of the "too-big-to-fail" banks. Another result will be that small businesses and individuals who do not fit neatly into standardized financial modeling, or who live outside of metropolitan areas served by larger banks, will find it more difficult to obtain credit. Neither of these outcomes will protect consumers, the financial system, or the recovery of the American economy.
- Community banks play a vital role in this nation's economy, particularly with respect to small businesses and rural communities, and their continued health and vitality is central to the nation's economic recovery. Community banks provide 48.1 percent of small-business loans issued by US banks, 15.7 percent of residential mortgage lending, 43.8 percent of farmland lending, 42.8 percent of farm lending, and 34.7 percent of commercial real estate loans, and they held 20 percent of all retail deposits at US banks as of 2010.
- Community banks are a vital source of credit and banking services to rural communities. Community banks are four times more likely than large banks to have an office in rural counties. More than 1,200 US counties—with a combined population of 16 million Americans—would have severely limited banking access without community banks.
- Community banks were not responsible for the causes of the financial crisis determined by the authors of Dodd-Frank. Community banks did not engage in widespread subprime lending. They did not engage in securitization of subprime residential mortgages. Nor did they use derivatives to engage in risky speculation to maximize return. Community banks simply did not contribute to the financial crisis.
- Although policymakers enacted Dodd-Frank to avoid too-big-to-fail situations, in reality, its effect is the opposite. The act will force greater asset consolidation in fewer megabanks by increasing the competitive advantage large banks have over smaller banks.

- Dodd-Frank will make it harder for community bank customers to obtain loans because it encourages financial product standardization, which undermines the relationship banking model and decreases the diversity of consumer banking options. As a result, credit and banking services will be eliminated or become more expensive for small businesses, those living in rural communities, and millions of "informationally opaque" American consumers and businesses that are challenging or less profitable for large banks to serve.

The Impact of Dodd-Frank on Community Banks

In the summer of 2008, the collapse of the American residential real estate market pushed the world's economy off a cliff, and all Americans felt the pain. Unemployment rates rose. Residential foreclosure rates skyrocketed. Corporate investment plummeted. The credit markets seized. In the immediate aftermath, policymakers attempted to understand the causes of the financial crisis and quickly "fix" the economy.

In the narrative that emerged, greedy investors and banks, fueled by incentive structures that favored short-term gain over long-term stability, made risky investments and created exotic financial instruments that they failed to fully understand.[1] These risky activities ensnared Main Street America, according to the narrative, through subprime mortgage lending and subsequent securitization. When the subprime mortgage origination and securitization machinery collapsed, it dragged homeowners, investors, and originators down with it.[2]

The market confusion immediately following the failure of Lehman Brothers convinced policymakers that the high concentration of assets in a very small number of institutions, and their perceived interconnectedness, meant that the failure of one could set off a cascade of stress and failures throughout the American economy.[3] To prevent conflagration across the entire financial industry, the federal government and the American taxpayer stepped in to prop up these "systemically significant" institutions. While Main Street struggled, so the story goes, the Wall Street banks that created the crisis were deemed "too big to fail," lest their failure further exacerbate the crisis.

This financial crisis narrative—largely adopted by the Obama administration, the majority in the 111th Congress, and the Financial Crisis Inquiry Commission—convinced policymakers that the regulatory framework for American banking was broken and that only government intervention could fix it.[4] That intervention came in January 2010 when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[5] Sponsors explained that Dodd-Frank was designed to "address the numerous failures that led to the near collapse of our financial system."[6] Specifically, they highlighted the following Dodd-Frank regulations: (a) the creation of the Financial Stability Oversight Council to monitor potential threats to the financial system; (b) the provision of the orderly wind-down of systemically significant banks and avoidance of a repeat of too big to fail; (c) robust consumer protection reform through the creation of the Consumer Financial Protection Bureau; (d) increased transparency for the over-the-counter derivatives market, and (e) mortgage reform.

Drafters intended all of these policies to correct the perceived “inefficiencies and failures” in the financial system that led to the financial crisis.[7]

Financial institutions with assets of more than $100 billion constitute 0.3 percent of all US financial institutions. Banks in this category are behemoths, employing thousands of workers in their complex organizational and operational structures. JPMorgan Chase alone has $2.1 trillion in assets under supervision.[8] By contrast, the vast majority of the roughly 7,000 American banks are relatively small. The 5,000 members of the Independent Community Bankers of America collectively hold $1.2 trillion in assets. The median American bank has $165 million in assets and 39 employees.[9] Nearly 3,000 banks have fewer than 30 employees.[10]

Large financial institutions engage in a wide range of business lines, including affiliating with firms that underwrite and sell securities. Small banks, by contrast, remain focused on the traditional banking model—they accept deposits, reinvest those deposits in the community in the form of loans, and live off the spread in interest rates. Smaller banks, the so-called “community banks,” barely resemble their too-big-to-fail cousins. Yet, under our one-size-fits-all regulatory framework, they are subject to the same rules and procedures.

The authors of Dodd-Frank were correct that the framework for regulating American financial institutions is broken. However, by adding rules of wide-ranging application to a framework that treats all federally chartered banks the same, regardless of size or complexity, Dodd-Frank undermines its key goals.

Since Dodd-Frank was signed into law, various congressional committees and federal financial regulators have held hearings on its potential unintended consequences, particularly the possible impact on small financial institutions and small businesses. The testimony of Thomas Boyle, vice chairman of State Bank of Countryside (Countryside, Illinois) is typical:

> We strongly believe that our communities cannot reach their full potential without the local presence of a bank—a bank that understands the financial and credit needs of its citizens, business, and government. However, I am deeply concerned that this model will collapse under the massive weight of new rules and regulations. . . . Banks are working every day to make credit and financial services available. Those efforts, however, are made more difficult by regulatory costs and second-guessing by bank examiners. Combined with the hundreds of new regulations expected from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional community banks, handicapping our ability to meet the credit needs of our communities. The consequences are real. Costs are rising, access to capital is limited, and revenue sources have been severely cut. It means that fewer loans get made. It means a weaker economy. It means slower job growth.[11]

Small-bank representatives like Boyle have offered consistent testimony reflecting three themes. First, community banks play a vital role in this nation's economy, particularly with respect to small businesses and rural communities, and their continued health and vitality is central to the nation's economic recovery. Second, community banks played no role in causing the financial crisis. They did not engage in subprime residential lending, package and sell securitized mortgages, or participate in the opaque and risky derivatives markets. Third, while Dodd-Frank makes an effort to roughly distinguish between banks on the basis of size, excluding financial institutions with assets of less than $10 billion from some rules, it will still significantly affect community banks. Dodd-Frank is a massive and complicated piece of legislation—16 titles and 838 pages—the consequences of which will not be known for years because it relies so heavily on rule making by regulatory agencies.

At least one leader of a "systemically important" financial institution has acknowledged that the costs of complying with Dodd-Frank will increase the competitive advantage of large banks to the detriment of community banks. Jamie Dimon has estimated that the cost for JPMorgan Chase to comply with Dodd-Frank will be "close to $3 billion" over the next few years.[12] However, in a February 2013 note to clients, Citi financial services analyst Keith Horowitz described a conversation with Dimon regarding the impact of new regulations on the financial services sector:

> [Dimon] . . . pointed out that while margins may come down, market share [for JP Morgan] may increase due to a 'bigger moat.' . . . In Dimon's eyes, higher capital rules, Volcker, and OTC derivative reforms longer-term make it more expensive and tend to make it tougher for smaller players to enter the market, effectively widening JPM's 'moat.' While there will be some drags on profitability—as prices and margins narrow, efficient scale players like JPM should eventually be able to gain market share.[13]

As Dimon acknowledged, Dodd-Frank has the potential to have a very costly and unnecessary impact on community banks, threatening their ability to compete and hastening the pace of mergers and acquisitions. As a result of this competitive disadvantage, rather than strengthening the safety and soundness of the American financial system and protecting consumers, Dodd-Frank may ultimately create several new problems for the American economy.

First, Dodd-Frank furthers the trend toward too big to fail because it will lead to greater asset concentration in a smaller number of financial institutions. For the past several decades, bank consolidation and asset concentration has increased dramatically in the American banking sector. From 1982 to September 30, 2012, the number of commercial banks in the United States decreased by 57 percent.[14] Both mergers and bank failures account for this decrease. Except in the years following the savings and loan crisis of the late 1980s and early 1990s and the years since the financial crisis, bank failures have been relatively rare (table 1).

Table 1. Number of Bank Failures, 2002–12

Year	**Failure of Banks with Assets under $250 Million**	**Failure of Banks with Assets over $1 Billion**	**Total Bank Failures**
2002	8	1	9
2003	2	0	3
2004	4	0	4
2005	0	0	0
2006	0	0	0
2007	2	1	3
2008	8	9	25
2009	62	30	140
2010	76	23	157
2011	58	7	92
2012	35	1	51
Total	**255**	**72**	**484**

Source: Federal Deposit Insurance Corporation Failed Bank List, www.fdic.gov/bank/individual/failed/banklist.html.

Between 2002 and 2012, approximately 1,700 commercial banks disappeared. Failures account for less than 500 of that total. The remainder was lost to mergers. Since 1990, 6.5 mergers have occurred for every bank failure.[15]

Both failures and mergers disproportionately impact smaller banks. The number of banks with assets of less than $100 million decreased by more than 80 percent from 1985 to 2010, while the number of banks with assets greater than $10 billion nearly tripled over the same period.[16] Meanwhile, the concentration of capital in those large banks increased. A mere 7.6 percent of banks currently hold about 86 percent of all banking assets in the United States.[17]

The cumulative regulatory burden imposed by Dodd-Frank will exacerbate this problem. For example, in September 2012, Shelter Financial Bank, a $200 million community bank in Columbia, Missouri, was closed by its owners because they anticipated that Dodd-Frank would add $1 million per year to the bank’s expenses. “It was going to cost more than what we got out of the bank,” one bank official explained.[18] At the same time, the pace of mergers affecting small banks has increased. As one observer explained, “The smallest banks very much realize that the deck is stacked against them because their ability to earn reasonable rates of return is impaired and that is a permanent impairment." The former president of Western Reserve Bank in Medina, Ohio, a $190 million community bank that sold itself to a larger bank in 2012, explained his decision: "I don't run a bank anymore. I run around trying to react to regulation and frankly, that's no fun."[19] So although policymakers enacted Dodd-Frank to avoid too-big-to-fail situations, in reality, the effect is the opposite. The act will force greater asset consolidation in fewer megabanks by increasing the competitive advantage large banks have over smaller ones.

Second, Dodd-Frank will make it harder on community bank customers to obtain loans because it encourages financial product standardization, which undermines the relationship-banking model and decreases the diversity of consumer banking options. As a result, credit and banking services will be eliminated or become more expensive for small businesses, those living in rural communities, and millions of American consumers and businesses that are challenging or less profitable for large banks to serve.

This paper will examine the role of community banking in the American economy and analyze the unintended impacts of Dodd-Frank on community banks. We begin by defining community banks and placing them in the broader context of the American financial sector. We then turn to a discussion of the role that community banks play in the economy, particularly with respect to small-business, farm, and commercial real estate lending and focusing on rural communities underserved by larger financial institutions. Next, we demonstrate that community banks did not participate in subprime lending, securitization, or derivatives trading, which the authors of Dodd-Frank assert were the primary causes of the financial crisis. We conclude the first part of the paper by examining several challenges currently facing community banks.

We then turn to the act, analyzing its approach to "correcting" the "inefficiencies and failures" of the financial system; specifically, its heavy reliance on rule making by federal agencies and the broad discretion it grants those agencies. We delineate the major categories of Dodd-Frank that may impact community banks. Within those categories, we identify and explain specific sections relevant to community banks. Finally, we conclude by identifying the two chief risks that Dodd-Frank poses for community banks. First is the lingering uncertainty about the act's impact on community bank income and expenses. Second is the act's endorsement of standardization in the name of consumer protection, a trend that undermines the community banking model and could ultimately harm consumers by limiting their access to financial services.

Who Are the Community Banks?

The term “community bank” is used generally to describe medium and small banking organizations located in and focused on limited geographic areas and that engage in traditional banking activities while obtaining most of their funding from local deposits.[20] We use the term broadly because no set definition exists for a community bank. Even government regulators fail to agree on a common definition.

Among the banking industry’s three primary federal regulators—the Federal Reserve, the Office of the Comptroller of the Currency (the OCC), and the Federal Deposit Insurance Company (the FDIC)—no single regulatory definition for “community bank” exists. The Federal Reserve defines community banks to include institutions with $10 billion or less in total assets.[21] The OCC says community banks are banking organizations with less than $1 billion in total assets.[22] And the FDIC formerly defined community banks as banking organizations with less than $1 billion in assets[23] but recently revised its definition by moving to a more inclusive, multicriteria approach.[24]

Although there are many different definitions of “community bank,” the current FDIC test, or some derivative thereof, most thoroughly encompasses the factors that make a community bank. The revised FDIC definition uses a five-step “research definition” process.[25] The steps, briefly, include aggregating charter-level organizations into their larger bank holding company parent organizations; excluding specialty banks; including larger organizations engaged in basic banking activities; including organizations operating in limited geographic areas; and, finally, including an asset size threshold as a catchall.[26] The net effect of this new definition is that certain institutions with more than $1 billion in assets—that formerly failed to meet the community bank definition—are now designated as community banks because each meets the banking activity and geographic area tests.[27] For purposes of this paper, we follow a method similar to the FDIC’s revised definition.[28]

Analytically, it is also helpful to think about community banks by analyzing the financial services they offer and their organizational structures. By and large, community banks offer simple financial services, operate in limited geographic areas, and are often located in rural areas. For example, 82 percent of community banks operated within three or fewer counties in 2011, while 37 percent of noncommunity banks operated within three or fewer counties.[29] Community banks are often found in small towns and sparsely populated regions, making up more than 70 percent of banking offices in rural areas.[30] Community banks are also more likely than noncommunity banks to locate their headquarters in a nonmetro area (47 versus 17 percent) and almost three times more likely than noncommunity banks to locate offices in nonmetro areas (38 versus 13 percent).[31]

The populations primarily served by community banks would be significantly disadvantaged if those banks were absorbed into larger institutions or went out of business entirely. Approximately 17 million adult Americans are “unbanked,” lacking a checking or savings account. Additionally, 20 percent of American households are “underbanked,” meaning they rely on alternative financial services like payday loans in addition to a traditional bank account.[32] The unbanked and underbanked typically bear far higher costs than those fully served by banks and may find it much more challenging to fully participate in the economy.

In addition to benefiting economically fragile populations, the relationship banking model benefits the stability of the American economic system in two main ways. First, relationship banking supports the safety and soundness of community banks because community banks experience fewer credit losses than their noncommunity counterparts.[33] Second, the relationship banking model relies on repeat business within a limited population, which provides a strong economic disincentive to predatory lending and other practices that exploit consumers.

As George Hansard, president and CEO of the Pecos County State Bank in Fort Stockton, Texas, a $150 million community bank, explained: “Community banks have no desire to make bad loans. Bad loans not only impact the bank’s bottom line, but they also negatively impact the banker’s job, the community, and are also negative to a borrower. And a bad loan makes a good customer a bad customer.”[34] Federal Reserve Chairman Ben Bernanke expressed a similar sentiment, commenting, “One element that has kept the traditional model alive for so long is that community banks know their customers—and likewise, their customers know them—which I believe fosters greater customer loyalty.”[35]

Community banks make up the vast majority of US banks. As of December 31, 2010, community banks constituted 92.4 percent of chartered banking organizations in the United States.[36] That is—more than 9 out of 10 US banks are community banks. Although numerically dominant, community banks hold only 14.2 percent of all banking institution assets, or $1.42 out of every $10.00.[37] The juxtaposition of banking presence to assets means that 7.6 percent of banks—those with $1 billion or more in assets—hold 85.8 percent of all banking assets in the United States (table 2).[38]

Table 2. Distribution of Banking Organizations by Type of Bank

Type of Banking Organization	Number of Banks	Percentage of Total Banks	Assets ($ in 000s)	Percentage of Total Bank Assets
Community Bank	6,798	92.4%	1,971,883,240	14.2%
Noncommunity Bank	558	7.6%	11,920,361,536	85.8%
Total	**7,356**	**100.0%**	**13,892,244,776**	**100.0%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Because there is a vast difference between a bank holding $100 million and one holding $1 billion, community banks are commonly broken out by size according to assets. The largest portion of the community banking industry is composed of institutions with assets between $100 million and $1 billion—midsize community banks. These banks make up over half of all banks. As table 3 depicts, the community bank peer group includes 2,357 institutions with less than $100 million in assets, 4,112 with assets between $100 million and $1 billion, and 329 with assets greater than $1 billion.[39]

Table 3. Distribution of Community Banks by Size

Size of Community Bank	Number of Community Banks	Percentage of All Banks	Assets ($ in 000s)	Percentage of Total Bank Assets
< $100M	2,357	32.0%	136,211,766	1.0%
$100M to $500M	3,480	47.3%	774,980,975	5.6%
$500M to $1B	632	8.6%	433,930,335	3.1%
>$1B	329	4.5%	626,760,164	4.5%
Total	**6,798**	**92.4%**	**1,971,883,240**	**14.2%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Why Community Banks Matter in the US Economy

After we define what a community bank is, the question remains as to why they are important in the broader context of the American financial sector. Simply, the answer is that community banks provide significant portions of total US banking activity and give banking access to many Americans that otherwise would have no bank.

Marty Reinhart, the president of Heritage Bank in Spencer, Wisconsin, a $100 million bank formed in 1908, summarized the community banking model:

> Community banks . . . serve rural, small town, and suburban customers and markets that are not comprehensively served by large banks. Our business is based on longstanding relationships in the communities in which we live. We make loans often passed over by the large banks because a community banker's personal knowledge of the community and the borrower provides firsthand insight into the true credit quality of a loan, in stark contrast to the statistical models used by large banks located in other states and regions. These localized credit decisions, made one-by-one by thousands of community bankers, support small businesses, economic growth, and job creation.[40]

As Reinhart's testimony explains, community banks engage in so-called "traditional" banking activities, such as retail banking, taking deposits, making loans, and other simple financial services. Because their banking activities are directed toward small businesses, farmers, and consumers, community banks are considered "relationship" banks.[41] Community banks use personal knowledge of a customer's financial situation and local business conditions to make lending decisions.[42]

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. Recipients of these loans are often called "informationally opaque" borrowers.[43] For example, the president of a $250 million bank in the upper Midwest explained that his customers face challenges that larger banks unfamiliar with the area would not understand.[44] The community served by his bank relies on timber and mining, both seasonal activities. As a result, cash flows for both consumer and business customers vary throughout the year. The community bank understands this local reality and is able to successfully underwrite and structure loans for borrowers who would be unlikely to obtain credit from large banks.

In terms of financial services, community banks provide 48.1 percent of small-business loans issued by US banks, 15.7 percent of residential mortgage lending, 43.8 percent of farmland lending, 42.8 percent of farm lending, and 34.7 percent of commercial real estate loans, and they held 20 percent of all retail deposits at US banks as of 2010.[45] Meanwhile, community banks provide financial services to sectors of the American economy—particularly rural areas—that would otherwise go underserved. Community banks operate in 1,200 US counties with no other bank. Community banks are the only financial service providers available to more than one-third of American counties.[46]

Analyzing the relative significance of community banks in these two important areas is essential to understanding why community banks matter in the US economy. In the following sections, we explore each area of significance in more detail.

Financial Services

Small-Business Lending. Small businesses drive the American economy. As of 2010, small businesses accounted for 46 percent of private, nonfarm gross domestic product (GDP), meaning that they generated almost half of all production in the United States.[47] Small businesses also provide half of all employment in the United States and 42 percent of total US payroll spending.[48] Policymakers on both sides of the aisle agree that small businesses are the "engine of job creation in America" and, therefore, are vital to the economic recovery.[49]

Small businesses depend on community banks for basic financial services and for the credit to fuel their investment and job-creation efforts. Community banks provide banking services to small businesses—such as deposit taking, checking accounts, and payroll services—while also functioning as a funding source for working capital, expansion loans, and even start-up costs. [50]

At year-end 2010, US banks had $334.2 billion in outstanding loans to small businesses.[51] Small-business loans are defined as loans secured by nonfarm, nonresidential properties with original amounts of $1 million or less.[52] At the end of 2010, community banks held $160 billion in small-business loans on their books, representing 48.1 percent of total outstanding small-business loans (table 4). In other words, $1 out of every $2 lent to small businesses comes from community banks. Based on these numbers, if roughly half of US GDP comes from small businesses and half of small businesses have loans outstanding to community banks, then community banks fund the production of at least a quarter of US GDP, an extremely significant portion.

Table 4. Distribution of Small-Business Lending by Type of Bank

Type of Banking Organization	**Small-Business Loans Outstanding ($ in 000s)**	**Percentage of All Small-Business Lending**
Community Bank	$160,923,062	48.2%
Noncommunity Bank	173,290,081	51.8%
Total	**334,213,143**	**100.0%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Unsurprisingly, small-business lending by community banks follows the same distribution as bank size (table 5). Among community banks, the midsize banks—those with assets between $100 million and $500 million—provided the highest percentage of small-business loans at 22.8 percent of all small-business loans, likely reflecting their 47.3 percent share of all US banking organizations.

Table 5. Distribution of Small Business Lending by Community Banks

Size of Community Bank	Small-Business Loans Outstanding ($ in 000s)	Percentage of All Small-Business Lending
< $100M	$12,210,155	3.7%
$100M to $500M	76,105,672	22.8%
$500M to $1B	35,777,574	10.7%
>$1B	36,829,661	11.0%
Total	**$160,923,062**	**48.2%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Residential Mortgage Lending. Homeownership is an essential element of the American dream and a vital part of the American economy. The US government has encouraged homeownership for decades through various economic and tax policies.[53] The prevailing policy theory is that homeownership creates more stable neighborhoods, better environments for children, and less crime because homeowners are more protective, more involved in their communities, and more familiar with their neighbors than renters. On a personal level, homeownership is a primary way for individuals to build wealth. According to the Federal Reserve, homes constitute 32 percent of total family assets, establishing a borrowing base and an appreciable asset.[54]

Few individuals are able to purchase a home without obtaining a mortgage loan. Only 11 percent of home purchases are all-cash by noninvestor purchasers—meaning that about 9 out of 10 homeowners require a mortgage to purchase their house.[55] Clearly, the availability of residential mortgage loans is essential to widespread homeownership in America.

At year-end 2010, US banks held $2.5 trillion in residential mortgage loans (table 6). Out of this total, community banks held $398 billion, or about 15.7 percent. As we will discuss, community banks also provide residential mortgage loan services to customers in rural and underserved areas that would otherwise have limited access to a home loan—an unquantifiable yet valuable contribution to the economy.

Table 6. Distribution of Residential Mortgage Lending by Type of Bank

Type of Banking Organization	Residential Mortgage Loans Outstanding ($ in 000s)	Percentage of all Residential Mortgage Lending
Community Bank	$398,168,438	15.7%
Noncommunity Bank	2,138,394,700	84.3%
Total	**2,536,563,138**	**100.0%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Table 7 depicts the relative shares of total US residential mortgage loans by community bank size. Of note, the small share of loans held by community banks with less than $100 million in assets likely reflects the fact that community banks hold residential mortgage loans, rather than using securitization to move them off their books. As a result, a small community bank would be less likely to tie up its balance sheet in residential mortgage loans, since only a relatively small number of loans might be too risky based on the assets held by the community bank.

Table 7. Distribution of Residential Mortgage Lending by Community Banks

Size of Community Bank	Residential Mortgage Loans Outstanding	Percentage of all Residential Mortgage Loans Outstanding
< $100M	26,254,022	1.04%
$100M to $500M	158,631,362	6.25%
$500M to $1B	90,634,573	3.57%
>$1B	122,648,481	4.84%
Total	**398,168,438**	**15.7%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Farm and Farmland Lending. Farming added almost 1.0 percent to US GDP in 2010.[56] American farms produced $132.6 billion of economic value in 2010, about the same as the oil and gas industry or twice that of the automobile industry.[57] Farms also provide an additional economic impact through the downstream marketing services required to get the food to market. According to the US Department of Agriculture, farmers receive only 14 cents of each dollar spent on domestically produced food by US consumers.[58] This means that the other 86 percent of each dollar goes to processing, retail, and food services businesses equaling another $985 billion for which farms are responsible. That is almost a trillion dollars of economic value directly attributable to farming.

Aside from farming's economic impact, it has an obvious and direct effect on Americans' everyday lives. American families rely heavily on US farms as a food source. As of 2009, 83 percent of food consumed in the United States was produced domestically.[59]

It is safe to say that without community banks, farming would face many more difficulties than just droughts and early freezes. Farms rely on community banks as sources of both short-term credit for crop production and long-term capital funding. Indeed, community banks provide $2 out of every $5 of credit used to finance agricultural production or purchase farmland. As of year-end 2010, all US banks held $59.3 billion in farm loans and $67.9 billion in farmland loans. Of this total, community banks held $25.4 billion of farm loans and $29.8 billion of farmland loans.

"Farm loans" are defined as loans made for the purposes of financing agricultural production and, in this paper, represents all outstanding farm loans with original amounts less than $500,000 as of December 31, 2010.[60] "Farmland loans," meanwhile, include all outstanding loans secured by farmland with original amounts less than $500,000 as of December 31, 2010.[61]

Consistent with their overwhelming banking presence in rural areas, community banks hold a vastly disproportionate share of all farm lending with 42.8 percent of farm loans and 43.8 percent of farmland loans (table 8). More notable, however, is how disproportionately large farm and farmland lending is when compared to assets held by the lending institution. Community banks hold only 14 percent of total bank assets but provide more than 40 percent of farm lending.

Table 8. Distribution of Farm and Farmland Lending by Type of Bank

Type of Banking Organization	**Farmland Loans Outstanding**	**Percentage of All Farmland Loans Outstanding**	**Farm Loans Outstanding**	**Percentage of All Farm Loans Outstanding**
Community Bank	29,800,374	43.8%	25,400,290	42.8%
Noncommunity Bank	38,179,839	56.2%	33,927,474	57.2%
Total	**67,980,213**	**100%**	**59,327,764**	**100%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Table 9 depicts the relative and total shares of farm loans and farmland loans by community bank size. Midsize community banks were the largest contributors to community bank farm lending in 2010, accounting for 22.1 percent of total farm loans and 23.4 percent of total farmland loans in the United States. The smallest community banks—those with assets less than $100 million—were the second-largest contributors to community bank farm lending. Small community banks' disproportionate share of farmland and farm lending suggests that they are particularly adept at serving the needs of farming families and are likely the only banking services available to farm families.

Table 9. Distribution of Farm and Farmland Lending by Size of Community Bank

Size of Community Bank	Farmland Loans Outstanding	Percentage of All Farmland Loans Outstanding	Farm Loans Outstanding	Percentage of All Farm Loans Outstanding
< $100M	$6,373,957	17.2%	$6,624,563	20.9%
$100M to $500M	15,935,737	23.4%	13,108,263	22.1%
$500M to $1B	4,156,777	11.2%	3,072,375	9.7%
>$1B	3,333,903	9.0%	2,595,089	8.2%
Total	**29,800,374**	**43.8%**	**25,400,290**	**42.8%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Lack of substitutes for the banking services provided to rural areas further emphasizes the important role of community banks in farm lending.[62] With less than a 30 percent share of banking offices in rural areas, larger banks tend to be more geographically distant from farming operations.[63] As a result, large banks incur more monitoring costs when lending to smaller borrowers such as farms and rural small businesses. Because farm loans do not cost larger banks more, the banks are less willing to extend credit. Consequently, no evidence exists that larger banks would be willing or able to substitute for the local farm lending practiced by smaller community banks.

Commercial Real Estate Lending. At year-end 2010, US banks carried $1.07 trillion in commercial real estate (CRE) loans on their books (table 10).[64] Commercial real estate includes nonresidential property types such as offices, retail shopping centers, industrial and warehouse buildings, and multifamily residential properties. Community banks held $371 billion, or 34.7 percent of those loans.[65]

Table 10. Distribution of Commercial Real Estate Lending by Type of Bank

Type of Banking Organization	CRE Loans Outstanding ($ in 000s)	Percentage of All CRE Lending
Community Bank	$371,976,173	34.8%
Noncommunity Bank	701,217,992	65.2%
Total	**1,073,194,165**	**100.0%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

The composition of loan portfolios held by community banks has changed significantly over the past quarter decade. Nearly 80 percent of loans on the books of community banks in 2011 were secured by real estate.[66] But the emphasis on loans secured by CRE, as opposed to residential real estate, has steadily and significantly increased. In 1984, residential real estate loans represented 61 percent of all loans at community banks. By 2011, that had dropped to 36 percent, reflecting the dominance of larger banks and their securitization pipelines in the residential real estate lending market. As community banks moved out of the residential real estate business, they began making more loans secured by commercial real estate. From 1984 to 2011, commercial real estate loans increased from 21 percent of community bank loan portfolios to 42 percent.[67] It is important to note that not all loans secured by commercial real estate are for the acquisition or development of commercial real estate assets like office buildings, shopping centers, or residential subdivisions. Many business loans are at least partially secured by a mortgage on the real estate owned by that business.

Community banks are the primary, and often the only, lenders willing to finance CRE acquisition and development projects and properties in tertiary markets and rural areas. The other major providers of credit to CRE borrowers—life insurance companies, commercial mortgage backed securities lenders, and private investors—are focused almost exclusively on large, high-quality properties in the most densely populated regions. But small CRE properties make up the lion's share of US CRE, and they are primarily financed by community banks.[68]

In 2010, the CRE sector contributed 2.6 percent to US GDP, primarily through construction spending.[69] Through CRE lending, community banks directly provided credit for the production of 0.90 percent of US GDP in 2010. However, this number significantly understates the importance of CRE lending to the American economy.

First, it is important to remember that CRE has not fully recovered from the financial crisis and that CRE lending levels in 2010 were lower than they were in the first five years of the century. Second, the kind of CRE that community banks support with credit is integral to the success of small businesses. From the perspective of tenants, the commercial real estate sector is a financing mechanism of equal importance to a line of credit.[70] Businesses that choose to lease their real estate have the flexibility to employ capital to buy equipment or fund payroll. If the CRE sector did not exist, many small businesses that could not afford to purchase their own buildings would also not exist.

Like other financial services, community banks provide a disproportionately large amount of CRE loans to assets. While holding only 14 percent of assets, community banks provide 34 percent of commercial real estate loans. Table 11 breaks out CRE lending by community bank size. Notably, smaller community banks—those with less than $100 million in assets—provide only 1.5 percent of all CRE loans. This small share likely reflects the fact that many CRE projects tend to require larger credit extensions that would be riskier for smaller banks, as well as the location of many small banks in rural communities where the majority of local economic activity would be captured in farm and farmland lending.

Table 11. Distribution of Commercial Real Estate Lending by Community Banks

Size of Community Bank	**CRE Loans Outstanding ($ in 000s)**	**Percentage of All CRE Lending**
< $100M	$16,148,387	1.5%
$100M to $500M	144,792,665	13.5%
$500M to $1B	90,496,862	8.4%
>$1B	120,538,259	11.2%
Total	**371,976,173**	**34.8%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Retail Deposit Services. Retail deposit services are fundamentally important to the economy on several levels. First, consumers and small businesses use deposit accounts to manage cash. Second, banks need deposits because deposits are low-cost, reliable sources of capital that generate strong fee income.[71] By virtue of their emphasis on relationship banking, community banks are large providers of retail deposit services.

Retail deposits include transaction accounts, such as checking accounts, and nontransaction accounts like savings accounts and CDs. Here, retail deposits serve as a proxy for overall banking services because checking accounts are closely related to total retail banking activity.[72] Where providing credit and loans is the core retail banking activity on the asset side of a bank balance sheet, deposit taking is the core activity on the liability side of the balance sheet.[73]

At year-end 2010, US banks held $6.98 trillion in retail deposits.[74] At the same time, community banks held $1.4 trillion in retail deposits, representing a 20 percent share (table 12). The fact that one in five deposited dollars is held by a community bank illustrates why community banks are important in the broader economy.

Table 12. Distribution of Retail Deposits Held by Type of Bank

Type of Banking Organization	**Retail Deposits Held ($ in 000s)**	**Percentage of All Retail Deposits Held**
Community Bank	1,404,138,220	20.11%
Noncommunity Bank	5,577,320,183	79.89%
Total	**6,981,458,403**	**100.0%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

A second area of importance is retail deposit taking in rural areas, where customers have fewer banking options. As noted previously, community banks play an outsized role in nonmetropolitan areas, helping explain their 70 percent deposit share in rural areas.[75] Again, although community banks hold only 14 percent of total banking assets, they provide valuable, and potentially irreplaceable, services to many Americans, particularly those in rural areas.

As shown in table 13, the share of deposits among community banks largely follows bank size, with midsize community banks holding the largest share of deposits and small community banks holding the smallest.

Table 13. Distribution of Retail Deposits Held by Community Banks

Size of Community Bank	Retail Deposits Held ($ in 000s)	Percentage of All Retail Deposits Held
< $100M	$104,451,725	1.50%
$100M to $500M	566,505,636	8.11%
$500M to $1B	303,698,605	4.35%
>$1B	429,482,254	6.15%
Total	**1,404,138,220**	**20.11%**

Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Community banks are more focused than larger banks on core financial services, demonstrated in their disproportionate involvement in key activities. As we have discussed, community banks hold only 14.2 percent of total bank assets, but they provide 48.1 percent of small business lending, 43.8 percent of farm loans, 42.8 percent of farmland loans, 34.7 percent of commercial real estate lending, and 15.7 percent of residential mortgage loans and hold 20.1 percent of retail deposits. And as the following discussion of their geographic scope makes clear, many of these services are provided to borrowers and depositors who would otherwise find it difficult to avail themselves of credit or banking services.

Geographic Scope

One of the most important ways that community banks contribute to the American economy is serving rural areas that would otherwise go without banking access.[76] Rural areas contribute significantly to the American economy. Counties with fewer than 10,000 in population contribute 4.4 percent of US real economic output, while counties with populations between 10,000 and 50,000 contribute another 7.9 percent. Combined, these nonmetropolitan areas contribute over 12 percent of US economic activity.[77] These rural—and productive—areas also depend highly on community banks to provide credit and other necessary financial services.

Studies show that community banks are four times more likely than large banks to have an office in rural counties.[78] As a result, banking consumers in rural areas are four times more likely to use a community bank office than a branch of a large bank.

In a broader perspective, community banks serve more than a third of US counties that would otherwise go underserved. More than 1,200 US counties—with a combined population of 16 million Americans—would have severely limited banking access without community banks.[79]

In 2010, 629 US counties had no banking institution office other than a community bank.[80] Consumers in those counties would have no banking access were it not for community banks. Finally, noncommunity banks operated three or fewer offices in another 639 US counties.[81]

Comparing community bank share of all branches by state with state population density rankings makes a similar point (table 14). As summarized in table 14, the average community bank share of all branches in the 10 most population-dense states is 31 percent.[82] That is, 3 of every 10 bank branches in the densest states are community banks. By contrast, the average share for community banks in the 10 least population-dense states is 47 percent—a full 57 percent higher than in the 10 most dense states. As a result, a consumer seeking banking services in one of the least population-dense states is one and half times more likely to use a community bank than a noncommunity bank.

Table 14. Community Bank Share of Branches Operating as of the Second Quarter of 2010

The 10 Least Population-Dense States		**The 10 Most Population-Dense States**	
State	**Community Bank Share of Branches**	**State**	**Community Bank Share of Branches**
Utah	20%	New Jersey	28%
Nevada	8%	Rhode Island	33%
Nebraska	66%	Massachusetts	45%
Idaho	29%	Connecticut	30%
New Mexico	50%	Maryland	45%
South Dakota	69%	Delaware	31%
North Dakota	81%	New York	21%
Montana	55%	Florida	21%
Wyoming	46%	Pennsylvania	33%
Alaska	49%	Ohio	27%
Average	**47%**	**Average**	**31%**

Source: FDIC Community Banking Research Project, *Community Banking by the Numbers*, February 16, 2012, www.fdic.gov/news/conferences/communitybanking/community_banking_by_the_numbers_clean.pdf.

As the preceding evidence shows, community banks are vital to the American economy both because of the large percentage of financial services they provide, and because they are often the only banks available to a third of US counties.

Community Banks and the Financial Crisis

Congress enacted Dodd-Frank on January 5, 2010, and President Obama signed it into law on July 21, 2010.[83] Passed during the worst economic recession since the Great Depression, the legislation was intended to remedy problems in the financial services sector that the Democratic majority in Congress believed caused the financial crisis. Compelling evidence exists that community banks[84] did not participate in subprime lending, securitization, or derivatives trading—three of the primary causes of the financial crisis according to the authors of Dodd-Frank.[85] Many provisions of the act, however, apply to both large financial institutions and community banks. In this section, we present evidence showing that community banks did not participate in the perceived causes of the financial crisis.

Subprime Lending

Community banks participate significantly in the US residential mortgage market because of their role as relationship bankers. At the end of 2010, community banks held about 15 percent of loans secured by single-family residences—about the same proportion as they held of total banking assets. For many customers, obtaining a mortgage loan is a financial service sought from the provider of the customers' other banking needs. For example, if a customer has checking and money market accounts at Small Town Community Bank, then that customer is most likely to look first at Small Town Community Bank for a mortgage loan because she is most comfortable with that bank and the bankers at Small Town Community Bank understand her personal financial circumstances. Because of this personal familiarity, a small informationally opaque borrower may also be more likely to get a loan from a small community bank than from a large data-driven lender.

Much of recent US economic policy has promoted homeownership as a method for Americans to build wealth. Entire ancillary, and heretofore nonexistent, industries have sprung up around the housing market as a result. To get as many US consumers into homes as possible, some mortgage originators used innovative and risky loan arrangements, as we will discuss. Policymakers, however, envisioned homeownership through responsible mortgage lending, rather than the type of risky lending—that is, subprime lending—that led to the financial crisis. Prior to the housing bubble, much of mortgage banking was performed similar to the way community banks practice relationship banking. That is, lenders wanted to know their customer, know their creditworthiness, and ensure that mortgages held on the lender's books would not default. By contrast, because of a disconnect between incentives and consequences, subprime mortgage originators were more focused on short-term results, including earning fees and feeding the mortgage securitization pipeline.

The authors of Dodd-Frank cited residential subprime mortgage lending as a precipitating cause of the financial crisis.[86] Although there is no official definition of a subprime loan, it is usually understood to be a mortgage loan made to a borrower with a poor or limited credit history. Popular references to "subprime lending" also include Alt-A loans. These loans are generally made to borrowers with strong credit scores but who have other characteristics that make the loans riskier. For example, the lender may have no or limited documentation of a borrower's income, there may be a high loan-to-value ratio, or the secured property may be for investment rather than a primary residence.

Alt-A loans were once a modest percentage of the residential mortgage market, often used by people who were self-employed. Because subprime and Alt-A loans are riskier to lenders than prime loans—those made to borrowers with strong credit scores and few risk factors—the market permits lenders to charge higher interest rates and fees on subprime and Alt-A loans.

In 1990, subprime loans totaled $37 billion, or 9 percent of residential mortgage originations. As home values increased and interest rates dropped, the pace of residential lending exploded. At the peak of the market in 2005, subprime loans totaled $625 billion, or 25 percent of all residential mortgage originations. In 2006, Alt-A and subprime loans combined to constitute 40 percent of all origination activity. This origination volume was made possible because the vast majority of these loans were pooled into mortgage-backed securities (MBS) and repooled into collateralized debt obligations (CDOs).

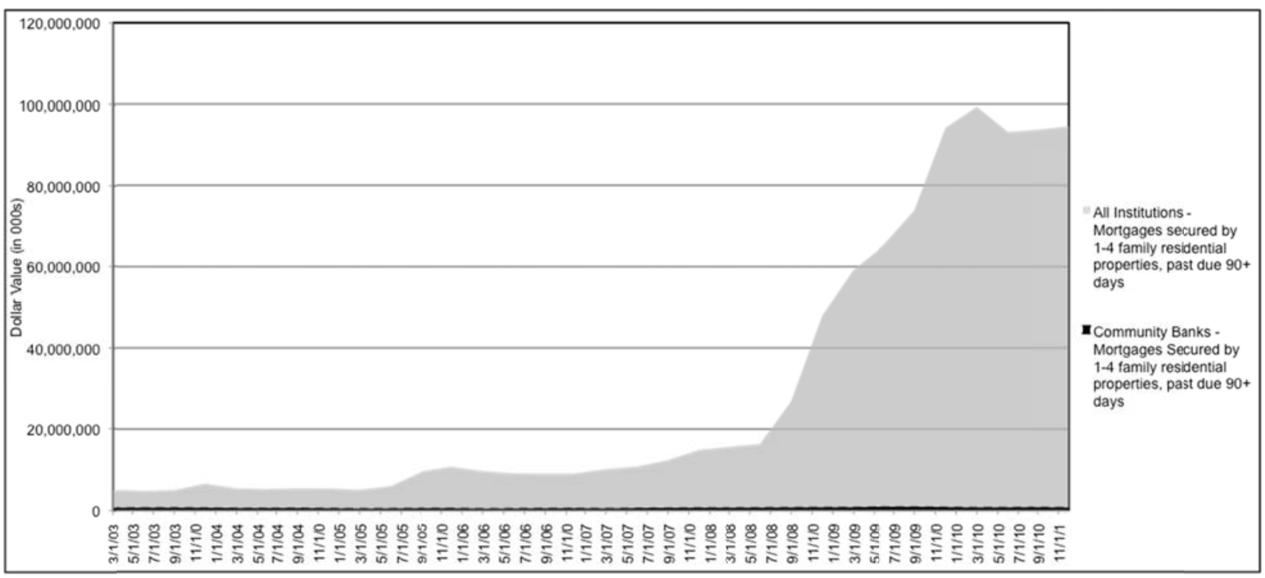
As the volume of subprime and Alt-A mortgages increased to meet investor demand for MBS and CDOs, the number of Americans with a home to mortgage or refinance did not substantially increase. As a result, underwriting standards were further relaxed, and many borrowers with limited ability to repay obtained mortgages. When home values stopped rising, however, homeowners began to default in unprecedented numbers—curtailing the cash flow underlying many MBS and related CDOs and creating a cascade of defaults throughout the financial system.[87]

Subprime mortgage lending was clearly a significant problem that contributed to the financial crisis; however, as figure 1 shows, it is equally clear that community banks played no role in that market.

Although not all mortgage defaults are a result of subprime lending, default rates do serve as a valuable proxy for participation in the subprime lending market. First, subprime loans are by definition riskier and as a result more likely to default than prime loans. Second, the data depicted in figure 1 follow the subprime lending narrative closely. That is, in 2007 subprime borrowers began to default at rates never seen before, precipitating the crash in MBS values.

On an absolute level, figure 1 shows the relative dollar value of mortgages 90 days or more past due at all banking institutions versus those at community banks. As the chart makes clear, community banks' contribution to overall mortgage defaults is a tiny fraction of total mortgage defaults during the financial crisis.

Figure 1. Total Residential Mortgages 90+ Days Past Due from March 1, 2003, through November 1, 2010



Source: Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18.

Between January 2003 and September 2012, residential mortgages originated and held by community banks significantly outperformed residential mortgages in general. Only 0.20 percent of total residential mortgages held by community banks were in default during this period. The same ratio at all institutions was eight times higher, at 1.64 percent.[88]

Remarkably, this trend is magnified when comparing default ratios at community banks to all institutions for period since 2009, when mortgage defaults ballooned. Since 2009, portfolio default rates have averaged 0.23 percent at community banks versus 3.62 percent at all institutions. That is—the default ratio has been 15.7 times higher for all institutions than for community banks since 2009.[89]

With total residential mortgage defaults at community banks making up only 2 percent of all defaults between 2003 and 2010, it is clear that community banks were very minor players in the subprime lending market on absolute and relative levels.

Securitization

The authors of Dodd-Frank also identified securitization of subprime residential mortgages as a leading cause of the financial crisis. In securitization, an originator pools a large number of debt instruments (mortgages, car loans, student loans, etc.) into a single security, then sells interests in that security to investors. Sponsors market the securities based on the characteristics of the underlying debt instruments in each pool. Banks and financial institutions safely engaged in securitization prior to the financial crisis. Securitization is not inherently risky; rather, it is a valuable tool for mitigating risk and supplying additional credit into the economy.

Prior to the financial crisis, mortgage-backed securities were popular low-risk investments because residential mortgages had very low historic rates of default. During the financial crisis, it became clear, however, that a housing bubble had developed and that securities based on residential mortgages made at the height of that bubble were far riskier than investors believed.

Community banks participated in only 0.07 percent of residential mortgage securitization activities between 2003 and 2010.[90] Fees generated from securitization activities accounted for a tiny amount of noninterest income for community banks between 2001 and 2011 but 8 percent of noninterest income for noncommunity banks.[91] At less than one-tenth of 1 percent of total securitization activity, community banks did not participate in the securitization of subprime mortgages cited by the authors of Dodd-Frank as a cause of the financial crisis.

Derivatives

According to the narrative adopted by the authors of Dodd-Frank, over-the-counter trading of credit derivatives contributed to the financial crisis in three primary ways. First, credit default swaps were marketed as insurance against MBS loan losses, which encouraged investors to take more risk without offsetting it. Second, the structure of a synthetic CDO—essentially a speculative bet on the performance of MBS without actually owning any mortgages—requires the use of a credit default swap. Synthetic CDOs allowed investors to multiply the number of bets on the same underlying MBS, increasing systemic credit exposure exponentially. Third, because many different investors had made bets on the same underlying MBS instruments, fear of a contagion effect spread, causing panic in the markets and pressuring the government to step in with assistance to restore liquidity in the system. The most fundamental problem with derivatives, according to the authors of Dodd-Frank, was that they were essentially unregulated and opaque so that regulators, shareholders, counterparties, and the general public could not accurately assess individual or systemic risk.

Even if we accept this narrative as correct, community banks were irrelevant to the kinds of derivatives markets implicated in the financial crisis. Some community banks do use low notational value custom interest rate swaps, a form of derivative, to hedge interest rate risk or to provide risk management services to customers.[92] According to the Government Accountability Office (GAO), only 11 percent of community banks held any derivatives in 2010.[93] But these interest rate swaps are wholly unlike the derivatives traded by large banks participating in the greater derivatives market. At no point between 2003 and 2010 did community bank derivatives activity make up more than a fraction of 1 percent of total banking institution derivatives activity. FDIC data on derivatives show that the average notional value of derivatives held on community bank balance sheets constituted about one-tenth of 1 percent of all derivatives held by all banking institutions between 2003 and 2010.[94] Moreover, community banks made up an insignificant portion of all credit derivatives trading. Community banks held just 0.003 percent of all credit derivatives held by banking institutions between 2003 and 2010.

We have presented compelling evidence that community banks were not responsible for the causes of the financial crisis adopted by the authors of Dodd-Frank. Community banks did not engage in widespread subprime lending. They did not engage in securitization of subprime residential mortgages. Nor did they use derivatives to engage in risky speculation to maximize return. Community banks simply did not contribute to the financial crisis. Richard Cordray, the director of the Consumer Financial Protection Bureau, agreed with this analysis, telling a group of community bankers that although community banks did not cause the financial crisis, they must "unfortunately" deal with regulations to prevent another crisis.[95]

Dodd-Frank and Community Banks

As the GAO noted in a September 2012 report, although Dodd-Frank was primarily aimed at large, systemically important financial institutions, 7 of the act's 16 titles are expected to affect community banks.[96] Two years after Congress passed Dodd-Frank, it is remains unclear to what extent these provisions will impact community banks because of the act's heavy reliance on agency rule making.

Dodd-Frank directs federal regulatory agencies to implement the act's provisions through 398 separate rule-making requirements. Some of those requirements grant the regulatory agency very limited discretion in terms of deciding how to implement the relevant provision. But many are discretionary, either directing agencies to issue regulations that they deem "necessary and appropriate," or permitting agencies discretion in the substance of the regulation.

Some of the most significant discretion, for the purposes of this paper, is that granted to regulatory agencies to determine whether or not a particular rule should be applied to a set of financial institutions.[97] Although this language is fairly standard in regulatory rule making, it is significant in the context of Dodd-Frank for two reasons. First, although the political justification for Dodd-Frank was to stabilize the financial system and prevent another crisis, regulators have the power to expand the scope of the act significantly. Second, perhaps because of the speed with which the act was assembled and passed, many of the provisions have fundamental ambiguities that do not give sufficient guidance to regulators to craft rules consistent with congressional intent.

The Durbin Amendment is a good example of the wide discretion granted to rule-making agencies. Section 1075 of Dodd-Frank, better known as the Durbin Amendment, directed the Federal Reserve to adopt rules relating to interchange fees, the fees paid by merchants to the issuers of debit cards when those cards are used in a transaction. Sarah Bloom Raskin, a governor of the Federal Reserve, testified before the House Subcommittee on Financial Institutions and Consumer Credit on February 17, 2011, that there was meaningful uncertainty regarding the parameters of the proposed rule.[98] For example, Section 1075 requires the Federal Reserve to limit interchange fees to a level that is "reasonable" and "proportional," but the act does not define what either of those words mean. In addition, the Federal Reserve was directed to determine the "incremental cost" that an issuer incurs to authorize, clear, and settle a particular transaction to help arrive at a regulatory cap on interchange fees. However, Congress did not define "incremental cost," and there is no generally accepted definition of the term. Governor

Raskin testified that it "was a little bit hard to translate [that term] into something workable"[99] and that, in general, "there are quite a number of provisions in this set of directives that have been difficult to interpret."[100] As a result of these undefined terms, among others, Congress granted the Federal Reserve fairly wide latitude in its rule making to effectuate the Durbin Amendment, without clear guidance about what Congress hoped to accomplish through the provision.

The stakes are high for the Federal Reserve's interpretation of "reasonable," "proportional," and "incremental cost," as well as a range of other issues related to interchange fees. Community banks rely heavily on interchange fees to offset the costs of providing free checking accounts. In an attempt to not punish community banks by limiting such a vital source of income, Dodd-Frank specifically exempts "small issuers," those with total assets of less than $10 billion, from the cap on interchange fees. Prior to the adoption of the final rule by the Federal Reserve, however, community banks were concerned that the creation of a two-tier interchange fee system would impose significant hardship on the industry, as it would incentivize merchants to discourage the use of debit cards from small issuers with interchange fees higher than the cap applicable to large banks. In other words, the law may have expressly exempted community banks, but basic economic theory suggests that approach would have been unsuccessful.

When asked about the economic impact of the Durbin Amendment on small banks, Governor Raskin testified: "Whether or not [small issuers] still are able to make a profit is going to depend on the market dynamics on how this all looks in the end."[101] Then, in response to a follow-up question, she continued: "The market dynamics of these [interchange fees] are really pretty complicated and unclear. So, it is not exactly perfectly quantifiable regarding what is to happen."[102]

Governor Raskin's Durbin Amendment testimony illustrates two central problems with Dodd-Frank and its potential application to community banks. First, community banks cannot be certain which provisions of Dodd-Frank will apply to them, given the wide latitude granted to regulators. How the Federal Reserve defined "incremental cost" had a significant impact on the final rule. Whether a regulator determines that it is "necessary" or "appropriate" to exempt small financial institutions from the application of a particular rule is a necessary first step to assessing the impact of the provision, and one fraught with uncertainty. Second, community banks cannot predict how the highly regulated environment in which they operate will change as a result of those broad, discretionary rules and how much those changes may impact their bottom line. That is, it is impossible to quantify how the implementation of rules that have not yet been written will affect "market dynamics." As illustrated in the case of the Durbin Amendment, we are all left to guess how these new rules will affect the way banks provide financial services and the continued viability of the community banking model.

As of January 2, 2013, slightly more than one-third of the 398 rule-making requirements in Dodd-Frank had been satisfied with finalized rules. Rules have been proposed to meet an additional one-third, and the remaining one-third have not been addressed.[103]

It is beyond the scope of this paper to comprehensively analyze the entire 838-page Dodd-Frank Act. Instead, we summarize the major provisions that are anticipated to impact community banks and credit unions in this section.[104] A more comprehensive list of the relevant provisions and a more technical summary of each is included in the appendix.

Title I—Financial Stability

Title I of Dodd-Frank creates the Financial Stability Oversight Council (the FSOC), intended to be a supercommittee to coordinate the efforts of the various federal regulators, monitor systemically important financial institutions, and evaluate potential threats to the financial system. Consistent with the stated goals of Dodd-Frank to "prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large interconnected financial institutions,"[105] Title I creates a special category of banks and nonbank financial companies with assets greater than $50 billion.

These large banks are subject to additional reporting and other requirements. For example, Title I, Section 115, authorizes the FSOC to develop additional prudential standards and reporting and disclosure requirements appropriate to the size and complexity of these organizations. Title I, Section 116, permits the FSOC to require periodic certified reports from banks with assets greater than $50 billion on, among other topics, the financial condition of the bank and "the extent to which the activities and operations of the company and any subsidiary thereof, could, under adverse circumstances, have the potential to disrupt the financial markets or affect the overall financial stability of the United States."[106]

The approach of Dodd-Frank in identifying these "systemically important" companies has led to concern that the act inadvertently grants a competitive advantage to those institutions. In June 2012, the State National Bank of Big Spring (Texas), the 60 Plus Association, and the

Competitive Enterprise Institute filed a lawsuit in the United States District Court in the District of Columbia alleging that certain aspects of Dodd-Frank are unconstitutional.[107] The attorneys general of eight states joined the lawsuit in February 2013.[108] The complaint alleges that the "'systemically important' (or, 'too big to fail') . . . designation signals that the selected companies have the implicit backing of the federal government—and, accordingly, an unfair advantage over competitors in attracting scarce, fungible capital."[109]

The complaint further alleges that small banks, like plaintiff State National Bank of Big Spring, is injured by the FSOC's designation of "systemically important" nonbank financial companies "because each additional designation will require the Bank to compete with yet another financial company . . . that is able to attract scarce, fungible investment capital at artificially low cost."[110] To support these allegations, the plaintiffs cite a 2011 report by the Federal Reserve Bank of Richmond that expressed concern that the "[systemically important] designation may confer benefits on a company by reducing its cost of capital . . . because [c]reditors may believe that enhanced supervision lowers an institution's credit risk."[111] They also rely on a March 2010 speech by Federal Reserve Chairman Bernanke in which he stated that "financial institutions that are deemed 'too big to fail' . . . face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks."[112]

Title I, Section 171, may also have a significant impact. This provision is consistent with the stated intention of policymakers to bring domestic capital requirements in line with international standards as outlined by the Basel Committee on Banking Supervision in the "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III) standard. Section 171(b)(4)(C) and Section 171(b)(5)(C) provide for limited exceptions relevant to community banks, but under rules proposed on June 12, 2012, by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, Basel III standards will apply equally to both large financial institutions and community banks. These proposed rules would require banks to hold significantly more basic capital than current rules require. They may be required to hold additional reserve capital, based on an assessment of the riskiness of their assets. Regulators have stated publicly that they will take the concerns of community banks into consideration when formulating the final rules, but uncertainty remains about how much capital community banks will be required to hold.[113]

In addition, the Basel III capital rules are complex and would require community banks to track 13 categories of deductions and adjustments to capital and changes to risk weighted assets on a quarterly basis. Most community banks lack the in-house expertise to implement these new rules and will need to hire additional compliance staff or outside consultants. Even if it is reasonable for large American banks to be brought into the Basel III international regime, the authors of Dodd-Frank have not explained why it is good policy to require community banks to implement such a complex system.

Title VII—Wall Street Transparency and Accountability

Title VII confers regulatory and extensive rule-making authority on the Commodity Futures Trading Commission (CFTC), in consultation with the Securities and Exchange Commission (SEC) with respect to the over-the-counter derivative markets. The key premise of these reforms is that standardized derivatives will be moved to a central clearinghouse to increase transparency of the market and improve competition. Customized swaps, which are perceived to be riskier, will be subject to higher capital and margin requirements than standardized swaps. The open issue is whether the final rules the CFTC and the SEC adopted will exempt the customized interest rate swaps community banks commonly utilize. If the rules fail to adequately do so, they will put community banks at a competitive disadvantage relative to the larger financial institutions whose volume of transactions can support standardized interest rate swaps.

Title IX—Investor Protections and Improvements to the Regulation of Securities

Title IX includes several provisions that may affect community banks. Section 975 is of considerable concern to community banks. This "municipal advisor" provision appears to be aimed at regulating those who underwrite or broker municipal securities. Community banks are not involved in those activities. However, municipalities are often important depository and lending customers of community banks. The act does not include an exemption for the activities of banks related to their municipal customers. This is problematic because several phrases in the act, including "municipal advisor" and "provides advice to" are so broad as to include a range of traditional banking services and products.

To resolve the question of whether Section 975 applies to community banks, H.R. 2827 was introduced on August 26, 2011, to clarify the definition of "municipal advisor" and specifically exempt banks that provide "traditional banking products" from the proposed rule.

The House of Representatives passed the bill on September 19, 2012. The Senate did not vote on it before the 112th Congress dissolved.

Title X—Bureau of Consumer Financial Protection

Title X of Dodd-Frank established the Bureau of Consumer Financial Protection, now referred to as the Consumer Financial Protection Bureau (CFPB). The CFPB has been granted broad powers to “regulate the offering and provision of consumer financial products or services.” The limit to those powers, and how those powers may be implemented in regards to community banks, remain uncertain and represent the most significant risk to the operations of community banks as a result of Dodd-Frank. Although the act specifically exempts financial institutions with total assets of less than $10 billion from direct examinations by the CFPB, it does not exempt smaller institutions from other rules.

One of the most troubling provisions in Title X is Section 1026, which states that the CFPB may “require reports . . . as necessary” to support its mission. It is impossible for community banks to quantify the impact of a rule that permits a regulatory agency to require reports whose content and scope is unknown. In addition, the CFPB is directed to collect additional data from all financial institutions related to small businesses and residential mortgages. Some of the relevant data is described in the act, but the CFPB is permitted to require the disclosure of additional information that it deems necessary or appropriate. Finally, all financial institutions will be required to expand customer access to account, transaction, and fee information.

The CFPB will likely also play a powerful role in establishing a baseline of standardized disclosures, practices, and products that other regulators and the market will perceive as protective to consumers. For example, the CFPB has, through its construction of the qualified mortgage regulations, signaled that it believes that consumers will benefit from standardized financial products. Of course, using residential mortgage lending as an example, the idea that data-driven, fit-a-borrower-in-a-box lending is inherently safer and more beneficial to the consumer than personalized underwriting and customized loan products inherently values the business model of the large banks over the relationship banking model of community banks. Not only does that reasoning fly in the face of the incentives and business practices that the authors of Dodd-Frank believe caused the collapse of the residential real estate market, but it places millions of Americans at risk of being denied traditional banking services and being forced to rely on high-cost alternative financial service providers or lose access to services entirely. Many Americans simply do not fit neatly in a box but may still reasonably be judged to be good credit risks by a lender with a fuller picture of that borrower and the local economy.

The admirable goal of the CFPB is to protect consumers. During the run-up to the financial crisis, many consumers were the victims of predatory lending and other abusive practices. But community banks have not been accused of participating in those practices. Instead, their business model depends on establishing long-term relationships with customers and the community. Imagine the typical small bank in a rural community. If it were taking advantage of its customers, word would spread quickly, and it would be out of business. Even if the CFPB is necessary or advisable to protect consumers from large financial institutions and nonbank financial services providers, the authors of Dodd-Frank have not made the case that it is necessary to expand the compliance burden on community banks by subjecting them to the wide-ranging authority of the CFPB.

Title XIV—Mortgage Reform and Anti-Predatory Lending Act

The key concern about Title XIV is that community banks may be forced to change their operations or incur increased costs that will place them at a competitive disadvantage with larger financial institutions, despite the fact that they did not engage in subprime lending.

The most significant provision in Title XIV is Section 1411, "Minimum Standards for Mortgages: Ability to Repay." This fairly remarkable provision prohibits lenders from making a residential mortgage loan unless the lender can sufficiently document, at the time the loan is made, that the borrower has a "reasonable" ability to repay the loan. This intention of the provision is clear. As CFPB Director Richard Corday wrote, "In the run-up to the financial crisis, we had a housing market that was reckless about lending money. Lenders thought they could make money on a loan even if the consumer could not pay back that loan, either by banking on rising housing prices or by off-loading the mortgage into the secondary market. This encouraged broad indifference to the ability of many consumers to repay loans, which dramatically increased mortgage delinquencies and rates of foreclosures."[114]

Although Corday's statements may have been true with respect to the subprime loans originated and sold into the secondary market, community banks lend on a different model, as substantiated by the drastically lower default rates that they have experienced. The standard practice of community banks is to make loans and keep those loans on their books until maturity or earlier repayment. They sell loans at a far lower rate than larger financial institutions. Community banks bear the risk that their underwriting was insufficient—that a borrower lacks the ability to repay a loan. In other words, again, the business model of community banks precludes them from participating in the sins that this title is intended to prevent.

Despite that, this provision raises the stakes for community banks. In addition to bearing the risk that a borrower might default, if a lender cannot adequately document at the time that the loan is made that the borrower has the ability to repay, the lender violates the Truth in Lending Act and is subject to a lawsuit by the borrower as well as a defense to foreclosure. Section 1412 of Dodd-Frank attempts to mitigate this harsh remedy by providing a safe harbor.

The core of Section 1412 defines "qualified mortgage"—lenders will be deemed not to have violated their obligations under the ability to repay rules if the mortgage meets the definition of a qualified mortgage. In January 2013, the CFPB issued the final rule defining this key term. This rule requires lenders to consider and verify eight factors when processing a loan application: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio; and (8) credit history. The rule also includes guidance on how lenders should interpret and weigh each factor. The CFPB has also requested comment on a proposal to adjust the qualified mortgage rules for small banks and certain government programs.

This is a new definition, and the consequences for failing to understand, implement, or document the eight factors are high. Again, community banks largely lack the in-house expertise to protect themselves from mistakes that could lead to costly litigation. In addition to changing their processes for originating and underwriting residential mortgages, they will likely be compelled to hire additional compliance staff or outside consultants.

Measuring the Impact of Dodd-Frank

If we accept the narrative of the financial crisis put forth by the authors of Dodd-Frank, then it is clear that the problems that led to the crisis did not involve community banks. The twin goals of Dodd-Frank are to ensure the stability of the financial system and to protect consumers. Neither requires the application of this remedial legislation to community banks. First, community banks are, by definition, too small on an individual basis to destabilize the financial system. Second, the business model employed by community banks has proven to be sufficient to protect consumers. Community banks have far different incentives in underwriting solid loans than mortgage originators like Countrywide. Their success depends on the repayment of the loans on their books and the goodwill and loyalty of their customers.

Despite the lack of political or policy justification for doing so, Dodd-Frank, the most comprehensive reform of the American financial system since the Great Depression, *will* impact community banks and the American economy. The vital question is—how? Two years after the act's passage, too much remains unknown to precisely quantify its effect. Of course, that lack of information is the chief challenge facing community bankers—they must plan for a future in which the rules are largely unknown.[115]

The most likely impacts of Dodd-Frank are twofold. First, community banks will incur significant compliance costs that will place them at a further competitive disadvantage to large banks. The number of community banks will continue to shrink, through failure and merger, leading to increased consolidation and continued growth of the too-big-to-fail banks. Second, the influence of the Consumer Financial Protection Bureau and its baseline assumption that increased standardization will benefit consumers will continue to undermine the customization of the community banking model. Neither of these outcomes will fulfill the purposes of Dodd-Frank, namely, to promote systemic stability and consumer protection.

Compliance Costs and Consolidation

Community bankers have repeatedly expressed concern that Dodd-Frank will impose new and costly regulatory compliance burdens on community banks. Both the GAO and FDIC, in reports released in September 2012 and December 2012, respectively, concluded that it is impossible at this time to quantify the costs that community banks will incur as a result of Dodd-Frank. This is due to two main factors.

First is the uncertainty regarding the content of two-thirds of the rules mandated by the act. As previously discussed, community banks cannot quantify the impact of rules if they do not know whether those rules will apply to them or how they will affect their operations.

Second, integrating regulatory compliance activities into normal bank operations complicates data gathering to establish a baseline of regulatory compliance costs before Dodd-Frank. This means that although it may be possible for banks to quantify existing direct compliance costs (compliance staff, continuing education, dedicated software, and so forth), it would be costly and difficult for banks to attempt to quantify existing indirect compliance costs, such as the time spent by noncompliance personnel on compliance-related tasks. The smaller banks will likely find it even harder to separate out those costs because of small staffs with overlapping duties. Banks do not routinely document their direct compliance costs, those costs are not regularly tracked in call reports, and they have not been studied in recent years. Of course, this lack of information poses a catch-22. It is difficult for community banks to make the case that their compliance costs are too high without data on those costs. At the same time, obtaining those data would burden community banks.

Anecdotal information, however, suggests that compliance costs at small banks have already significantly increased in recent years. For example, the president of Commerce Bank, a $550 million community bank in Texas, told a congressional subcommittee that his regulatory compliance budget is $10 to $12 million per year. He testified that four to five years ago, his bank had “maybe 7” people in compliance. By 2012, that number had ballooned to 48.[116] The president of a $177 million, 37-employee, minority-owned community bank in El Paso testified at the same hearing that the percentage of his bank’s employees who were directly involved in compliance had increased from 10 to 25 percent over the same period.[117]

The president of an 80-year old $150 million community bank located in Fort Stockton, (population 8,000) and Sanderson, Texas (population 750), testified that during the 11 years that he had been with the bank, the lending staff had not increased. He added, “during that same time period, we have had to add two employees simply to handle government regulation. And if I have to double that staff due to Dodd-Frank, that will constitute 10 percent of my entire staff.”[118]

Although they are largely unable to quantify the expected costs, community banks are focused on the rules contemplated by Dodd-Frank, particularly with respect to the Basel III capital rules, data gathering and reporting mandated by the CFPB, and the mortgage reform provisions. All of these provisions are complex, and the stakes for understanding and following them are high. The chief executive of a small North Carolina institution summarized the impact: "For a little bank like ours with 19 people, [it] could be a full-time job for somebody to make sure we comply with the provisions of [Dodd-Frank].”[119]

The Bureau of Labor Statistics expects that Dodd-Frank will significantly increase the regulatory burden on banks. The “financial examiners” job category, which includes compliance officers, is projected to grow 27 percent from 2010 to 2020, faster than average for all occupations.[120] But community banks, particularly small institutions located in rural areas, may have difficulty recruiting and retaining qualified personnel. As one community bank executive testified to a congressional subcommittee: "I personally know of two community banks that simply threw in the towel and sold out after being beat up by regulators about not having enough high power talent in their compliance position, a position they tried fervently to fill but were unable to attract someone of that caliber to relocate to their rural community."[121]

Even though the most significant regulations yet to be promulgated under Dodd-Frank have not become effective, a handful of community banks have announced that rather than incur the costs necessary to comply with the new rules, costs that would make their products more expensive for their customers, they will simply abandon lines of business implicated in the act. Jim Purcell, the chairman and chief executive of State National Bank of Big Spring, Texas, a community bank with $300 million in assets, stated that his institution has stopped extending residential mortgage loans because of the increased costs. In particular, he cited the cost of the information technology that would have been necessary for his institution to establish and manage the escrow accounts required by Section 1461 of the act. "[It] makes no economic sense for us," Purcell said.[122]

Community bankers have consistently expressed concern about the creeping regulatory compliance burden.[123] Greg Ohlendorf, president of the $150 million First Community Bank and Trust in Beecher, Illinois, put the new Dodd-Frank compliance costs in perspective: "What we have to understand is we're already overburdened with regulation. We have significant numbers of regs that we need to comply with today, and it seems like just one more isn't going to change the deck a whole lot, but the consistent piling on of additional regulation is very, very stunning. It's punishing."[124] The president of a $150 million community bank in Texas illustrated the cumulative impact of decades of regulation: "Several months ago, we at Pecos County State Bank stumbled across our bank's policy manual from 1986. That policy manual was 100 pages long. Today, our same policy manual is over 1,000 pages, which requires a full-time compliance officer and also a real estate clerk to remain abreast of regulatory changes to ensure that we remain in compliance."[125]

Finally, Lester Leonidas Parker, president of the $177 million United Bank of El Paso Del Norte, El Paso, Texas, quantified the costs already incurred:

> We are a simple, non-complex organization, yet the direct compliance costs in the bank have increased 240% over the past five years far exceeding the growth of the bank, its loans, investments, or deposits. That compliance cost figure includes only the direct cost of specific managers while working on regulatory compliance, the new cost of a skilled compliance officer, and the cost of myriad outside, third-party auditors and reviewers to

> ensure that our compliance efforts are adequate. It does not count the other costs of implementation, the annual training that I must do with all employees and the compliance activities that they have throughout each week.[126]

The rising costs of regulatory compliance put a more significant relevant burden on community banks than their larger cousins.[127] For example, JPMorgan Chase estimates that its cost to comply with Dodd-Frank will be approximately $3 billion over the next few years. In comparison, JPMorgan Chase lost $6.25 billion in 2012 from losses incurred by a single credit derivative trader known as the "London Whale."[128] Jamie Dimon referred to that loss as a "sideshow" and a "complete tempest in a teapot."[129] Despite the loss, in 2012, JPMorgan Chase posted a record net income of $21.3 billion on total revenues of $99.9 billion.[130] Recall that the median American bank has $165 million in assets. Over the next several years, JPMorgan Chase will incur regulatory costs 18 times greater than the total assets held by the median American bank, a sum equal to roughly 3 percent of the bank's 2012 revenue.

Although the regulatory costs associated with Dodd-Frank will annoy the large banks, they will constitute a blip on their balance sheets. They will have a far greater impact on community banks. Basic economic theory supports the presumption that smaller banks are disproportionately affected by the costs of regulatory compliance. The most recent research on this point was conducted by Federal Reserve staff in 1998.[131] That study found evidence that smaller banks are at a cost disadvantage compared to larger banks. That cost disadvantage will intensify with further investments in compliance staff, technology, lawyers, and consultants.

Over 250 banks with assets less than $250 million have failed in the past decade. As Jamie Dimon predicted, the pressure of Dodd-Frank will cause additional failures and will cause small banks to merge. In his 2012 testimony to a House subcommittee, the president of a $330 million community bank in Ohio, founded in 1884, predicted that merger may be his institution's only chance to survive:

> This afternoon, when I return to the bank, I have an appointment with a gentleman from a much larger banking institution to discuss the possibility of merging. . . . [W]e have the number one market share in Ashtabula County. We are a significant financial institution playing a significant role in our community, and it would be a tremendous loss. But the reality is, what we see in the headwinds of compliance, based on our size, we feel we have to generate a larger size in one fashion or another to absorb the cost just to meet regulatory compliance.[132]

These failures and mergers are not without consequence. They will leave communities, particularly rural communities, without a local financial institution and will increase the number of unbanked and underbanked Americans. As one community banker observed:

> [W]hen a large institution buys out a smaller local entity, they tend to pick and choose the profitable pieces that fit their model and abandon the parts that don't. In many cases, the pieces that are discarded are the locations in smaller markets, and there's evidence of this today as some too-big-to-fail banks are simply closing local offices because they no longer fit their model. . . . [L]ocal community knowledge and service is lost forever. If consolidation continues, as I wholeheartedly believe it will, and there is not a local entity to pick up the pieces, that local community will undoubtedly suffer as a result. . . . Without a strong community banking presence in so many smaller and rural areas, the future outlook for [small businesses in those areas] decline as opposed to prosper.[133]

Standardization

A recurring theme in Dodd-Frank, particularly with respect to the Consumer Financial Protection Bureau, 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. One of the chief advantages of community banks is their ability to successfully lend to borrowers who are considered informationally opaque because they do not have the deep credit history necessary for the model-based lending used by large financial institutions.

If regulators push the entire financial services industry in lockstep towards standardization—of underwriting, financial products, and applications—then many small businesses and individuals currently served by the community bank model may be denied credit. In addition, because of their higher operating costs relative to larger banks based on economies of scale, if community banks become forced through standardization into small versions of large financial institutions, they will be at a severe competitive disadvantage.

Conclusions

The purpose of Dodd-Frank was to protect consumers and the stability of the financial system. Community banks provide vital services to millions of Americans, many of whom would be underserved if the community bank model were broken or if community banks abandoned lines of service. If community banks are forced to merge, consolidate, or go out of business as a result of Dodd-Frank, one result will be an even greater concentration of assets on the books of the too-big-to-fail banks. Another result will be that small businesses and individuals who do not fit neatly into standardized financial modeling or who live outside of metropolitan areas served by larger banks will find it more difficult to obtain credit. Neither of these outcomes will protect consumers, the financial system, or the recovery of the American economy.

More broadly, Dodd-Frank exacerbates the broken model of American financial regulation that fails to differentiate between small banks engaged in traditional relationship banking and modern, complex financial services firms. Meaningful reform of the financial regulatory system, reform that would actually reduce systemic risk and protect consumers, would establish a two-tiered regulatory framework. Community banks operating on the traditional model would be subject to less stringent regulation and examination. This is appropriate because the success of their business model depends on the quality of their underwriting and their long-term relationships with repeat customers. Freed of unnecessary regulatory burden, and allowed by examiners to engage in true relationship banking without fear of criticism, community banks would strengthen their ability to serve their customers. The largest financial institutions would be subject to regulations and examinations appropriate to their size, complexity, and role in the American economy. Staff of existing regulatory agencies could more appropriately and efficiently address the unique challenges that these large banks pose to the stability of the financial system if they could focus less on community banks.

Much remains to be settled under Dodd-Frank, which means that there is still opportunity, through comments to regulatory agencies and remedial legislation, to reassert the value of community banks to the American consumer and the American economy and to work to maintain the viability of the community banking model within the Dodd-Frank framework. But more meaningful reform consistent with the goals of Dodd-Frank would require the implementation of a two-tiered regulatory system.

Appendix

Language quoted below appears in the cited section of Dodd-Frank. “Bureau” refers to the Consumer Financial Protection Bureau.

Section 165—Enhanced Supervision and Prudential Standards for Nonbank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies. Section 165(h)(2)(B) is a permissive regulation that gives discretion to the Board of Governors of the Federal Reserve to require publicly traded bank holding companies with less than $10 billion in assets to establish a risk committee if “determined necessary or appropriate by the Board of Governors to promote sound risk management practices.”

Section 171—Leverage and Risk-Based Capital Requirements. Section 171(b)(2) is a permissive regulation that calls on regulators to “establish minimum risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board of Governors.” Although the section establishes a floor for those requirements, no other guidance is provided.

Section 723—Clearing. This section instructs the CFTC to “consider whether to exempt” depository institutions with total assets of $10 billion or less from the mandatory clearing requirement.

Section 737—Position Limits. This section grants broad discretion to the CFTC to exempt, conditionally or unconditionally, “any person or class of persons” and “any transaction or class of transactions” from the position limit requirements. Therefore, the CFTC could choose to exempt community banks and low notational value interest rate swaps.

Section 763—Amendments to the Securities Exchange Act of 1934. Consistent with Section 723, this section instructs the SEC to “consider whether to exempt” depository institutions with total assets of $10 billion or less from the mandatory clearing requirement. Consistent with Section 737, this section also grants broad discretion to the SEC to exempt, conditionally or unconditionally, “any person or class of persons” and “any transaction or class of transactions” from the position limit requirements.

Section 939(A)—Review of Reliance on Ratings. Within one year after the enactment date of the section, federal agencies were required to review any regulation that requires the assessment of the creditworthiness of a security or money market instrument, and remove all references in such regulations to credit ratings. Instead, agencies were granted wide discretion to replace credit ratings requirements with "such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." Community banks relied heavily on credit ratings. It is unclear whether the standards that replace credit ratings will increase costs for community banks.

Section 941—Definition of Asset-Backed Security. Section 941(b) amends the Securities Exchange Act of 1934 to (1) require "the Federal banking agencies and the [SEC]" to jointly prescribe regulations to require a securitizer of an asset-backed security, other than a residential mortgage-backed security, to retain an economic interest in a portion of the credit risk for any asset that the securitizer transfers to a third party; and (2) require the federal banking agencies, the SEC, the secretary of Housing and Urban Development, and the Federal Housing Finance Agency to jointly prescribe regulations to require a securitizer to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer transfers to a third party. Securitizers are prohibited from hedging that retained risk, and the economic interest retained must be not less than 5 percent of the credit risk for any asset that is not a "qualified residential mortgage" that meets certain other criteria. The regulatory agencies were given fairly wide discretion to craft risk retention rules and to grant exemptions to them, provided that such exemptions were consistent with the goals of the section.

Section 975—Registration of Municipal Securities Dealers and Municipal Advisors. This section amends the Securities Exchange Act of 1934 to require the registration of municipal advisors and prohibits unregistered municipal advisors to provide advice with respect to "municipal financial products."

Section 1021—Purpose, Objectives, and Functions. This section sets forth the primary objectives of the bureau as follows: "[to ensure] that, with respect to consumer financial products and services: (1) consumers are provided with timely and understandable information to make responsible decisions about financial transactions; (2) consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination; (3) outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens; (4) Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and (5) markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation."

Section 1022—Rulemaking Authority. Section 1022(b)(3) grants the bureau broad authority to "conditionally or unconditionally exempt any class of covered persons, service providers, or consumer financial products or services, from any provision of this title, or from any rule issued under this title, as the Bureau determines necessary or appropriate to carry out the purposes and objectives of this title."

Section 1025—Supervision of Very Large Banks, Saving Associations, and Credit Unions. This section grants the bureau the authority to require reports and conduct examinations of insured depository institutions and insured credit unions with total assets of more than $10 billion, for the purposes of assessing compliance with the requirements of federal consumer financial laws.

Section 1026—Other Banks, Savings Associations, and Credit Unions. A companion to Section 1025, this section provides that the bureau "may require" reports from insured depository institutions and insured credit unions with total assets of $10 billion or less "as necessary to support the role of the Bureau in implementing Federal consumer financial law, to support its examination activities under subsection (c), and to assess and detect risks to consumers and consumer financial markets." Prudential regulators of the institutions with total assets of less than $10 billion are authorized to enforce the requirements of federal consumer financial laws with respect to such institutions, rather than the bureau. Section 1026(c)(1) provides that the bureau may, at its discretion, include examiners in some of the examinations the prudential regulator performs to assess the compliance of institutions with total assets of less than $10 billion with the requirements of federal consumer financial law.

Section 1031—Prohibiting Unfair, Deceptive, or Abusive Acts or Practices. This section grants the bureau broad authority to "prescribe rules applicable to a covered person or service provider identifying as unlawful unfair, deceptive or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service." This section somewhat constrains the bureau's ability to define "unfairness" or "abusive," although the considerations are still fairly broad.

Section 1032—Disclosures. Section 1032(f) instructs the bureau to combine the disclosures required under the Truth in Lending Act and sections 4 and 5 of the Real Estate Settlement Procedures Act of 1974 into a single, integrated disclosure.

Section 1071—Small Business Data Collection. This section amends the Equal Credit Opportunity Act. It requires financial institutions, in connection with any application for credit, to inquire whether the business is women-owned, minority-owned, or a small business and to compile such information and report it to the bureau as set forth in the section, in addition to "any additional data that the Bureau determines would aid in fulfilling the purposes of the section." Although this section defines "financial institution" broadly, the bureau is granted the authority to "conditionally or unconditionally exempt any financial institution or class of financial institutions from the requirements of this section."

Section 1073—Remittance Transfers. This section amends the Electronic Fund Transfer Act to require remittance transfer providers to make certain disclosures to consumers in accordance with rules prescribed by the bureau.

Section 1075—Reasonable Fees and Rules for Payment Card Transactions. This section, more commonly known as the Durbin Amendment, requires the Federal Reserve to prescribe regulations that establish limits on interchange transaction fees charged for an electronic debit transaction. The section exempts institutions with less than $10 billion in total assets from the cap on interchange fees.

Section 1094—Amendments to the Home Mortgage Disclosure Act of 1975. This section increases the data on residential mortgages that must be collected by originators and disclosed to the bureau. In addition to items delineated in the section, the bureau was granted authority to require the collection and disclosure of additional data.

Section 1098—Amendments to the Real Estate Settlement Procedures Act of 1974. This section is a companion to Section 1032, which requires the bureau to combine two separate mortgage loan disclosures into an integrated disclosure.

Section 1401—Residential Mortgage Loan Origination Standards: Definitions. This section broadly defines "mortgage originator" as including any person who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain . . . takes a residential mortgage loan application."

Section 1402—Residential Mortgage Loan Origination. This section states the purpose of the Mortgage Reform and Anti-Predatory Lending Act—namely, "to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive." This section also requires that mortgage originators be "qualified" and, when required, registered and licensed as mortgage originators.

Section 1403—Prohibition on Steering Incentives. This section prohibits certain types of compensation paid to mortgage originators. It also directs the Consumer Financial Protection Bureau to prescribe regulations to prohibit mortgage originators from steering consumers to certain types of mortgage loans.

Section 1404—Liability. This section establishes liability for mortgage originators who violate the Truth in Lending Act, as amended by Section 1403, and specifies the damages that mortgage originators may be subject to for violating the act.

Section 1405—Regulations. This section grants broad rule-making authority to the bureau relating to the terms of residential mortgage loans. This section instructs the bureau to prescribe regulations to "prohibit or condition terms, acts or practices relating to residential mortgage loans that the Board finds to be abusive, unfair, deceptive, predatory, necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section and section 129C [of the Truth in Lending Act] . . . or are not in the interest of the borrower." The section also permits the bureau to exempt from certain disclosure requirements for any class of residential mortgage loans "if the Board determines that such exemption or modification is in the interest of consumers and in the public interest."

Sections 1411—Minimum Standards for Mortgages: Ability to Repay. This section amends the Truth in Lending Act to provide that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments."

Section 1412—Safe Harbor and Rebuttable Presumption. This section provides a safe harbor for the requirements of Section 1411 that a creditor must predetermine a borrower's ability to pay. Any creditor may presume that the borrower has the ability to pay so long as the mortgage is a "qualified mortgage," as that term is defined in the section. It also authorizes the bureau to prescribe regulations that "revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers."

Section 1420—Disclosures Required in Monthly Statements for Residential Mortgage Loans. This section amends the Truth in Lending Act to provide for a standardized disclosure to appear on all monthly statements for residential mortgage loans.

Section 1422—State Attorney General Enforcement Authority. This section amends Section 130(e) of the Truth in Lending Act to provide state attorneys general with increased enforcement authority for delineated provisions of the act.

Section 1431—Definitions Relating to High-Cost Mortgages. This section amends the Truth in Lending Act to redefine “high-cost mortgages” and to prohibit certain characteristics in such mortgages.

Section 1461—Escrow and Impound Accounts Relating to Certain Consumer Credit Transactions. This section amends the Truth in Lending Act to require that the creditors of most first-lien residential mortgage loans must establish an escrow or impound account for the payment of taxes and hazard insurance and, if applicable, other types of periodic payments or premiums. The bureau is granted discretionary authority to exempt from these requirements certain creditors. Small banks contend that establishing an escrow account for each mortgage loan will be costly and may be unnecessary—lenders are in a better position to decide on a case by case basis whether an escrow account is advisable.

Section 1462—Disclosure Notice Required for Consumers Who Waive Escrow Services. This section amends the Truth in Lending Act to require that creditors must provide specific disclosures to borrowers who waive escrow services.

Section 1471—Property Appraisal Requirements. This section amends the Truth in Lending Act to establish certain minimum requirements for appraisals of “higher-risk mortgages,” generally defined as mortgages that are not “qualified mortgages.” Regulators are granted the discretionary authority to exempt a class of loans from these requirements if “the agencies determine that the exemption is in the public interest and promotes the safety and soundness of creditors.”

Section 1472—Appraisal Independence Requirements. This section amends the Truth in Lending Act to define “appraisal independence” and makes it unlawful, in extending credit secured by the principal dwelling of the consumer, to engage in any act or practice that violates appraisal independence.

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Notes

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2. See Michael Lewis, *The Big Short: Inside the Doomsday Machine* (New York: W. W. Norton, 2010).
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5. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010), 1376.
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7. Although Dodd-Frank itself does not recite a clearly stated goal, the Financial Stability Oversight Council, the new supercommittee created by the act, has stated that the purpose of the act is to "build a stronger, more resilient financial system—less vulnerable to crisis, more efficient in allocating financial resources, and less vulnerable to fraud and abuse." Financial Stability Oversight Council, *Financial Stability Oversight Council 2011 Annual Report* July 26, 2011, www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf.
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19. Robin Sidel, "Small Banks Put Up 'For Sale' Sign," *Wall Street Journal*, June 18, 2012.
20. Federal Deposit Insurance Corporation, *FDIC Community Banking Study I*, December 2012, http://fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.
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23. Ibid.

24. Federal Deposit Insurance Corporation, *Community Banking Study,* note 19.
25. Ibid., 1.1–1.5.
26. Ibid.
27. Ibid. In this paper, we define community banks similarly but do not exactly replicate the study group currently used by the FDIC. By contrast, using the revised definition the FDIC identifies 6,524 community banks. As a result, we have used FDIC data to identify 6,798 chartered community banks as of year-end 2010.
28. We are adopting the five-step definition used by the FDIC, but we have not aggregated charter-holding organizations up into their parent bank holding companies. As explained in the study, the primary purpose for aggregation is for evaluating the community bank study group over time, especially before the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994. Because our research only pertains to the last decade, we need not aggregate up all chartered organizations.
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36. Federal Deposit Insurance Corporation, *Statistics on Depository Institutions,* note 18.
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64. Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18. CRE loans are defined as nonresidential loans secured by real estate, excluding farm loans.
65. Ibid.
66. Not all of these loans are classic real estate loans, in which the loan proceeds were used to purchase or refinance the property securing the debt. Instead, it appears that some are business loans in which the real estate owned by the business was encumbered by a mortgage as additional security. Federal Deposit Insurance Corporation, *Community Banking Study*, note 19, at 5–15.
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72. Ibid.
73. Ibid.
74. Federal Deposit Insurance Corporation, *Statistics on Depository Institutions*, note 18. Here, retail deposits are defined as core deposits held domestically excluding time deposits (CDs) of more than $250,000 and brokered deposits less than $250,000.
75. Federal Deposit Insurance Corporation, *Community Banking Study*, note 19, at 3.5.
76. Under FDIC analytical methods, rural and micropolitan counties make up the broader category of "nonmetropolitan" counties. Rural counties are those with fewer than 10,000 in population. Micropolitan counties are those with populations between 10,000 and 50,000. For a more thorough explanation, see page 3.4 of Federal Deposit Insurance Corporation, *Community Banking Study*, note 19.
77. Federal Deposit Insurance Corporation, *Community Banking Study*, note 19.

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80. Ibid.
81. Ibid.
82. The FDIC Community Banking Research Project, *Community Banking by the Numbers*, February 16, 2012, www.fdic.gov/news/conferences/communitybanking/community_banking_by_the_numbers_clean.pdf.
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EDUCATION

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TEACHING EXPERIENCE

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Associate Professor of Law
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Indiana University School of Law – Indianapolis 2006 to 2010
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Course: Legal Analysis, Research and Communication III

SCHOLARSHIP:

- *The Impact of Dodd-Frank on Community Banks*, American Enterprise Institute white paper (2013). Co-authored with Joseph Norman.
- *Too Big to Fail versus Too Small to Notice: Addressing the Commercial Real Estate Debt Crisis*, 63 ALA. L. REV. 321 (2012). Selected for the 2012 C-LEAF Junior Faculty Business and Financial Law Workshop.
- *Foreclosures and the Failure of the American Land Title Recording System*, 111 COLUM. L. REV. SIDEBAR 19 (2011).
- *Sometimes Blackacre IS a Widget: Rethinking Commercial Real Estate Contract Remedies* 88 NEB. L. REV. 635 (2010).
- *A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities*, 22 VA. TAX REV. 137 (Summer 2002), reprinted in part in Elizabeth Schmidt, *Nonprofit Law* (Aspen 2011).

OTHER RECENT PUBLICATIONS:

- Contributing Editor, Property Prof Blog (lawprofessors.typepad.com/property/) (2009 to present).
- *Preserving Community Banks Should be Bi-Partisan Priority*, The Huffington Post (July 16, 2013)
- *Treat Community Banks Differently: They're essential American institutions, and Dodd-Frank is harming them*, National Review Online (May 14, 2013).
- *Understanding the Commercial Real Estate Debt Crisis*, 1 HARV. BUS. L. REV. ONLINE 33 (2011).
- *One More Casualty of the Foreclosure Crisis: Property Tax Revenues*, The Huffington Post (March 22, 2011).
- *The Cost of Surrendering the 30-Year Fixed Rate Mortgage Loan*, The Huffington Post (March 9, 2011).
- *A Government-Mandated Foreclosure Moratorium is a Popular (and Bad) Idea*, The Huffington Post (October 27, 2010).

PROFESSIONAL ASSOCIATIONS:

- American Enterprise Institute, Adjunct Scholar (2013 – present)
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    - Co-founder and co-organizer of monthly Professor's Corner teleconferences (2012 – present)
    - Vice-Chair, Property, Casualty and Other Non-Title Insurance Committee (2008 - 2012)
    - Member, Task Force on Property Law School Curriculum (2008-2010)
    - Fellow (2006-2008)
- ABA Advisor to National Conference of Commissioners on Uniform State Laws Study Committee on Fiduciary Powers and Authority to Access Digital Information (2012 – present)
- Executive Committee, the Association of American Law Schools, Section on Real Estate Transactions (2011 – present)
- Committee Member, Southeastern Association of Law Schools, Moderator Committee (2011 – present)
- Fellow, American Bar Foundation (2009 - present)

PROFESSIONAL EXPERIENCE

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Frost Brown Todd LLC 2008 to 2010
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Senior Counsel, Real Estate Section

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Built and managed seven-attorney legal department. Assisted with transition from private company to real estate investment trust traded on NYSE. Worked closely with CEO, COO, and CFO.

Ice Miller LLP 2001 to 2003
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Supreme Court of Indiana 2000 to 2001
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Required by House Rule XI, Clause 2(g)(5)

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1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2010. Include the source and amount of each grant or contract.

none

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

none

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2010, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

n/a

I certify that the above information is true and correct.
Signature: TD Marsh

Date: July 16, 2013